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In Celebration

This issue marks the completion of the first five years of publication of the *NY Business Law Journal***.** Since publication began in 1997, the *NY Business Law Journal*, published twice annually, and mailed free of charge to all members of the Business Law Section of the New York State Bar Association, has become another important reason for membership in the Section.

Over the past five years, members of the Section have received timely and valuable information through the *Journal* regarding topics relevant to the business practitioner. For example, past issues of the *Journal* have included the following articles:

- Helpful filing hints from the New York State Department of State, Division of Corporations (Vol. 1, No. 1);
- Amendments to the New York Business Corporation Law (Vol. 2, No. 1);
- Director Liability Issues (Vol. 2, No. 2);
- Election of Remedies in New York (Vol. 3, No. 1);
- Protection of Trade Secrets (Vol. 3, No. 2);
- The Business Record Rule (Vol. 4, No. 1);
- Financial Privacy under the new GLB Regulations (Vol. 4, No. 2); and
- Foreign Corporations under BCL § 307 (Vol. 5, No. 1).

These articles and many more were contributed to the *Journal* by New York business practitioners, most of whom are members of the Business Law Section. All articles have been selected to convey useful insight and guidelines to business practitioners in this state. We are proud of the accomplishments of the *Journal* and its staff, including all of the contributing authors and, in particular, the team assembled at Albany Law School under the direction of Professor James D. Redwood, Editor-in-Chief of the *Journal*.

As we enter the sixth year of publication, we encourage subscribers to write to us with comments and suggestions: What do you find most helpful in the *Journal*? What would you like to see in future issues of the *Journal*?

We also encourage all practitioners to consider sharing their practice experience and knowledge by submitting articles on topics of general interest to New York State practitioners. Manuscripts should be submitted to Professor Redwood and those selected for publication will appear as articles in future issues of the *Journal* consistent with publication deadlines. Further instructions regarding publication policy, manuscript guidelines, and publication deadlines appear on p. 51 in this issue.

Stuart B. Newman
Chair, *NY Business Law Journal* Board

NY Business Law Journal Student Writing Competition

The *NY Business Law Journal* is pleased to announce a writing competition open to all law school students. This competition is a reflection of the goal of the New York State Bar Association to encourage membership and participation in the association by attorneys at all levels of experience and is, in part, an attempt by the Association to familiarize law students with the activities, interests and opportunities offered by the New York State Bar Association.

Law students are encouraged to submit manuscripts of between 2,500 and 7,500 words on any topic of general interest to New York State business law practitioners within areas of the law covered by the scope of the nine committees of the Business Law Section listed below:

Banking Law	Futures and Derivatives Law
Bankruptcy Law	Insurance Law
Consumer Financial Services	Internet and Technology Law
Corporations and Other Business Entities	Securities Regulation
Franchise, Distribution and Licensing Law	

Articles may be based on any topic of case law, statutory interpretation, or general observation regarding a practice issue within the purview of a particular committee.

All submissions will be judged by members of the *Journal*'s Advisory and Editorial Boards, whose decision will be final. Cash prizes will be awarded to the authors as follows:

First Prize:	$1,500
Second Prize:	$1,000
Third Prize:	$500

Winning articles will, of course, be published in the *Journal*, and submission of an article constitutes the author's consent to such publication. Manuscripts should be submitted to the Editor-in-Chief of the *Journal* no later than June 15, 2002. Submissions should identify the committee that would most likely be interested in the subject matter, and should follow the instructions and manuscript guidelines set forth in each issue of the *Journal*.

Message from the Editors

Welcome to the Fall 2001 issue of the *NY Business Law Journal*. The Editor-in-Chief, our colleague Jim Redwood, is taking a well-deserved rest for this issue, giving us the opportunity (and the challenge) of editing an issue which, we hope, will live up to the high standard set by its predecessors.

We must start by thanking our contributing authors who have somehow found time, despite their busy schedules, to share with their fellow members of the Business Law Section of the New York State Bar their expertise in the excellent articles which appear in this issue. As they receive no financial emoluments, we hope that they agree that virtue is its own reward. We also hope that they have discovered that one of the best ways to increase your knowledge of a topic is to write about it. We encourage all Section members to submit articles for consideration for future issues. Not only is this a valuable service to the Section and to the bar: it can also yield tangible benefits in your own practices.

This issue begins with a celebration: the *Journal* has reached a significant milestone, as this issue completes our fifth year of publication. The celebration summarizes some of the valuable articles that we have published over that period.

