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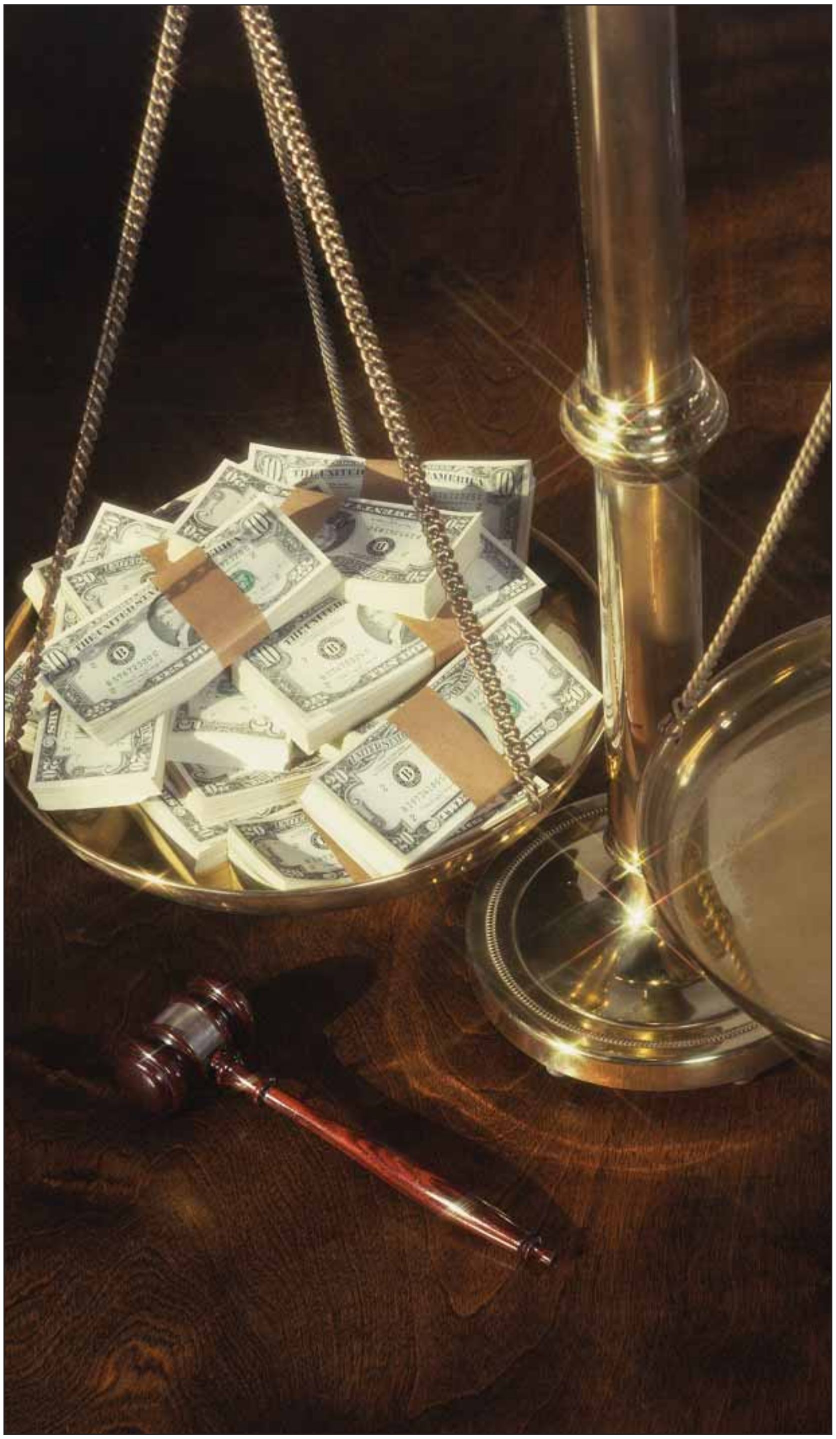

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Bankruptcy Law	Mark S. Tulis Oxman Tulis Kirkpatrick Whyatt & Geiger 120 Bloomingdale Road White Plains, NY 10605 mtulis@oxmanlaw.com
Consumer Financial Services	William R. Henrick DealerTrack, Inc. 1111 Marcus Avenue, Suite M04 Lake Success, NY 11042 randy.henrick@dealertrack.com

Corporations Law .... Janet Thiele Geldzahler
Sullivan & Cromwell LLP
1701 Pennsylvania Avenue, NW
Washington, DC 20006
geldzahlerj@sullcrom.com

Derivatives and Structured Products Law .... Ilene K. Froom
JPMorgan Chase Bank, NA
245 Park Avenue, 11th Floor
New York, NY 10167
ilene.k.froom@jpmchase.com

Franchise, Distribution and Licensing Law .... Thomas M. Pitegoff
Pitegoff Law Office
Ten Bank Street, Suite 540
White Plains, NY 10606-1933
pitegoff@pitlaw.com

Insurance Law .... Robert M. Yellen
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175 Water Street, 10th Floor
New York, NY 10038
ry@nysbar.com

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Sullivan & Cromwell LLP
125 Broad Street
New York, NY 10004-2498
lavignep@sullcrom.com

Membership .... Andrea M. Elder-Howell
Sempra Energy Trading Corp.
58 Commerce Drive
Stamford, CT 06902
aelder@sempratrading.com

Securities Regulation .... Jeffrey W. Rubin
Hogan & Hartson LLP
875 Third Avenue
New York, NY 10022
jwrubin@hhlaw.com

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MasurLaw
101 East 15th Street, 2nd Floor
New York, NY 10003
smasur@masurlaw.com

NY BUSINESS LAW JOURNAL

HeadNotes

Our Spring 2008 issue is our largest to date, reflecting the large and increasing volume of quality articles submitted by New York practitioners.

Identity theft is a pervasive and growing headache, for financial institutions as well as consumers. Efforts to address one aspect of this problem—the dissemination and misuse of Social Security numbers—have gained bipartisan support in Congress, with no fewer than three bills currently under consideration. Katherine Kinkela, Esq. compares and contrasts the three bills, along with a discussion of the identity-theft issue more generally, in "Proposed Social Security Number Privacy Legislation and Its Impact on Human Resources Management." As Ms. Kinkela notes, these bills would pose additional challenges for human resource management, and thus should be on the radar screen of business lawyers more generally.

Without a doubt, the subprime mortgage meltdown was the major financial news story of 2007. Its multiple and far-reaching effects are still coming to light. In "The Subprime Disaster and the Retail Investor: Does the Law Permit a Recovery?" J. Scott Colesanti, Special Professor at the Hofstra University School of Law in Securities Regulation and Broker-Dealer Regulation, explores one aspect of this issue: Whether, under the securities laws, retail investors may recover for losses incurred in purchasing securities representing pools of such mortgages, known as "collateralized debt obligations" (CDOs). Many financial institutions have taken large and well-publicized losses on CDOs, as they have been compelled to write down their value to reflect the losses on underlying mortgages. The question explored by Professor Colesanti is whether, and to what extent, the securities laws support a cause of action by retail investors. His article is a useful primer on the law in this area more generally.

Another significant development in securities litigation is the subject of "The Supreme Court Rejects Liability of Customers, Suppliers and Other Secondary Actors in Private Securities Fraud Litigation," by Anissa Seymour and Yuval Rogson of Katten Muchin Rosenman. The authors comment on the Supreme Court's decision earlier this year in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* By a 5 to 3 majority, the Court rejected "scheme liability"—i.e., the allegation that the actions of third parties such as customers and suppliers made them liable for losses suffered by shareholders. The case was closely monitored by the securities litigation bar because of the impact it could have had on the exposure of customers, suppliers and other secondary actors to liability in private federal securities fraud litigation.

On the securities regulatory front, in "SEC Revises Four Sets of Rules," Guy Lander, Esq. and his colleagues at Carter Ledyard & Milburn address recent revisions by the Securities and Exchange Commission to Rules 144 and 145, to liberalize resales of restricted securities of reporting companies; financial reporting requirements for foreign private issuers; revisions to the eligibility requirements for US and non-US issuers to use the "short forms" that permit incorporation by reference of prior SEC filings; and regulatory relief and simplification for smaller reporting companies. A former Chair of the Section, Mr. Lander has published extensively in the field of securities regulation.

Beginning with this issue, we will be offering a regular feature on "Ethical Issues for Business Lawyers" by C. Evan Stewart, a prolific contributor to the *Journal* and to the Section's programs. In "When Exceptions Swallow the Rule: The Growing Demise of the 'No-Contact' Rule," Mr. Stewart comments on "the slippery slope" the rule has been on since the 1990 *Niesig* case. The rule itself is straightforward and familiar to all attorneys: In essence, it prohibits a lawyer from directly contacting a person who the lawyer knows to be represented by another lawyer in the matter. In *Niesig*, the Court of Appeals held that a lawyer representing an employee in an action against an employer could contact other employees, as long as they were not "alter egos" of the employer. But, as Mr. Stewart demonstrates, that holding has created a host of other problems and started unsuspecting attorneys down the proverbial slippery slope.

Another new feature beginning with this issue is "New York Employment Law Update." James Grasso of Phillips Lytle will be providing regular and timely updates for New York business lawyers regarding developments affecting employers and employees in the state. Of note in this issue: The NLRB has clarified that employees do not have the right to use an employer's e-mail system for union organizing activities. There are also timely updates regarding new state legislation and an amendment to the Family and Medical Leave Act.

Bruce Hoover of Goldberg Segalla in Buffalo contributes a useful and practical article on "Terminating Surety and Fidelity Bonds Upon the Insolvency or Bankruptcy of the Principal." Mr. Hoover notes that the exposure of a surety significantly increases when his or her principal files for bankruptcy, but that the Bankruptcy Code was not necessarily drafted with surety-related issues in mind. He analyzes the issues a surety should consider in relation to the relevant Code provisions, and discusses various ways of addressing these issues in the surety documents themselves.

Given the cost, delays and uncertainty of litigation, arbitration clauses are increasingly favored by many types of businesses, and the Federal Arbitration Act (FAA) expresses a strong federal policy favoring arbitration. At the same time, however, New York law increasingly disfavors arbitration clauses, especially in areas related to consumer protection. In "Courts Diverge on Whether State Statutes that Bar Arbitration Are Pre-Empted by the Federal Arbitration Act," David Elsberg of Quinn Emanuel Urquhart Oliver & Hedges addresses two recent New York cases which reach opposite conclusions on the question of whether New York's attempt to limit arbitration should be preempted by the FAA.

In "Underbanked People in an Overbanked Country," Clifford Weber, Esq. of Hinman Howard & Kittell discusses the Money Services Business Act, a proposed legislative attempt to promote banking services in underserved communities. Noting the anomaly that many local communities remain "underbanked" while the nation as a whole is generally regarded as "overbanked," Mr. Weber explains that check cashers and other money services businesses have filled the void in providing services to persons who, for a variety of reasons, have shied away from using the banking system. But because these businesses are deemed to be at high risk for money laundering, banks have been increasingly unwilling to provide credit to them. The legislation, proposed by Representative Carolyn Maloney (D-NY), would attempt to address this problem by creating a safe harbor for banks under certain conditions.

Another approach to the "underbanked" problem is reflected in a report by Barbara Kent, Esq., which concludes this issue. Ms. Kent, who was formerly Deputy Superintendent of the New York State Banking Department, heads the not-for-profit Coalition for Debtor Education and continues to be an active participant in the Section and its programs. She reports on the Banking Development District program conducted by the Coalition in conjunction with the New York City Housing Authority, a statewide initiative designed to provide access to banking services for unbanked and underbanked New Yorkers. The funding provided by the Section in a grant from its surplus was applied to this worthy program.

David L. Glass
Editor-in-Chief

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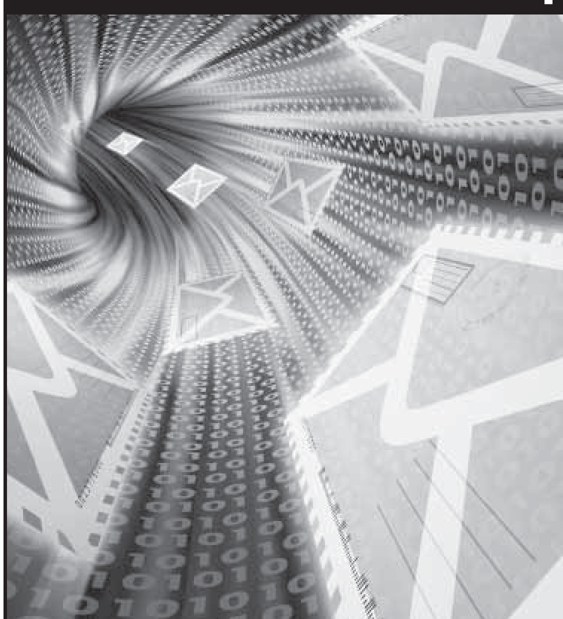

If you have written an article you would like considered for publication, or have an idea for one, please contact the *NY Business Law Journal* Editor:

David L. Glass
Editor-in-Chief
NY Business Law Journal
Macquarie Holdings (USA) Inc.
125 West 55th Street
New York, NY 10019
david.glass@macquarie.com

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Business Law Update: Proposed Social Security Number Privacy Legislation and Its Impact on Human Resources Management

By Katherine Kinkela

Identity theft is a growing issue, and Human Resources Managers are concerned about the impact that identity theft can have on their employee populations. Undeniably each individual has a personal responsibility to safeguard his or her own personal information, but the individual also expects that the business, governmental and educational institutions he or she interacts with will take the same level of care in dealing with sensitive personal information that the organization maintains with regard to the individual because the organizations are aware such information may be used for fraudulent purposes. The question for policymakers and lawmakers to decide is who has the responsibility to safeguard personal information that is stolen and used to perpetrate fraudulent schemes and how this responsibility should be enforced. For all these reasons, during the last congressional term in the fall of 2007, the United States Congress has given attention to the issue of securing SSNs by introducing bills addressing the issue of privacy rights concerning the display, sale and disclosure of Social Security numbers.

Congress Introduces Proposed Privacy Legislation

The members of both houses of Congress recognize that identity theft is an increasing problem facing their constituents today, and consequently three new bills introduced in the House of Representatives and Senate providing federal remedies for misuse or sale of personal identification information have gained bipartisan support. It is very possible that new privacy legislation concerning Social Security numbers will be enacted before the end of 2008. The three new bills currently pending are the Social Security Number Privacy and Identity Theft Prevention Act of 2007,[1] the Social Security Number Protection Act of 2007,[2] and the Social Security Number Misuse Prevention Act[3] (S. 238). The new legislation will have an impact on how businesses maintain employee and client records, and will impose sanctions on those who do not safeguard the personal information in records they keep.

The impact of identity theft on the individual victim varies greatly from case to case. For some people who have had their information stolen and used without permission, there are minor unauthorized credit card charges and random acts. For other victims of identity theft, credit ratings have been ruined, and lives torn apart, by allegations of criminal activity, SSN changes, and time lost rebuilding reputation and credibility. Businesses must understand the importance of safeguarding personal information by creating policies and standards throughout an organization that support individual privacy.

"The question for policymakers and lawmakers to decide is who has the responsibility to safeguard personal information that is stolen and used to perpetrate fraudulent schemes and how this responsibility should be enforced."

Internal Control: Privacy Rights, Business Responsibility and the Social Security Number

In the United States, the Social Security Number (SSN) issued to each United States citizen by the Social Security Administration of the United States Government is the primary identifier for United States citizens. Governmental agencies are required to comply with the Privacy Act of 1974[4] regarding display of Social Security numbers as private individual information. In this age of incredibly easy information access through cyberspace, a person's private personal information can generally be easily accessed by using the SSN in conjunction with other easily obtainable personal information. Unfortunately, many schools, businesses and business institutions use or have used the SSN as a unique identifier for students, employees and customers and as a password for secure systems, because the number was easy to remember for the person and the SSN enabled computer database programmers to compile data easily using the uniform tracking number. Many business practices and the lack of secure procedures within companies made it easy to obtain an individual's SSN in the recent past. As such, the personal information for many employees, students and customers was largely unsecured or definitely at risk in the systems kept by these organizations.

This lack of security in the use of SSNs as identifiers for individuals is apparent in practices by business and academic organizations. Many organizations would send human resources related correspondence with the person's name and social security number clearly visible. Computer runs and rosters provided for administrative purposes and widely distributed would list the SSN. Sometimes this SSN information would be e-mailed to the individual or a third party without any form of encryption. The SSN provided an easy way for firms and schools to track individuals who might have similar names and information. Unfortunately, as Internet commerce grew and it became easier to compile and access personal information, identity theft also grew because of the abuse of companies that did not secure individual information or even sold personal information for profit. Many businesses have taken the individual initiative to change their policies and convert their systems to other identifying tracking numbers that can be used to create an individual's profile within their systems. However, conversion of computer data systems can be time-consuming and expensive, so not all businesses have changed their systems to protect SSN information adequately.

Federal Legislation Pending Before Congress

Promoters of the congressional legislation feel that major federal action is necessary to compel all governmental and private-sector entities to examine the way they are keeping records about private identity information and the internal rules they have in place regarding the sale of customer or employee information. The widespread use of the Internet to convey personal data heightens this responsibility.

"Promoters of the congressional legislation feel that major federal action is necessary to compel all governmental and private-sector entities to examine the way they are keeping records about private identity information and the internal rules they have in place regarding the sale of customer or employee information."

The Social Security Number Protection Act of 2007 prohibits the sale or purchase of a Social Security number and is aimed at preventing fraud and "an undue risk of bodily, emotional, or financial harm to individuals."[5] The Protection Act provides the state with a cause of action against violators of the law, including an $11,000 penalty per violation, to a maximum of $5 million.[6] In addition to monetary damages, equitable relief is also available under the bill in the form of injunctive or other compliance enforcement.[7] Permissible exceptions to the distribution rules include law enforcement, public health or research uses, where the use is safeguarded and monitored to prevent fraud.[8]

The Social Security Number Misuse Prevention Act provides penalties for the display, sale or purchase of the Social Security numbers.[9] The Misuse Prevention Act defines display of Social Security numbers as communication of Social Security numbers to the general public on the Internet and in any other manner.[10] The bill contains an exception where disclosure is permissible if the express consent of the individual is obtained prior to the display.[11] The sale provision in the Misuse Prevention Act states that no one should seek profit from the sale of Social Security number lists.[12] Commercial financial institutions and governmental agencies are identified as keepers of Social Security numbers. The legislation urges governmental agencies to review current documents of public record, such as professional and marriage licenses, and birth and death records, to determine whether Social Security number disclosure is necessary on the face of the document.[13] The bill gives the Federal Trade Commission the enforcement authority to create procedural regulations and remedies based on risk to privacy, potential misuse and misappropriation of information.[14] The bill authorizes a one-year study, including a governmental cost-benefit analysis, as to the timeframe, cost and technology necessary for the removal of Social Security numbers from public records.[15] Under the bill, a study of the cost-benefit impact of deleting the Social Security numbers from the business records of private businesses will also be included in the report.[16]

The most comprehensive bill currently pending is the Social Security Number Privacy and Identity Theft Prevention Act of 2007. The bill has three major parts. The first defines the safeguards that governmental agencies are required to implement and to enforce with respect to individual privacy rights concerning SSNs. The second part creates civil remedies prohibiting the sale, purchase and display of SSNs. The final sections of the bill provide a comprehensive list of remedies, including criminal penalties, civil remedies, fraud-based remedies and special remedies in the case of terrorism, drug trafficking, violent crime, and repeat offenders. Finally, the bill authorizes further remedies as appropriate.

The bill requires that governmental agencies must restrict the display of Social Security numbers.[17] This will include the reformatting of governmental correspondence and government checks.[18] Social Security numbers cannot be displayed on government-issued benefit checks.[19] SSNs cannot be used as identifiers by governmental agencies for benefits purposes.[20] In addition, as an added safeguard, prison inmates cannot have access to SSNs as a part of their work projects.[21]

The bill imposes privacy compliance regulations on the transaction of public business. For the public business, the bill prohibits the sale, purchase and display of SSNs.[22] Display is defined under the bill to include any dissemination to the general public.[23] Compliance with other aspects of the bill extends to recordkeeping requirements and the maintenance of procedures which limit access to sensitive information to appropriate personnel.[24] The sale and purchase of lists and information by individuals and business entities containing SSNs is another focus of the bill.

The proposed law contemplates the fact that some disclosures of SSNs still may be legally required as a part of governmental filings and legal investigations. The proposed law also provides some exceptions; for example, private businesses are permitted to disclose SSNs to maintain national security and assist in law enforcement.[25]

"Privacy legislation concerning disclosure of Social Security numbers has already been enacted in a number of states, and additional privacy legislation concerning SSNs is pending in many states."

Remedies enumerated under the bill for violation of privacy rules include criminal penalties, civil monetary penalties, fraud-based penalties, and a series of enhanced penalties for terrorism, drug trafficking, violence, and prior offenses.[26] Within the range of penalties that may be imposed, consideration is given to whether the action committed was done on purpose by the actor; the law imposes harsh penalties where the sale of private information is intentional.

State Law Precedent for Federal Legislation

Many states have already introduced privacy information legislation, including California and Michigan. The success of California state legislation is a model for implementation of SSN privacy controls at the national level. California state privacy legislation has successfully created privacy controls within businesses.

The congressional bills are in many ways modeled after similar legislation that was introduced on the state level. Privacy legislation concerning disclosure of Social Security numbers has already been enacted in a number of states, and additional privacy legislation concerning SSNs is pending in many states. California enacted privacy laws in 2002 that prohibit the display of Social Security numbers on documents sent through the mail. The only exceptions to these laws allowing disclosure of SSNs in mailed correspondence pertain to medical and tax records, and even then the exceptions permit disclosure only where necessary. The California laws were phased in from 2002 to 2007. California took the initiative to make the transition to compliance with the new laws as easy for businesses as possible. The California Privacy Commission has set out guidelines for businesses to follow with regard to screening sensitive information to ensure compliance with privacy laws.

Once the new federal legislation is passed, it is likely that there will be a phase-in time for compliance. California businesses will have a head start.

Endnotes

1. Social Security Number Privacy and Identity Theft Prevention Act of 2007, H.R. 3046, 110th Cong. (2007).
2. Social Security Number Protection Act of 2007, H.R. 948, 110th Cong. (2007).
3. Social Security Number Misuse Prevention Act, S. 238, 110th Cong. (2007).
4. Privacy Act of 1974, Pub. L. No. 93-579, 88 Stat. 1897 (1974) (codified as amended at 5 U.S.C. § 552a (2000)).
5. Social Security Number Protection Act of 2007, H.R. 948, § 3(b)(2)(B).
6. *Id.* at § 3(e)(2)(A)(iii).
7. *Id.* at § 3(e)(2)(A)(iv).
8. *Id.* at § 3(b)(3).
9. Social Security Number Misuse Prevention Act, S. 238, § 3.
10. *Id.* at § 1028B(a)(1).
11. *Id.* at § 1028B(b).
12. *Id.* at § 2(5).
13. *Id.* at § 1028C(e).
14. *Id.* at § 5(b)(1).
15. *Id.* at § 1028C(b).
16. *Id.*
17. Social Security Number Privacy and Identity Theft Prevention Act of 2007, H.R. 3046, § 2(a)(x)(I).
18. *Id.* at § 3(a)(xi).
19. *Id.* at § 4(a)(xii).
20. *Id.*
21. *Id.* at § 5(a)(xiii).
22. *Id.* at § 8(a).
23. *Id.* at § 208A(3)(a).
24. *Id.* at § 208A(g).
25. *Id.* at § 208A(b)(2).
26. *Id.* at §§ 9–12.

Katherine Kinkela is a New York-based tax attorney. She focuses on employee benefits and ERISA.

The Subprime Disaster and the Retail Investor: Does the Law Permit a Recovery?

By J. Scott Colesanti

I. Introduction

Since the fall of 2007, the experts and the papers have seemingly dwelled upon the ramifications of the subprime mortgage debacle for the stock market, in general, and well-heeled players therein, in particular. In sum, global proprietary funds have dried up, heretofore popular management has fallen, and traditional business lines have been summarily forsaken. Considerably less attention has been focused to date on the extent to which retail investors may have been victimized by the aggressive efforts to sell collateralized debt obligations ("CDOs")[1] between 2003 and 2006.

Accordingly, this article recaps the ever intensifying disclosures of mortgage-related losses and regulatory responses thereto, and then utilizes the applicable law to analyze a recent case filed by an entity claiming that CDOs were unsuitable investments.

II. Timeline for the Crisis and Reactions

In the summer of 2007, various financial service firms began disclosing that the mortgages underlying securitized instruments were not performing on a mass scale. The press began to sound the alarm by announcing unprecedented write-downs by some very storied firms. Simultaneously, the brokerage industry's largest self-regulator, the Financial Industry Regulatory Authority ("FINRA"), began to question firms "with large fixed-income and mortgage-backed securities exposure," focusing their inquiries on "inventory valuation, controls over pricing and collateral monitoring."[2] In a subsequent "Regulatory Notice," FINRA put firms on notice that sales of "complex structure products" CDOs would be expressly examined. The Notice also reminded FINRA members of their suitability obligations when selling mortgage-related products to senior investors,[3] thus hinting that more than just hedge funds and pension plans may have been embroiled in the fray.

Throughout the fall, the press detailed daily the broker-dealer resignations and continuing losses. By November, Bank of America announced that its CDO write-down had reached $3 billion, a disclosure branded, tellingly, "in line with recent estimates by some analysts."[4] In December, the SEC and other regulators were said to be investigating brokerages regarding the pricing of mortgage securities and the need for public disclosure of rapidly declining prices.

More formal SEC responses quickly followed. In the presence of $80 billion in market write-downs in the last few months of 2007, the SEC was said to have initiated three dozen investigations; however, with the securities in question being difficult to accurately price, an SEC official was quoted as stating, "We don't know that we will be recommending any enforcement actions in the subprime area."[5]

> *"[T]his article recaps the ever intensifying disclosures of mortgage-related losses and regulatory responses thereto, and then utilizes the applicable law to analyze a recent case filed by an entity claiming that CDOs were unsuitable investments."*

Adding scrutiny (if not resolution) was FINRA's announcement in the New Year that it had begun requesting from its member firms details on the marketing and sale of mortgage-related products, "specifically those sold to individual investors." The regulator was described as having questioned over one dozen firms on CMO topics ranging from internal valuations to selling efforts. The investigation was detailed as the second leg of FINRA's "sweep," and sought sales scripts and customer account information from an unspecified number of firms.[6]

By late January 2008, Merrill Lynch, which had written down $10 billion of mortgage-related securities (and posted its first loss in almost two decades), disclosed its intent to altogether abandon the structured credit business.[7] Contemporaneously, the firm agreed to re-purchase from one of its customers, the City of Springfield, Massachusetts, approximately $14 million worth of CDOs (described in detail later herein).[8]

By January's end, New York's Attorney General Andrew Cuomo was said to have directed his staff to issue subpoenas and utilize the broad Martin Act in examining whether big-name firms failed to disclose CDO risks to customers. Despite the Attorney General's earlier successes in targeting a real estate appraisal company and effecting a settlement with "predatory lenders," commentators cited the absence of a link between product warnings and unrealistic credit firm ratings, thus undermining claims of investor harm.[9] Undaunted, the next month the Attorney General launched a broader attack, initiating inquiries into whether ratings firms had done enough to fix the means of their rating bonds tied to mortgages.[10]

Still, retail investor losses, if any, seemed collateral to greatly varied and more urgent cries for reform. The NYSE CEO announced that top regulators had discussed the need for stock exchanges to post quotes and executed trades in CDOs, as they do now for more conventional investments.[11] At the same time, the SEC was said to be continuing its focus on the valuation policies utilized by firms, and whether proper disclosures were made regarding the declining values of CDOs, with participating federal criminal investigators from the Eastern District of New York questioning one firm in particular. The FBI was also said to be involved, having opened criminal inquiries into 14 unnamed companies.[12] And New York's Senator Charles Schumer vowed passage of legislation regulating mortgage brokers while simultaneously calling for the reform of credit rating agencies.[13] The SEC chimed in with its intention to propose rules that would require credit-rating agencies to both disclose the accuracy of past ratings and distinguish among the products rated.[14] Subsequently, bond insurers announced that they were going broke, adding to the list of CDO "victims."

And so the pattern continued into the deep winter of 2008. While experts opined that retail investors would prove to share the losses,[15] it was clearly too soon to tell to what degree. Further, it was not clear to what degree such losses *should* be recovered, as intellectual pieces posited that perhaps the world of finance had grown too complicated to support blame leveled at any one of its components.[16] Meanwhile, scores of class-action lawsuits were filed, with defendants ranging from loan originators to brokerage houses[17] to the funds themselves.[18] Overall, the subprime meltdown evinced a strangely predictable cycle of disclosure of debt, a knee-jerk regulatory response, and little clarification on legal blame. And yet the sheer magnitude of the dollars involved, the lingering market shock, the mystical attributes of the securities in question and corresponding uncertain legal conclusions all hearkened back to a prior time of bond investment woe—namely, the Orange County CMO[19] crisis of 1994.

III. One Town's Fabled Experience with Exotic Bonds

The Orange County bankruptcy of 1994 focused (and subsequently blurred) attention on the role of derivative salesmen and CMOs. In that unfortunate turn of events, the County's Treasurer invested hundreds of millions of dollars of the County's money in interest-rate-sensitive structured notes known as "inverse floaters" linked to the London Interbank Offered Rate ("LIBOR"). When the rate moved against the Treasurer's picks, the County suffered a multi-billion dollar loss. The County's ensuing lawsuits alleged, among other things, that its brokerage firm should have known the municipality and its agent lacked the legal authority to purchase these investments, a claim jeopardized by Merrill's position that the employee was a knowledgeable investor, the scattered range of deep-pocketed targets,[20] and the employee's ultimate plea of guilty to charges he misled citizens and misrepresented the County's interest earnings.[21]

Despite the headlines, a world of inventory pricing and legal difficulties confronted the County's lawsuit. Commentators were quick to note that derivatives, nominally subject to the Commodities Futures Trading Act and CFTC jurisdiction, are not subject to an investor suitability rule.[22] Closer to home, it's been consistently and aptly noted that, since CMOs don't trade on an exchange, "courts have recognized that the valuation of CMOs is not a precise science";[23] the absence of legal prohibitions / limitations and precision in valuation combine to make it almost impossible to hold a brokerage house *per se* liable for its sale of the product. Not surprisingly, the notion of a void of responsibility for the complicated investments of entity customers has traditionally crept into civil class-action litigation.

Nonetheless, four years after initiating its lawsuit, Orange County settled its litigation with various parties for in excess of $830 million, with Merrill Lynch contributing over $430 million.[24] A separate grand jury proceeding centering on Merrill's role in the bankruptcy ended in 1997 with the firm paying the District Attorney $30 million to end the investigation, with all relevant grand jury transcripts remaining sealed.[25] Neither the SEC nor any self-regulatory organization (SRO) instituted any significant disciplinary action against Merrill for its role as investor adviser to Orange County during its bankruptcy debacle. Thus, the Orange County catastrophe ended without legal resolution of the question of who bears ultimate responsibility when a complex investment goes wrong or, more importantly, what defines a "sophisticated" investor.

A. The Sophistication Argument

To the question of when a securities purchaser is *sophisticated*, the short answer is that there is no federal "sophisticated investor" law or rule, leaving courts, stock exchanges and other forums free to decide when an investor has been victimized for lack of acumen, as well as when such an analysis is misplaced.[26] The applicable hodgepodge of interpretations and regulations effectively confuses the issue by alternating between definitions tied to technical job functions and simplistic tests of wealth.

Under federal law, Section 3(a)(54) of the Securities Exchange Act distinguishes and defines "qualified investors" as, among other things, banks, mutual funds, foreign governments, entities qualifying as broker-dealer affiliates or subsidiaries, and state-sponsored employee benefit plans. For purposes of permitting investment in non-registered hedge funds and securities, SEC Rules 215 and 501 establish monetary thresholds for individuals consistently set at $1 million in assets or $200,000 in annual income.[27] Further, the effort in recent years to "up" these dollar thresholds[28]—a move which would both limit access by individuals to hedge funds and adjust for inflation—was met with surprising hostility from the individuals it was motivated to protect.[29]

Further down the line, the stock exchange rules define an *institutional investor* according to the function being supervised, resulting in differing descriptions in rules, among others, addressing the making of account records and the supervision of correspondence.[30] More generically, the NYSE glossary defines "institutional investors" as "organizations whose primary purpose is to invest their own assets or those entrusted to them by others," the most common examples of which are "insurance companies, mutual funds, university endowments, and banks."[31]

Meanwhile, for purposes of trading non-registered securities on a dedicated NASDAQ trading system, "qualified institutional buyers" are generally described as entities with more than $100 million in assets under control.[32] The accompanying acronym of "QIB" is frequently (and perhaps carelessly) used to connote institutions large enough to appreciate almost any risk. The result is a host of titles for investors to employ when seeking to prove that they've been duped, without much clear guidance on which moniker fits best.

"[G]eneralized efforts at recovery in the courts under SEC Rule 10b-5 for unexpected stock losses carry with them the burden of reasonable inquiry into each investment . . ."

Which is not to say that the cacophony will support a litigation free-for-all. Witness the example from West Virginia, where a decade ago the state Supreme Court set aside a jury verdict exceeding $50 million against several firms for "speculative" CMO investments that plunged during the same bond market collapse underlying Orange County's claims:

> Notwithstanding that Morgan Stanley sedulously cultivated good Customer relations with the State of West Virginia, Morgan Stanley was nonetheless a principal in the transactions at stake, not a broker, and Morgan had the right to trade with the State without undertaking the obligation to insure the State against its elected officers' lack of wisdom. 'Sophistication,' as that term is used in the investment law, should never be confused with intelligence, prudence or good luck.[33]

The Court's bold dismissal of the jury verdict paraphrased what the experts had opined all along: *Sophistication* depends upon circumstance, and anti-fraud rules are a most difficult fit for complex investments gone awry. Such clarity pervades the *Morgan Stanley* decision, which elsewhere admonished that the state's coffers were not to be refilled through location of a deep pocket. But the decision can be said to reflect more than Southern hospitality, as the state Supreme Court no doubt understood the thin legal ice of Rule 10b-5 that the plaintiffs were skating upon.

B. The Uncertainty of SEC Rule 10b-5

Coined the elastic anti-fraud prohibition, SEC Rule 10b-5 prohibits misstatements, omissions, and deceptive devices, depending upon which of its three prongs is invoked. It has been applied successfully to schemes and crimes as diverse as insider trading and penny stock frauds.

But generalized efforts at recovery in the courts under SEC Rule 10b-5 for unexpected stock losses carry with them the burden of reasonable inquiry into each investment, as has been tersely summarized by Professor Norman Poser of Brooklyn Law School.[34] Conversely, facts attending a specific customer arrangement can always lend themselves to a finding of a fiduciary duty and concomitant higher standard of care.[35]

Accordingly, the few courts that have found stock recommendations to state a cause of action under the rule have effectively required that the defendant deliberately act in bad faith in several ways—i.e., knowing the securities were not suited to the investor's needs, making the recommendation anyway, and either making accompanying material misrepresentations or omitting material information, when a duty to speak has been found. Thus, plaintiffs in federal court have had claims dismissed when alleging that a brokerage house recommended unsuitable CMO investments.[36]

Exchange proceedings to consider charges of Rule 10b-5 violations premised upon unsuitable recommendations have been more successful. In one FINRA case from last year, the broker was found to have violated the National Association of Securities Dealers (NASD) suitability rule—even where his customer was a "wealthy investor"—through his "fraudulent failure to disclose" substantial market losses at the time of investment.[37] Thus, with the CFTA inapplicable, the securities law definitions conflicted, and the time lag inherent in class-action litigation daunting, the focus turns to the stock exchanges, those regulators of the everyday marketplace, for the applicable regulations and guidance as to who has done what to whom when a new or complex product goes south.

IV. The SRO Law of Unsuitability and the Retail Investor

Under the regulatory mosaic of the federal securities laws, primary responsibility for the day-to-day supervision of the over 5,000 registered broker-dealers resides with the exchanges, which operate as "Self-Regulatory Organizations" (SROs). The SROs are responsible for, among other things, the routine examination of member firms for review of sales, operational and financial procedures and policies.[38] In July 2007, in an effort to alleviate regulatory duplication, the NYSE and NASD agreed to merge their regulatory arms into the new entity called FINRA.[39]

The FINRA glossary provides that the violation of *unsuitability* occurs "when an investment made by a broker is inconsistent with the investor's objectives, and the broker knows or should know the investment is inappropriate." The duty as enforced by the stock exchanges is at odds with traditional notions of fiduciary duty, at once elevating obligation from disclosure of risks to comprehension of a customer's needs while contemporaneously avoiding such pitfalls as the need to prove *deception*. Thus, Rule 405 of the NYSE rulebook—the Exchange's "know your customer" rule—holds member brokerage firms and their employees to the duty of using "due diligence to learn the essential facts relative to every customer, every order, every cash or margin account" handled by the member organization. The rule is broadly worded and function-based. Consequently, it is applied in ever expansive ways; indeed, a 2004 NYSE case held a registered representative / compliance officer at fault for not adequately supervising the accounts handled by his superior, a branch office manager.[40]

But the most common applications of NYSE Rule 405 are to firms that failed to supervise their brokers, leaving the more mundane consideration of whether or not a trade was suitable to other standards. FINRA's suitability analysis starts with NASD Rule 2310, a rule that—unlike its more broadly phrased NYSE counterpart—lists specific considerations to be weighed by the broker when recommending investments. Specifically, the broker must have "reasonable grounds for believing that the recommendation is suitable" for the customer based upon the facts; the relevant facts, which the broker is obliged to make reasonable efforts to obtain, are as follows:

- The customer's financial status,
- The customer's tax status,
- The customer's investment objectives, and
- Such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[41]

More importantly, after the news of Orange County's dilemma in 1994, NASD adopted an interpretation ("IM-2310-3") specifically addressing the suitability obligations when recommending investments to institutional customers. That guidance delineates dual "important considerations in making recommendations to an institutional customer": 1) "The customer's capability to evaluate investment risk independently," and 2) "The extent to which the customer is exercising independent judgment in evaluating a member [firm's] recommendation." But the guidance—which is still in effect—sends mixed messages as to the most important factors in that evaluative process.

For example, while reminding member firms that they are "expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer," firms are also reminded that the fact that a customer "initially needed help in understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision." More broadly speaking, while alerting firms to the dangers of new and speculative investments and cautioning them to consider "the complexity of the security" involved, the Interpretation nonetheless allows for simultaneous consideration of whether the institutional customer utilizes "one or more consultants, investment advisers or bank trust departments" and whether there is "any written or oral understanding" between the customer and the firm. Perhaps most significantly, no guidance exists for establishing at what point the acumen of the agent / treasurer / comptroller is distinguishable from that of the entity itself.

As is the case when ensuring a firm's compliance with NASD rules governing communications, research, and other activities, IM-2310-3 creates an "institutional carveout" for suitability. The result is a modicum of uncertainty whenever a customer entity later claims "we didn't understand what we bought."

Further, the SROs lack jurisdiction over individuals who can shed light on investor sophistication (e.g., friends, relatives, bank contacts, and accountants). Given the esoteric nature of SRO rules, the unsatisfying Orange County litigation, and the lingering vagaries of federal law, state law emerges as the last realistic point of clarification. Indeed, the expansive, overlapping powers of the Attorneys General—particularly the one situated in New York—are legendary. It seems safe to say that the duties ultimately delineated by these "local" regulators could help to educate all as to unacceptable sales practices.

Fortunately, within the federal securities laws, specified roles are also reserved for private actions and discipline by the states.[42] And prior Wall Street scandals centering on illegal IPO allocations, unsavory research practices, lavish gifts and gratuities, and unsuitable CMO sales readily evidence both that the industry enjoys enough flexible authority to condemn any novel or complicated selling effort and that state regulators will rush to take up the cause.

Thus, would the opening thrust on behalf of the non-sophisticate have to come from an attorney general or secretary of state, unencumbered by 10b-5 case law and the SROs' cloistered analysis, with a hometown victim / constituent to boot? A detailed example manifested itself in February 2008, when Massachusetts Secretary of State William Galvin brought an administrative complaint against Merrill Lynch alleging, among other things, fraud, misrepresentations, and "illegal investments" in CDOs.

V. The Massachusetts Example

A day after receiving a full refund of its CDO investment from Merrill Lynch, the Commonwealth of Massachusetts brought three charges against the firm based upon the actions of two of its brokers (the "Agents").[43] That pending case, which seeks, among other things, a fine and mandatory retention of a consultant to review firm procedures, relies in large part upon several pressure points in aggressive regulation theory, as is discussed below.

The facts of the Massachusetts complaint are straightforward. The city of Springfield, Massachusetts had opened three non-discretionary accounts with the Albany, New York office of Merrill Lynch in November 2006.[44] The Springfield accounts, which held approximately $50 million, were to be handled on a non-discretionary basis by the Agents, who allegedly understood that the only purchases would be in "safe money-market-like investments authorized by [Springfield] City personnel that would protect the City's principal."[45]

In April and June 2007, three CDOs were purchased for the accounts at a cost of approximately $14 million.[46] The parties dispute the extent to which these three purchases were "authorized." The bonds were described in the complaint as particularly "complex synthetic securities" known as CDO-squared because of their reliance upon other CDOs as collateral.[47] Merrill sold the CDOs to Springfield from Merrill's own account (a "principal" transaction) and the bonds were said to trade as part of an "auction market"[48] (i.e., they were not listed on a stock exchange).

The complaint further alleges that the market quickly began to "dry up" for these types of investments, resulting in a 16% decline in one of the CDOs by August 2007 and a 50% decline by September; by December, the CDO was valued at 5% of its purchase price, and the City requested that all three CDOs be sold.[49] Merrill allegedly responded "that there were no buyers."[50] Subsequently, Merrill denied Springfield's written complaint, leaving the City with over $12 million in investment losses.[51] Specifically, Merrill's letter to Springfield dated November 29, 2007 declared the losses to be attributable to the "unfortunate disappearance of liquidity in residential mortgage-backed CDO markets" and, regardless, the investments had been fully approved by the customer, who had maintained non-discretionary accounts with the firm.[52]

The Commonwealth's Lawsuit

The ensuing administrative complaint alleged three violations. Count I argued that the fact pattern supported a finding of fraud as prohibited by Section 101 of the Massachusetts Uniform Securities Act[53] (i.e., the state's version of SEC Rule 10b-5). Count III asserted a violation of Section 204 of the same act in that Merrill allegedly failed to supervise the agents.[54]

But Count II—which alleged unsuitable and unauthorized transactions, as well as the failure to disclose an affiliate relationship between Merrill and the Springfield CDOs—cited, in part, to three-year-old regulations under the Massachusetts Business Corporations Act.[55] Also included in Count II was a cite to Section 28 of the regulations, which makes blanket reference to "the NASD rules of Fair Practice." Further, the Count expressly incorporated NASD Rule 2210(d)(1)(A) for the premise that broker-dealers may not omit any material facts in their communications with customers. Thus, the Secretary, in attempting to condemn Merrill's handling of the Springfield accounts, relied upon both Massachusetts law and SRO rules.

Additionally, the administrative complaint took issue with a number of detailed sales practices at Merrill, alleging various inadequacies as highlighted below:

- The brokers "did not look at the disclosure documents" for the CDOs, thus illustrating a lack of familiarity with the investments. The brokers were also faulted for not making an attempt to understand the CDOs' collateral and for not evaluating liquidity or other risks;
- Merrill, as underwriter for the CDOs, was alleged to have received both underwriting fees in excess of $10 million and "remarketing fees" in subsequent sales of pieces thereof;
- The purchases were said to be unauthorized in that the city "did not authorize these specific CDOs in advance." Further, the complaint alleges that the purchases did not appear on the city's monthly account statements as CDOs until July 2007;
- The agents were alleged to have failed to disclose to the city such negative factors as the possibility of a failed auction marketplace for the CDOs; and

- The CDOs in question were alleged to be "highly complex instruments" that should be sold "only to sophisticated investors."

Most dramatically, Merrill was alleged to have improperly obtained the requisite signature for a required QIB form from a City representative, which form misclassified the City as an "investment company."

As a penalty, the Secretary of State sought a cease and desist order, a fine, disgorgement of all profits, censure, and the appointment of "an independent consultant to review the systematic supervisory breakdowns and incentives within Merrill Lynch that allowed the alleged wrongdoing to occur."[56]

On January 31, 2008, the day before the complaint was both filed and made public, it was reported that Merrill Lynch had agreed to buy back the three CDOs at their original purchase price of approximately $14 million. For its part, Merrill expressed surprise at the ensuing formal disciplinary action.[57] To the eyes of interested observers, the breadth and daring of the complaint are almost equally startling.

VI. Analysis

Secretary Galvin's ambitious complaint represents the first of its kind, to wit, a charging instrument centering on the allegation of a CDO recommendation. Yet the uniqueness of the alleged facts and the sheer weight of attendant rule allegations in the complaint threaten to compromise future actions by other regulators. Regardless, the administrative charges make clear that the casting of a CDO purchase as a *prima facie* "sophisticated" investment is a difficult, fact-intensive study, to say the least.

First, the supervision charge against Merrill Lynch seems unripe. Drawing from the SRO experience (which is more than hypothetical given the Secretary invoked a regulation that links to NASD rules), a case citing to a firm's supervisory failures can proceed along two lines, either faulting an entity for failing to implement relevant supervisory procedures or failing to adhere to the same (or both).[58] Additionally, SRO supervisory cases have been premised upon the need for a "heightened supervision" of sale practices attending the sale of specialty products, such as deferred variable annuities.[59]

In any of these examples, the advancing of a failure to supervise case would seem to rest heavily upon the consensus that CDOs as a product required specialized written procedures; such a warning label had not been implemented by the industry prior to the summer of 2007. Moreover, the blame for the subprime meltdown may ultimately be so dispersed as to become nonexistent. The federal government itself has studied the "global market turmoil" created by the CDO downturn and recently concluded that its "principal underlying causes" included failures in underwriting standards, "risk management weaknesses," "flaws in credit ratings agencies' assessments," and "a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures."[60]

Second, even judged by Massachusetts' own standards, the complaint's failure to supervise allegation appears to represent a first for the Secretary: The allegation that supervision was lacking in the absence of multiple customer "victims,"[61] a firm-sponsored sales practice, [62] or a red flag noted by a supervisor.[63]

Thus, the viability of the Commonwealth's action returns to the nagging issue of customer sophistication, which is inextricably tied to NASD rules. As previously noted, fraud violations based upon recommendations tend to be ultimately dependent upon a finding of a palpable duty. Further, violations of NASD guidance on unsuitability for institutional investors appear destined to a two-tiered analysis, with the standard of care rising and falling with facts establishing or undermining the proposition that the customer was capable of "exercising independent judgment."

Overall, the joining of an unsuitability claim to the more damning allegation of fraud would appear to pose three appreciable obstacles for the Commonwealth:

1) While accusations of "inappropriate and illegal" investments capture the attention of the press, such accusations are dependent upon the relationship between the agents and Springfield's Director of Finance. Noteworthy here is the fact that Exhibit 1 on the Secretary's web site includes an e-mail to an agent from the Director of Finance at Springfield stating the City might be "in the mood to pursue greater returns."[64] Moreover, the doctrine of ratification would seem to be the likely response to the accusation that Springfield did not immediately understand which CDOs it had purchased. Additionally, it is hard to discount the lessons of *West Virginia v. Morgan Stanley*, wherein liability was renounced even in the presence of facts establishing that the firm had "sedulously" courted the entity customer because the entity was, essentially, big enough to know better.

2) Regarding the breadth of disclosures, the current panoply of regulatory questions and proposals works to undermine any assertion of enhanced brokerage duty. Noteworthy here is the fact that the Offering Circular for one of the Springfield CDOs included in its risk factors warnings that there was no market for the product at the time and that an investment "will not be appropriate for all investors."[65] Also noteworthy is that at present a very large and very knowledgeable array of government officials cannot yet determine whose failure contributed most to the disappearance of the CDO market.

3) Finally, stated bluntly, the accusation of fraud serves to weaken the case for unsuitable trading. Indeed, the most tantalizing piece of evidence to date appears on the Secretary's web site in the form of a Merrill form document citing to Springfield as an "investment company" and a QIB. But this document may prove to be more harmless error than smoking gun, and, in either case, perhaps a nullity: Possessing a "$21.4 million surplus" in 2006, Springfield readily qualifies as an "accredited," "institutional," or "qualified" investor. Thus, if the charge of misleading paperwork succeeds, it tells us simply that lying equates with fraud, while if it fails, it reinforces the notion that one size fits none when it comes to determining the level of care due to a customer entity purchasing a complex product.

"[M]any experts predict that the subprime crisis shall worsen, as more adjustable-rate mortgages reset and more is learned about the manner in which the related securities were packaged and marketed."

VII. Conclusion

The administrative complaint is noteworthy for its timeliness and zeal, but if it is opposed by the firm, a court may find it bounded by reliance upon legal concepts that have plagued similar cases since the time of the Orange County litigation (and evidence of personal relationships). Nonetheless, despite the chaotic subprime chatter of the present economic environment, some educated considerations do emerge for retail investors suffering similar precipitous portfolio declines:

- There shall be other claims filed by customers who profess a lack of sophistication. In light of the detailed Offering Circulars, prospectuses, etc. often describing these products, the claims will likely cite to alleged omissions by sales agents. The degree to which disclosures should have (or could have) been made will likely correlate to the relationship between the agents of the broker-dealer and the customer. In turn, the details of that relationship will necessitate a fact-intensive study. In the case of Merrill and Springfield, a provocative alleged fact appears in paragraph 10 of the complaint, wherein it is alleged that the Executive Director of the Springfield Finance Control Board "had a personal relationship" with one of the agents, whom he had met "years earlier." As future entities assert a similar lack of awareness, familiarity between agents of customer and firm will no doubt be crucial.
- Likewise, the need for specific disclosures would seem to depend mightily upon the emergence of a primary villain in the subprime meltdown. The present situation has revealed none. Accordingly, broker dealers (and their agents) can, quite plausibly, point to assigned ratings, popularity of the investment, customer tolerance of risk and/or broad and unexpected home mortgage difficulties as significant contributing factors to their customers' losses.
- Concurrently, the abundance of class-action finger-pointing, as well as the intervention of criminal authorities, will delay the formation of any concrete rule of law for adjudicating guilt on the part of the retail distributors. The seemingly countless class actions pending across the nation include targets ranging from loan originators to enabling credit ratings agencies to distributing broker-dealers. Moreover, there are federal agents asking questions of brokerage firms, no doubt inspiring a good deal of deferral of inquiry by state regulators and SROs throughout the country.
- Inescapably, some actions will allege fraud of either the Rule 10b-5 or state variety. The rules of the stock exchanges will nonetheless play a key part in adjudicating such inevitable legal disputes—and those rules do not favor the regulator where the customer can be shown through its holdings to be a sophisticate. A likely exception to these difficulties lies where it can be shown that the course of dealings between the brokerage firm and the customer implied reliance by the latter upon the former; however, as noted above, such relationships are normally fact-intensive arrangements that depend heavily upon circumstance and investigation.

What the Future Holds . . .

Press releases and public speeches to date have made it clear that examination of registered broker-dealers will be frequent and focused. Further, rare investigative steps seem likely, if the SEC, the SROs, the FBI, the Treasury and the states jointly call for reform.

Moreover, many experts predict that the subprime crisis shall worsen, as more adjustable-rate mortgages reset and more is learned about the manner in which the related securities were packaged and marketed. There is a wide variety of probes, inquiries, and investigations occurring in 2008. However, the zeal to prosecute may be somewhat tempered by the difficulty in locating precedent for claims clouded by inexact pricing, complex structuring, a never-ending list of victims (both large and small), and murky regulations.

The subprime meltdown—to borrow a term from CMO language—appears to definitely have a retail investor tranche. All things considered, recovery for losses—if such recovery survives—would seem to be limited to those cases where plaintiffs are clearly misled, with the specter of *sophistication* and accompanying "independent judgment" always looming about. At the very least, attempts at recovery should ensure that brokerage firms will be placed on notice of those pitfalls in offering certain types of investments which are likely to trigger regulatory inquiries and responsive legal work, and generate another "blip" in FINRA's arbitration statistics on the number of claims filed.

Endnotes

1. While largely a financial term of art, *Investopedia.com* describes 'CDOs" as follows: "Similar in structure to a collateralized mortgage obligation (CMO) or collateralized bond obligation (CBO), CDOs are unique in that they represent different types of debt and credit risk. In the case of CDOs, these different types of debt are often referred to as 'tranches' or 'slices'. Each slice has a different maturity and risk associated with it. The higher the risk, the more the CDO pays." *See* http://www.investopedia.com/terms/c/cdo.asp (last visited February 10, 2008).
2. Mary L. Schapiro, Chief Executive Officer, FINRA, Remarks at SIFMA Annual Meeting (November 9, 2007).
3. Regulatory Notice 07-43 (September 2007), *available at* www.finra.org/web/groups/rules_regs/documents/notice_to_members/p036816.pdf.
4. *See* Valerie Bauerlein, *Why BofA Didn't Flag Its Hit*, WALL ST. J., Nov. 14, 2007, at C2.
5. Susan Pulliam, *Pricing Probes on Wall Street Gather Steam*, WALL ST. J., Dec. 21, 2007, at C1.
6. Kara Scannell, *Wall Street's Watchdog Probes Brokerage CMOs*, WALL ST. J., Jan. 4, 2008, at A4. Federal law requires all registered broker-dealers to register with (and be subject to examination and investigation by) FINRA. This universe of firms is consistently approximated as exceeding 5,000 in number.
7. Shanny Basar, *Thain Declares Structured Credit Exit*, FIN. NEWS ONLINE, Jan. 31, 2008, http://www.efinanicalnews.com.
8. *See* Administrative Complaint, *In re Merrill Lynch*, Docket No. 2008-0001 (Feb. 1, 2008), *available at* http://www.sec.state.ma.us/sct/sctml/mlcomp.pdf [hereinafter *Complaint*].
9. Kate Kelly et al., *State Subprime Probe Takes a New Tack*, WALL ST. J., Jan. 31, 2008, at A3.
10. *See, e.g.*, *Cuomo Wants Ratings Firms to Go Further with Reforms*, WALL ST. J., Feb. 7, 2008 (describing the press statement of New York's Attorney General in which he labeled reforms to date "window dressing").
11. *Regulators Reach out to NYSE; Credit Derivatives Transparency Project Possible*, SEC. INDUSTRY NEWS, Feb. 4, 2008, *available at* http://www.securitiesindustry.com/index.html.
12. Kara Scannell et al., *The Subprime Cleanup Intensifies*, WALL ST. J., Feb. 2, 2003, at B1.
13. *Senior lawmaker vows mortgage broker crackdown*, REUTERS, Feb. 6, 2008, http://www.reuters.com/article/summitNews2/idUSN0629444420080207.
14. Kara Scannell, *Next Up for Raters: SEC Rules?*, WALL ST. J., Feb. 9. 2008, at B2.
15. *See, e.g.*, Sarah Kellogg, *The Subprime Mortgage Meltdown: An Uncertain Future*, WASH. LAW., Feb. 2008, at 22, 28 ("There are a lot of moving pieces to this. There are a lot of potential litigants. There used to be just borrowers. Now you've got borrowers, plus the institutional investors, and the people like you and me who bought the securities.") (quoting banking specialist Jeffrey Taft of Mayer Brown LLP).
16. James Surowiecki, *Bonds Unbound*, THE NEW YORKER, Feb. 11, 2008, at 56.
17. *See* Kate Kelly, *Barclays Sues Bear Over Failed Funds*, WALL ST. J. Dec. 20, 2007, at C3.
18. *See, e.g.*, Complaint, *Atkinson v. Morgan Asset Mgmt.* No. 2:07-CV-02784 (W.D. Tenn. Dec. 6, 2007).
19. Collateralized Mortgage Obligations, or "CMOs," are mortgage-backed bonds that separate mortgage pools into different maturity classes called "tranches." They are usually backed by "government-guaranteed or other top-grade mortgages." Downs and Goodman, BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 102 (1998).
20. *See* Jennifer Heiger, *Worst Deals of the Decade*, THE ORANGE COUNTY REGISTER, Dec. 28, 1999 ("The county sued almost everyone in sight—Merrill Lynch, auditor KPMG Peat Marwick, bond counsel LeBoeuf Lamb Greene & MacRae, and bond-rating agency Standard & Poor's.").
21. Hon. Robert L. Gottsfield et al., *Derivatives—What They Are; What They Cause; What's the Law*, 32 ARIZ. ATT'Y 33 (1996).
22. J. Christopher Kojima, *Product-Based Solutions to Financial Innovation: The Promise and Danger of Applying the Federal Securities Laws to OTC Derivatives*, 33 AM. BUS.L.J. 259 (1995).
23. *See, e.g.*, Arthur N. Lambert & Marc R. Lepelstat, *Claims from Sales of Collateral Mortgage Obligations*, N.Y.L.J., Feb. 15, 2008.
24. Ronald Campbell, *An Ugly Chapter Draws to a Close*, THE ORANGE COUNTY REGISTER, June 16, 1999.
25. John McDonald, *Merrill Lynch Transcripts to Remain Sealed*, THE ORANGE COUNTY REGISTER, July 23, 1999.
26. *See generally*, C. Edward Fletcher III, *Sophisticated Investors Under the Securities Laws*, 1988 Duke L.J. 1981 (1988).
27. 17 C.F.R. §§ 230.215, 501(a) (2006).
28. *See* SEC Proposal, Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 2 (Jan. 4, 2007) (to be codified at 17 C.F.R. part 230) (proposing, among other things, new SEC Rules 509 and 216).
29. *See* M. Joan Conrad, Comment to the SEC on Proposed Rule (February 6, 2007), *available at* http://www.sec.gov/comments/s7-25-06/s72506-337.pdf (stating that the proposed rule change was "unconstitutional, if not communistic").
30. NASD Rules 2211(a)(3) and 3110(c). Rule 3110 expressly applies its institutional investor definition to the NASD suitability rule, found at Rule 2310.
31. NYSE Glossary *available at* http://www.nyse.com/regulation/rules/1098571481177.html.
32. 17 C.F.R. § 230.144A (2006).
33. *State v. Morgan Stanley*, 459 S.E.2d 906, 913 (W.Va. 1995).
34. Professor Poser has described the majority theory as follows:

    The misrepresentation/omission theory of liability: The problem of justifiable reliance:

    > An institutional investor who claims that a broker-dealer misrepresented (or failed to disclose) the unsuitability of the securities that it sold to the institution must prove that it justifiably relied on the misrepresentation or omission. Under the majority view of the courts, the plaintiff, whether an individual or an institution, must show not only that it actually relied on the defendant's misrepresentation or omission, but also that the reliance was justifiable. In order to recover, the plaintiff must demonstrate that it exercised due care and reasonable diligence in ascertaining the truth about the investment. Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Rec-*

ommendations to Institutional Investors, 2001 B.Y.U.L. Rev. 1493 (2001) (cites omitted).