We continue with Committee Reports including a report from the Committee on Futures and Derivatives Law, which describes committee activities resulting from the enactment of the Commodity Futures Modernization Act of 2000. The report also notes that the committee is working on an article on futures commission merchant liability for the torts of non-guaranteed introducing brokers, which we hope to publish once the final article has been approved by the committee. Finally, the report describes the committee's efforts to increase its membership and to develop closer ties with its counterpart at the Association of the Bar of the City of New York.

The Insurance Law Committee reports that it discussed compliance and implications for the scope of liability with respect to a hardening insurance market. In addition, the committee discussed recent developments in bankruptcy law and the potential implications of the proposed Community Reinvestment Modernization Act of 2001.

Next, we include the minutes of the April 2001 meeting of the Committee on Internet and Technology Law. Among the topics discussed are bills recently introduced in the New York State Legislature, including A.7902, the so-called anti-UCITA (Uniform Computer Information Transactions Act) bill. The minutes also discuss reports submitted by various subcommittees.

The Securities Regulation Committee submitted the final report included in this volume. The committee reminds members that it meets monthly for discussions and presentations of a variety of topics. Among the issues that the committee has considered are: modernizing the corporate financing rule, derivatives, strategy in proxy contests, Arthur Levitt's legacy and the "new" SEC, and the N.Y. state legislation concerning investment advisers.

Our first article was written by two experts in franchising law. David J. Kaufmann is a senior partner in the firm Kaufmann Feiner Yamin Gilding & Robbins LLP, of New York City. Joseph J. Punturo is Franchise Section Chief & Assistant Attorney General in the Office of the New York State Attorney General, and Chair of the Section's Franchise, Distribution and Licensing Law Committee. They have written a detailed and timely article discussing recent developments in franchise law, including a helpful overview of the different types of state, federal and foreign franchising laws, and citations to the pertinent statutes. Other topics addressed include the relatively new "coordinated review" process for multi-state franchise disclosure documents, forthcoming revisions to the FTC Franchise Rule, recent activities of the NASAA, franchising and the Internet, proposed federal legislation and significant recent New York decisions.

The next article is a helpful review of the complex new SEC rules governing public company audit committees and auditor independence, written by two specialists in corporate and securities law. Guy Lander, a frequent contributor to the *Journal*, is a partner at Davies Ward Phillips & Vineberg LLP in New York City and is the First Vice-Chair of the Business Law Section. Lori Sullivan is a partner in the same firm's Toronto office. In addition to providing a detailed description of the new requirements, the article includes the list of non-audit services that impair auditor independence.

The third article discusses New York's recent adoption of revised Article 9 of the UCC. The author is Nancy Ota, one of the co-editors of this issue and a Professor of Law at Albany Law School. In addition to providing a summary of the important changes, the article addresses the new filing requirements, transition issues and the non-uniform amendments adopted in New York, and points out some traps for the unwary. A sidebar lists helpful resources for the practitioner.

Our final article was again written by Guy Lander, who apparently never sleeps, and contains a detailed overview of the public offering registration process, which will be particularly useful to those practitioners who are rarely called upon to navigate these treacherous waters. The article describes the roles of the lawyer and other professionals, the various forms and documents that must be prepared, and the SEC review of the registration statement.

We were exceptionally fortunate to have as our research assistant for this issue, Whitney Phelps, a third-year student at Albany Law School and member of the *Albany Law Review*. Her intelligence, diligence and unfailing good humor made our jobs much easier, and the opportunity to visit with her charming daughter was an unexpected bonus. Whitney has prepared a Case Note on an interesting recent Court of Appeals decision, *In re Penepent Corp.*, in which the Court addressed a potential conflict between the provisions of a shareholders' agreement and the provisions of BCL § 1104-a. Whitney has also compiled brief summaries of several other recent decisions involving business law issues.

Finally, please note the announcement of the student writing competition, sponsored by the Business Law Section, which offers to the winners substantial cash prizes and publication in these august pages. If any reader knows a student who might be interested in entering, please bring the competition to the student's attention.

As always, we hope that you enjoy this issue and find it useful. We are always interested in your comments on past issues and your suggestions for articles for future issues. You can address your comments to any member of the Advisory Board or Editorial Board or to either of us.