35. *Id.*, at 1510 ("Courts have repeatedly held, however, that a broker-dealer can have a fiduciary relationship with an institutional customer, if the customer reposes trust and confidence in the broker-dealer, and if the transaction that is the subject of the dispute is relevant to the matters entrusted to the broker.") (citing *Press v. Chem Inv. Serv. Corp*, 166 F.3d 529, 536 (2d Cir. 1999); *Union Bank of Switz. v. HS Equities, Inc.*, 457 F. Supp. 515 (S.D.N.Y. 1978) (wherein a broker was found to owe a fiduciary duty to a bank to keep it informed as to material matters)).

36. *See Banca Cremi v. Alex. Brown & Sons*, 132 F.3d 1017 (4th Cir. 1997).

37. *FINRA Dep't of Enforcement v. Dana N. Frankfort*, 2007 NASD Discip. LEXIS 16 (May 24, 2007) (upholding Hearing Panel's determination that Frankfort be barred for both the Rule 10b-5 violation and the separate violation of the NASD suitability rule).

38. *See* David P. Doherty et al., *The Enforcement Role of the New York Stock Exchange*, 85 Nw. U. L. Rev. 637 (1991) (delineating the NYSE's enforcement, investigation and disciplinary functions).

39. FINRA commenced operations in July 2007; however, the new, combined regulator will continue to rely on the separate NYSE and NASD rulebooks until their formal reconciliation, which is not expected to be completed until 2009. *See* NASD News Release, NASD and NYSE Group Announce Plan to Consolidate Regulation of Securities Firms (November 28, 2006), *available at* http://www.finra.org/PressRoom/NewsReleases/2006NewsReleases/P017973.

40. Robert Louis Semanak, NYSE Hearing Panel Decision 04-98 (July 2004) (the producing branch office manager was the famed Frank Gruttadauria, who went to prison for millions of dollars in theft from customers).

41. NASD Rule 2310(b), available at http://www.finra.org/index.htm.

42. *See* 15 U.S.C. § 78(bb) (2006).

43. *See supra* note 8.

44. *Id.* at 3.

45. *Id.*

46. *Id.*

47. *Id.* at 2.

48. *Id.* at 3.

49. *Id.* at 5.

50. *Id.*

51. *Id.* at 6.

52. *Id.*

53. *Id.* at 20.

54. *Id.* at 22.

55. Specifically, it cites 950 CMR § 12.204(1)(a). *Id.* at 21.

56. *Id.* at 23.

57. *See* Craig Karmin, *Merrill Faces Fraud Allegations*, Wall St. J., Feb. 1, 2008.

58. For examples from last year, see RBC Capital Mkt. Corp., NYSE Hearing Panel Decision 07-151 (Sep. 14, 2007) and Mesirow Fin. Inc, NYSE Hearing Panel Decision 07-144 (Oct. 10, 2007).

59. *See* SEC Release, SEC Approves FINRA Rule Governing Sales Practices of Deferred Variable Annuities, Sep. 10, 2007, *available at* www.sec.gov/news/press/2007/2007-178.htm.

60. The President's Working Group on Fin. Mkt., Policy Statement on Financial Market Developments, Mar. 2008, *available at* www.treas.gov/press/releases/hp871.htm.

61. *See* Consent Order, *In re Citizens Inv. Serv. Corp.* (July 22, 2005) (citing annuity sales practices in violation of NASD rules), *available at* http://www.sec.state.ma.us/sct/sctpdf/citconsent.pdf.

62. *See* Administrative Complaint, *In re Morgan Stanley & Co., Inc.* (Sept. 12, 2007), *available at* www.sec.state.ma.us/sct/sctms2/ms2complaint.pdf.

63. *See* Administrative Complaint, *In re A.G. Edwards & Sons, Inc.* (Dec. 5, 2007), *available at* www.sec.state.ma.us/sct/sctedwds/edwds_corp_exch.pdf.

64. The Exhibits to the Administrative Complaint are *available at* www.sec.state.ma.us/sct/sctml/mlexh.pdf.

65. Complaint, *supra* note 8, at 11. While alleging that the Agents did not review the Offering Circular, the Complaint is not clear on whether or not the document was delivered to Springfield at or near the time of their investment.

J. Scott Colesanti is a Special Professor at the Hofstra University School of Law, teaching Securities Regulation and Broker-Dealer Regulation. Professor Colesanti previously served as Trial Counsel for the New York Stock Exchange Division of Enforcement and has been an arbitrator for the NYSE and NASD/FINRA since 2000.

The Supreme Court Rejects Liability of Customers, Suppliers and Other Secondary Actors in Private Securities Fraud Litigation

Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. (In re Charter Communications)

By Anissa Seymour and Yuval Rogson

Summary

On January 15, 2008, the United States Supreme Court issued its decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[1] a case that was closely monitored by the securities litigation bar because of the impact it would have on the exposure of customers, suppliers and other secondary actors to liability in private federal securities fraud litigation. At issue in *Stoneridge* was "scheme liability"—shareholder plaintiffs' theory that secondary actors who engage in deceptive transactions that enable publicly held companies to commit securities fraud may be liable under Rule 10b-5. By a 5 to 3 majority, the Supreme Court in *Stoneridge* rejected scheme liability, holding plaintiffs could not show that the shareholders relied upon any of the secondary actors' actions "except in an indirect chain that [is] too remote for liability."[2]

In *Stoneridge*, shareholder plaintiffs brought a securities fraud action against cable company Charter Communications ("Charter"), and its suppliers of set-top cable boxes, Scientific-Atlanta and Motorola (the "Vendors").[3] Plaintiffs alleged that when Charter realized it was unlikely to meet its projected revenue and operating cash-flow numbers, it enlisted the Vendors' help to enter into transactions that would enable Charter to make it appear as if it had met its projections.[4] Specifically, plaintiffs alleged that Charter would overpay the Vendors for the set-top boxes with the understanding the Vendors would return the overpayment by buying advertising from Charter.[5] Charter then recognized the advertising fees as revenue, even though the fees were merely a refund.[6] So that Charter's auditors would not unearth the arrangements, "the companies drafted documents to make it appear the transactions were unrelated and conducted in the ordinary course of business."[7] The Court's ruling meant that neither Scientific-Atlanta nor Motorola could be held liable for any of Charter's deceptive acts, regardless of their participation in them.

However, the Court noted that its ruling did not foreclose all options against culpable secondary actors because:

- secondary actors can be liable for aiding and abetting fraud in an action brought by the Securities and Exchange Commission;[8]
- secondary actors may be liable for aiding and abetting fraud in an action brought under certain state laws;[9]
- secondary actors are subject to criminal penalties;[10]
- the securities statutes provide an express private right of action against accountants and underwriters under certain circumstances;[11] and
- secondary actors who commit primary violations may be held liable.[12]

The decision in *Stoneridge* has already had an immediate impact on pending cases. The Supreme Court denied *certiorari* in *Regents of University of California v. Merrill Lynch Pierce Fenner & Smith, Inc. (In re Enron),* [13] declining to address the Enron shareholders' argument that *Stoneridge* does not extend to secondary actors who are financial professionals. By doing so, the Supreme Court has allowed the Fifth Circuit's decision to reject claims of scheme liability made against such financial professionals to remain the law. By contrast, the Supreme Court vacated the Ninth Circuit's decision to permit certain scheme liability claims and remanded the case with instructions to the Ninth Circuit to reconsider its holding in light of *Stoneridge*. In *In re Parmalat Securities Litigation*,[14] where the district court had earlier denied motions to dismiss securities fraud claims based on scheme liability, the district court has asked the parties to brief the effect of *Stoneridge* on the issue of summary judgment.

The Genesis of "Scheme Liability"

The Supreme Court eliminated aiding and abetting liability for federal securities fraud in *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*[15] The following year, as part of the Private Securities Litigation Reform Act of 1995 (PSLRA),[16] Congress provided the SEC with statutory authority to prosecute aiders and abettors of violations of the securities laws.[17] It declined to provide similar statutory authority to private litigants.

Since *Central Bank*, the plaintiffs' bar has struggled to find a way to broaden the scope of Rule 10b-5 to reach secondary actors. Through the theory of scheme liability, plaintiffs attempted to sidestep the decision in *Central*

Bank by recasting secondary actors as primary violators of the rule. Under the theory of scheme liability, secondary actors who knowingly facilitate securities fraud by engaging in deceptive transactions with the primary actor do not merely aid and abet a violation of Rule 10b-5, but actually commit an independent violation of the statute, taking them outside the ruling of *Central Bank*.

Courts wrestled with the concept of scheme liability and ultimately reached different conclusions. Courts in the Second and Ninth Circuit recognized scheme liability as possibly falling outside of *Central Bank*. The Fifth and Eighth Circuits rejected scheme liability as merely a compelling subspecies of aiding and abetting liability foreclosed by *Central Bank*.

In *Parmalat*, for example, the Court considered allegations of scheme liability brought against several banking defendants.[18] The plaintiffs alleged that the banking defendants participated in a scheme to improperly enhance Parmalat's earnings by engaging in deceptive transactions such as double-counting receivables and disguising loans as equity transactions.[19] The Court saw no distinction between the actions of Parmalat and those of the banking defendants:

> The transactions in which the defendants engaged were by nature deceptive. They depended on a fiction, namely that the invoices had value. It is impossible to separate the deceptive nature of the transactions from the deception actually practiced upon Parmalat's investors.[20]

As a result, the Court determined that the banking defendants could be held liable for a primary violation of Rule 10b-5: "[W]here, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b-5."[21] Accordingly, the Court recognized scheme liability as unaffected by the holding of *Central Bank* and denied several of the banking defendants' motions to dismiss.[22]

Similarly, in *Simpson v. AOL Time Warner, Inc.*,[23] the Ninth Circuit considered allegations of scheme liability against several defendants accused of participating in sham transactions that allowed Homestore.com to inflate its revenue and deceive its investors.[24] The Ninth Circuit held that the defendants who engaged in these transactions could be held liable for a primary violation of Rule 10b-5:

> If the Defendants' conduct, as alleged in the [complaint], had the purpose and effect of creating a false appearance from illegitimate transactions in furtherance of a scheme to misrepresent revenues, then Plaintiff has alleged a primary violation of § 10(b).[25]

The Court then dismissed the complaint because it found that the allegations against the defendants did not meet this standard.[26]

However, both the Fifth Circuit and the Eighth Circuit rejected similar claims of scheme liability. When the Eighth Circuit considered *In re Charter Communications, Inc., Securities Litigation*,[27] it held that the "district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the[y] knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs."[28] The court agreed with the district court that the Vendors:

> did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition. None of the alleged financial misrepresentations by Charter was made by or even with the approval of the Vendors.[29]

Similarly, in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,[30] the Fifth Circuit considered allegations of scheme liability brought against banks associated with Enron Corporation prior to its collapse.[31] The plaintiffs had alleged the banks "entered into partnerships and transactions that allowed Enron [] to take liabilities off its books temporarily and to book revenue from the transactions when it was actually incurring debt."[32] The district court had certified a class against these bank defendants based on the fraud-on-the-market presumption of reliance.[33] Inherent in the district court's certification was a finding that the bank defendants had committed a deceptive act in violation of Section 10(b).[34] The Fifth Circuit reversed the district court:

> The district court's conception of "deceptive act" liability is inconsistent with the Supreme Court's decision that § 10 does not give rise to aiding and abetting liability. An act cannot be deceptive within the meaning of § 10(b) where the actor has no duty to disclose. Presuming plaintiffs' allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided and abetted that fraud by engaging in transactions that make it more plausible; they owed no duty to Enron's shareholders.[35]

The Court further held that the bank defendants did not engage in market "manipulation" because they "did not act directly in the market for Enron securities."[36]

Parmalat and *Simpson*, on the one hand, and *Charter* and *Regents*, on the other hand, demonstrate the judicial divide regarding scheme liability that gave rise to the Supreme Court granting *certiorari* in *Stoneridge*.

The Supreme Court's Decision in *Stoneridge*

In its decision in *Stoneridge*, the Supreme Court set out to resolve the uncertainty regarding scheme liability.[37] The Court recounted the plaintiffs' allegations in Charter against the Vendors and noted that the Vendors had allegedly engaged in transactions with Charter that had "no economic substance" and "enable[d] Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash-flow numbers."[38] The Court further noted, however, that the Vendors "had no role in preparing or disseminating Charter's financial statements."[39]

The Court began by reiterating that *Central Bank* eliminated aiding and abetting liability for private actions under Section 10(b) and Rule 10b-5.[40] Thus, to state a claim against the Vendors, the petitioner's allegations would have to "satisfy each of the elements or preconditions for [primary] liability[.]"[41]

The Court held that the petitioner's allegations failed to meet the element of reliance necessary to state a Rule 10b-5 claim against the Vendors.[42] The Court reasoned that the Vendors "had no duty to disclose; and their deceptive acts were not communicated to the public."[43] As a result, "[n]o member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times."[44] Thus, the Court held that the petitioner "cannot show reliance upon any of respondents' actions except in an indirect chain we find too remote for liability."[45]

The discussion of what actions were "immediate" and "remote" to the injury informed the holding of the Court. The Court determined that "[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did."[46] Accordingly, the Court distinguished Charter's more immediate act of recording and releasing its fraudulent financial statements from the Vendors' more remote act of engaging in sham transactions with Charter that enabled Charter to ultimately misstate its financials. This distinction was sufficient to break the chain of liability under Rule 10b-5. In reasoning this way, the Court struck down any permissive view of scheme liability.

Several additional factors led the Court to its decision. The Court determined that allowing scheme liability to function as an exception to *Central Bank* would ignore the will of Congress.[47] In response to *Central Bank*, Congress amended the securities laws to authorize the SEC to bring actions against aiders and abettors of securities fraud. Congress did not provide such authority to private litigants. Thus, the Court held that if it adopted scheme liability "it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud[,]" which "would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants."[48] It also noted the power of the SEC to pursue secondary actors in an enforcement action.[49]

The Court also expressed concern that allowing scheme liability would unduly expand the implied private right of action under Rule 10b-5. Under the petitioner's theory, Section 10(b) would be made to apply "beyond the securities markets—the realm of financing business—to purchase and supply contracts—the realm of ordinary business operations."[50] "Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business[.]"[51]

The Court noted the risks attendant to such an increase in exposure to securities claims. "[E]xtensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."[52] The "[a]doption of petitioner's approach would expose a new class of defendants to these risks" and therefore "raise the cost of being a publicly trading company. . . ."[53] This, in turn, may discourage foreign investment in "domestic capital markets" and adversely affect the economy.[54] In light of these concerns, the Court expressly held that the implied private right of action under § 10(b) "should not be extended beyond its present boundaries" without direction from Congress.[55] Accordingly, the Supreme Court affirmed the dismissal of the petitioner's securities fraud claims against the Vendors.[56]

Conclusion

The Court in *Stoneridge* refused to recognize scheme liability as a work-around or an exception to the rule in *Central Bank* eliminating aiding and abetting liability. In addition, the Court expressly refused to extend the implied private right of action under Rule 10b-5 past its current boundaries. In reaching these conclusions, the Court provided predictability and clarity while balancing the interests of investors, businesses, and the economy.

Endnotes

1. 128 S. Ct. 761 (2008).
2. *Id.* at 769.
3. *Id.* at 766.
4. *Id.*
5. *Id.*

6. *Id.*
7. *Id.* at 767.
8. *Id.* at 771, 773 (citing 15 U.S.C. § 78t(e)).
9. *Id.* at 773 (citing, *e.g.*, Del. Code Ann., Tit. 6, § 7325).
10. *Id.* (citing 15 U.S.C. § 78ff).
11. *Id.* (citing 15 U.S.C. § 78k).
12. *Id.* (citing *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994)).
13. 128 S. Ct. 1120 (2008).
14. 376 F. Supp. 2d 472 (S.D.N.Y. 2005).
15. 511 U.S. 164 (1994).
16. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C. (1994)).
17. 15 U.S.C. § 78t(e).
18. *Parmalat*, 376 F. Supp. 2d at 481–90.
19. *See id.*
20. *Id.* at 504.
21. *Id.* at 510.
22. *Id.*
23. 452 F.3d 1040 (9th Cir. 2006).
24. *Id.* at 1043.
25. *Id*
26. *Id.* at 1052-55.
27. 443 F. 3d 987 (8th Cir. 2006).
28. *Id.* at 992.
29. *Id.*
30. 482 F. 3d 372 (5th Cir. 2007).
31. *See id.* at 377.
32. *Regents*, 482 F. 3d at 377.
33. *Id.* at 378.
34. *Id.*
35. *Id.* at 386.
36. *Id.* at 392.
37. *Stoneridge*, 128 S. Ct. at 767–68.
38. *Id.* at 766.
39. *Id.* at 767.
40. *Id.* at 768–69.
41. *Id.* at 769.
42. *Id.*
43. *Id.*
44. *Id.*
45. *Id.*
46. *Id.* at 770.
47. See *id.* at 771.
48. *Id.*
49. *Id.* at 770–71.
50. *Id.* at 770.
51. *Id.*
52. *Id.* at 772.
53. *Id.*
54. *Id.*
55. *Id.* at 773.
56. *Id.* at 774.

Anissa Seymour is a partner in the Los Angeles office of Katten Muchin Rosenman LLP. Her practice focuses on defending civil government investigations and securities actions against public companies, their officers and directors, accounting firms, and forensic accountants.

Yuval Rogson is an associate in the Los Angeles office of Katten Muchin Rosenman LLP. He focuses his practice on complex business litigation with particular emphasis on shareholder derivative lawsuits and securities class actions.

SEC Revises Four Sets of Rules

By Guy P. Lander, Stephen V. Burger, G. Christina Gray-Trefry, Angelo Kramvis and Aaron Salsberg

The SEC has recently adopted four sets of rules that: (a) revise Rules 144 and 145, (b) adopt International Financial Reporting Standards, (c) revise the eligibility requirements for offerings on forms S-3 and F-3, and (d) provide regulatory relief and simplification for smaller reporting companies. The following article describes the changes.

A. SEC Amends Rules 144 and 145 under the Securities Act of 1933

Introduction

The SEC recently amended Rules 144 and 145 (the "Amendments") under the Securities Act of 1933[1] (the "Securities Act"). The major changes to the Rules are to:

- shorten to six months from one year the Rule 144(d) holding period for resales of restricted securities of "reporting companies," i.e., companies subject to the reporting requirements of the Securities Exchange Act of 1934[2] (the "Exchange Act"), such as Forms 10-K and 10-Q;
- shorten to one year from two years the holding period after which non-affiliates of both reporting companies and non-reporting companies may resell restricted securities of those companies without conditions;
- significantly reduce the Rule 144 restrictions on resales of restricted securities by non-affiliates of the issuers so that after the holding period is met, the resale of restricted securities by a non-affiliate will no longer be subject to any other condition of Rule 144, except that, for the resale of securities of a reporting company, the current public information requirement in Rule 144(c) will apply for an additional six months after the six-month holding period requirement is met;
- eliminate the "manner of sale" requirement for debt securities;
- amend the volume limitation for debt securities to permit resales of debt securities of up to 10% of a tranche of securities, when aggregated with all sales of securities of the same tranche within a three-month period;
- amend the manner of sale requirement to permit the resale of equity securities through "riskless principal transactions," and amend the definition of "brokers' transactions" to include the posting of bid-and-ask quotations in alternative trading systems;
- increase the Form 144 filing thresholds below which no filing is required, from 500 shares to 5,000 shares, or from $10,000 to $50,000, in both cases within a three-month period;
- codify certain SEC staff interpretive positions that relate to Rule 144; and
- eliminate the "presumptive underwriter" provision in Rule 145 (except for transactions involving a shell company), and revise the resale requirements in Rule 145(d) to conform to certain amendments to Rule 144.

The SEC intended these amendments to increase the liquidity of privately sold securities, make private offerings more attractive to investors and decrease the cost of capital for all issuers, without compromising investor protection. These amendments became effective on February 15, 2008 and apply to securities acquired before or after this effective date.

Background—Rule 144 before the Amendments

Rule 144 provides to security holders a safe harbor for relying on the Section 4(1) exemption for resales of securities. Section 4(1) of the Securities Act exempts from Securities Act registration transactions by any person other than an issuer, underwriter or dealer. If a selling security holder meets all the requirements of Rule 144, then he or she is deemed not to be engaged in a distribution of securities (i.e., is not an underwriter) and may resell the applicable securities without registration under the Securities Act. Rule 144 applies to (a) the sale of "restricted securities" (including securities acquired from an issuer in a transaction not involving a public offering), and (b) the sale of "control securities" (generally, securities held by an affiliate of the issuer, regardless of how the affiliate acquired the securities).

Formerly, the conditions to Rule 144 included the following:

- there must be available adequate current public information about the issuer (the issuer's Exchange Act filings are the most common source of information for purposes of this condition);
- the security holder could resell restricted securities after holding them for one year, subject to all other Rule 144 requirements, and non-affiliates could resell restricted securities without restrictions after two years;
- the amount of securities sold must be within specified volume limitations;

- the resale must comply with certain manner of sale requirements for ordinary (unsolicited) brokerage transactions; and
- a Form 144 must be filed with the SEC if the amount of securities being sold exceeds *de minimis* thresholds.

Amendments

1. Shortening Holding Period to Six Months for Reporting Companies

Currently, both affiliates and non-affiliates can resell restricted securities of reporting companies (i.e., companies that were reporting under the Exchange Act for at least 90 days before the resale) after holding the restricted securities for six months. Restricted securities of a non-reporting company (i.e., a company that has not been reporting under the Exchange Act for at least 90 days before the sale) will remain subject to the one-year holding period.

2. Reduction of Conditions that Apply to Non-Affiliates

After the six-month holding period has been met, non-affiliates of reporting companies who have not been affiliates during the three months before the sale of securities are not subject to any conditions of Rule 144, other than the current public information requirement, which applies for an additional six months. After the one-year holding period has been met, non-affiliates of reporting companies will be able to resell securities with no Rule 144 conditions at all.

Non-affiliates of a non-reporting company (i.e., a private company) may resell securities with no limitations after a one-year holding period. No resales by non-affiliates of securities of a non-reporting company are permitted under Rule 144 before the end of this one-year period.

3. Conditions That Remain Applicable to Affiliates

After the six-month holding period, affiliates of reporting companies may resell securities only in accordance with all the conditions of Rule 144, including current public information, volume limitations, manner of sale requirements for equity and filing Form 144.

After a one-year holding period, affiliates of a non-reporting company may resell securities only in compliance with all the conditions of Rule 144. No resales by affiliates of securities of a non-reporting company are permitted under Rule 144 before the end of this one-year period.

4. Summary

The chart below summarizes the conditions imposed by Rule 144 after the amendments for the resale of restricted securities held by affiliates and non-affiliates of the issuer:

	Affiliate or Person Selling on Behalf of an Affiliate	**Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)**
Restricted Securities of Reporting Issuers	*During six-month holding period* - no resales under Rule 144 permitted. *After six-month holding period* - may resell in accordance with all Rule 144 requirements including: • current public information, • volume limitations, • manner of sale requirements for equity securities, and • filing of Form 144.	*During six-month holding period* -no resales under Rule 144 permitted. *After six-month holding period but before one year* - unlimited public resales under Rule 144 except that the current public information requirement still applies. *After one-year holding period* - unlimited public resales under Rule 144; need not comply with any Rule 144 requirements.
Restricted Securities of Non-Reporting Issuers	*During one-year holding period* - no resales under Rule 144 permitted. *After one-year holding period* - may resell in accordance with all Rule 144 requirements, including: • current public information, • volume limitations, • manner of sale requirements for equity securities, and • filing of Form 144.	*During one-year holding period* - no resales under Rule 144 permitted. *After one-year holding period* - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

5. Elimination of Manner of Sale Requirements for Resales of Debt Securities

The amendments eliminate the manner of sale requirements for resales of debt securities (including non-participating preferred stock and asset-backed securities) held by affiliates of the issuer. This amendment allows the holders of debt and similar securities to have greater flexibility in the manner (including the option to privately resell the securities) and amount of the resale of their securities.

6. Manner of Sale Requirements

Formerly, Rule 144(f) required that securities be sold in "brokers' transactions" as defined in Rule 144(g), or in transactions directly with a "market maker" as defined in Section 3(a)(38) of the Exchange Act. The Rule also prohibited a selling security holder from (a) soliciting or arranging for the solicitation of orders to buy securities in anticipation of, or in connection with, a Rule 144 transaction and (b) making any payment in connection with the offer or sale of the securities to any person other than the broker who executes the order to sell the securities.

First, the SEC amended the Rule 144(f) manner of sale requirements (which still apply to resales of equity securities by affiliates). This change permits the resale of securities through riskless principal transactions in which offsetting trades are executed at the same price, excluding mark-ups, mark-downs and other commission-like fees.

Second, the SEC amended Rule 144(g) to permit the posting of bid-and-ask quotations in alternative trading systems; they are no longer a solicitation prohibited under the definition of brokers' transactions. However, the broker must have published bona fide bid-and-ask quotations for the security in the alternative trading system on each of the last 12 business days.

7. Raising Volume Limitations for Debt Securities

Formerly, Rule 144(e) provided that the amount of securities sold in a three-month period may not exceed the greater of: (i) 1% of the outstanding shares and (ii) the average weekly volume of trading in such securities on all national securities exchanges and automated quotation systems (such as NASDAQ) during the four calendar weeks preceding the filing of the Form 144. These limits effectively made Rule 144 unavailable for the resale of debt securities. Now, Rule 144(e) provides an alternative volume limitation specifically for the resale of debt securities. The rule permits the resale of debt securities that does not exceed 10% of a tranche (or class for non-participatory preferred stock), when aggregated with all sales of securities of the same tranche sold by the security holder within three months. This amendment, along with the elimination of the manner of sale requirements for debt securities, permits greater trading in debt securities under Rule 144.

8. Increased Form 144 Filing Thresholds

Formerly, Rule 144(h) required a selling security holder to file a notice on Form 144 if the intended sale exceeded either 500 shares or other units, or an aggregate sale price in excess of $10,000, within a three-month period. Now, under Rule 144(h), the dollar threshold required for the filing of a Form 144 is $50,000, and the share threshold is 5,000 shares, for sales to be made within three months. Additionally, Form 144 is now only required for sales by an affiliate of the issuer.

Codification of Staff Positions Concerning Rule 144

1. Securities Acquired under Section 4(6) of the Securities Act are Considered "Restricted Securities"

The amendments codify the SEC staff position that securities acquired from an issuer in a transaction exempt under Section 4(6) are, like securities received in other non-public offerings, restricted securities under Rule 144. Section 4(6) is an exemption from registration for an offering that does not exceed $5 million, is made only to accredited investors, does not involve any advertising or public solicitation, and for which a Form D has been filed.

2. Tacking of Holding Periods When a Company Reorganizes into a Holding Company Structure

The amendments codify the SEC staff position that security holders may tack the Rule 144 holding period for securities acquired in transactions made solely to form a holding company. The amended Rule 144(d)(3)(ix) permits the tacking of the holding period of the restricted securities of the predecessor company to the holding period of the restricted securities of the holding company received in the reorganization. This provision permits tacking if three conditions are met:

- The newly formed holding company's securities were issued solely in exchange for the securities of the predecessor company as part of a reorganization of the predecessor company into a holding company structure;
- Security holders received securities of the same class, evidencing the same proportional interest in the holding company as that previously held in the predecessor company, and the rights and interests of the security holders are substantially the same as those they possessed in the predecessor company's securities; and
- Immediately following the transaction, the holding company had no significant assets other than the securities of the predecessor company and its subsidiaries, and has substantially the same assets and liabilities on a consolidated basis as the predecessor company.

3. Tacking of Holding Periods for Conversions and Exchanges of Securities

The amendments clarify Rule 144(d)(3)(ii) to specifically include securities that are not convertible or exchangeable by their terms. The new rule states that if securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer, the newly acquired securities shall be deemed to have been acquired at the same time as the securities surrendered for conversion or exchange, even if the securities surrendered were not convertible or exchangeable by their terms.

Additionally, the SEC added a note to Rule 144(d)(3)(ii) stating that if: (i) the original securities do not permit cashless conversion or exchange by their terms, (ii) the parties amend the original securities to allow for cashless conversion or exchange, and (iii) the security holder provides consideration, other than solely securities of the issuer, for that amendment, then the newly acquired securities will be deemed to have been acquired on the date of the amendment of the original securities (not the date the securities were originally purchased) as long as, in the conversion or exchange, the securities to be sold were acquired from the issuer solely in exchange for other securities of the same issuer.

4. Cashless Exercise of Options and Warrants

The amendments codify the staff's position that upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired, even if the options or warrants originally did not provide for cashless exercise by their terms. As indicated above, the amendments added a note to Rule 144(d)(3)(x) stating that if (i) the original options or warrants do not permit cashless exercise, and (ii) the security holder provides consideration, other than solely securities of the issuer, to amend the options or warrants to allow for cashless exercise, then the amended options or warrants would be deemed to have been acquired on the date that the original options or warrants were so amended (similar to the treatment of conversions and exchanges above).

Additionally, the grant of certain options or warrants that are not purchased for cash or property (e.g., employee stock options) does not create an investment risk for the security holder. Consequently, the holder cannot tack the holding period for the options or warrants to the holding period for the securities received upon exercise of the options or warrants. Therefore, the security holder would be deemed to have acquired the underlying securities on the date the option or warrant was exercised (not the date granted), so long as the full purchase price for the newly acquired securities has been paid at the time of exercise.

5. Aggregation of Pledged Securities

A note to Rule 144(e) has been added to address how two or more pledgees of securities should calculate the Rule 144 volume limitations. The note states that so long as two or more pledgees are not the same "person" for Rule 144 purposes, are not acting in concert, and the pledges are bona fide transactions, one pledgee may resell the pledged securities without having to aggregate its sale with the sales of other pledgees of the same securities from the same pledgor. However, each pledgee must separately aggregate its sales with the sales of the pledgor.

6. Treatment of Securities Issued by "Reporting and Non-Reporting Shell Companies"

The amendments attempt to curtail the abuse of Rule 144 by codifying a staff position concerning shell companies. A shell company is defined as a registrant, other than an asset-backed issuer, that has: (i) no or nominal operations, and (ii) either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets. These amendments apply to a broader category of companies than provided for in the above definition, as they apply to any "issuer" meeting the above standard, not just any registrant. The SEC calls these companies "reporting and non-reporting shell companies" and this includes blank-check companies (i.e., development-stage companies with no specific business plan other than to merge with or acquire another company, and that issues penny stock).

First, under Rule 144(i), Rule 144 is not available for the resale of securities initially issued by a reporting or non-reporting shell company or an issuer that has been at any time previously a reporting or non-reporting shell company, unless the issuer is a former shell company that meets all the conditions discussed below.

However, Rule 144 is available for the resale of restricted or unrestricted securities that were initially issued by an issuer that is or was a reporting or non-reporting shell company if the following conditions are met: (a) the issuer: (i) has ceased to be a shell company, (ii) is subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act and (iii) has filed all Exchange Act reports and materials required to be filed during the preceding 12 months (or for such shorter period that the issuer was required to file such reports and materials), other than certain Form 8-K reports; and (b) at least one year has elapsed since the issuer initially filed current Form 10-type information with the SEC reflecting its status as an entity that is not a shell company. (Form 10-type information is information that a company would be required to file if it were registering under the Exchange Act a class of securities on Forms 10 or 20-F. Shell companies must file this information on a Form 8-K for the transaction by which they cease to be a shell company.)

7. Representations Required from Security Holders Relying on Rule 10b5-1(c) under the Exchange Act

Rule 10b5-1(c) provides an affirmative defense to the prohibition against insider trading, i.e., trading "on the basis of" material nonpublic information. The defense is available if the person can show that:

- before becoming aware of the material nonpublic information, that person had entered into a binding contract to purchase or sell the securities, provided instructions to another person to execute the trade for his account, or adopted a written plan for trading the securities;
- the contract, instructions or written trading plan meets the conditions of Rule 10b5-1; and
- the purchase or sale that occurred was pursuant to the contract, instruction or plan.

Form 144 requires a selling security holder to represent that when he or she signed the Form, he or she did not know any material adverse information concerning the current and prospective operations of the issuer of the securities to be sold which has not been publicly disclosed. The amendments codify the staff's position that a selling security holder who meets the conditions of Rule 10b5-1(c) may modify the Form 144 representation to indicate that he or she had no knowledge of material adverse information about the issuer when the holder adopted the written trading plan or gave the trading instructions. However, the holder must specify the date and indicate that the representation speaks as of that date.

Simplification of the Preliminary Note and Text of Rule 144

The amendments simplified the Preliminary Note to Rule 144 by rewriting parts of it in plain English without altering the substantive operation of the rule. A statement was also added to the Preliminary Note that the Rule 144 safe harbor is not available for any transaction that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act.

Amendments to Rule 145

Rule 145 provides that exchanges of securities in connection with business combinations (i.e., reclassifications of securities, mergers, consolidations or transfers of assets) that are subject to shareholder vote are sales of those securities that must be registered, unless an exemption is available. Formerly, under Rule 145(c), persons who were parties to such transactions, other than the issuer or affiliates, were deemed to be underwriters. (This is called the "presumptive underwriter provision.") Rule 145(d) permits the resale of securities received in such transactions by persons deemed underwriters if certain conditions are met.

The amendments eliminate the presumed underwriter provision of Rule 145(c), except for transactions involving a shell company. Rule 145(c) had been used to limit resales by affiliates of a company that is a party to a Rule 145 business combination. These affiliates were presumptive underwriters, and as such, could not resell securities acquired in the Rule 145 transaction without meeting the volume, manner of sale and other limitations of Rule 145(d). The amended rule will allow affiliates of a company that is a party to a Rule 145 transaction (who do not immediately become affiliates of the acquirer) to immediately resell the securities received in the transaction without regard to volume, manner of sale and other restrictions of Rule 145(d). These affiliates will also be able to hedge their positions prior to the closing of the transaction as a result of this amendment.

Because of the SEC's experience with abusive sales of securities involving shell companies, any party, other than the issuer, to a Rule 145 transaction involving a shell company which publicly offers or sells securities of the issuer acquired in connection with the transaction will continue to be deemed an underwriter. If the issuer meets the conditions of new Rule 144(i)(2) (i.e., that Form 10 information is filed indicating the company is no longer a shell company), the presumptive underwriters may only resell their securities if:

- the current public information, volume limitation and manner of sale requirements of Rule 144(c), (e), (f) and (g) are met and at least 90 days have elapsed since the securities were acquired; or
- after six months have passed since the securities were acquired, the Rule 144(c) current public information condition is met, and the seller is not an affiliate at the time of sale and has not been an affiliate during the three months before the sale; or
- at least one year has passed since the securities were acquired, and the seller is not an affiliate at the time of sale and has not been an affiliate during the three months before the sale.

Similar to the amendment to the Preliminary Note to Rule 144, a note to Rule 145(c) and (d) states that these Rules are not available for any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. The changes to Rule 145 concerning shell companies were made to harmonize Rule 145 with the previously described changes to Rule 144.

Conforming and Other Amendments

With the amendments to Rule 144, the SEC also adopted conforming amendments to Regulation S, Rule 190 and Rule 701.

1. Regulation S Distribution Compliance Period for Category-Three Issuers

The Amendments conform the distribution compliance period in Rule 903(b)(3)(iii) of Regulation S for Category-Three reporting issuers to six months (formerly one year), the same as the new Rule 144 holding period. The SEC noted that there is no reason for the distribution compliance period, which ensures that during an offering and in subsequent after-market trading those relying on Rule 903 are not engaged in an unregistered, non-exempt distribution of securities into the United States, to be longer than the Rule 144 holding period.

2. Underlying Securities in Asset-Backed Securities Transactions and Rule 190

Rule 190 governs whether registration of the sale of underlying assets is required at the time of a registered offering of asset-backed securities. When dealing with underlying securities that are restricted securities under Rule 144, Rule 190 required, in order for the underlying securities not to be registered, that under the provisions of Rule 144(k) at least two years must have elapsed between the date the underlying securities were acquired from the issuer or an affiliate and the date they are pooled and resecuritized pursuant to Rule 190. Rule 144(k) has been eliminated under the amendments; therefore, Rule 190 is being amended to remove the reference to Rule 144(k) and independently set forth the requirement for a two-year holding period.

3. Rule 701(g)(3)

Rule 701(g)(3) outlines the resale limitations for securities issued under Rule 701 pursuant to certain compensatory benefit plans. The limitations for resales by non-affiliates under this rule make reference to Rule 144(e) and (h), which under the Amendments no longer apply to resales by non-affiliates. Accordingly, the SEC conformed the resale restrictions of securities acquired pursuant to employee benefit plans under Rule 701 to remove the references to Rule 144(e) and (h).

Practical Implications of Amendments

The most significant effect of the Amendments will be to reduce the restrictions on the resale of restricted securities, especially the holding period, thereby increasing the liquidity of these securities and decreasing the cost of capital for issuers of restricted securities.

The changes to Rule 144 should, among other things:

- reduce the pricing difference between private placements and registered offerings of similar securities,
- reduce the need for offering registered debt securities in exchange for privately placed debt securities ("Exxon Capital Exchange Offers" or "A / B Exchange Offers")
- reduce the need for registration rights agreements, and
- affect the valuations of the stock consideration issued as a result of a merger or similar transaction with a public company, including PIPE transactions.

Rule 145 will now permit affiliates of a target company who do not become affiliates of the acquiring company to immediately sell or hedge the securities they receive from the acquirer in a Rule 145 transaction without regard to the volume, manner of sale and other restrictions of Rule 145. Those companies involved in business combinations who engage in Rule 145 transactions should consider whether contractual provisions addressing these types of transactions by affiliates of target companies would be appropriate.

The SEC intends to issue a new Staff Legal Bulletin amending SLB 3 in light of the revisions to Rules 144 and 145. This will likely change the language we currently place in information circulars for plans of arrangement done in reliance on Section 3(a)(10) of the Securities Act. We expect the change to be that a shareholder who is an affiliate of a party before the transaction will be free to resell, immediately and without restriction, securities received in the transaction if he or she is not an affiliate of the issuer of the securities received in the transaction.

While the six-month abbreviated holding period in Rule 144 applies only to securities of Exchange Act-registered companies, the resale provision of Rule 144(k) that was reduced to one year from two years will apply to all issuers and hence should apply to most non-U.S. issuers.

Private equity sponsors should be aware that because of the increased liquidity rights of all involved, the sponsor's management team and co-investors, many of whom may not be affiliates of an issuer, may be able to front-run the sponsor in selling securities of the portfolio company post-IPO once the underwriters' lock-up period expires. Contractual post-IPO transfer restrictions might need to be more strictly imposed on management and co-investors to limit this risk.

The amendments will require financial institutions and transfer agents to update their standard Rule 144 documentation. The SEC stated it will not object to the removal of legends from restricted securities held by non-affiliates once all the applicable Rule 144 conditions have been met (a decision within the sole discretion of the issuer). The significant easing of restrictions on sales by non-affiliate holders of restricted securities may cause issuers and broker-dealers to work with transfer agents to streamline the process of removing restrictive Securities

Act legends from security certificates, which may extend to affiliates for sales of debt securities.

Issuers should review the terms of their registration rights agreements to determine if they are still required to maintain the effectiveness of an existing resale shelf registration statement to comply with the terms of a registration rights agreement.

B. SEC Eliminates U.S. GAAP Reconciliation Requirement for Foreign Private Issuers that Adopt International Financial Reporting Standards

The SEC recently adopted rules to permit foreign private issuers that file a Form 20-F to file financial statements using International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") without a reconciliation to U.S. generally accepted accounting principles ("GAAP"). The SEC's rules apply to foreign private issuers that file their annual reports on Form 20-F.

Statement in Notes to Financial Statements

Foreign private issuers that elect to provide IFRS financial statements must state explicitly and unreservedly in the notes to their financial statements that their financial statements are in compliance with IFRS as issued by IASB. Also, the foreign private issuer's independent auditor must provide an unqualified report that opines that the issuer's financial statements comply with IFRS as issued by IASB. Where there is no discrepancy between IFRS as issued by IASB and a jurisdictional variation, issuers may state, and their auditor's report may opine, that the financial statements comply with both IFRS as issued by IASB and the jurisdictional variation. However, the statements concerning compliance with IFRS as issued by the IASB must be unreserved.

Interim-Period Financial Statements

Foreign private issuers may file financial statements for required interim periods without reconciliation to U.S. GAAP if they also prepare their interim financial statements using IFRS as issued by the IASB. These issuers need not provide any disclosure under Article 10 of Regulation S-X (describing the minimum content of financial statements for an interim period) if the interim financial statements fully comply with International Accounting Standard 34, "Interim Financial Reporting" (prescribing the minimum content of an interim financial report and the principles for recognition and measurement in interim period financial statements).

The requirement for interim period financial statements is often triggered by the filing of a registration statement under the Securities Act of 1933. Generally, foreign private issuers must provide unaudited consolidated interim-period financial statements if the registration statement is dated more than nine months after the end of the last audited financial year. These interim-period financial statements must cover at least the first six months of the financial year and the comparative period for the prior financial year.

Foreign private issuers may omit the U.S. GAAP reconciliation from their unaudited interim financial statements only if the annual audited financial statements included or incorporated by reference into the registration statement for all required periods are prepared in accordance with IFRS as issued by IASB. However, the issuer must comply with and explicitly state compliance with IAS 34 for the interim periods.

Selected Financial Data

The SEC revised the instruction to Item 3.A. of Form 20-F to clarify that selected financial data based on the U.S. GAAP reconciliation is required only if the issuer prepares its primary financial statements using a basis of accounting other than IFRS as issued by IASB.

First Time Adopters

During their first year of reporting under IFRS as issued by IASB, foreign private issuers may file two years rather than three years of income statements, changes in shareholders' equity, cash flows and balance sheets.

Multijurisdictional Disclosure System

The Multijurisdictional Disclosure System ("MJDS") permits eligible Canadian issuers to use their disclosure documents prepared in accordance with Canadian requirements in filings with the SEC. While not all filings under the MJDS must contain a U.S. GAAP reconciliation, registration statements and annual reports on Form 40-F and registration statements on Form F-10 generally require a U.S. GAAP reconciliation.

Canadian foreign private issuers eligible for MJDS may file financial statements prepared in accordance with IFRS as issued by IASB without a U.S. GAAP reconciliation. However, Canadian accounting standards are not expected to allow the use of IFRS as issued by the IASB as the basis of accounting for Canadian public issuers until 2011.

European Union—IAS 39—Two-Year Transition Period

Issuers listed in the European Union (the "EU") are already required to prepare their financial statements using IFRS as adopted by the EU. Currently, the only difference between IASB IFRS and EU IFRS relates to International Accounting Standard 39, "Financial Instruments: Recognition and Measurement" ("IAS 39"). EU IFRS offers greater flexibility concerning hedge accounting for certain financial instruments than does IASB IFRS. The SEC provided an accommodation to existing SEC issuers from the EU that have already used the IAS 39 "carve out" in financial statements previously filed with the SEC. For the first two financial years that end after November 15, 2007, the SEC will accept these issuers' financial statements (without a U.S. GAAP reconciliation) provided their financial statements otherwise comply with IASB IFRS and contain a reconciliation to IASB IFRS.

Disclosure from Oil and Gas Companies

The SEC amended Item 18 of Form 20-F to expressly require any issuer that provides disclosure under Financial Accounting Standards Board Statement No. 69, "Disclosures about Oil and Gas Producing Activities," to continue to provide that disclosure even if the issuer is preparing financial statements in accordance with IFRS as issued by IASB without a reconciliation to U.S. GAAP.

Regulation S-X

Regulation S-X contains the form and content requirements for financial statements in SEC filings, along with many provisions that do not relate to U.S. GAAP, such as requirements for auditor qualifications and independence. Regulation S-X will continue to apply to the filings of all foreign private issuers, but foreign private issuers that file financial statements prepared under IFRS as issued by the IASB should comply with IASB requirements for form and content within the financial statements. This effectively strips out the GAAP requirements but leaves in the other requirements, including those for auditing issuers.

Form 20-F was amended to clarify that if the financial statements of a foreign acquired business or investee under Rule 3-05 or 3-09 of Regulation S-X are prepared under IFRS as issued by the IASB, they do not need a U.S. GAAP reconciliation regardless of the significance of the entity. The SEC will accept the condensed consolidating financial information of guaranteed securities and guarantors under Rule 3-10 of Regulation S-X without a U.S. GAAP reconciliation if the financial information is prepared under IFRS as issued by the IASB.

Article 11 of Regulation S-X requires issuers to prepare unaudited pro forma financial information that is intended to give effect as if a particular transaction had occurred at the beginning of the financial period. Article 11 will continue to apply. Pro forma financial information continues to be governed by the financial statements of the issuer, as the pro forma information must be presented using the same basis of accounting as the issuer. A foreign private issuer using IFRS as issued by IASB as its basis of accounting need not reconcile its pro forma financial information to U.S. GAAP.

Areas Not Addressed by IFRS

In areas not addressed by IFRS, consistent with IAS 1 and IAS 8, the SEC expects issuers to provide full and transparent disclosure in their financial statements and related disclosure about accounting policies selected and the effects of those policies on the IFRS financial statements. Under IAS 8, issuers using IFRS may also look for guidance from the SEC, including Accounting Series Releases, Financial Reporting Releases, Staff Accounting Bulletins and Industry Guides.

Implications of the SEC's New Rules

The use of IFRS by foreign private issuers removes a significant regulatory impediment for foreign private issuers, facilitating their ability to access the U.S. capital markets. These rules are intended as a major step toward the goal of creating a single set of globally accepted accounting standards and the convergence of IFRS and U.S. GAAP. The SEC has issued a separate concept release, which considers whether U.S. domestic issuers should also be allowed to use IFRS, and it may allow U.S. domestic issuers to use IFRS in the near future.

Effective Dates

The SEC's rules apply to annual financial statements for fiscal years ending after November 15, 2007, and to interim periods within those years that are contained in SEC filings made after March 4, 2008.

C. Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3

The SEC recently amended the eligibility criteria for using Forms S-3 and F-3 for registered securities offerings. These forms enable U.S. and non-U.S. issuers to register primary securities offerings (i.e., offerings by issuers), including shelf offerings, without regard to the size of their public floats or the ratings of their debt.[3] The new conditions are effective now.

Form S-3 and Form F-3 are the "short forms" that permit incorporation by reference, i.e., incorporating certain information from past and future filings made by the issuer under the Securities Exchange Act of 1934 (the "Securities Exchange Act"), instead of printing the information into the registration statement. By permitting "forward" incorporation by reference (i.e., incorporating later filed information), Forms S-3 and F-3 enable companies to conduct continuous primary offerings for up to three years "off the shelf" under Rule 415 under the Securities Act of 1933 (the "Securities Act"). Once a shelf registration statement is declared effective by the SEC, shelf offerings generally are not subject to further SEC staff review. This can reduce or even eliminate the delay and costs associated with preparing and filing post-effective amendments to a registration statement. An issuer's ability to take securities off the shelf as needed gives it a significant financing alternative to other widely available methods, such as private placements sold at a discount for illiquidity or "private investments in public equity" ("PIPES").

Formerly, a company was able to register its cash offerings on Form S-3 or F-3 only if its "public float" was $75 million or more.[4] Now, the new General Instruction I.B.6. to Form S-3, and the new General Instruction I.B.5. to Form F-3 permit the use of Forms S-3 and F-3 by an issuer with less than a $75 million public float to register offerings of its securities if it:

- has been subject to the reporting requirements of Section 12 or 15(d) of the Securities Exchange Act, and has filed all material required to be filed with the SEC for a period of at least 12 calendar months immediately preceding the filing of the registration statements on Form S-3 and Form F-3;
- has filed in a timely manner most reports required to be filed, other than certain Form 8-K filings, during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement;
- has a class of common equity securities that is listed and registered on a national securities exchange;
- has not sold more than one-third of its public float in primary offerings under Form S-3 or F-3 over the previous 12 calendar months;[5] and
- has not been a shell company for at least 12 calendar months before filing the registration statement.[6]

Additionally, to use Form F-3, an issuer must be a foreign private issuer that has filed at least one annual report on Form 20-F (or 40-F).

To ascertain the amount of securities that may be sold under Form S-3 by issuers with a public float below $75 million, the new rule requires a two-step process:

- determining the issuer's public float immediately before the intended sale; and
- aggregating all sales of the issuer's equity and debt[7] securities that were primary offerings under General Instruction I.B.6. during the previous 12-month period, including the intended sale, to determine whether the one-third cap would be exceeded.

Issuers must compute their public float using the price at which their common equity was last sold, or the average of the bid and asked prices of their common equity, in the principal market for the common equity as of a date within 60 days before the date of sale. Then, to calculate the aggregate market value of securities sold during the preceding 12 calendar months, issuers must add together the gross sales price (of debt or equity) for all primary offerings under General Instruction I.B.6. during the preceding 12 calendar months. Based on that calculation, an issuer may sell securities with a value up to, but not greater than, the difference between one-third of its public float and the value of securities sold in primary offerings under General Instruction I.B.6. in the prior 12 calendar months.

If an issuer's public float increases to a level that equals or exceeds $75 million after its Form S-3 or F-3 becomes effective, the one-third cap is lifted and additional sales may be made without numerical restraints. In that case, under Rule 401 under the Securities Act, issuers must also re-compute their public float each time an amendment to the Form S-3 is filed to update the registration statement as required by Section 10(a)(3) of the Securities Act. If the issuer's public float as of the date of the filing of the annual report falls back to less than $75 million, the one-third cap will be re-imposed for all later sales made under General Instruction I.B.6., and will remain in place until the issuer's float equals or exceeds $75 million again.

For securities that are convertible into or exercisable for equity shares, such as convertible debt or warrants, issuers must calculate the amount of securities they may sell in any period of 12 calendar months, based on the aggregate market value of the underlying equity shares in lieu of the market value of the convertible securities. The aggregate market value of the underlying equity shares will be based on the maximum number of shares into which the securities sold in the prior 12 calendar months are convertible as of a date within 60 days before the date of sale, multiplied by the same per share market price of the issuer's equity used for purposes of calculating its public float under Instruction 1 to new General Instruction I.B.6. of Form S-3.

D. Smaller Reporting Company Regulatory Relief and Simplification

The SEC recently amended its rules to simplify its reporting requirements for smaller companies by replacing its current "small business issuer" category with a new broader category of "smaller reporting companies." Companies with less than $75 million in public equity float or, if the float cannot be calculated, having revenues less than $50 million, now qualify for the simplified disclosure. Smaller reporting companies are now also given disclosure options for various disclosure categories, and can choose to be less or more expansive as they wish. All foreign companies that fit the new definition, use a U.S. issuer reporting form and elect U.S. GAAP can also take advantage of the new regime.

These rules (1) expand the number of smaller companies that qualify to use scaled disclosure requirements by creating a new definition in Regulation S-K for "smaller reporting company"; (2) streamline the scaled disclosure process for smaller companies by integrating the majority of the Regulation S-B item requirements into Regulation S-K and Regulation S-X and eliminate the forms for Regulation S-B; and (3) combine the category of "small business issuers" with the category of "non-accelerated filers" to reduce unnecessary complexity in the SEC's regulations. Last, the amendments eliminate the transitional small business issuer format.

I. New Definition of "Smaller Reporting Company"

These amendments are intended to expand the group of companies that qualify to use the scaled disclosure requirements. The SEC has stated that the new definition of smaller reporting company will allow approximately 1,500 additional companies to qualify for the scaled disclosure requirements. The amendments create a new definition for "smaller reporting companies" that are eligible to use the scaled disclosure requirements, which combines the definition of "small business issuer" under Regulation S-B with the category of "non-accelerated filer." Formerly, a company qualified as a small business issuer if both its public / private equity float and annual revenues were less than $25 million.

A smaller reporting company is defined in Rule 405 under the Securities Act as a company that is not an investment company, an asset-backed issuer, or a majority-owned subsidiary of a parent that is not a smaller reporting company, and that

- had a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter;[8] *or*
- in the case of an initial registration statement under the Securities Act or Exchange Act for shares of its common equity, had a public float of less than $75 million as of a date within 30 days of the date of the filing of the registration statement; *or*
- in the case of an issuer whose public float was zero, had annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available.

The determination dates and calculations for whether a company qualifies as a smaller reporting company depend on whether the company is a reporting company, a non-reporting company that is filing an initial registration statement, or a company that is unable to calculate its public float. A reporting company will determine its public float by using the price at which the shares of its equity were last sold or the average of the bid and asked prices of the shares in the principal market for the shares as of the last business day of the company's second fiscal quarter, and multiplying that price by the number of outstanding shares held by non-affiliates. A non-reporting company that is filing an initial registration statement will determine if its public float is less than $75 million by adding the number of shares of common stock outstanding that are held by non-affiliates before the offering to the number of shares of common stock to be sold at the estimated offering price, and multiplying this sum by the estimated offering price per share when the registration statement is filed. A company that is unable to calculate its public float will simply have to show it has annual revenues less than $50 million during the last fiscal year before filing the registration statement.

Non-U.S. companies in addition to Canadian companies will now also be able to qualify as smaller reporting companies. The new definition of smaller reporting company will be expanded to include non-U.S. companies that are eligible to file on U.S. company forms permitting disclosure based on smaller reporting company standards, like Forms S-1, S-3, S-4, 10-Q, and 10-K. However, to qualify for scaled disclosure, the non-U.S. companies must provide the financial data on their forms in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"). Formerly, Canadian companies were the only non-U.S. companies eligible for scaled disclosure and the eligible Canadian companies were able to provide Canadian GAAP data that was reconciled to U.S. GAAP. However, now they can only use U.S. GAAP for scaled disclosure.