Sincerely,

Nancy K. Ota
Professor of Law
Albany Law School

David A. Pratt
Professor of Law
Albany Law School

Committee Reports

Report of the Committee on Futures and Derivatives Law

In the wake of the recently enacted Commodity Futures Modernization Act of 2000 (the "Act"), the Committee on Futures and Derivatives Law (the "Committee") has been particularly focused on the changes brought about by this legislative change. From December 19, 2000 through June 28, 2001, the Committee held seven meetings, most of which were devoted to discussing the Act and the rules proposed, or to be proposed, in connection with the legislation. As part of these discussions, the Committee was fortunate to have four distinguished speakers. At the December 19, 2000 meeting, days after both houses of Congress passed the Act, Douglas E. Harris gave a presentation on Title IV of the Act, which addresses legal certainty for bank products, and Richard A. Miller gave a presentation on the main portion of the Act, Title I, as well as an overview of the Act's history. Both Mr. Harris and Mr. Miller are members of the Committee. Commissioner Thomas J. Erickson of the Commodity Futures Trading Commission was the guest speaker at the Committee's February 22, 2001 meeting. As part of his presentation, Commissioner Erickson gave a brief overview of the Act and then focused primarily on the Act's regulatory reform and jurisdictional implications. Finally, Patrick Parkinson of the Board of Governors of the Federal Reserve System was the guest speaker at the Committee's June 28, 2001 meeting. Mr. Parkinson discussed the Act's unresolved issues that relate to retail swaps and the Securities and Exchange Commission's jurisdiction over OTC derivatives that are not "swap agreements."

During the past six months, the Committee has also moved forward on a number of its projects. Chief among these projects has been the completion and final approval of an article on futures commission merchant liability for the torts of non-guaranteed introducing brokers. Norma B. Levy and Anthony J. Leitner have been instrumental in the drafting and subsequent revisions of the article, a final version of which is expected to be approved by the Committee in the near future. Other Committee projects include the eventual creation of a Committee Web site and an effort to increase the level of cooperation between the Committee and its counterpart at the Association of the Bar of the City of New York regarding submission of comments on proposed rule making. The latter project is especially relevant, given the amount of rule making required by the Act in a relatively short period of time. The Committee has also focused on increasing Committee membership by encouraging current members to bring their colleagues to Committee meetings.

Respectfully submitted,
Rebecca J. Simmons, Chair

* * *

Report of Insurance Law Committee
April 25, 2001

Administrative

The meeting opened with Anne Ottaviano, Chair of the Membership Subcommittee, reporting on new members. Potential Fall Meeting speakers were discussed. Jeff Gaylord, Chair of the Executive Liability Insurance Subcommittee, agreed to speak on priority of payments language and related bankruptcy issues. Robert Yellen, Chair of the Insurance Law Committee, committed to speaking or finding an alternate speaker from AIG. The Hartford was also expected to provide a speaker, with the topic to be determined.

Legal/Market Developments

We held a discussion of the impact that a hardening insurance market would have on compliance. Implications for the scope of executive and professional liability were expected to be significant. Developments in bankruptcy law relating to priority of payments under executive liability policies were considered in relation to the anticipated contraction in coverage.

Pending Legislation

The Insurance Law Committee reviewed the potential implications of H.R. 865, the Community Reinvestment Modernization Act of 2001. The Act would extend the Community Reinvestment Act of 1977 to insurers.

Respectfully submitted,
Robert Yellen, Chair

* * *

Report of the Committee on Internet and Technology Law

April 25, 2001

The meeting, which was held at the Association of the Bar of the City of New York, was called to order by Chair Alan D. Reitzfeld.

It was announced that this was the last meeting in Mr. Reitzfeld's three-year term as Chair and that Micalyn S. Harris is the incoming Chair.

Articles were solicited for the next issue of the Committee Newsletter, with a target submission date of next week.

There was an extensive discussion of A.7902, which is an act introduced in the New York State Assembly on March 27, 2001 "to amend the general obligations law, in relation to ensuring that computer information transaction contracts are interpreted in accordance with state law." This legislation has been informally referred to as the anti-UCITA (Uniform Computer Information Transactions Act) bill. In recognition of the fact that various Committee members held strong views for and against UCITA, a Subcommittee was appointed, to be chaired by Micalyn S. Harris, to contact other New York State Bar Association committees and make a recommendation to the Committee concerning this legislation.

Various other state legislation involving privacy, electronic contracts and electronic voting issues will be followed by Walter Klasson (S.4353, S.4358) and David Lerner (S.4356, S.4357).

The following Subcommittees gave reports through their respective Subcommittee Chairs:

1. Walter Klasson gave the Privacy and Security Subcommittee's report. He led an extensive discussion of privacy developments in the U.S. and of various cases of interest.
2. Robert M. Yellen updated the Committee on the status of the Bar Association's new Web site and gave the Subcommittee on Legislation's report on legislation regarding cyberterrorism, online privacy and anti-spam.
3. Travis L. Gering gave the Securities Subcommittee's report on electronic signatures and the sharing of information relating to privacy.
4. Steven Masur gave the Entertainment Subcommittee's report on the *Napster* case and gave the Computer Finance, M&A and Deals Subcommittee's report on "dot.com" exit strategies.
5. Written Subcommittee reports were distributed by the E-Commerce Subcommittee (Julian S. Millstein, Chair); Taxation in Cyberspace Subcommittee (Thomas Glascock, Chair); and Trademark Usage in Cyberspace Subcommittee (Martin J. Ricciardi, Chair).

Respectfully submitted,
Alan D. Reitzfeld, Chair

* * *

Report of Committee on Securities Regulation

August 22, 2001

The Committee on Securities Regulation is comprised of approximately 85 members, principally securities lawyers in private practice and in corporation law departments, but also including members of the New York Attorney General's office and the New York Department of State. We meet monthly in New York City to discuss various topics involving federal and state securities laws and receive presentations both by members of our Committee and guest speakers. We also submit comment letters to the Securities and Exchange Commission in connection with rule-making proposals and other matters, and we also address issues arising under the New York State Martin Act. Some of the topics addressed during the past six months were:

- Suzanne Rothwell, former Chief Counsel, Corporate Financing Department, NASD Regulation, Inc., discussed modernizing the corporate financing rule.
- Conrad Bahlke, Partner, Weil, Gotshal & Manges LLP, discussed derivative securities.
- Lawrence E. Dennedy, Senior Vice President, Mackenzie Partners, Inc., discussed strategic considerations for a proxy contest.
- Harvey Goldschmid, of Counsel, Weil, Gotshal & Manges LLP, and Former General Counsel of the Securities and Exchange Commission, discussed Arthur Levitt's legacy and the "new" SEC.
- Ellen Lieberman, Partner, Debevoise & Plimpton, discussed the proposed New York State investment adviser legislation which the Committee has been working with the New York Attorney General's office and members of the New York State Senate in an effort to develop mutually acceptable legislation.

We invite all members of the New York State Bar Association who are interested in the securities laws to join our Committee.

Respectfully submitted,
Gerald S. Backman, Chair

Recent Developments in Franchise Law

By David J. Kaufmann and Joseph J. Punturo

I. Introduction

A. Franchising

Funny, isn't it? Although franchising today accounts for fully 41 percent of all domestic retail sales—nearly one trillion dollars worth—you probably never heard the word "franchising" uttered in law school (nor will you hear it today, since only a handful of law schools even address the subject). You rarely see a CLE course offered on the subject. And because the major law firms sneered at representing franchisors when they exploded on the American economic scene in the 1950s and '60s ("We represent General Electric, not hamburger flippers"), they are, for the most part, nonplayers in the representation of what are now huge, multinational and multibillion-dollar businesses.

Thus, the law governing franchising is almost exclusively practiced by a small cadre of government regulators, in-house counsel and outside practitioners who are relatively few in number—perhaps 300 nationwide who exclusively devote their time to franchising—but who are, in every sense of the word, business and legal experts in an area otherwise understood by very few. These practitioners must master not only franchise-specific laws, rules and regulations (which are summarized below), but also the plethora of other bodies of law that impact daily on the operation and regulation of franchising. These other regimes include antitrust, intellectual property, tort, securities, labor, corporate, real estate and tax law—to say nothing of the international laws with which, more frequently, franchise regulators and counsel must be intimately familiar.

In this article, we will briefly summarize the law governing franchising and then describe the series of momentous developments in the law that have transpired over the past few years and continue to transpire even as this article is being written. The article ends with a discussion of New York case law on franchising.

II. A Brief Overview of the Law of Franchising

Until the 1970s, the only so-called franchise law that existed was the body of law affecting business in general. Due to franchising's structural attributes, the federal antitrust laws and the Lanham Trademark Act were especially important. Today, however, practitioners must be aware of four distinct bodies of law governing franchising: (i) federal and state registration/disclosure laws, rules and regulations; (ii) franchise relationship laws; (iii) business opportunity laws; and (iv) foreign laws governing franchising. An overview of each follows.