II. Integrating Regulation S-B into Regulations S-K and S-X

The amendments move 12 non-financial scaled disclosure item requirements from Regulation S-B into Regulation S-K and the scaled requirements will be available only for smaller reporting companies.[9] The other 24 item requirements in Regulation S-B are substantially similar to the corresponding item requirements in Regulation S-K, and therefore, will not be amended in Regulation S-K. Item 310 of Regulation S-B (concerning financial statements) will be added as a new Article 8 in Regulation S-X. By moving the financial statement rules for smaller reporting companies into a new Article 8 in Regulation S-X, the amendments will require smaller reporting companies to provide two years of balance sheet data instead of one year as was required under Regulation S-B. Under the amendments, smaller reporting companies are permitted to elect on a quarterly basis to comply with scaled financial and non-financial disclosure or provide the larger company financial statement presentation on an item-by-item or "à la carte" basis. Therefore, smaller reporting companies can choose to provide the scaled financial statement requirements or the larger company financial statement requirements on an item-by-item basis. The amendments also eliminate the SEC's "SB" forms, but allow a phase-out period for small business issuers transitioning to smaller reporting company status.

The amendments also make other minor adjustments, such as technical and language changes to the rules concerning the form and content of financial statements for smaller public companies. To help smaller companies, an index will be added to the beginning of Regulation S-K, which will outline the scaled disclosure requirements that are available to smaller companies.

III. Effective Dates

Companies that were small business issuers as of February 4, 2008 can use Form 10-KSB or Form 10-B when filing their next annual report for a fiscal year ending on or after December 15, 2007. However, after the small business issuer files its next annual report, the company's later periodic reports cannot be filed on forms with the "SB" designation. While most of the amendments were effective as of February 4, 2008, Form 10-QSB will be phased out as of October 31, 2008, and Regulation S-B and Form 10-KSB will be phased out as of March 15, 2009.

Endnotes

1. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa.
2. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-77mm.
3. *See* Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 & F-3, Release No. 33-8878, 72 FR 73534-01, (December 19, 2007), *available at* http://www.sec.gov/rules/final/2007/33-8878.pdf.
4. A company's public float is the aggregate market value of its voting and non-voting common equity held by non-affiliates of the company. An affiliate of, or person "affiliated" with a specified person, is a person who directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.
5. The SEC adopted a corresponding amendment to Rule 401(g) under the Securities Act to provide that violations of the one-third cap would also violate the requirements as to proper form under Rule 401, even though the registration statement previously had been declared effective. The one-third cap imposed by new General Instruction I.B.6. to Form S-3 only relates to other primary offerings conducted pursuant to General Instruction I.B.6. Accordingly, an issuer that is temporarily prevented from using Form S-3 for shelf offerings to raise capital would not be foreclosed from registering a primary offering of securities on Form S-1 or in private placements.
6. Shell companies are prohibited from registering securities in primary offerings on Form S-3 or Form F-3 unless they meet the minimum $75 million float threshold of General Instruction I.B.1. to Form S-3. Rule 405 under the Securities Act defines a "shell company" as a issuer, other than an asset-backed issuer, that has (a) no or nominal operations and (b) either, (a) no or nominal assets, (b) assets consisting solely of cash and cash equivalents, or (c) assets consisting of any amount of cash and cash equivalents and nominal other assets. This prohibition also applies to "blank check companies" as defined in Rule 419 of the Securities Act.
7. As adopted, the method of calculating the one-third cap on sales is the same whether the issuer is selling equity or debt securities, or a combination of both. Therefore, eligible issuers will also be able to offer non-investment grade debt on Form S-3.
8. *See* note 4, *supra*.
9. The 12 scaled item requirements are: (1) Description of Business (Item 101); (2) Market Price of and Dividends on Registrant's Common Equity and Related Stockholder Matters (Item 201); (3) Selected Financial Data (Item 301); (4) Supplementary Financial Information (Item 302); (5) Management's Discussion and Analysis of Financial Condition and Results of Operations (Item 303); (6) Quantitative and Qualitative Disclosures about Market Risk (Item 305); (7) Executive Compensation (Item 402); (8) Transactions with Related Persons, Promoters and Certain Control Persons (Item 404); (9) Corporate Governance (Item 407); (10) Prospectus Summary, Risk Factors, and Ratio of Earnings to Fixed Charges (Item 503); (11) Use of Proceeds (Item 504); and (12) Exhibits (Item 601).

Guy P. Lander is a partner with Carter Ledyard & Milburn LLP in New York City and a past Chair of the Business Law Section of the New York State Bar Association. He practices in the areas of corporate and securities law for international and domestic companies and financial institutions, with particular emphasis on U.S. and international public and private offerings, Rule 144A placements, and cross border transactions. A frequent contributor to the *Journal*, Mr. Lander has published extensively, and is the author of the treatise "U.S. Securities Law for International Financial Transactions and Capital Markets" published by the West Group. Stephen V. Burger is a partner, and G. Christina Gray-Trefry and Aaron Salsberg are associates, of Carter Ledyard & Milburn LLP in New York City, focusing on corporate and securities law matters. Angelo Kramvis is a former associate of Carter Ledyard & Milburn LLP.

When Exceptions Swallow the Rule: The Growing Demise of the "No-Contact" Rule

By C. Evan Stewart

The concept of the "slippery slope" is one with which every lawyer (indeed, every first-year law student) is familiar.[1] In one part of the attorneys' code of professional responsibility—the "no-contact" rule, embodied by ABA Model Rule 4.2—the slope has gotten pretty slippery indeed.

The Model Rule

Under Rule 4.2, "a lawyer shall not communicate . . . with a person the lawyer knows to be represented by another lawyer in the matter."[2] This rule, which many (but not all) states have adopted in whole or in part, was clarified in 1995, when the word "person" was substituted for "party" so as to ensure that the *ex parte* ban covered, *inter alia*, pre-litigation contexts.

The basic policies implicated by the "no-contact" rule are numerous. Principal among them is the need to protect communications and information covered by the attorney-client privilege and work product doctrine, as well as a desire to protect unknowledgeable people from unscrupulous lawyers.[3]

The Slippery Slope Begins

The "no-contact" rule was once fairly unremarkable, and not much litigated, until the New York Court of Appeals decided *Niesig v. Team I*.[4] In *Niesig*, the Court held that a lawyer representing an injured worker suing his company could interview, *ex parte*, employees of the company.[5] New York's "no-contact" rule, DR 7-104(A)(1), was held to apply to only those current employees "whose acts or omissions in the matter under inquiry are binding on the corporation (in effect, the corporation's 'alter egos') or imputed to the corporation for purpose of its liability, or employees implementing the advice of counsel."[6] Believing that the "alter ego" test it created would "become relatively clear in application,"[7] the Court concluded that its ruling would further the "informal discovery of information" and "serve both the litigants and the entire justice system by uncovering relevant facts, thus promoting the expeditious resolution of disputes."[8]

In adopting its definition of what constitutes a party for purposes of DR 7-104(A)(1),[9] the Court considered and rejected not only a standard based upon that which had been determined by the U.S. Supreme Court in *U.S. v. Upjohn* (where each corporate employee was deemed to be a client for purposes of the attorney-client privilege),[10] but also a "control group" test (i.e., only those who "control" a company may not be contacted) because of "practical and theoretical problems."[11] With respect to the *Upjohn* decision, the New York Court of Appeals determined that the attorney-client privilege was "an entirely different subject" from the "no-contact rule," and that "a corporate employee who may be a 'client' for purposes of the attorney-client privilege is not necessarily a 'party' for purposes of DR 7-104(A)(1)."[12]

Paradise Starting to Get Lost

Right off the bat, the *Niesig* decision created a number of problems / issues. The first concerns the risk of disqualification or professional sanction / discipline. How will an attorney who wishes to interview a current employee know whether he or she is an "alter ego" employee? As one California court that has faced this issue put it, an attorney would have to make a "unilateral decision . . . based upon *expectations or predictions*."[13]

An obvious illustration of this quandary is posed by the hearsay exception set forth in Rule 801(d)(2)(D) of the Federal Rules of Evidence. A statement is not hearsay if it is "offered against a party and is . . . a statement by his agent or servant concerning a matter within the scope of his agency or employment, made during the existence of the relationship."[14] Before an interview, however, an attorney will have some (or great) difficulty in knowing whether an employee's knowledge of relevant facts comes from outside the scope of his or her employment.

The *Niesig* Court brushed this concern aside because the hearsay rule in New York is different from Rule 801(d)(2)(D). Under New York's evidentiary rule, few employees are in a position to bind their companies by their statements.[15] Even assuming the correctness of that analysis, however, what about jurisdictions which do not have an evidentiary rule similar to New York's, but which nonetheless choose to follow the *Niesig* holding,[16] or a New York federal court sitting in diversity—seeking to apply *Niesig*'s substantive rule, while being bound to apply the Federal Rules of Evidence?[17]

Another concern relates to whether the "alter ego" test is in fact "relatively clear in application" (as the New York Court of Appeals prophesied) or whether it leads to another procedural / litigation layer, with lawyers uncertain on how best to proceed. One look at the federal courts in New Jersey would suggest a not-so-sanguine answer.[18] And that disparate treatment / confusion is only a tip of the iceberg as to the satellite litigation that has been spawned in this area.[19]

The *Niesig* decision also represents the diminishment of the attorney-client privilege. Notwithstanding the New York Court of Appeals' declaring that the privilege has nothing whatever to do with the "no-contact" rule, just saying so does not make it so.[20] As the U.S. Supreme Court made clear in *Upjohn*, "the privilege exists to protect not only the giving of information to the lawyer to enable him to give sound and informed advice."[21] Accordingly, to be consistent with *Upjohn*, an employee who is a "client" for privilege purposes (i.e., one who gives information and receives advice) should also be a "party" for purposes of the "no-contact" rule.[22]

Finally, how does one reconcile the policy of protecting unknowledgeable people from unscrupulous lawyers with the policy embraced by the Court of Appeals—the "informal discovery of information"? Clearly, New York's highest court placed the latter policy on a higher plane. The *Niesig* Court in fact seemed to believe that the facts are the facts, regardless of whether one gets them pre- or post-horse-shed preparation by the opposing side's lawyer.[23] Of course, if that were true then lawyers would see no tactical advantage in seeking out *ex parte* interviews, but would instead merely await depositions. As they say in Latin, *res ipsa loquitur*.

Oops, They Did It Again

Some commentators (not me, of course) believe that *Niesig* draws "a sensible line" between who can and cannot be contacted *ex parte*.[24] But even they could not have predicted how far the New York Court of Appeals would take its "relatively clear" standard and its "informal discovery" policy.

In *Muriel Siebert & Co. v. Intuit Inc.*,[25] a business alliance between the brokerage firm (Siebert) and the financial software maker (Intuit) went south. That led to Siebert suing Intuit for, *inter alia*, breach of contract and breach of fiduciary duty.[26]

The COO of Siebert was a key participant in the Intuit alliance, and (by the Court of Appeals' own recognition) he was also a key member of Siebert's "litigation team" once the Intuit litigation had been instituted (i.e., a Siebert "alter ego" and part of its "litigation control group").[27] Eventually, however, the COO had a falling out from the company and he was terminated.[28]

Immediately after hearing of the COO's termination, Intuit's lawyers contacted him and thereafter interviewed him *ex parte*.[29] Once Siebert's lawyers learned of the *ex parte* interview, they moved to disqualify Inuit's lawyers and to bar Intuit from using any of the information gleaned from the interview.[30]

The trial court granted the motion, disqualified Intuit's lawyer, ordered the destruction of any and all interview notes, and barred the disqualified lawyers from passing on any tainted information to Intuit's new lawyers.[31] The court did not base its decision upon DR 7-104(A)(1), however, on the ground that the COO was a former employee; instead, it disqualified Intuit's lawyers citing the "appearance of impropriety" standard.[32]

The Appellate Division reversed that ruling. It did so because: (i) it believed *Niesig* had made "it clear that *ex parte* interviews of an adversary's former employees are neither unethical nor legally prohibited"; and (ii) Intuit's lawyers had cautioned the ex-Siebert COO not to disclose privileged information (and it appeared that that advice had been followed).[33]

On appeal to the New York Court of Appeals, the Court affirmed the Appellate Division.[34] Notwithstanding the fact that the COO had indisputably been a Siebert "alter ego" for purposes of the *Niesig* test, the Court reasoned that because he no longer was an employee at the time of the *ex parte* interview, that meant Intuit's lawyers had done nothing improper.[35] And because the lawyers had been careful not to elicit privileged information from the ex-COO, the interview had merely served to facilitate the Court's policy goals of furthering the "informal discovery of information," and there were thus no grounds to disqualify them.[36]

While the *Siebert* Court's decision is in line with ABA Model Rule 4.2 and a number of jurisdictions—i.e., the *ex parte* rule only applies to current employees— that is not the consensus view throughout the United States, especially as to ex-employees who had been in the "litigation control group."[37] Beyond being careful (and knowledgeable) as to the jurisdictions in which one undertakes to contact ex-employees, what other lessons can be gleaned from *Siebert*?

Obviously, if you are the *ex parte* inquiring lawyer you must be very clear and explicit in giving privilege warnings to the ex-employee. As for companies facing such scenarios, it further reinforces the employment leverage that key managerial individuals have during the pendency of important litigation—i.e., in the words of Don Corleone, it is better to keep your friends close, but your enemies closer. Alternatively, companies may want to consider having an ongoing legal representation provision as part of their termination agreements; presumably, key ex-employees would be happy to have their former employers pay the freight of legal representation, in exchange for not agreeing to sit for *ex parte* interviews with the opposition.[38]

Good Things Come in Threes?

Just months after *Siebert*, the New York Court of Appeals decided to go itself one better. In *Arons v. Jutkowitz*,[39] the Court held that defense lawyers in a medical malpractice action could conduct *ex parte* interviews with the plaintiff's doctor.[40] The Court also ruled that any attorney work product generated in conjunction with the *ex parte* interviews was immune from discovery.[41]

While much of the decision wallows in medical minutiae mandated by the Health Insurance Portability and Accountability Act of 1996,[42] the Court's decision is, at bottom, a further refinement / extension of *Niesig*. After recounting its prior rulings in *Niesig* and *Siebert*, the Court determined that there was no reason why there should not be informal discovery (i.e., *ex parte* interviews) of non-party treating physicians as well.[43] To the concern that doctors may be "gulled into making an improper disclosure," the Court was completely blasé, having previously rejected such a concern for corporate employees (*Niesig*) and a former corporate executive (*Siebert*).[44]

Whether the *Arons* decision is going "to open a small floodgate of attempts by insurance companies and defense lawyers to privately approach treating physicians without the knowledge or permission of the patients and take statements without their counsel" remains to be seen.[45] What we do know, however, is that the exceptions in New York to the "no-contact" rule seem to be getting bigger and bigger and bigger.[46] And that is not even the end of it!

Dirty Tricks

In *Gidatex v. Campaniello Imports, Ltd.*,[47] the plaintiff's lawyer in a trademark infringement case sent undercover investigators into the defendant's furniture showroom in order to prove that the defendant had engaged in "bait and switch" tactics.[48] The investigators surreptitiously taped their discussions with the defendant's employees, and the plaintiff's lawyer then sought to introduce the tapes at trial to impute liability to the defendant.[49] The defendant moved to preclude the tapes on the ground that a lawyer cannot send a non-lawyer to do that which a lawyer is ethically barred from doing (i.e., be deceptive, violate the "no-contact" rule, etc.).[50]

The *Gidatex* court, liberally citing *Niesig*'s non "bright-line rule" and a New Jersey decision which applied *Niesig* in a similar situation,[51] ruled that the tapes were admissible.[52] Although the trial judge determined that plaintiff's counsel had "technically" run afoul of applicable ethics rules, she ruled he did not substantively violate those rules "because his actions simply do not represent the type of conduct prohibited by the rules."[53] This seeming nonsequitur was justified / explained by the fact that the investigators did not engage in an interrogation of the defendant's employees, but instead "merely" recorded the employees' ordinary business pattern.[54]

Gidatex has been rejected by subsequent courts,[55] and has been criticized by ethics gurus,[56] but it recently got a big shot in the arm from the New York County Lawyers' Association's Committee on Professional Ethics. On May 23, 2007, the Committee issued Formal Opinion 737, which endorsed an ethical safe harbor for lawyers who employ "dissemblance" in the evidence-gathering process. Adopting the *Gidatex* model for ethically permissible behavior, the Committee's Opinion expressly stands for the proposition that—in the Association's view—there should be formal exceptions to the broad admonition against lawyers engaging in "dishonesty, fraud, deceit, or misrepresentation."[57]

Conclusions

Whether lawyers should take much comfort (let alone act upon) the New York County Lawyers' Association's Opinion is open to robust debate. But it does demonstrate just how far the law (and sentiment) have moved since the *Niesig* Court handed down its "relatively clear" decision endorsing "informal discovery" 18 years ago. If in fact "informal discovery" is so important, maybe the "no-contact" rule should be scrapped altogether? Given how much of it has been eviscerated to date, we might not have too far to go.

Endnotes

1. To my surprise, it turns out that there are a number of learned treatises on the "slippery slope." *See, e.g.*, F. Schaver, *Slippery Slopes*, 99 Harv. L. Rev. 360 (1985); E. Lode, *Slippery Slope Arguments and Legal Reasoning*, 87 Cal. L. Rev. 1469 (1999); E. Volkh, *Mechanism of the Slippery Slope*, 116 Harv. L. Rev. 1026 (2003); M. Rizzo & G. Whitman, *The Camel's Nose is in the Tent: Rules, Theories and Slippery Slopes*, 51 U.C.L.A. L. Rev. 539 (2003).
2. Model Rules of Prof'l Conduct R. 4.2 (1995).
3. *See Blanchard v. Edgemark Fin. Corp.*, 175 F.R.D. 293, 302, n.10 (N.D. Ill. 1997); *Candler v. Md.*, 910 F. Supp. 1115, 1119–20 (D. Md. 1996); *see also* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 396 (1995); S. Miller & A. Cairo, *Ex Parte Contact with Employees and Former Employees of a Corporate Adversary: Is It Ethical?* 42 Bus. Law. 1053, 1054–55, 1060–65, 1071 (1987).
4. 76 N.Y. 2d 363, 559 N.Y.S.2d 493 (1990).
5. *Id.* at 376, 559 N.Y.S.2d at 499.
6. *Id.* at 374, 559 N.Y.S.2d at 498.
7. *Id.* at 375, 559 N.Y.S.2d at 499.
8. *Id.* at 372, 559 N.Y.S.2d at 497.
9. Unlike the ABA's Model Rule 4.2, New York's DR 7-104(A)(1) has always applied to a "party," as opposed to a "person."
10. 449 U.S. 383 (1981). In *Upjohn*, the Supreme Court recognized that "[m]iddle-level—and indeed lower-level—employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that their employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties." *Id.* at 391.
11. The *Upjohn* Court had also rejected the "control group" test. At present, at least four states (Arizona, Kansas, Idaho, and Illinois) employ this test.
12. *Niesig*, 76 N.Y.2d at 371–72, 559 N.Y.S.2d 497.
13. *Mills Land & Water Co. v. Golden West Ref. Co.*, 230 Cal Rpt. 461, 468 (1986).
14. Fed. R. Evid. 801(d)(2)(D).

15. *Niesig*, 76 N.Y.2d at 374, 559 N.Y.S.2d at 498. More than a decade before, this issue had been flagged by the Committee on Professional Ethics of the Association of the Bar of the City of New York. *See* Assoc. of the Bar of the City of N.Y., Comm. on Prof'l Ethics, Inquiry Reference No. 46 (1980).

16. *See, e.g.*, *Messing, Rudavsky & Weliky v. President & Fellows of Harvard Coll.*, 764 N.E.2d 825 (Mass. 2002); *Stranser v. Exxon Co. U.S.A.*, 843 P.2d 613 (Wyo. 1992); *Dent v. Kaufman*, 406 S.E.2d 68 (W. Va. 1991).

17. Once having allowed the interviews, the New York federal court would also have to allow into evidence any statements made by the employee within the scope of his or her employment, pursuant to Rule 801(d)(2)(D). *See Gidatex v. Campaniello Imp., Ltd.*, 82 F. Supp. 2d 119 (S.D.N.Y. 1999) (*see infra* notes 24–26 and accompanying text). If, on the other hand, the court were to look to ABA Model Rule 4.2, it could conclude that the company is protected—not only as to those who could be interviewed, but with respect to evidentiary exposure as well. *See Polycast Tech. Corp. v. Uniroyal, Inc.*, 129 F.R.D. 621 (S.D.N.Y. 1990).

18. *Compare Pub. Serv. Elec. & Gas Co. v. Assoc. Elec. & Gas Ins. Serv. Ltd.*, 745 F. Supp. 1037 (D.N.J. 1990) (*ex parte* barring communication with present or former employees) *with Curley v. Cumberland Farms Inc.*, 134 F.R.D. 77 (D.N.J. 1990) (allowing *ex parte* communications with former employees, unless they played a central role in the controversy in dispute), *with In re Prudential Ins. Co. of America Sales Practices Litig.*, 911 F. Supp. 148 (D.N.J. 1995) (allowing *ex parte* communications with former employees, except for those in the company's "control group"), *and with Andrews v. Goodyear Tire & Rubber Co. Inc.*, 191 F.R.D. 59 (D.N.J. 2000) (allowing *ex parte* communications with former employees, except for those in the company's "litigation control group").

19. *Compare Orlowski v. Dominick's Finer Foods Inc.* 937 F. Supp. 723 (N.D. Id. 1996); *Valasses v. Samuelson*, 143 F.R.D. 118 (E.D. Mich. 1992); *Dubois v. Gradco Sys. Inc.*, 136 F.R.D. 341 (D. Conn. 1991) *with Armsey v. Medshores Mgmt. Serv. Inc.*, 184 F.R.D. 569 (W.D. Va. 1998); *Lang v. Reedy Creek Improvement Dist.*, 888 F. Supp. 1143 (M.D. Fla. 1995); *Midwest Motor Sports, Inc. v. Arctic Cat Sales, Inc.*, 144 F. Supp. 2d 1147 (D.S.D. 2001); *Palmer v. Pioneer Inn Assoc., Ltd.*, 59 P.3d 1237 (Nev. 2002), U.S.L.W. (BNA) 1411 (Jan. 14, 2003).

20. During that same period, the New York Court of Appeals showed varying degrees of solicitude for the attorney-client privilege. *Compare Rossi v. Blue Cross & Blue Shield*, 73 N.Y.2d 588, 524 N.Y.S.2d 508 (1989) *with Hopes v. Carota*, 74 N.Y.2d 716, 544 N.Y.S.2d 808 (1989).

21. *Upjohn*, 449 U.S. at 390.

22. *See* Geoffrey C. Hazard & W. William Hodes, Law of Lawyering 437 (1985) (an employee covered by the privilege, as per *Upjohn*, should be considered a "party" under the ethical rules). Indeed, the *Niesig* court's client / party dichotomy does not stand up to scrutiny because the status, knowledge, and / or responsibility of an employee should be irrelevant for purposes of whether an *ex parte* contact is permissible. An employee who can bind the company may be just as much in possession of underlying facts as one who cannot. Moreover, if "uncovering relevant facts" is the uppermost policy goal, should there be any difference as to which type of employees may invoke this protection? Finally, as indicated above, the policies served by the privilege and the "no contact" rule are, in fact, aligned.

23. For a cautionary tale on the importance of proper horse-shedding, see *Redvanly v. NYNEX Corp.*, 152 F.R.D. 460 (S.D.N.Y. 1993). *See also* C.E. Stewart, *Corporate Counsel and Attorney Work Product*, N.Y.L.J., Nov. 8, 1993.

24. John K. Villa, Corporate Counsel Guidelines § 3.23, 3-146 (2007). *See also* R. Zitrin and C. Langford, Legal Ethics in the Practice of Law 157-61 (1995).

25. 8 N.Y.3d 506, 836 N.Y.S.2d 527 (2007).

26. *Id.* at 509, 836 N.Y.S.2d 528.

27. *Id.*

28. *Id.* at 510, 836 N.Y.S.2d 528.

29. *Id.*

30. *Id.* at 510, 836 N.Y.S.2d 529.

31. *Id.*

32. *Id.*

33. *Id. See* 820 N.Y.S.2d 54 (1st Dep't 2006).

34. *Siebert*, 8 N.Y.3d at 512, 836 N.Y.S.2d at 530.

35. *Id.* at 511, 836 N.Y.S.2d at 530.

36. *Id.* at 512, 836 N.Y.S.2d at 530. *See Merrill v. City of New York*, No. 04 Civ. 1371 2005 WL 2923520, at *1 (S.D.N.Y. Nov. 4, 2005); *Wright v. Stern*, No. 01 Civ. 4437, 02 Civ. 4699, 2003 WL 23095571, at *1 (S.D.N.Y. December 20, 2003); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 359 (1991).

37. *See supra* note 11 and accompanying text. *See also Kaiser v. Am. Tel. & Tel.*, No. Civ. 00-724, 2002 WL 1362054 (D. Ariz. 2002); *Camden v. Md.*, 910 F. Supp. 115 (D. Md. 1996); *Rentclub Inc. v. Transam. Rental Fin. Corp.*, 811 F. Supp. 651 (M.D. Fla. 1992); *Chancellor v. Boeing Co.*, 678 F. Supp. 250 (D. Kan. 1998). *See generally* Sherman L. Cohn, *The Organizational Client: Attorney-Client Privilege and the No-Contact Rule*, 10 Geo. J. Legal Ethics 739 (1997).

38. For such a dual representation to be kosher, it must be in accord with DR 5-105(c) (the "disinterested lawyer" test).

39. 9 N.Y.3d 393, 850 N.Y.S.2d 345 (2007). The *Arons* decision resolved a number of appeals from the lower courts of New York. *See, e.g.*, *Kish v. Graham*, 40 A.D.3d 118, 833 N.Y.S.2d 313 (4th Dep't. 2007) (barring *ex parte* interviews with doctors of opposing party).

40. *Arons*, 9 N.Y.3d at 416, 850 N.Y.S.2d at 357.

41. *Id.*

42. Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-91, 110 Stat. 1936, 1936 (codified as amended in scattered sections of 18, 26, 29, and 42 U.S.C.)

43. *Arons*, 9 N.Y.3d at 409, 850 N.Y.S.2d at 351.

44. *Id.* at 410, 850 N.Y.S.2d at 352.

45. *See* David Harlow, HealthBlawg, http://healthblawg.typepad.com/healthblawg/2007/11/hipaa-goes-dark.html (quoting Eric Turkewitz, N.Y. Personal Injury Law Blog) (last visited April 12, 2008).

46. *See also* "Opinion Explains Which Corporate Insiders Can Be Contacted Without Counsel's Consent," American Bar Ass'n, Bureau of Nat'l Aff., ABA / BNA Lawyer's Manual on Professional Conduct 270 (2007) (Wisconsin St. Bar Op. E-07-01); *Ohio Panel Embraces ABA's Revised Formula for Applying No-Contact Rule to Employees in* ABA / BNA Lawyers' Manual on Professional Conduct 117 (2005) (Ohio Sup. Court Bd. Op. 20005-3). One area in which there is *positive* news is the increased recognition that there can be *ex parte* communications with putative class members prior to a judicial determination of class certification. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 445 (2007); *see also* Philadelphia Bar Op. 2006-6 (2006). *But see Dondore v. NGK Metals Corp.*, Nos. Civ.A. 00-1966, Civ.A. 00-2441, 2001 WL 516635, at *2 (E.D. Pa. 2001) (no pre-class certification contacts allowed). I have previously criticized the *Dondore* decision as being contrary to law and precedent. *See* C. E. Stewart, *Class Action Communications: Ex Parte or Not?* BNA Class Action Litig. Rep. 61 (2002).

47. 82 F. Supp. 2d 119 (S.D.N.Y. 1999).

48. *Id.* at 119.

49. *Id.* at 120–21.

50. *Id.* at 119–20. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 396 (1995); *see also* Model Rules of Prof'l Conduct R. 5.3(c) 8.4(a) (2002). Model Code of Prof'l Responsibility DR 1-102(A)(1), DR 1-102(A)(4) and DR 1-104(D) (1983).

51. *Id.* at 123. *See Apple Corps Ltd., MPC v. Int'l Collectors Soc'y*, 15 F. Supp. 2d 456 (D.N.J. 1998) (misrepresentations by attorneys and their agents where they were used in furtherance of "detect[ing] ongoing violations of the law are not ethically proscribed, especially where it would be difficult to discover the violations by other means").

52. *Gidatex*, 82 F. Supp. 2d at 126.