A. Federal and State Franchise Registration/ Disclosure Laws, Rules and Regulations

Both the federal government and 15 states have laws, rules and/or regulations requiring franchisors—prior to offering or selling a franchise (or any interest therein)—to prepare and disseminate to prospective franchisees a prospectus-type disclosure document containing all material information necessary for such prospects to make informed investment decisions.

The federal disclosure mandate is set forth in the Federal Trade Commission's Franchise Rule.[1] Pursuant to this Rule, franchisors must make full pre-sale disclosure nationwide in a disclosure document issued in accordance with the Federal Trade Commission's Interpretive Guides.[2] Alternatively, franchisors seeking to comply with the Rule may utilize the state-ordained Uniform Franchise Offering Circular (UFOC) disclosure format to satisfy the FTC Franchise Rule's disclosure dictates. Regardless of which format is used, no registration or prior FTC review of franchise disclosure documents is required under the FTC Franchise Rule.

It is critical to note that while the Federal Trade Commission permits franchisors to satisfy their disclosure requirements by utilizing the state ordained UFOC document, the converse does not hold true. That is, those 15 states having franchise registration/disclosure laws on their books forbid the use of an FTC Franchise Rule formatted disclosure document to satisfy state disclosure obligations. Thus the vast majority of franchisors in this country utilize the UFOC disclosure format because it satisfies all federal and state disclosure requirements.

On the state level, attempts to prevent, combat and rectify franchise sales abuse date back to the passage in 1971 of the California Franchise Investment Law,[3] which requires franchisors to register with the state and to disseminate to prospective franchisees a prospectus-type disclosure document prior to engaging in any franchise sales activity. Since then, 14 other states have enacted laws, which adopt the franchise registration and prospectus disclosure requirements pioneered by California. These states are: Hawaii,[4] Illinois,[5] Indiana (notice filing only),[6] Maryland,[7] Michigan (notice filing only), [8] Minnesota,[9] New York,[10] North Dakota,[11] Rhode Island,[12] South Dakota,[13] Texas (notice filing only), [14] Virginia,[15] Washington[16] and Wisconsin (notice filing only).[17]

State registration and disclosure laws provide that, unless a statutory exemption is available, no offer or sale of a franchise can take place unless and until the franchisor has filed with the appropriate state agency—and that agency has approved and registered—a prospectus setting forth honestly, and in detail, all of the material facts of the franchise sales transaction. Then, in accordance with the FTC Franchise Rule's timing requirements (which preempts all state laws on the issue), the franchisor must give the registered prospectus to prospective franchisees at the earlier of: (i) the "first personal meeting" between a franchisor and its prospective franchisee (i.e., the first face-to-face meeting held for the purpose of discussing the sale, or possible sale, of a franchise); (ii) 10 business days prior to the execution by the prospective franchisee of any franchise-related agreement; or (iii) 10 business days prior to the payment by the prospective franchisee of any monies or other consideration in connection with the sale, or proposed sale, of a franchise.

State franchise registration/disclosure statutes attempt to forge a comprehensive structure to thwart, combat and rectify franchise sales abuse. The registration and disclosure process is only one element of this structure. The other components include post-sale monitoring, investigation, litigation and prosecution.

Enforcement through these other measures begins with laws that define "fraudulent" and "unlawful" practices in the broadest of terms. Any intentional making of an untrue statement of a material fact, any intentional omission of a material fact whose absence renders another statement misleading, any scheme or artifice to defraud, any act or practice which would or does operate as a fraud or deceit, any violation of any franchise registration/disclosure statute, or any rules or regulations promulgated thereunder, or, any attempt to compel franchisee waiver of any given statute's provisions are, under most state franchise registration/disclosure statutes, declared fraudulent and unlawful practices.

State registration/disclosure statutes confer upon franchise administrators broad powers to investigate franchise sales fraud and illegality. If they do uncover fraud, these administrators can institute civil proceedings seeking restitution (without limitation), damages, injunctions, fines and penalties and court-ordered receiverships. Many state franchise administrators also possess "stop order" powers—the ability to suspend *ex parte* a franchisor's franchise registration, and thus its ability to legally offer and sell franchises—should the administrator believe that fraudulent or illegal activity is being engaged in by the subject franchisor. In addition, violation of state franchise registration and disclosure statutes in many states give rise to criminal liability, which accrues per violation. Under most state franchise registration/disclosure statutes, both criminal and civil liability for violations thereof inures not only to the subject franchisor itself, but also to that franchisor's officers, directors and senior management personnel on a "joint and several" basis. Moreover, many state franchise registration/disclosure statutes confer upon franchisees a limited private right of action for rescission, damages and attorneys' fees.

"State registration and disclosure laws provide that, unless a statutory exemption is available, no offer or sale of a franchise can take place unless and until the franchisor has filed [a prospectus] with the appropriate state agency . . ."

Interestingly, New York was among the last of the states to adopt franchise-specific legislation. While considering the New York Franchise Act, the Legislature heard testimony from the Attorney General estimating that, from 1972-1979 alone, over 14,000 New Yorkers lost nearly 40 million dollars through franchise fraud.[18] Yet by 1980, when both the federal government and every other significant industrial state was regulating the franchise sales process by means of legislation or regulation, New York remained conspicuously silent, having no law directly concerned with franchising.

New York closed the breach with Article 33 of the General Business Law, the New York Franchise Act (the "Act"), which the Legislature enacted in June 1980 with an effective date of January 1, 1981. The Act establishes a comprehensive scheme of pre-sale disclosure (by means of a prospectus registered with the Attorney General) and post-sale redress of franchise sales fraud (by means of Attorney General-initiated prosecutions—both criminal and civil—and private actions commenced by franchisees alleging violations of the Act).[19]

B. State Franchise Relationship Laws

Eighteen states (Arkansas,[20] California,[21] Connecticut,[22] Delaware,[23] Hawaii,[24] Illinois,[25] Indiana,[26] Iowa,[27] Michigan,[28] Minnesota,[29] Mississippi,[30] Missouri,[31] Nebraska,[32] New Jersey,[33] South Dakota,[34] Virginia,[35] Washington,[36] Wisconsin[37] and the U.S. Virgin Islands[38] and Puerto Rico[39]) have enacted franchise relationship statutes. These state franchise relationship laws govern when, and under what circumstances, a franchisor may terminate an existing franchise agreement or refuse to renew a franchise. Some of these state franchise relationship statutes also address such aspects of the franchise relationship as fair dealing, discriminatory treatment, market protection, the ability of franchisees to belong to franchisee associations, and, the minimum advance notice of franchise termination or expiration which must be given to franchisees.

C. Business Opportunity Laws

Twenty-three states have enacted business opportunity laws. These states are Alabama,[40] California,[41] Connecticut,[42] Florida,[43] Georgia,[44] Indiana,[45] Iowa,[46] Kentucky,[47] Louisiana,[48] Maine,[49] Maryland,[50] Michigan[51] (notice filing only), Minnesota,[52] Nebraska,[53] New Hampshire,[54] North Carolina,[55] Ohio,[56] Oklahoma,[57] South Dakota,[58] Texas,[59] Utah,[60] Virginia[61] and Washington.[62] Business opportunity laws typically do not directly regulate franchising, but only regulate the sale of opportunities to engage in new business ventures. However, since franchises are, by definition, new business ventures, business opportunity laws do impact upon franchising in many states. These laws require registration and disclosure in much the same fashion as state franchise registration statutes and usually require, in addition, the posting of a surety bond or other financial security instrument.

While the definition of a "business opportunity" is clear in a typical franchise, there is often confusion about whether or not these laws apply to most franchisors. In many states, franchise offerings are explicitly excluded on the basis of compliance with federal or state franchise registration and disclosure requirements. In other states, however, franchise offerings are covered even if there is compliance with such disclosure requirements if the franchisor makes certain representations in the course of selling the franchise.

D. Foreign Franchise Laws, Rules and Regulations

With ever increasing frequency, U.S.-based franchisors are spreading their business empires around the world. Indeed, following the collapse of the Communist Eastern Bloc a decade ago, it was the American franchise community which, in large part, introduced Western-style capitalism to the nations of Eastern Europe and the former Soviet Union, such that you can now stay at a Holiday Inn, utilize the services of Snelling & Snelling or purchase Pizza Hut pizza in many of these regions as easily as you can here in the United States.

In response to franchising's broad scale introduction throughout the world, many countries enacted franchise laws, rules and regulations governing either the offer and sale of franchises and/or the franchisor-franchisee relationship. A full and thorough review of the tenets of international franchise laws, rules and regulations—and the business paradigms utilized by American-based franchisors when conducting business overseas—could occupy an entire textbook. Therefore, we simply remind counsel that the following have laws, rules and/or regulations which may, or will, govern American-based franchisors engaging in international operations: Australia, Canada, China, the European Union, France, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Romania, Russia and Spain.