53. *Id.*

54. *Id.*

55. *See, e.g.*, *Midwest Motor Sports v. Arctic Sales. Inc.*, 347 F.3d 693 (8th Cir. 2003) (attorneys acting exactly as did the lawyers in *Gidatex* were found to have violated applicable professional ethics standards).

56. *See, e.g.*, John K. Villa, *ACCA Docket* 58 (2000); A. Davis, *The Permissible Use of Deceptive Tactics*, N.Y.L.J., July 2, 2007.

57. *See* DR 1-102(A)(4). *See also* Davis, *supra* note 56 (the Committee's Opinion is flawed on numerous grounds, the most important of which is that it is expressly contrary to the maxim that "the ends do not justify the means.")

C. Evan Stewart is a partner in the New York City office of Zuckerman Spaeder LLP, focusing on business and commercial litigation. He has published over 150 articles on various legal topics and is a frequent contributor to the *New York Law Journal* and this publication.

New York Employment Law Update

By James R. Grasso

A. FMLA Leave Expanded to Include Families of Military Personnel

On January 28, 2008, President Bush signed into law the National Defense Authorization Act for Fiscal Year 2008[1] (NDAA), which includes provisions expanding leave rights under the Family and Medical Leave Act[2] (FMLA) for military personnel and their families. The NDAA expands the FMLA in two ways. First, two new leave categories have been created. Eligible employees may now take FMLA leave for "any qualifying exigency" arising from a spouse, child or parent's active-duty military service or call to active duty.[3] The new law also allows eligible employees to take FMLA leave to care for a spouse, child, parent or next of kin injured in the line of duty. ("Next of kin" is a new category of family member under the FMLA and is defined as the "nearest blood relative.")[4] Second, employees taking leave to care for an injured service member are entitled to a total of 26 weeks of leave, rather than the standard 12 weeks of FMLA leave.[5] Employees taking leave for this reason are limited to a total of 26 weeks of leave for all FMLA reasons and may not add an additional 12 weeks of leave for other FMLA reasons.[6] This leave also must be taken in a single 12-month period and is limited to a one-time use.[7] Leave taken for "any qualifying exigency" is limited to 12 weeks.

The United States Department of Labor (DOL) has confirmed that the provisions in the NDAA permitting leave to care for an injured member of the military are effective immediately and that regulations to guide employers are forthcoming. The DOL also stated that it will require employers to act in good faith in providing this type of leave until it issues regulations. The provisions providing leave for "any qualifying exigency" will not be effective until the DOL issues regulations defining that term. Nonetheless, the DOL is encouraging employers to provide this type of leave immediately.

B. New Form I-9 and Handbook Released

All employers are required to complete a Form I-9 for each employee hired in the United States. On November 7, 2007, the U.S. Citizenship and Immigration Services (USCIS) released a revised Form I-9, *Employment Eligibility Verification Form*, for immediate use and a new M-274, *Handbook for Employers, Instructions for Completing the Form I-9*. Employers were required to begin using the new Form I-9 on December 26, 2007. Employers who fail to use the new form will be subject to penalties.

The new Form I-9 removes the following five documents from List A of the List of Acceptable Documents:

- Certificate of U.S. Citizenship (Form N-560 or N-561)
- Certificate of Naturalization (Form N-550 or N-570)
- Alien Registration Receipt Card (I-151)
- Unexpired Reentry Permit (Form I-327)
- Unexpired Refugee Travel Document (Form I-571)

One document was added to List A of the List of Acceptable Documents:

- Unexpired Employment Authorization Document (I-766)

All the Employment Authorization Documents with photographs in circulation are now included as one item on List A. These are:

- I-688, I-688A, I-688B, I-766

The instructions for Section 1 of the I-9 now state that an employee is not obligated to provide a Social Security Number unless he or she is employed by an employer who participates in E-Verify, a web-based employment verification system. This change does not affect the requirement to provide a Social Security Number for W-2 reporting purposes. The I-9 instructions on photocopying and retaining the form now include information about electronic signing and retention.

Employers must use the new form for new hires and employees who require re-verification of work authorization.

C. New York Legislative Update for Employers

The recent months have been busy ones for the New York legislature and former Governor Spitzer as far as New York employers are concerned. Several new laws have been enacted concerning the workplace. Those new laws and what employers need to be aware of regarding them are discussed below.

Expression of Breast Milk in the Workplace

The New York Labor Law was amended by adding a new § 206-c that requires employers, regardless of the number of employees, to provide break time for nursing mothers to express breast milk.[8] The new law took effect August 15, 2007. The law requires employers to provide reasonable unpaid break time or permit an employee to use paid break or meal time each day to express breast milk for up to three years after the birth of a child.[9] The statute also requires employers to make reasonable efforts to provide a room or other location near the work area where an employee can express milk in privacy.[10] Employers are prohibited from discriminating against an employee who exercises her rights under the law.[11]

As the law allows use of meal time or paid breaks, employers can require that employees express breast milk at those times and are not required to provide additional breaks for employees to do so. However, employers that nonetheless provide unpaid breaks must remember that under applicable wage and hours laws any break of less than 20 minutes must be paid. Therefore, to avoid providing an additional paid break, employers may wish to consider requiring any break taken for expressing breast milk, other than at meal time or during a paid break, to be at least 20 minutes long. Employers should consider adopting a policy governing the use of breaks to express breast milk to avoid potential wage violation issues.

Leave to Donate Blood

Effective December 13, 2007, under Labor Law § 202-j employers that employ at least 20 employees at one worksite must allow employees who work an average of at least 20 hours per week to take at least 3 hours of leave in any 12-month period to donate blood.[12] The statute requires employees wishing to take leave to comply with notice requirements to be issued by the Commissioner of Labor.[13] The new law does not state whether the leave must be paid. Employers are prohibited from retaliating against an employee for requesting or using leave to donate blood.[14]

Requirement for Written Sales Commission Agreements

As the result of an amendment to Labor Law § 191(c), effective October 16, 2007, the terms of employment of a commission salesperson must be in writing and signed by the employer and employee.[15] The writing must include a description of how wages, salary, drawing account, commissions, and all other monies earned and payable will be calculated.[16] If the writing provides for a recoverable draw, the frequency of reconciliation must be included.[17] The writing must also include details about the payment of wages, salary, drawing account, commissions, and all other monies earned and payable in case of termination of employment by either party.[18] To encourage compliance, the statute provides that in the absence of a written agreement there will be a presumption the terms of employment asserted by the employee are the actual terms of employment.[19] As a result, if a dispute arises between an employer and a commission salesperson over the terms of employment, in the absence of a written agreement the employee's version of the terms of employment will be presumed to be true.[20] The writing must be kept by the employer for at least three years and be made available to the Commissioner of Labor upon request.[21] As a result of this change, employers who have commission salespersons should prepare and execute written agreements with them as soon as possible.

Protection for Youthful Offender Adjudications and Persons Convicted of Violations

Effective November 1, 2007, § 296(16) of the New York Human Rights Law is amended to prohibit employers from taking any adverse action against an applicant or employee due to a youthful offender adjudication or for conviction of a violation sealed pursuant to the Criminal Procedure Law.[22] Before this amendment, § 296(16) only prohibited employers from taking adverse action for a non-pending arrest that did not result in conviction. As most violations are usually sealed, the practical effect will be to prohibit New York employers from taking adverse action against individuals based on conviction of a violation. However, employers will retain the right to take action based on pending arrests.[23]

Protection for Persons Convicted of Prior Criminal Offenses

As a result of amendments to Article 23-A of the New York Correction Law effective July 18, 2007, current employees are now protected to the same extent as applicants concerning prior criminal convictions.[24] Employers are now prohibited from discriminating against employees, as well as applicants, convicted of a criminal offense where the conviction occurred before employment began, unless there is a direct relationship between the offense and the employee's job, or continuation of employment would involve an unreasonable risk to property or the safety of specific individuals or the general public.[25] The law specifically states that it does not affect an employer's right to take adverse action against an applicant or current employee for an intentional misrepresentation in connection with an application for employment.[26] Thus, New York employers remain free to take adverse action against an applicant or current employee for failing to disclose a prior criminal conviction when requested to do so on an application. Employers may also still take adverse action against current employees for a conviction that occurs during employment.

Monetary Exclusion in Definition of "Clerical and Other Worker" Increased to $900

As of January 14, 2008, the exclusion from the definition of "Clerical and Other Worker" in Labor Law § 190(7) changed from exempt executive, administrative, and professional employees earning in excess of $600 per week to such persons earning in excess of $900 per week.[27] This change has three major effects. First, exempt executive, administrative, and professional employees making less than $900 per week now have to be paid no less frequently than semi-monthly (previously, they could be paid monthly). Second, employers can require direct deposit only for exempt executive, administrative, and professional employees earning more than $900 per week (previously, direct deposit could be required for such employees earning more than $600 per week). Third, exempt executive, administrative, and professional employees earning less than $900 per week may now invoke the Labor Law to recover unpaid wage supplements, including vacation, holiday pay, and bonuses due under the employer's policies. The right to invoke the Labor Law is significant because the Labor Law allows a successful employee to recover attorney's fees and liquidated damages equal to 25% of the wages owed.

Prevailing Wage Law Changes

On August 28, 2007, former Governor Spitzer signed into law a bill that closes a loophole in the prevailing wage law that exempted contracts entered into by a third party on behalf of a public entity from prevailing wage requirements.[28] The new law closes that loophole by specifically providing that the contracts for public work entered into by a third party acting in place of, or on behalf of, a public entity are subject to the law's requirements. The law became effective October 27, 2007 but expires in five years.[29]

The Governor also signed into law a bill that requires contractors and subcontractors to provide laborers, workers, and mechanics on public projects with written notice of the prevailing wage rate for his or her particular job classification on every pay stub.[30] The law also requires that at the start of every public works contract and with the first paycheck after July 1st of each year, contractors and subcontractors must notify all such employees in writing of the contact information for the New York State Department of Labor and of the employee's right to contact the Department if the employee does not receive the proper prevailing wage rate or supplements the employee is entitled to receive under the public works contract.[31] In addition, the law provides for new penalties for failing to comply with these and other notice requirements. The law's effective date is February 24, 2008.

D. NLRB Issues Major Decisions Affecting Employers

The National Labor Relations Board (NLRB) recently issued several decisions of major importance addressing employee use of e-mail, union "salting," the burden of proof in back pay cases, the recognition bar doctrine, the ability of employees to release claims under the National Labor Relations Act (NLRA), and an employer's ability to use illegally obtained evidence to discipline an employee. All of these decisions change or expand existing law in favor of employers. Thus, both unionized and union-free employers in the private sector should take note so that they can properly exercise their rights. A summary of each case and the change it has brought about follows.

NLRB Rules Employees Do Not Have Right to Use Employer's E-mail

The NLRB recently ruled in *The Register-Guard*[32] that employees have no statutory right to use an employer's e-mail system for activities protected under Section 7 of the NLRA.[33] (Section 7 protects an employee's right to support a union and to refrain from doing so.) The NLRB also established a new standard for determining when an employer unlawfully discriminates against union-related activity in the workplace. The NLRB had previously ruled that if an employer allowed employees to discuss personal matters, such as sports scores or news, or allowed employees to solicit for charitable causes, that it could not prohibit union solicitations in the workplace. The decision in *The Register-Guard* overrules those prior decisions and establishes a new standard allowing an employer to establish a policy prohibiting union solicitations while at the same time still permitting employees to discuss personal matters and solicit for charitable causes. In explaining the new standard the NLRB stated that "an employer may draw a line between charitable solicitations and noncharitable (*sic*) solicitations, between solicitations of a personal nature (e.g., a car for sale) and solicitations for the commercial sale of a product (e.g., Avon products), between invitations for an organization and invitations of a personal nature, between solicitations and mere talk, and between business-related use and non-business-related use."[34] The Board stated that even though union solicitation would fall on the prohibited side of such a rule, the rule would not violate the NLRA.[35] This decision reaffirms an employer's right to control its property and expands an employer's right to prohibit union solicitation in the workplace.

NLRB Limits Protection for Union "Salting"

"Salting" describes a union-organizing strategy whereby a union supporter, including even a paid union organizer who has no real interest in working for the employer, attempts to obtain employment with a nonunion company for the sole purpose of organizing a union at the company. The use of salting increased dramatically in the last decade after the Supreme Court upheld an NLRB decision holding that union salts were protected from discrimination under the NLRA. Recently, however, in *Toering Electric Co.*,[36] the NLRB significantly reduced the protection for union "salts" by holding that only "someone genuinely interested in seeking to establish an employment relationship with the employer" is entitled to protection from discrimination based on union affiliation or activity.[37] The NLRB stated the NLRA only protects employees and that in its view "only those individuals genuinely interested in becoming employees can be discriminatorily denied that opportunity on the basis of their union affiliation or activity; one cannot be denied what one does not genuinely seek."[38] While this decision does not mean that union salts are never protected by the NLRA, it does mean that to be protected they will have to demonstrate a genuine interest in working for the employer in addition to their organizing interests. The NLRB also gave employers another major victory by placing the burden of proving that a union salt was genuinely interested in working upon the NLRB's General Counsel.[39] This decision is of particular importance to employers in the construction industry, who routinely have been targeted by union salts.

Employer Burden in Back Pay Cases Modified

The NLRB announced another major policy change in *St. George Warehouse*,[40] by relieving employers in back pay cases from having to prove that an individual failed to use reasonable care in finding available employment.[41] Under the NLRA, if an employer terminated an employee or didn't hire an applicant because of the individual's union activity, the affected person is entitled to recover the amount of pay that he or she otherwise would have earned from the employer. This "back pay" is determined in a separate compliance proceeding. Prior to this decision, the General Counsel of the NLRB had only to prove the amount of gross back pay the person would have earned with the employer. The employer then had the burden to establish an affirmative defense by proving that the employee failed to mitigate his or her damages. To show a failure to mitigate, the employer had to prove *both* that suitable work was available for the individual and that the individual failed to use reasonable efforts to find it. Establishing that the person failed to use reasonable efforts to find work was historically difficult in many cases because the employer is not entitled to conduct discovery prior to the hearing, such as is available in court cases.

In *St. George Warehouse*, the NLRB significantly lightened the employer's burden to establish failure to mitigate damages. The NLRB ruled that once an employer shows there were substantially equivalent jobs available in the relevant area, the burden then shifts to the General Counsel to prove the individual took reasonable steps to find work.[42] As a result, employers will be able to raise the affirmative defense of failure to mitigate merely by introducing evidence that equivalent jobs were available. Once the employer shows suitable work was available, the General Counsel will have the burden to prove that the person could not find alternative work despite using reasonable efforts in order for back pay to be awarded.[43] Alternative work often is available within a reasonable period of time. Hence, this change may substantially reduce the size of back pay awards that employers face for violations of the NLRA stemming from terminations during organizing drives, subcontracting, or relocation of work.

NLRB Modifies Recognition Bar

In another major departure from established law, the NLRB in *Dana Corp.*[44] modified the recognition bar doctrine by holding employees have 45 days after receiving notice that an employer has recognized a union based on a card-check majority to file a petition for a decertification election or to support an election by a rival union.[45] It has been NLRB policy for over 40 years to presume once an employer recognizes a union that the union continues to have support from the majority of the employees and to bar any challenges to the union for a reasonable time after recognition, typically one year. In *Dana Corp.*, the NLRB modified this recognition bar doctrine in the situation where an employer voluntarily recognizes a union based on a review of union authorization cards, commonly referred to as a "card check."[46] The NLRB stated that this change was necessary to provide employees with an adequate opportunity to exercise free choice in deciding whether to be represented by a union because of the differences between secret ballot elections and card-signing campaigns.[47] The NLRB noted that employees are susceptible to substantially more group pressure when asked to sign a union card than when casting an election ballot, since union elections are supervised by the NLRB and votes are cast in secret, whereas an employee's refusal to sign a union card often is publicized by organizers to his or her co-workers.[48]

As a result of this decision, whenever an employer recognizes a union based on a card-check majority, the employer and / or union will now have to notify the NLRB regional office in writing of the recognition and the employer must post an official NLRB notice in the workplace for 45 days. Employees will then have 45 days from the posting of the notice to file a petition to decertify the union or to support another union.

The *Dana Corp.* decision is significantly at odds with the Employee Free Choice Act[49] (EFCA) that died in Congress because although a majority in both Houses supported its passage, the majority could not muster 60 votes in the Senate to cut off debate. The ECFA would require employers to recognize a union based on a card-check majority, thereby effectively doing away with the current election process. If the Democratic Party, which has sponsored the EFCA, is successful in increasing its Senate and House majorities in this year's elections, the EFCA likely will be on the legislative agenda in 2009. If passed, the EFCA may be amended to overrule *Dana Corp.*

Unfair Labor Practice Charges Barred by Releases

In *BP Amoco Chem.-Chocolate Bayou*,[50] the NLRB held that laid-off employees who signed releases as part of a severance package offered during a reduction-in-force not only waived their right to file unfair labor practice charges against the company, but also waived the right to have charges filed on their behalf by the NLRB's

General Counsel.[51] This case is significant because the General Counsel has historically taken the position, as it did in this case, that an employee cannot waive his or her right to file a charge with the NLRB or to have the General Counsel file a charge on the employee's behalf. In this case, the company was in the middle of a union-organizing campaign when it announced a reduction-in-force that affected employees in the proposed bargaining unit.[52] The company offered the affected employees a severance package in exchange for signing a release that gave up various claims against the company, including those under the NLRA.[53] After the union lost the election, it filed unfair labor practice charges challenging the company's conduct during the election and alleging that the company terminated the employees selected for the reduction-in-force because of their pro-union activity.[54] After a hearing, the Administrative Law Judge found that the company violated the NLRA during the campaign, but held that the releases barred any challenge to the employees' termination.[55] The case was then appealed to the NLRB.[56]

On appeal, the NLRB ruled that under the circumstances, the employees' releases were valid and barred them from filing charges with the NLRB and also barred charges from being filed on their behalf.[57] In so holding, the NLRB relied on the following factors: (i) the employees voluntarily agreed to be bound by the releases; (ii) the employees were aware of the content of the releases and knew they were waiving claims against the company; (iii) there was no evidence of fraud, duress, or coercion; (iv) the employees had adequate time to consider the releases; (v) the company did not have a history of violating the NLRA; and (vi) the agreements were reasonable in light of the alleged violations and the litigation risks presented because there was a significant risk that the charge was not meritorious.[58] As a result of this decision, employers should now consider adopting language sufficient to include claims arising under the NLRA in releases obtained from employees.

NLRB Allows Employers to Base Discipline on Illegally Obtained Evidence

In *Anheuser-Busch Inc.*,[59] the NLRB held that the NLRA does not prohibit an employer from disciplining an employee for misconduct, even if the evidence of the misconduct was obtained in violation of the NLRA.[60] In *Anheuser-Busch Inc.*, the company violated the NLRA by installing hidden surveillance cameras because it did not first bargain with the union about doing so.[61] The cameras recorded employees engaging in various forms of misconduct, including taking unauthorized breaks and using drugs.[62] The company suspended some employees and terminated others.[63] The union filed an unfair labor practice charge challenging the company's actions, claiming that the company could not rely on the evidence captured by the cameras because the company's use of the cameras was illegal due to the failure to bargain over their installation, which the NLRB has held is a mandatory subject of bargaining.[64] In its decision, the NLRB noted that § 10(c) of the NLRA specifically prohibits the NLRB from granting make-whole relief to employees who are disciplined "for cause."[65] The NLRB had to decide whether illegally obtained evidence of misconduct can be used to establish "cause" under the NLRA. In holding that it can, the NLRB stated that the "meaning of the phrase 'for cause' does not include an inquiry into the source of the employer's knowledge of the misconduct."[66] This case is good news for employers because it will expand the scope of evidence that employers can rely on in defending unfair labor practice charges challenging discipline. However, employers must remember that despite this decision an arbitrator may nonetheless exclude illegally obtained evidence when deciding if "just cause" exists for discipline under a collective bargaining contract.

Endnotes

1. National Defense Authorization Act for Fiscal Year 2008, Pub. L. No. 110-181, 122 Stat. 3 (2008).
2. Family Medical Leave Act of 1993, Pub. L. No. 103-3, 107 Stat. 6 (1993) (codified as amended in scattered sections of 29 U.S.C.).
3. National Defense Authorization Act for Fiscal Year 2008, Tit. V, § 585(a)(2)(A).
4. *Id.* at § 585(a)(2)(B).
5. *Id.*
6. *Id.*
7. *Id.*
8. N.Y. Lab. Law § 206-c.
9. *Id.*
10. *Id.*
11. *Id.*
12. N.Y. Lab. Law § 202-j.
13. *Id.*
14. *Id.*
15. N.Y. Labor Law § 191(c).
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. N.Y. Exec. Law § 296(16).
23. *Id.*
24. N.Y. Correct. Law §§ 751–52.
25. N.Y. Correct. Law § 752.
26. N.Y. Correct. Law § 751.
27. N.Y. Lab. Law § 190(7).
28. N.Y. Lab. Law § 231.

29. *Id.*
30. N.Y. Lab. Law § 220(3-a)(a).
31. *Id.*
32. 351 NLRB No. 70 (2007).
33. *Id.* at 1.
34. *Id.* at 12.
35. *Id.*
36. 351 NLRB No. 18 (2007).
37. *Id.* at 5.
38. *Id.*
39. *Id.*
40. 351 NLRB No. 42 (2007).
41. *Id.* at 1.
42. *Id.*
43. *Id.*
44. 351 NLRB No. 28 (2007).
45. *Id.* at 2.
46. *Id.*
47. *Id.* at 14.
48. *Id.* at 7.
49. Employee Free Choice Act of 2007, H.R. 800, 110th Congress (2007).
50. 351 NLRB No. 39 (2007).
51. *Id.* at 2.
52. *Id.* at 4.
53. *Id.* at 2.
54. *Id.* at 1.
55. *Id.*
56. *Id.*
57. *Id.* at 2.
58. *Id.* at 2–3.
59. 351 NLRB No. 40 (2007).
60. *Id.* at 4.
61. *Id.* at 1.
62. *Id.*
63. *Id.* at 2.
64. *Id.* at 1–2.
65. *Id.* at 4.
66. *Id.* at 6.

James R. Grasso is a partner with Phillips Lytle LLP, Buffalo. He focuses his practice in the area of labor and employment on behalf of management in the private and public sectors and counsels clients on the full range of human resources issues. His labor law practice encompasses labor arbitrations, negotiating collective bargaining agreements, contract administration and defending management before the NLRB, PERB and other federal and state agencies.

Terminating Surety and Fidelity Bonds Upon the Insolvency or Bankruptcy of the Principal

By Bruce W. Hoover, Christopher J. Belter and Joseph M. Hanna

Sureties believe that their risk of exposure significantly increases when a principal becomes insolvent or files for bankruptcy protection. As a result, sureties oftentimes seek to terminate their surety or fidelity obligations upon the principal's insolvency or bankruptcy. The disposition and implications of a surety's bond(s) where the principal has filed bankruptcy can be difficult to assess since the Bankruptcy Code[1] was not necessarily drafted with specific consideration for surety bonds, but rather the rights and benefits necessary for debtors and creditors in general.

This article discusses the issues a surety or fidelity must analyze in connection with seeking to terminate its surety and fidelity obligations upon the insolvency or bankruptcy of its principal. These issues include the interplay between the rights of a surety or fidelity under the terms of the applicable bond and the rights of debtors under the Bankruptcy Code.

Many surety and fidelity bonds give the surety the right to terminate the bond. Some typical provisions include the following:

> **Sample language No. 1.** This bond may be terminated by the surety by written notice of its intention to do so filed in the Office of the Labor Commissioner, and by giving written notice thereof to the principal in which event the surety's liability shall terminate at the expiration of 90 days from the date of such filing and not earlier. However, such termination shall not relieve the surety of its continual liability under this bond for obligations that accrued prior to the effective date of such termination.
>
> **Sample language No. 2.** This bond may be terminated as of and on a specified date by the surety by and in written notice of termination delivered to the director of the Workers' Compensation Administration, and given by Certified Mail to the principal. Such termination shall not be effective, however, unless the specified date thereof occurs at least 30 days after the date of such filing and mailing and not earlier. The liability of the surety shall nevertheless continue as to any and all obligations of the principal as a self-insured employer under the Workers' Compensation Act arising out of compensable accidents occurring prior to the effective date of termination, subject, however, to termination of all liability of the surety under this bond, upon the director's acceptance of any acceptable replacement bond or security from or on behalf of the principal.
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> **Sample language No. 3.** Either the principal or the surety may cancel the obligation under this bond but such cancellation will only be effective if the surety mails a notice of such intent to cancel, by Registered or Certified Mail, with Return Receipt Requested, to the Commissioner at least 90 days prior to the cancellation date specified in the notice. In such event, the obligations of the surety shall cease at the close on the cancellation date specified in the notice as to any future acts, activities, or failures or refusals to act of the principal but not as to any acts, activities, or failures or refusals to act occurring before the close of the business on such 90th day.
>
> **Sample language No. 4.** This bond shall terminate with respect to any employee on a date specified in a written notice given by the obligee to the surety, or in a written notice of at least 30 days given by the surety to the obligee. In the event of any termination of the foregoing clause, the surety shall refund the unearned premium on demand.

Each of these provisions enables a surety to terminate its obligation prospectively upon some form of notice to the principal and/or obligee. Typically, upon notice of termination, the obligations of the surety are limited to obligations that existed or accrued up to the time of termination. The termination applies to only prospective obligations. Absent a bankruptcy filing by a principal, the surety is free to exercise its right of termination. Absent a specific provision in the bond, the surety has little recourse to terminate its bond upon the insolvency of the principal.

Once a principal files for bankruptcy, a surety has several issues to evaluate to assess termination of its bond. Does the bond have provisions for termination?

If the bond has provisions for termination, the surety must then assess what provisions of the bankruptcy code, if any, impact the ability or procedure of the surety to exercise its right to terminate. If the bond does not contain provisions for termination of a bond at any time on notice, the bankruptcy of the principal may actually provide the surety with an opportunity or leverage to terminate the bond or to improve the surety's position vis-à-vis the principal.