III. Developments in Franchise Law

A. Coordinated Review of Multi-State Disclosure Documents

One of the most fascinating and still nascent developments in the field of franchise law is the recent attempt by the franchise-regulating states to make the registration process for multistate franchisors more readily obtainable through a process called "coordinated review." Coordinated review of a UFOC is a process that streamlines registration for franchisors filing franchise registration applications in multiple states. Coordinated review does not eliminate the filing of required registration documents with each state, but consolidates the various states' comments into one unified comment letter sent to the franchisor. Applicants seeking to register under the coordinated review program still have to pay the applicable state registration/filing fees directly to each state in which the applicant seeks to register. Moreover, this program is only open to applicants that have audited financial statements.

"Coordinated review . . . streamlines registration for franchisors filing franchise registration applications in multiple states."

This process was created by the North American Securities Administrators Association's (NASAA)[63] Franchise and Business Opportunity Committee (the "Committee"). Eleven franchise registration states have agreed to participate in the coordinated review program on a voluntary basis.[64] The coordinated review process should result in a more comprehensive and uniform review of the franchisor's UFOC and lead to more complete disclosure for prospective franchisees.

Under the coordinated review program, a franchisor files its UFOC with the participating states and submits a form FCR-1 that identifies the applicant as requesting coordinated franchise review. The state serving as the project administrator (currently, the Attorney General in Maryland) receives a copy of the complete application for coordinated franchise review, even if the franchisor does not seek to register there. Upon receipt of an application for coordinated franchise review, the project administrator designates a single state, called the Lead State, to coordinate the review process. In general, the Lead State contacts all participating states to prepare for the coordinated review project and notifies the participating states of the deadlines for their responses.

Each state participating in the coordinated franchise review reads the franchisor's filed materials, including its UFOC, as that state would review any franchise registration application. Rather than respond to the franchisor, however, the states submit their comments to the Lead State within the deadlines specified. In these comments, the states apply the UFOC guidelines as a uniform standard, in addition to their own specific statutory, regulatory and policy requirements.[65]

After receiving comments from each of the participating states, the Lead State determines whether any of the participating states have made conflicting comments relating to the UFOC guidelines. If participating states have made conflicting comments or if an applicant receives a comment from one state that, if complied with, would contradict another state's regulation or comment, the Lead State seeks to resolve those inconsistencies by contacting those states. If participating states have not made conflicting comments, the Lead State compiles and coordinates the state's comments, and then prepares and sends one coordinated review comment letter. The Lead State sends out an initial coordinated comment letter within 30 business days of the date the applicant files its application materials with the states.

After the applicant receives the coordinated review comment letter, it contacts the Lead State to discuss questions regarding the letter. If necessary, the applicant also sends to the Lead State a revised UFOC and any additional documents, as directed in the coordinated review comment letter. The Lead State again replies directly to the applicant. If any participating states submit state-specific comments to the Lead State, the Lead State may ask the states for guidance in evaluating the responses to the state-specific deficiencies. Alternatively, a participating state may ask the Lead State for the right to review the applicant's responses to the state-specific comment. When the Lead State approves the franchisor's application for coordinated franchise review, all participating states agree to approve it as well.

B. Forthcoming Revisions to the FTC Franchise Rule

Practitioners should beware that the FTC Franchise Rule is about to undergo its most dramatic overhaul since that regulation took effect in 1979. On October 22, 1999, the Federal Trade Commission released a Notice of Proposed Rulemaking (NPR) detailing such forthcoming changes. The product of almost five years of proposals, hearings and input from franchisors, franchisees, their counsel and advocates, the NPR reflects remarkable wisdom and sophistication. The FTC developed its proposal by identifying a multitude of issues impacting franchising, weighing various alternate courses, digging deep into the business world to truly comprehend what makes sense, and taking into consideration future technological changes.

If the FTC Franchise Rule is ultimately revised as suggested by the Commission's NPR (and it almost certainly will be, with some minor modifications), significant changes will result. The proposed Rule eliminates coverage of business opportunities (the Commission plans to promulgate a separate regulation governing business opportunity offerings). In addition the new Rule will eliminate current FTC Franchise Rule's format of disclosure. Instead, the amended Rule requires franchisors to utilize exclusively the UFOC disclosure format, but with a twist—the NPR layers on additional disclosure requirements (and some modified disclosure requirements) from those currently required under the UFOC guidelines.