There are many provisions of the Bankruptcy Code that come into play with respect to sureties and their bonds upon the bankruptcy of their principals. For purposes of this article, §§ 362, 365 and 541 are considered as they relate to the rights of a surety and debtor to assume, reject or terminate a bond. (In addition, §§ 361, 363, 364, 501, 502, 503, 506, 547, 550, 552, and 553, among others, may be relevant to a surety and its bond(s)). Under § 362(b) of the Bankruptcy Code (all references herein are to sections of the Bankruptcy Code, unless otherwise noted), parties are automatically stayed from commencing any proceeding against the debtor or taking any action with respect to property of the bankruptcy estate after the filing of a bankruptcy petition. The question then posed is whether or not the act of a surety to terminate its bond constitutes an act in violation of the automatic stay provisions of § 362. Practitioners are generally familiar with the provisions of § 362 of the Bankruptcy Code which is commonly referred to as the "automatic stay." In relevant part §§ 362(a)(1) and (3) provide:

> A petition filed under . . . this title . . . operates as a stay, applicable to all entities, of . . . (1) the commencement of . . . process . . . or proceeding against the debtor . . . or[2] (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.[3]

Section 541(a) of the Bankruptcy Code defines property of the estate as follows in relevant part:

> The commencement of a case under . . . this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held . . . all legal or equitable interests of the debtor in property as of the commencement of this case.[4]

In addition to the benefits of the automatic stay, § 365 allows debtors to assume or reject certain executory contracts, and in relevant part §§ 365(a)(c) and (f) provide as follows:

> (a) Except as provided in Sections 765 and 766 of this Title and in subsections (b), (c) and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.[5]
>
> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor. . . .[6]
>
> (f)(1) Except as provided in subsections (b) and (c) of this section, notwithstanding the provision in an executory contract or an expired lease of the debtor, or an applicable law, that prohibits, restricts or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph 2 of this subsection.[7]
>
> (2) The trustee may assign an executory contract or an expired lease of the debtor only if—(A) the trustee assumes such contract or lease in accordance with the provisions of this section and; (B) adequate assurance of the future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.[8]

Very few cases have addressed a surety's efforts to terminate its bond after a principal has filed for bankruptcy. In *Wegner Farms Co. v. Merchants Bonding Co.,*[9] the debtor, Wegner Farms Company, filed a voluntary Chapter 11 petition.[10] The debtor was a grain dealer licensed by the State of Iowa.[11] As part of its requirements to be a licensed grain dealer, the debtor had obtained a bond from Merchants Bonding Company in the penal sum of $25,000 for the benefit of companies buying grain from or selling grain to the debtor.[12] Under Iowa law and the terms of the bond, the bond was to remain in full force and effect until canceled by the surety.[13] At the time of the bankruptcy filing, the penal sum of the bond was $50,000.[14] Bond premiums were paid on an annual basis, and at the time of the bankruptcy filing the debtor was not in arrears on its premium payments.[15] Subsequent to the filing of the bankruptcy petition, Merchants sent a notice of termination to the debtor notifying the debtor that the bond would be canceled effective March 17, 1985 and that the debtor's grain dealer license would be revoked by operation of law unless notice of a replacement bond was received by the state before that date.[16] The question before the court was whether Merchants' unilateral termination of the bond post-petition violated the automatic stay.[17]

Citing §§ 362(a)(1) and 362(a)(3), the court held that Merchants' unilateral actions did violate the automatic stay.[18] Specifically, the court found that Merchants' efforts to cancel the bond constituted a "proceeding" against the debtor within the meaning of § 362(a)(1).[19] The court also found that Merchants' notice of cancellation of the bond violated § 362(a)(3), which prohibits "any act to obtain possession of property of the estate . . . or exercise control over property of the estate."[20] With respect to its interpretation of § 362(a)(3), the court noted that § 541(a), defining property of the estate, is extremely broad in scope.[21] The court stated:

> The bonding agreement was a valid contract entered into by Merchants and Debtor. Even though the payment obligation ran to the third parties doing business with Debtor as a grain dealer, Debtor's coverage under the bond was a contractual obligation bargained for by the debtor and for which it paid valuable consideration. It defies logic to say that Debtor as the named principal under bond and the payer of the premium for the coverage provided by the bond, had no legal or equitable interest in the bonding agreement. Quite the contrary, the Debtor had valuable contractual rights in the bonding agreement on the date of filing. Contractual rights constituted tangible property which is included within the definition of property of the estate. Consequently Merchants' unilateral termination of the agreement postpetition was an attempt to obtain possession of property of [*sic*] estate in controversy of section 362(a)(3).[22]

The *Merchants* court distinguished a series of cases in which courts had held that surety bonds were not property of the estate, including *In re Apache Construction, Inc.*.[23] The court in *Merchants* stated that,

> To the extent those cases can be read as merely holding that a Debtor has no interest in the penal sums intended for the benefit of the third party claimants, this Court passes no judgment. To the extent, however, these decisions can be construed as holding that debtor as a contracting party to the bonding agreement has no legal or equitable interest in the contract, the Court concludes that they are incorrect as a matter of law.[24]

The court then went on to address Merchants' argument that even if the bonding agreement was property of the estate, it is a financial accommodation of the kind described in § 365 which, according to Merchants, allowed Merchants to cancel its obligations under the bond without seeking relief from the automatic stay.[25] Under § 365(e)(2)(B), an executory contract to make a loan or extend other debt financing or financial accommodations, to or for the benefit of the debtor, is exempted from the general rule which prohibits cancellation or termination of contracts because of a provision in the contract providing for termination upon the insolvency or the filing of bankruptcy.[26] Executory contracts that are financial accommodations may not be assumed or assigned by the debtor, as set forth in § 365(c).[27] The court noted that while a surety bond does not fit squarely within the framework of traditional debt financing, the bond was a financial accommodation within the meaning of §§ 365(c) and 365(e).[28] As such, the court stated that a bond cannot be assumed by a debtor and can be terminated because of a debtor's bankruptcy.[29] However, the court went on to reason that even though a bond is a financial accommodation which could not be assumed by the debtor, the right of termination in favor of the surety does not allow the surety to circumvent the provisions of the automatic stay.[30] The only authority cited by Merchants in support of its right to unilateral termination, which the court did not accept or agree with, was William Collier's bankruptcy treatise,[31] which provided in relevant part: "Presumably the automatic stay of section 362, which prohibits a creditor from terminating or accelerating after the petition, will not apply to these special kinds of contracts or leases."[32]

In *Wegner*, the decision of the court did not cite or quote the exact provision of the bond by which Merchants sent its notice of cancellation. However, it appears the provision was similar to the provisions first referenced in this article, which are common for bonds of this nature. The provisions in bonds of this nature giving the surety the right of termination are not conditioned upon the insolvency or bankruptcy of the principal, but rather convey the unilateral right to cancel at any point in time without regard to any condition or specific event. Accordingly, the right of the surety to terminate should not be impacted by the bankruptcy of the debtor, except to the extent the surety must first obtain relief from the automatic stay. The provisions of § 365(e) are limited to provisions in contracts of financial accommodation which are conditioned upon the insolvency or bankruptcy of the debtor. Therefore, bonding companies, such as Merchants and others, should be free to exercise the notice of cancellation at any time post-petition, subject to seeking relief from the automatic stay.

Likewise, in *Edwards Mobile Home Sales, Inc. v. Ohio Casualty Insurance Co.*,[33] the Chapter 11 debtor sought to enjoin a bonding company, Ohio Casualty, from revoking a surety bond and preventing the state from revoking the debtor's license to sell mobile homes.[34] In that case the court held that even though the surety bond issued to the debtor was a financial accommodation within the meaning of the Bankruptcy Code, the bonding company was required to seek relief from the automatic stay before terminating the bond.[35] The court also noted that the state's subsequent revocation of the debtor's mobile home dealer's license came within the exception to the automatic stay for governmental actions taken to enforce police or regulatory powers.[36] In that case, the debtor filed for bankruptcy protection on January 3, 1990.[37] On March 26, 1990, Ohio Casualty sent a cancellation notice of the debtor's surety bond to the State of Florida.[38] The State of Florida advised the debtor that its license to sell mobile homes would be revoked unless a replacement surety bond was secured.[39] In its decision, the court first addressed whether Ohio Casualty's surety bond was a financial accommodation defined under § 365(c)(2).[40] The Court, citing *Wegner*, held that the bond was a financial accommodation and that the surety bond could not be assumed under the other provisions of § 365.[41] With respect to Ohio Casualty's right to unilaterally terminate the bond, the Court agreed with the reasoning in *Wegner* and held that Ohio Casualty was not allowed to unilaterally terminate the bond, but rather was required to first seek relief from the automatic stay under § 362.[42] The court found that Ohio Casualty's mailing of the cancellation notice was a violation of the automatic stay and set an evidentiary hearing to determine damages and sanctions under Section 362.[43]

In *In re Adana Mortgage Bankers, Inc.*[44] and in a companion case, *In re Adana Mortgage Bankers, Inc.*,[45] the court held that the obligation to pay sums of money by the Government National Mortgage Association (GNMA) pursuant to various guaranty agreements on the obligation of Adana Mortgage Bankers, Inc. (Adana) was a financial accommodation under § 365(c)(2),[46] and accordingly, GNMA was authorized pursuant to the terms of the guaranty agreements to terminate them post-petition.[47] The court rejected GNMA's argument that its right to terminate the guaranty agreements relieved it from the provisions of the automatic stay and held GNMA in contempt for unilaterally terminating the agreements post-petition.[48] In those cases, GNMA was financially responsible pursuant to various guarantee agreements with Adana to pay certificate holders of mortgage-backed securities if Adana failed to make payments to them in connection with the mortgage-backed securities.[49] The Court found GNMA's guaranty agreement to be a financial accommodation and, therefore, a non-assumable executory contract.[50] Further, pursuant to § 365(e)(2), contracts to make financial accommodations may be terminated upon insolvency, bankruptcy, or other financial defaults, unlike other types of executory contracts.[51] The provision relied upon by GNMA to terminate its financial accommodation provided the right of termination upon assignment of the contract.[52] Thus, unlike the facts in *Wegner*, GNMA's right of cancellation derived from the insolvency and bankruptcy of the debtor. As a result, it was necessary for GNMA to establish that the guaranty agreements were executory contracts in the nature of financial accommodations in order to terminate the agreements post-petition.

Notwithstanding the many cases holding that bonds or other guarantees are executory contracts in the nature of financial accommodations, there are cases which hold that guarantees and bonds are not executory contracts. In *In re Government Securities Corp.*,[53] the issuer of a securities dealer blanket bond sought to have the bond terminated following the takeover of the debtor by the Securities Investor Protection Corporation based upon a specific provision to that effect in the bond.[54] The Court found that the bond was not an executory contract and held that the automatic termination provision was of no force and effect under § 541(c)(1)(B)[55] of the Code.[56]

The Bankruptcy Code does not define an executory contract. The legislative history of § 365 states that an executory contract is a contract in which performance remains due on both sides.[57] Some courts and commentators have articulated the view of an executory contract as one in which, "[T]he obligations of both the bankrupt and the other party to the contract are 'so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.'"[58] Other courts have analyzed contracts under an analysis referred to as the "functional" approach. For example, in *In re G-N Partners*[59] and *In re Arrow Air, Inc.*,[60] both courts ultimately determined that the test for executory contracts based upon mutuality of remaining obligations would be too limiting if literally applied and would not serve to achieve the goals of the Bankruptcy Code. Rather, those courts and others as well have adopted an approach recognizing that the purpose of allowing a debtor-in-possession to assume or reject an executory contract is to enable a debtor to take advantage of a contract that will benefit the estate by assuming it or, alternatively, to relieve the estate of a burdensome contract by rejecting it. Accordingly, under the "functional" approach, even though there may be material obligations outstanding on the part of only one party to the contract, the contract nevertheless may be deemed executory if its assumption or rejection would ultimately benefit the estate.

In *In re Government Securities Corp.*, the court determined that the bond, under either approach, was not executory.[61] Under the "Countryman" approach, since the premiums on the bond had been paid prior to the bankruptcy, there were—in the court's opinion—no remaining obligations on the part of the debtor which, if unperformed, could rise to a claim against the estate.[62] Rather, the only obligations remaining on the part of the debtor were to provide notices of claims.[63] If the debtor failed to properly provide notice of claims, the bonding company would be relieved of its obligations under the fidelity bond.[64] With respect to the "functional" approach, the court reasoned that since rejection of the bond could only benefit the bonding company, a finding that the contract was executory would be detrimental to the estate.[65]

It is worthwhile to note that the termination provision relied upon by the bonding company was based upon the appointment of a receiver for the principal, as opposed to a unilateral right of termination simply upon notice. Presumably, a unilateral right of termination would have been exercisable upon relief from the automatic stay without regard to the status of the bond as an executory contract.

Further, the language of § 365(c)(2) that prohibits a trustee from assuming or assigning an executory contract that is in the nature of a financial accommodation is without exception. The language is not permissive and does not allow consensual agreements between the debtor and the party providing post-petition financing, such as a surety. In *In re Sun Runner Marine, Inc.*,[66] the Ninth Circuit Court of Appeals held that the express language of § 365(c)(2) prohibits a debtor and the party providing the financial accommodation from consensually agreeing to continue the financial accommodation post-petition.[67] In *Sun Runner*, Transamerica provided financing to dealers who purchased boats from Sun Runner.[68] Under the terms of the financing arrangement, if the dealer defaulted, Sun Runner was to repurchase the boat(s) from the dealer and pay the loan balance owed to Transamerica.[69] Sun Runner filed for bankruptcy.[70] Transamerica and Sun Runner agreed to continue the financial arrangement post-petition and submitted the matter to the bankruptcy court for approval.[71] The bankruptcy court approved the financial arrangement post-petition.[72] Another lender objected and the appeal followed.[73] On appeal, the court held that since the financial arrangement was a financial accommodation as defined in § 365(c)(2), the debtor and Transamerica were prohibited by § 365(c)(2) from assuming and continuing the financial accommodation under § 365.[74] Rather, the proper procedure to undertake or continue post-petition financing is § 364.[75]

The court in *Sun Runner* declined to follow the reasoning in *In re Prime, Inc.*,[76] where the court held that § 365(c)(2) does not prohibit the post-petition assumption of a financial accommodation contract if both the debtor-in-possession and the lender wish the contract to be assumed and continued.[77] The court reviewed § 365 and various other provisions of the Bankruptcy Code permitting a debtor-in-possession to operate a debtor's business and to incur debt. The *Prime* court concluded that it is apparent Congress intended businesses under reorganization to proceed in as normal a fashion as possible, noting that the language of § 365(c)(2) permits the inference that the debtor-in-possession may assume a contract for debt financing if the creditor consents.[78]

The *Sun Runner* court also declined to follow the holding in *In re Prime, Inc.* that § 365(c)(2) does not prohibit the assumption of a financial accommodation contract if both the trustee and lender wish the contract to be assumed and continued.[79] The *Prime* court had noted that both the debtor and the lender wished to continue the accounts receivable financing post-petition as it had been conducted pre-petition.[80] The *Sun Runner* court went on to review various general provisions of the Bankruptcy Code permitting the trustee or the debtor-in-possession to operate a debtor's business and to incur debt. And, as just mentioned, the court concluded that it is apparent Congress intended businesses under reorganization to proceed in as normal a fashion as possible, noting in this instance that the language of § 365(c)(2) permits the inference that the trustee may assume a contract for debt financing if the creditor consents.[81]

While there may be a divergence among courts regarding the ability of debtors and creditors to continue financial accommodations post-petition, opportunity exists for sureties with bonds that do not contain termination provisions. Specifically, sureties with bonds that do not contain termination provisions can argue that since § 365(c) prohibits a debtor from assuming a financial accommodation, the bond, as a financial accommodation, cannot be assumed by the debtor and accordingly must be terminated. The surety may be able to use this leverage to compel the debtor to allow the bond to be terminated or to issue a replacement bond as new credit under the much more favorable terms of § 364.[82]

If a surety intends to pursue a strategy of not continuing the bond as a financial accommodation post-petition, the surety cannot refuse to pay bond claimants or refuse the obligee's demand for performance for claims accrued to the date of the filing of the bankruptcy petition. In practice, in exchange for keeping a bond in effect, a surety will request that the debtor provide super priority lien(s) under § 364. Consequently, it is often in the interests of debtors to have bonds determined not to be financial accommodations and / or executory contracts. If a surety is ultimately compelled to seek cancellation of its bond(s) over the objection of the debtor, given the ramifications to the debtor's business and ability to reorganize, such action should be undertaken when consensus is impractical and the surety is otherwise being forced to remain at risk on behalf of a principal that is either incompetent or not trustworthy.[83]

In light of the conflicts among the various bankruptcy courts and circuit courts of appeal, in evaluating its bond in a bankruptcy case, any surety should be aware of how the district or circuit in which the bankruptcy case is filed treats bonds under §§ 362, 365 and 541.

Endnotes

1. 11 U.S.C. §§ 101–1532.
2. *Id.* at § 362(a)(1).
3. *Id.* at § 362(a)(3).
4. *Id.* at § 541(a).
5. *Id.* at § 365(a).

6. *Id.* at § 365(c)(2).
7. *Id.* at § 365(f)(1).
8. *Id.* at § 365(f)(2).
9. 49 B.R. 440 (Bankr. N.D. Iowa 1985).
10. *Id.* at 441.
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.* at 442.
18. *Id.*
19. *Id.*
20. *Id.* at 443.
21. *Id.*
22. *Id.*
23. 34 B.R. 415 (Bankr. D. Or. 1983).
24. *Merchants,* 49 B.R. at 443. There are a number of cases that hold that a debtor does not have an interest in bonds issued to guarantee obligations of a debtor. *See generally In re Lockard*, 884 F.2d 1171 (9th Cir. 1989) and cases cited therein. *Lockard* and the cases cited therein in support of the proposition generally involve a creditor who has commenced an action against a third-party guarantor or surety. The courts hold that the instrument sued upon is not property of the estate and that relief from the stay by the creditor is generally not necessary. As the *Wegner* court noted, none of these cases involved a surety seeking to terminate the debtor's complete interest in the bond.
25. *Merchants*, 49 B.R. at 443.
26. *Id.* (quoting 11 U.S.C. § 365(e)(2)(B)).
27. *Id.* (citing 11 U.S.C. § 365(c)).
28. *Id.* at 444.
29. *Id.*
30. *Id.*
31. 2 Collier on Bankruptcy, ¶ 365.05[1] (15th ed. 1985).
32. *Id.* At least one treatise has indicated there is authority in the Ninth Circuit to the effect that to end a financial accommodation, there is no need to lift the automatic stay. Duncan Clore, Richard Towle & Michael Sugar, Eds., Bond Default Manual, 350 (3d ed. 2005).
33. 119 B.R. 857 (Bankr. M.D. Fla. 1990).
34. *Id.* at 857–58.
35. *Id.* at 859.
36. *Id.* at 860–61.
37. *Id.* at 858.
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.* at 859.
42. *Id.*
43. *Id.* at 860. Section 362(k) (formerly 362(h)) provides that "an individual injured" by a violation of the automatic stay shall recover actual damages and, in appropriate cases, punitive damages. There is a split in the circuits whether corporate debtors may recover damages under 362(k). The Third and Fourth Circuits have held that former § 362(h) is applicable to business entities. *Cuffee v. Atl. Bus. & Cmty. Dev't Corp.*, 901 F.2d 325, 329 (3d Cir. 1990) and *Budget Serv. Co. v. Better Homes of Va, Inc.*, 804 F.2d 289, 292 (4th Cir. 1986). Other circuits have held that the literal language of the statute is unambiguous and that for business entity debtors, contempt proceedings are the proper means of compensation and punishment for willful violations of the automatic stay. *Maritime Asbestosis Legal Clinic v. LTV Steel Co.*, 920 F.2d 183 (2d Cir. 1990); *Sosne v. Reinert & Duree, P.C.*, 108 F.3d 881, 884 (8th Cir. 1997).
44. 12 B.R. 977 (Bankr. N.D. Ga. 1980).
45. 12 B.R. 989 (Bankr. N.D. Ga. 1980).
46. *Adana*, 12 B.R. at 987.
47. *Id.* at 988.
48. *Adana*, 12 B.R. at 1004.
49. *Adana*, 12 B.R. at 980.
50. *Id.* at 987.
51. *Id.* at 988.
52. *Id.* at 983.
53. 111 B.R. 1007 (Bankr. S.D. Fla. 1990).
54. *Id.* at 1009.
55. Section 541(c)(1)(B) provides in relevant part, "an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement . . . that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement . . ."
56. *Gov't Sec.*, 111 B.R. at 1009.
57. H.R. Rep. No. 95-598, at 347 (1998), *reprinted in* 1978 *U.S.C.C. A.N*. 5787, 6303.
58. *Gov't Sec.*, 111 B.R. at 1011. (citing Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 460 (1973)).
59. 48 B.R. 462, 465 (Bankr. D. Minn. 1985).
60. 60 B.R. 117, 120 (Bankr. S.D. Fla. 1986).
61. *Gov't Sec.*, 111 B.R. at 1012.
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*
66. 945 F.2d 1089 (9th Cir. 1991).
67. *Id.* at 1093.
68. *Id.* at 1090–91.
69. *Id.* at 1091.
70. *Id.*
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.*
76. 15 B.R. 216 (Bankr. W.D. Mo. 1981).
77. *Id.* at 219.
78. *Id.*

79. *Sun Runner*, 945 F.2d at 1093–94.

80. *Prime*, 15 B.R. at 218.

81. *Id.* at 219.

82. While a full discussion of § 364 is beyond the scope of this article, many practitioners are familiar with the section and its provisions which enable a debtor to seek court approval for postpetition financing on potentially very favorable terms to postpetition lenders. Those terms can include liens and super-priority liens over other creditors and lien creditors, if no other financing is available.

83. *See*, *Bond Default Manual*, at 350-52 and T. Scott Leo & Gary A. Wilson, *Suretyship and the Bankruptcy Code*, in LAW OF SURETYSHIP 9-9–9-12 (Edward G. Gallagher ed., 1993).

Bruce W. Hoover is a Partner with the firm of Goldberg Segalla LLP. Mr. Hoover concentrates his practice on commercial transactions and representing creditors and sureties in enforcing and protecting their rights in bankruptcy and other civil proceedings. He is a member of the New York State Bar Association and the Business Law Section. He is also a member of the American Bankruptcy Institute and the Defense Research Institute and DRI's Fidelity and Surety Committee.

Christopher J. Belter is a Partner with the firm of Goldberg Segalla LLP and is the Chair of the firm's Commercial and Construction Litigation Practice Groups. Mr. Belter concentrates his practice on commercial and construction litigation as well as surety work. He is a member of the New York State Bar Association and is the Vice Chair of the Defense Research Institute's Construction Law Committee and is also a member of its Fidelity and Surety Committee.

Joseph M. Hanna is an Associate with the firm of Goldberg Segalla LLP in its Buffalo office. Mr. Hanna concentrates his practice on commercial litigation with a focus on surety work, intellectual property law and construction litigation. He has published several articles in his practice areas for several publications. He is a member of the New York State Bar Association and the Defense Research Institute (DRI). As a member of DRI, Mr. Hanna serves as the Young Lawyers Committee Chairman of Minority Outreach Subcommittee, Liaison to the Fidelity and Surety Committee, and Vice-Liaison to the Commercial Committee.

Courts Diverge on Whether State Statutes that Bar Arbitration Are Pre-Empted by the Federal Arbitration Act

By David Elsberg

The Federal Arbitration Act[1] (FAA) and the decisional law thereunder reflect a strong federal policy in favor of arbitration. New York state's legislature, however, has enacted certain statutes that prohibit arbitration in specific circumstances. In situations where both federal and state law apply, New York's courts recently have given divergent answers to the question of whether the FAA's pro-arbitration policy should pre-empt more specific state statutory prohibitions against arbitration.

Nichols

In *Nichols v. Washington Mutual Bank*,[2] the court resolved the conflict in favor of the FAA's pro-arbitration policy.[3] That case arose out of the foreclosure sale of plaintiff's co-op apartment.[4] Plaintiff alleged that defendants engaged in deceptive practices in attempting to collect on a mortgage loan which resulted in foreclosure.[5] Plaintiff had signed a contract with an arbitration clause stating that "[a]ny controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association or other arbitration resource if otherwise mutually agreed upon in accordance with the Commercial Arbitration Rules."[6] Plaintiff conceded that the dispute fell within the scope of that clause,[7] but nevertheless contended that she should not be required to arbitrate, on the ground that applicable New York state law prohibited arbitration.[8]

More specifically, plaintiff argued that the arbitration clause was void under New York's General Business Law § 399-c.[9] As the court recognized, this statutory "provision prohibits mandatory arbitration clauses in contracts for the sale or purchase of 'consumer goods' . . . defined to include any services intended for the personal, family, or household purposes of a consumer."[10] The court assumed for purposes of its decision (without deciding) that the arbitration clause at hand fell within the scope of the statutory ban, meaning that it was within the class of arbitration agreements declared by New York's legislature to be "null and void."[11]

However, the court held that the FAA's general policy in favor of arbitration pre-empted the specific state statute, reasoning that "[t]his contract, made by facsimile and wire transfer between a New York citizen in New York and a Nevada corporation in California . . . is indisputably within the reach of Congress' power over commerce . . . and thus it is covered by the FAA. . . .[12] Thus, [assuming the New York statute applies, it] would be directly preempted by the FAA."[13]

Ragucci

The *Nichols* court diverged from the path of reasoning followed in the earlier decision in *Ragucci v. Professional Construction Service*,[14] which involved a similar argument about the same statute. *Ragucci* involved the construction of a house in New York.[15] The contract included a broad arbitration clause that covered the parties' dispute about architectural services rendered in connection with the design and construction of the house.[16] The property owner argued that such architectural services should be deemed to fall within the scope of New York's General Business Law § 399-c.[17] The Appellate Division, Second Department, agreed that such services should be deemed "consumer goods" within the meaning of the statute:

> The statute was enacted, in part, to address abuses uncovered by Federal Trade Commission inquiries in the 1970s, which disclosed that 'pre-commitment clauses were often not understood by customers, who then faced the need to pay significant filing fees under some clauses, and could be forced to attend hearings at inconvenient times and places or forfeit their claims. In certain instances, industry groups financed programs and arranged for selection of industry experts as the arbitrators, a practice often useful in commercial arbitration where both participants in the dispute are members of the same segment of an industry or a balanced panel is provided, but one-sided in consumer-merchant disputes.' The Federal Trade Commission's inquiries also found that [a]buses, particularly rife in the home improvement industry, gave truly voluntary business-consumer arbitration a bad name, and thus led to wide support for corrective action.[18]

The court ruled that the statute should be read to give effect to New York's pro-consumer public policy and therefore to extend to the architectural services.[19] Accordingly, the court held that the arbitration clause was null and void,[20] even though it appears it would have been easy enough to conclude—as the *Nichols* court did when examining a similar argument about the same statute—that the FAA applies and pre-empts New York's consumer statute. New York courts have held that disputes involving buildings located in New York—and specifically involving construction of buildings in New

York—involve a type of activity subject to the FAA.[21] The U.S. Supreme Court has held that "the FAA applies to any transaction 'affecting commerce,' whether or not there is a 'substantial effect' on interstate commerce,"[22] and further, that the FAA may apply "in individual cases without showing any specific effect upon interstate commerce if in the aggregate the economic activity in question would represent a general practice . . . subject to federal control."[23]

Persuading Courts in Future Cases

Ragucci and *Nichols* are illustrative of numerous decisions in recent years where the courts have struggled to reconcile pro-arbitration policy with other state policies, with results that are sometimes surprising and that have divided courts. For example, in *D'Agostino v. Forty-Three East Equities Corp.*,[24] the majority held that New York's public policy requires the courts to enforce certain housing standards and that disputes concerning such standards are too important to be "left in the hands of an arbitrator";[25] the dissent, however, contended that New York's "public policy favoring arbitration should prevail on legal, factual and pragmatic grounds."[26]

These recent and divergent decisions do not always give a satisfying answer as to which public policy is "better" in a particular circumstance. What these decisions do make clear is that litigants seeking to enforce arbitration agreements may be able to invoke pro-arbitration policy to overcome explicit statutory bans that would otherwise nullify arbitration pacts. Likewise, litigants seeking to avoid arbitration may be able to appeal to a court's view of what is in the public's interest to invalidate arbitration agreements that would otherwise be binding and enforceable. In future cases we can expect to see litigants continue to invoke public policy to try to achieve results that would otherwise appear to be foreclosed.

Endnotes

1. Federal Arbitration Act, 9 U.S.C. §§ 1-16 (2006).
2. No. 07-CV-3216, 2007 WL 4198252 (E.D.N.Y. Nov. 21, 2007).
3. *Id.* at *9.
4. *Id.* at *1.
5. *Id.*
6. *Id.*
7. *Id.* at *6.
8. *Id.* at *9.
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. 25 A.D.3d 43, 803 N.Y.S.2d 139 (2d Dep't 2005).
15. *Id.* at 44, 803 N.Y.S.2d at 140.
16. *Id.*
17. *Id.* at 46, 803 N.Y.S.2d at 141.
18. *Id.* at 49, 803 N.Y.S.2d at 144, *noted in* Givens, McKinney Practice Commentary, GBL § 399-c (2007).
19. 25 A.D.3d at 48, 803 N.Y.S.2d at 143.
20. *Id.* at 50, 803 N.Y.S.2d at 144.
21. *See Diamond Waterproofing, Inc. v. 55 Liberty Owners*, 4 N.Y.3d 247, 793 N.Y.S.2d 831 (2005) (holding that reconstruction of a New York building affected interstate commerce and was subject to the FAA because, *inter alia*, materials for the construction project were obtained from outside New York); *Wien & Malkin LLP v. Helmsley-Spear, Inc.*, 12 A.D.3d 65, 783 N.Y.S.2d 339 (1st Dep't 2004) (holding the FAA applied to dispute that "involved New York entities and . . . buildings located within New York City."), *rev'd on other grounds*, 6 N.Y.3d 471 (2006).
22. *Wien & Malkin LLP v. Helmsley-Spear, Inc.*, 12 A.D.3d 66, 783 N.Y.S.2d at 341 (citing *Citizens Bank v. Alafabco*, 539 U.S. 52, 56-57 (2003)).
23. *Id.* at 70, 783 N.Y.S.2d at 343 (citing *Alafabco*, 539 U.S. at 56-57). *But see Baronoff v. Kean Development Co., Inc.*, 12 Misc. 3d 627, 631, 818 N.Y.S.2d 421, 424–25 (N.Y. Sup. Ct. N.Y. Co. 2006) ("While the Federal Arbitration Act may in some cases pre-empt a state statute such as Section 399-c, it may only do so in transactions 'affecting commerce.' The agreements herein, when measured against the standards set by applicable case law, cannot be said to 'affect commerce.' To hold otherwise, would render General Business Law Section 399-c a virtual nullity." "If the use of any out of state materials triggers the applicability of the Federal Arbitration Act, then General Business Law Section 399-c would be eviscerated and pre-empted in most cases. Taking respondent's reasoning to its logical extreme, any contract for consumer goods, involving any goods from outside of New York, would not receive the intended protection of General Business Law Section 399-c.")
24. 16 Misc. 3d 59, 842 N.Y.S.2d 122 (1st Dep't 2007).
25. *Id.* at 60–61, 842 N.Y.S.2d 122–23.
26. *Id.* at 62, 842 N.Y.S.2d 124 (McCooe, J., dissenting). *See also* Elsberg, "Public Policy Trumps Arbitration Clauses and Statutes," N.Y.L.J., March 3, 2006, p. 4, col. 4; *John G. R Ryan, Inc. v. Molson USA, LLC*, No. 05CV3984, 2005 WL 2977767 (E.D.N.Y. Nov. 7, 2005) (holding that the FAA's pro-arbitration policy pre-empts a New York statute that explicitly bans mandatory arbitration clauses in certain types of agreements involving brewers and beer wholesalers). *Compare Larrison v. Scarola Reavis & Parent LLP*, 11 Misc. 3d 572, 580, 812 N.Y.S.2d 243, 248–49 (N.Y. Sup. Ct., N.Y. Co. 2005) (stating that a retainer agreement between a lawyer and a client "that contains a clause to arbitrate in front of the American Arbitration Association, which waives the client's right to access to the courts to resolve disputes arising out of the attorney/client relationship, must be viewed as inherently unenforceable and against public policy") *with Nasso v. Loeb & Loeb, LLP*, 19 A.D.3d 465, 796 N.Y.S.2d 256 (2d Dep't 2005) (holding that such a lawyer-client arbitration clause is enforceable and consistent with New York's public policy).

David Elsberg is a partner at Quinn Emanuel Urquhart Oliver & Hedges LLP. The views expressed in this article are not necessarily held by Quinn Emanuel or its clients.

Underbanked People in an Overbanked Country

By Clifford S. Weber

It has become axiomatic amongst banking professionals that, with 8,600 state and federally chartered commercial banks and thrift institutions operating more than 90,000 domestic branches,[1] the United States is "overbanked."[2] This condition has produced a sustained trend toward bank and thrift consolidation, driven by the desire for greater size and its presumed attendant efficiencies, increased compliance costs, and other factors.[3] Some commentators believe that in the short term, the current turmoil in mortgage markets, deteriorating credit quality and decreased profitability will accelerate this trend,[4] while others have concluded that the same factors will decelerate it.[5] The consensus, though, is that the trend will continue over the long term.

> *"The MSB Act expressly recognizes that money service businesses play an important role in the financial services system by delivering products and services to underbanked communities and urban customers."*

Living in the shadows of this overbanked, consolidating industry, conducting their business outside the traditional banking channels, lies a huge population[6] of unbanked and underbanked people. For a number of reasons, including cultural aversion to banks, immigration status, the need for immediate cash, and the unavailability of bank branch offices, these low- and moderate-income individuals don't maintain bank deposit accounts, borrow money from banks, or use the bank payment system. Instead, they use alternative financial service providers, such as money transmitters, payday lenders and check cashers.[7]

Check cashers are the primary providers of financial services in New York's unbanked communities. The New York Banking Department licenses, examines and regulates check cashers under Article 9-A of the New York Banking Law.[8] At the federal level, they are also subject to the Bank Secrecy Act[9] ("BSA") and the registration,[10] Suspicious Activity Report[11] and Currency Transaction Report[12] filing requirements applicable to money service businesses,[13] as administered by the Financial Crimes Enforcement Network ("FinCen"), an arm of the United States Treasury Department. As of 2006, there were 200 licensed retail check cashers operating 662 full service and 280 limited services branches in New York, predominantly in New York City. In 2006, these licensees cashed approximately 32 million consumer checks with a face value of $14.9 billion.[14]

Check cashers fund their operations with credit lines extended by commercial banks. The Superintendent of Bank's regulations[15] require applicants to document such credit facilities in the amount of $100,000 per licensed location, as a condition to licensure. In recent years, the number of banks providing banking services to check cashers has shrunk to 12, with two of them accounting for 90 percent of the business. The Banking Department has identified reputational risk (i.e., perceived money laundering) and unrecoverable compliance costs as the primary drivers of this service reduction.[16]

The banks' withdrawal from this business has attracted legislative attention, in large measure because it threatens the closure of businesses that serve the financial needs of constituents. On October 4, 2006, the New York State Assembly Committee on Banks and the Assembly Committee on Consumer Affairs and Protection held a public hearing on the issue. U.S. Representative Carolyn B. Maloney, Chair of the Financial Institutions and Consumer Credit Subcommittee of the House of Representatives Financial Services Committee, has introduced legislation entitled the "Money Services Business Act of 2007"[17] (the MSB Act). If enacted into law, this legislation could encourage banks to return as lenders and thereby increase banking choices for check cashers and other money services businesses.

The MSB Act expressly recognizes that money service businesses play an important role in the financial services system by delivering products and services to underbanked communities and urban customers. Significantly, the MSB Act also acknowledges that the financial regulators' anti-money laundering ("AML") and BSA efforts, while necessary for fighting terrorism, have caused banks to be law enforcers, which in turn has driven banks away from money service businesses. Additionally, the MSB Act notes that as banks withdraw from the business of lending to check cashers and money transmitters, this business may be driven underground to unregulated, unlicensed providers.

To address the problem of bank withdrawal, or "discontinuance," the MSB Act creates a safe harbor for banks. This essentially means that all federally insured banks may rely on a written certification by the money service business that it: i) has policies and procedures that comply with the AML laws and regulations; ii) is licensed by a state and; iii) is registered with FinCen. Banks that rely in good faith on a certification will have no responsibility for monitoring the money services business's AML compliance and no liability for its AML violations. The proposed legislation also imposes civil and criminal penalties for any false statements contained in the certifications to banks.

"Even if it doesn't become law, the MSB Act is a serious first effort towards solving the bank discontinuance problem, and hopefully it will generate more dialogue and congressional action."

The MSB Act tries to balance the national security goals of the AML statutes with the financing needs of the money services industry and its customers. The self-certification mechanism it uses would, at least in theory, address the banks' main complaint, which is that the government has forced them to police money service business borrowers. It is unclear whether this legislation will progress or whether it will attract banks back into the business if Congress enacts it. Even if it doesn't become law, the MSB Act is a serious first effort towards solving the bank discontinuance problem, and hopefully it will generate more dialogue and congressional action.

Endnotes

1. Federal Deposit Insurance Corporation, Summary of Deposits, Deposits of All FDIC-Insured Institutions: National Totals by Charter Class, Data as of June 30, 2007, *available at* http://www4.fdic.gov/sod/sodSumReport.asp?barItem=3&sInfoAsOf=2007. In addition, at year-end 2006, there were about 8,600 federally insured credit unions. *See* 2006 Year-End Statistics for Federally Insured Credit Unions, *available at* http://www.ncua.gov/ReportsAndPlans/statistics/YearEnd2006.pdf.
2. H. Rodgin Cohen, perhaps the most prominent American banking lawyer, has opined that "The United States remains overbanked by every conceivable metric. Competition is intense, and organic growth in a relatively mature industry is a constant struggle." Rodgin Cohen & Mitchell S. Eitel, *10 Factors That Will Guide Consolidation in 2005*, Am. Banker, February 5, 2005, *available at* http://www.americanbanker.com.
3. *See* Kenneth D. Jones & Tim Critchfield, *Consolidation and the U.S. Banking Industry: Is the 'Long Strange Trip' About to End?*, FDIC Banking Rev., Vol. 17, No. 4, 2005, *available at* http://www.fdic.gov/bank/analytical/banking/2006jan/article2/article2.pdf.
4. *Experts Expect More Bank Mergers*, Chi. Sun Times, January 12, 2008, *available at* http://www.suntimes.com.
5. *M&A Market Opens Year with Barely a Whimper*, Am. Banker, February 7, 2008, *available at* http://www.americanbanker.com.
6. While estimates of the population size vary, 40 million would appear to be at the low end of the range. *See* Jennifer Tescher, et al., Center for Financial Services Innovation, The Power of Experience in Understanding the Underbanked Market (2007) *available at* http://www.cfsinnovation.com/doc.php?load=/keybank_paper.pdf.
7. Banks are beginning to show more than perfunctory interest in banking the unbanked. *See* Katy Jacob, Center for Financial Services Innovation, Highlights From the Inaugural Underbanked Financial Services Forum (2006), *available at* http://www.cfsinnovation.com/document/highlights_underbanked_forum.pdf. Notably, in October, 2007, Checkspring, a new New York-chartered commercial bank, opened for business in the Bronx. Converting the unbanked into bank customers is the core of its business plan, as described at http://www.checkspring.net.
8. N.Y. Banking Law §§ 366–74.
9. 31 U.S.C. § 5312(a)(2)(k).
10. 31 C.F.R. § 103.41.
11. 31 C.F.R. § 103.20.
12. 31 C.F.R. § 103.22.
13. 31 C.F.R. § 103.11(uu).
14. Richard H. Neiman, Superintendent of Banks, Report and Recommendation to the Governor Pursuant to Banking Department Study Regarding Geographic and Fee Restrictions Imposed on Locations Used Primarily for the Cashing of Checks (2007) [hereinafter Report to the Governor].
15. N.Y. Comp. Codes R. & Regs. tit. 3, § 400.1(6)(e) (N.Y.C.R.R.).
16. Report to the Governor, *supra* note 14.
17. Money Services Business Act of 2007, H.R. 4049, 110th Cong. (2007).

Cliff Weber handles regulatory corporate securities, and transactional matters for financial institutions. He currently serves as Chair of the New York State Bar Association's Banking Law Committee. Previously, he served as General Counsel to the Community Bankers Association of New York State and as Counsel to the New York State Assembly Insurance Committee.

Coalition for Debtor Education: 2007 Accomplishments

By Barbara Kent

The Coalition for Debtor Education applied the grant from the New York State Bar Association's Business Law Section towards the work we are doing on the Banking Development District (BDD) program with the New York City Housing Authority (NYCHA). The BDD is a statewide initiative designed to provide access to banking services for unbanked and underbanked New Yorkers so that they may become part of the financial mainstream.[1] As you already know, in order to become a BDD branch, a bank must open a branch in an unbanked or underbanked area.[2] Additionally, BDD-designated branches are encouraged to provide financial education to residents.[3] Underbanked individuals and communities benefit from local bank branches with special products and services that meet their financial needs, thereby helping them avoid predatory financial products and services.[4]

The New York City Housing Authority provides decent and affordable housing in a safe and secure living environment for low- and moderate-income residents in all five boroughs.[5] NYCHA also works to enhance the quality of life of its residents by offering opportunities to participate in a multitude of community, educational and recreational programs, as well as job readiness and training initiatives.[6]

Our program consists of two components: 1) conducting train-the-trainer sessions in which we equip financial professionals and community leaders from partner institutions with the tools to teach financial literacy classes, and 2) organizing and executing teaching sessions in the NYCHA communities. The objective is to educate specific age groups—teens, working adults and seniors—on relevant financial topics. For example, with seniors, we focus on preventing identity theft, while with teens, we talk about spending and savings plans.

Initially, the Coalition created a pilot program at NYCHA locations in the South Bronx, and we have been using the NYSBA grant, along with funds from other grantors, to expand the program. Since mid-2007, following the pilot, we used the NYSBA grant to develop additional materials, conduct three train-the-trainer sessions and help lay the groundwork with local community organizations and BDD banks on the Lower East Side. As a result of this groundwork, we will hold 30 end-user sessions, including some taught in Spanish and Chinese, during the first quarter of 2008. The sessions are scheduled to commence during the first week of February. We will also plan to conduct eight train-the-trainer sessions throughout the year.

"Underbanked individuals and communities benefit from local bank branches with special products and services that meet their financial needs, thereby helping them avoid predatory financial products and services."

Our goal is to reach agreements with all banks that have a BDD branch. In addition, the Coalition and the BDD banks will work with NYCHA to build on the Bronx pilot to improve financial education among residents in NYCHA housing throughout the city.

Endnotes

1. *See* William C. Thompson, Jr., New York City Comptroller, Banking Development District Program, http://www.comptroller.nyc.gov/bureaus/cb/pdf/bdd-04.pdf.
2. *See id.*
3. Press Release, New York State Banking Department, Governor Pataki's Banking Development District Program is Adopted by Mayor Bloomberg and City Officials, (November 20, 2003), *available at* http://www.banking.state.ny.us/pr031120.htm.
4. *See* William C. Thompson, Jr., New York City Comptroller, Predatory Lending Program, http://www.comptroller.nyc.gov/bureaus/cb/pdf/predatory_lending_brochure_04.pdf.
5. New York City Housing Authority, About NYCHA, http://www.nyc.gov/html/nycha/html/about/about.shtml.
6. *Id.*

Barbara Kent is an attorney and former Deputy Superintendent of the New York State Banking Department.

Committee Reports

Report of the Outgoing Business Law Section Chair

The Business Law Section had a busy and productive year to date. Among the highlights:

- The Executive Committee voted unanimously to give a gift of $10,000 to the Coalition for Debtor Education, a not-for-profit New York corporation chaired by Barbara Kent, formerly Deputy Superintendent of Banks and a frequent speaker and contributor to Section programs. The Coalition provides financial literacy programs; training for debtor educators and bank staff in banking development districts; outreach programs to labor unions, colleges and law schools to provide financial literacy programs; and other measures to promote the responsible use of credit.
- We also voted unanimously to give $20,000 to the New York State Bar Foundation, which provides funding to public interest legal programs in the state. Both of these gifts came from the Section's surplus funds and reflect the strong commitment of our members to contribute to the public good.
- Our constituent committees continue to be an active source of continuing legal education and practical guidance to business law practitioners around the state. The reports of the individual committees appear below.
- We established two new standing committees, Legislative Affairs and Membership. We also revived our Insurance Committee under the leadership of Robert Yellen of American Insurance Group as the Chair.
- The Legislative Affairs Committee, led by Peter LaVigne of Sullivan & Cromwell, works actively with the parent Bar Association to provide input to the legislative process in areas of concern to our members. Among the Committee's achievements in 2007 was opening a dialogue and gaining the support of members of the legislature to eliminate the costly and onerous publication requirement for establishing a new limited liability company (LLC).
- Led by Andrea Elder-Howell, the Membership Committee is focused on outreach to new members, with an emphasis on enhancing diversity and encouraging young attorneys to participate in the Section's programs. In September the Committee hosted our Fall Cruise Connection, aimed at introducing the Section and its work to prospective new members during a pleasant cruise around New York Harbor.
- In October we held a successful annual meeting at the Breakers in Palm Beach, Florida, with CLE programs focused on corporations, securities law, project and structured finance, and the legal and ethical implications of anti-money laundering law.
- Our CLE program at the Association's Annual Meeting in January 2008 featured a segment on the subprime mortgage crisis, co-sponsored with the Metropolitan Black Bar Association. It was our second joint CLE program with the MBBA and we look forward to building on this promising collaboration.
- The Section remains strong and healthy, with nearly 4,500 members representing every discipline of business law and every part of the state.

Jim Orband of Hinman, Howard & Kittell became the Chair of the Section effective January 1, 2008. It was an honor and a privilege to serve as Chair of the Section during 2007. I look forward to continuing to work with Jim and my colleagues in the Section in 2008.

David L. Glass
Outgoing Section Chair

Banking Committee

The Committee's meetings have had a number of substantive presentations, and have included active participation by representatives of the federal and state regulatory authorities. In 2007 we featured the following presentations:

i) Roberta Kotkin, Esq. reported on *Watters v. Wachovia Bank,* in which the United States Supreme Court applied federal preemption principles to uphold the exclusive visitation rights of the Office of the Comptroller of the Currency, as the regulator of national banks, over the operating subsidiaries of national banks, even though those subsidiaries are established under state law; ii) Jacob Zamansky, Esq. gave a presentation on subprime mortgage litigation; iii) Celeste Kaptur, Esq., Regional Counsel for the Small Business Administration, gave a presentation on small business lending; and iv) Lewis Goodman, Esq., gave a presentation on workouts and restructuring.

Attendees uniformly found the presentations valuable and informative. They also received one hour of CLE credit. As Chair, I intend to arrange for CLE credit for all future meetings during my tenure, as a way to both increase attendance and make the meetings as relevant and helpful as possible for the members.

Clifford S. Weber
Chair

Bankruptcy Committee

Over 50 lawyers, members of the Bankruptcy and other committees, attended and joined in meeting and celebrating the appointment of the three most recent S.D.N.Y and N.D.N.Y. U.S. Bankruptcy Court Judges at an early-evening cocktail reception, arranged by the outgoing Committee Chair, Paul H. Silverman. The opportunity to meet the recently appointed judges as well as other attending judges, in total 7 judges, and the U.S. Trustee for Region Two was highly appreciated by those able to attend. In addition, the Committee meeting during the Annual NYSBA Meeting was dedicated by the incoming Committee Chair Mark Tulis to discussions with the Hon. Diana Adams, the U.S. Trustee whose authority includes all of New York state and other federal Region Two states. The Committee continues to hold events that allow close contact among its members, the bench and government administrators in the judicial system in an atmosphere that allows interaction, camaraderie, and education otherwise not available. In addition, as and when appropriate, the Committee receives, thru listserve web blasts, quick summaries of recent relevant law and rule changes as well as case law highlights.

In 2008 the Committee will present a basic bankruptcy law CLE course with volunteers from the Committee freely giving their time to prepare the course book and to make presentations in Buffalo, Syracuse, Albany, Long Island, and the City of New York.

Paul H. Silverman
Chair

Consumer Financial Services Committee

Once again, the hottest topics for the Consumer Financial Services (“CFS”) Committee meetings in 2007 were privacy, identity theft and data security. Incoming Committee Chair William (Randy) Henrick provided a reprise and an update of his Privacy, Data Security and Identity Theft presentation at the Business Law Section’s Annual Meeting in January. As “America’s fastest growing crime,” identity theft and the associated issues of privacy and data security were of interest to many attendees at the corporate level and to all who attended as consumers. Well done again, Randy!

At the January meeting of the CFS Committee, we discussed a number of topics currently on the radar screen for the consumer financial services industry. Phil Veltre led a discussion on the new Regulation “E” rules applicable to electronic check conversions; Phil also led a discussion of a recent home equity line of credit prepayment penalty case; Grace Sterrett gave us an analysis of the new rate cap for loans to the military and an overview of the new New York Mortgage Originators law; Warren Traiger provided an excellent summary of the status of Nontraditional Mortgage Guidance; and Geoff Rogers discussed (pre-decision) the preemption issues raised in *Watters v. Wachovia Bank*.

The CFS Committee has followed a policy of having its prospective attendees determine the topics for discussion at upcoming meetings. As outgoing Chair, I encourage members to continue their active participation in selecting discussion topics and leading those discussions. Beginning January 1, 2008, the CFS Committee came under the able leadership of incoming Chair Randy Henrick. As always, the CFS Committee encourages participation by an even more diverse group of attorneys. Please contact me, Geoff Rogers, at grogers@hudco.com or 518.383.9591 if you are interested in attending a meeting or in joining our committee.

Geoffrey C. Rogers
Chair

Corporations Law Committee

At the January 2008 annual meeting, the Corporations Law Committee met jointly with the Securities Law Committee and discussed the status of certain pending and proposed legislation, including amendments to the NPC law and potential updating of the LLC statute. There were CLE presentations on Foreign Investment and the Port Authority of New York / New Jersey and Merging New York Not for Profit Corporations. The topic of amending the BCL to permit the adoption of majority election of directors in the bylaws was raised again, in light of the ongoing trend to majority election of directors and the greater flexibility this would give boards of directors, as opposed to the present requirement of including such a provision in the certificate of incorporation.

Finally, the recent AirTran case was discussed, in which the court held that the issue of whether a foreign corporation was doing business in New York, thereby giving rise to shareholder inspection rights under the BCL for New York shareholders of such foreign corporation, is a matter that should be construed to afford the broadest relief to New York residents.

Janet T. Geldzahler
Chair

Derivatives and Structured Products Committee

The mission of the Derivatives and Structured Products Law Committee is to apprise members of developments in laws relating to the futures and derivatives markets and to maintain liaisons with trade associations, industry leaders, and representatives of governmental and regulatory bodies, such as the SEC, the CFTC, and the Federal Reserve System. Over the past year, the Committee has hosted meetings that brought the membership valuable information and interaction with important figures directly or indirectly involved in the futures and derivatives markets. Based on their positive experiences to date, members are seeking to expand membership by continuing to refine this mission and by sharing their experience with colleagues and contacts.

Our Committee meets one day each month, typically around lunchtime, during which time we have presentations by members and guest speakers covering a variety of intriguing topics relating to the futures and derivatives markets. We also seek out opportunities to prepare comment letters and articles.

If you are interested in joining our Committee, please contact the New York State Bar Association. When completing your membership in the Association, be sure to elect to join the Business Law Section and the Derivatives and Structured Products Law Committee.

Ilene K. Froom
Chair

Franchise, Distribution and Licensing Committee

The Franchise, Distribution and Licensing Committee has held three successful events in recent months.

In February, we held a half-day CLE program called "Franchise Law in New York." The purpose of the program was to introduce franchise law to lawyers who do not practice in this field on a regular basis, those who are new to franchising and those seeking an overview of franchise law and the new FTC disclosure requirements. Speakers included committee members David Oppenheim, Harold Kestenbaum, Richard Rosen and myself, as well as Joseph Punturo, the Assistant Attorney General and Franchise Section Chief in the Investor Protection Bureau of the NYS Attorney General's Office. Topics included The New FTC Rule, Franchise Law in New York, The Inadvertent Franchisor, Structuring the Franchise System and Enforcing System Standards.

In January the Committee held a meeting in conjunction with the Business Law Section's Annual Meeting. The topic of the committee meeting was "The State of Franchising—2008 Economic Outlook and Trends that Affect Franchising." The speaker was Darrell Johnson, the President and Chief Executive Officer of FRANdata.

At the Section Fall Meeting in October 2007, we held a meeting on the topic "Lost Profits and Lost Business Value in Franchise Disputes." The speaker was committee member Bruce Schaeffer, co-author of Commerce Clearing House's book entitled *Franchise Regulation and Damages*.

The Committee welcomes all suggestions from members and inquiries from potential new members. Contact the Committee Chair at pitegoff@pitlaw.com.

Thomas M. Pitegoff
Committee Chair

Information Technology Law Committee

In 2008, the Information Technology Law Committee has planned a number of events open to all Business Law Section members, starting with a CLE program about user-generated content websites featuring Adeo Ressi, the founding member of www.TheFunded.com. TheFunded.com is a community of venture-backed CEOs who anonymously post their opinions, stories and deal points about the VCs and private equity funds who invest in them. The committee also plans to write and publish about specifically targeted issues of interest to its members and their clients.

To be apprised of future events, please sign up for our email list. You can get on the email list regardless of whether you have joined the committee. We will consider you a "prospective member."

Martin J. Ricciardi
Chair

Insurance Committee

The Insurance Law Committee, which was dormant for a short while, is being revitalized. We are currently reviewing priorities and objectives, and developing a strategic vision for delivering relevance to the Business Law Section and other Association members. The first part of that process has involved culling through Association data on membership preferences and interests. Richard Martin of the Association is assisting us with that effort. The second will be a survey designed to test assumptions about interests, broaden appeal and deliver meaningful value. The Committee plans to focus on insurance law and regulation within New York state or which impacts New York businesses—including the insurance companies who provide coverage in New York. Product focus typically extends to commercial lines and property / casualty products, including specialty products like Directors and Officers Liability, Professional Liability, Employed Lawyers and Political Risk. As to issues, we expect Governor Paterson to continue the trend of his predecessor and keep us quite busy. On January 18, 2008, former Governor Spitzer hosted the first formal meeting of the Commission to Modernize the Regulation of Financial Services. Objectives are lofty, and they could mean a paradigm shift in financial regulation in New York. We intend to keep our perspective diverse, and would encourage practitioners from all backgrounds who have an interest in or are nevertheless forced to contend with insurance issues to feel welcome to join us. The revitalized committee will serve as a platform for tracking developments, concentrating expertise, flagging / considering issues worthy of consideration for proactive response by the Association, and building CLE programs for our Section and Association membership. If you are interested in becoming a member of this committee or would like more information, please e-mail us at inslaw@nysba.org.

Robert Yellen
Chair

Legislative Affairs Committee

The Legislative Affairs Committee has been established as a new standing Committee of the Business Law Section, effective June 2007. The Committee follows New York state legislation of interest to the Section and its constituent practice committees. The Committee reviews bills being proposed for vote in the state Senate or Assembly, provides memoranda in opposition or support and, where appropriate, meets with legislators or their staffs about the bills. The Committee will also, if needed, seek sponsors for proposed bills of interest to the Section. The Committee has one representative from each of the substantive committees of the Section.

The Committee's work is seasonal, following the legislative calendar, which is busiest from April to June. In the past year Committee members reviewed a list of proposed bills that had some likelihood of being reported out of legislative committee to identify those that should be opposed or supported. One bill, Senate 2152, was of special interest to the Corporations Law Committee because it would have required all New York public corporations over a certain size to enable remote participation in shareholder meetings by all shareholders. Although the Legislative Affairs Committee and the Corporations Law Committee did not object to a law that would have permitted corporations to allow remote participation, the committees objected to a law which would have required corporations to facilitate remote participation. Information obtained from companies providing services in this area indicated, among other things, that telephone connections permitting remote participation, including voting, by potentially thousands of shareholders are not currently technologically feasible. After meeting with counsel to Senator Libous, the sponsor of the Senate bill, to explain the technological and other problems presented, the Section and the Corporations Law Committee submitted a memorandum in opposition, drafted by Janet Geldzahler and reviewed by David Glass and Peter LaVigne, to the Senate Committee on Corporations, Public Authorities and Commissions, where the bill had originated. The bill was not put to the vote of the Senate and indications are that it will be revised in response to the comments of the Section.

Peter W. LaVigne
Chair

Membership Committee

The Membership Committee has been established as a full standing Committee of the Business Law Section, effective June 2007. The Committee's mission is to increase and improve membership in the Business Law Section. Specifically, the Committee seeks to grow the membership in the Business Law Section by ten percent; retain existing members and encourage them to become more active in the work of the Section; promote and improve diversity among our membership to reflect the society in which we live and work; and develop a robust mentoring program for young lawyers. We endeavor to reach our goals by providing lunch and learn seminars to law students throughout all geographic regions of the state, developing partnerships with local and minority bar organizations, and providing venues such as the fall cruise for networking. On September 17, 2007, the Committee hosted a private evening cruise and reception aboard the luxury yacht *Zephyr* to promote networking and introduce non-members to the benefits of joining the Business Law Section.

Andrea M. Elder-Howell
Chair

Securities Regulation Committee

The Committee on Securities Regulation has continued its monthly meeting programs, addressing a wide range of matters of importance to securities law practitioners. Among the topics presented at our recent meetings were electronic proxy delivery, Moody's reviews of executive compensation and internal control disclosures, short sales, "empty voting," the U.S. Chamber of Commerce's report on U.S. capital markets, the Pink Sheets, and various SEC rule proposals. In addition, the Committee submitted a comment letter to the SEC on its proposed rules regarding the prohibition of fraud by advisers to certain pooled investment vehicles, and the accredited investor standards associated with certain private investment vehicles.

The Committee is currently drafting comment letters regarding a number of new SEC rule proposals.

Our dinner meetings tend to foster lively discussions, and afford Committee members an opportunity to discuss "hot topics" with persons closely associated with those topics.

Jeffrey W. Rubin
Chair

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Submissions should be e-mailed or sent on a disk or CD in electronic format, preferably Microsoft Word (pdfs are not acceptable). A short author's biography should also be included.

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

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

Deadlines

Manuscripts intended for publication in the fall and spring issues must be received by the preceding July 31 and February 15, respectively. Manuscripts are to be submitted to:

David L. Glass
Editor-in-Chief
NY Business Law Journal
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125 West 55th Street
New York, NY 10019
telephone: (212) 231-1583
e-mail: david.glass@macquarie.com

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