In response to franchisee input, the NPR suggests that the FTC Franchise Rule will be revised to require franchisors to disclose any policy of obtaining contractual "gag clauses" prohibiting or restricting existing or former franchisees from discussing their business experiences, whether incident to litigation or otherwise. And franchisors would also be required, under the revised Rule, to set forth in their disclosure documents the identities of all franchisee associations known to them—not just "captive franchisee associations" (those established by the franchisor itself), but all such organizations whose existence is known to the franchisor. (Not required, however, will be disclosure regarding non-system-specific franchisee associations, such as the American Franchisee Association or the American Association of Franchisees and Dealers.) The UFOC disclosure format will be the only one available to franchisors to satisfy their disclosure obligations. But the revised rule would require additional and modified disclosures beyond those mandated today by the UFOC guidelines, leading certain pundits to refer to the FTC's proposed disclosure requirements as "UFOC" plus.

The proposed Rule settles the debate over the FTC Franchise Rule's application to sales by American franchisors to foreign individuals and entities. Over the past decade, the FTC signaled that the Rule did not apply to these sales. But, five years ago a U.S. District Court in Florida held that the Rule might be applicable to a franchise sale effected by an American-based franchisor to a

South American franchisee (a decision later reversed by the Eleventh Circuit).[66] The NPR makes clear that the FTC intends to revise its Franchise Rule such that it will not apply to such "pure outbound" franchise sales transactions. But beware—the FTC is not relinquishing its jurisdiction over such sales. That is, the NPR reveals that the Commission intends to reserve and exercise its power to combat fraudulent international franchise sales transactions through civil prosecutions.

Note that if the FTC Franchise Rule is revised to eliminate coverage of "pure outbound" franchise sales transactions, only one U.S. franchise law—the New York Franchise Act—will still govern such transactions. A federal court held that the New York Franchise Act governed international transactions, reasoning that New York's status as the commercial capital of the world was a sufficiently compelling state interest to justify the Act's international reach—so that New York-based franchisors offering and selling franchises anywhere in the world must first register with the New York Attorney General and disseminate to foreign franchisees a registered disclosure document before effecting any "pure outbound" franchise sale.[67]

The Commission proposes additional changes including eliminating the requirement for distribution of hard copies of disclosure documents. Instead, the NPR would allow franchisors to effect disclosure through electronic means—over the Internet, utilizing computer disks, through e-mail or other methods. Also, the NPR will allow prospective franchisees to acknowledge receipt of documents through "electronic signatures" (including digital signatures and passwords) to evidence their receipt of the disclosure document.

The proposed Rule also eliminates the current FTC Franchise Rule's "first personal meeting" disclosure trigger, the "ten business days" disclosure trigger and the "five business days" franchise agreement dissemination obligations. Acknowledging the age of electronic communications and disclosure, this change facilitates prospective sellers' communication with buyers using a wide array of communications media. Accordingly, under the revamped FTC Franchise Rule, there would be no specific disclosure "trigger" at all. Instead, the only requirement would be that the prospective franchisee receives the disclosure document 14 days (instead of ten business days) before signing any franchise agreement or paying any money to the franchisor. And the franchisee must receive the franchise agreement, in a form ready for execution, five calendar days before execution (rather than the current "five business days" advance requirement). With these changes, the franchisee still has adequate time to review the franchisor's disclosures in order to prevent fraud.

The revised FTC Franchise Rule will confer a benefit to franchisors as well. Responding to their input, the proposed Rule allows a disclosure exemption altogether for "sophisticated investor" transactions. These transactions include franchise sales involving an investment by the franchisee of at least $1.5 million (with the Commission specifically seeking comment on whether this threshold is too high or low); sales to large corporations which have been in the subject business for at least five years and have a net worth of at least $5 million; and sales to officers, directors and other executives of the franchisor in question.

A key concern to almost everyone in the franchise community is whether the FTC Franchise Rule will be revised to require franchisors to disclose "financial performance information" such as information regarding past or projected franchisee gross revenues, profits, earnings before interest, depreciation and tax, "breakeven" points, etc. The answer? No.

C. Mandating Disclosure of Franchise Network Financial Performance Information

Although the proposed FTC rule does not require financial performance disclosure, since 1994, the NASAA's Franchise Project Group has been working on a Financial Performance Earnings Initiative, which would require franchisors to disclose earnings projections for their franchises.[68] Currently, only 15 to 20 percent of franchisors make earnings projections.[69] Franchisors take an unfavorable view of this proposal since it could hinder the sale of some franchises with less than stellar earnings data. The FTC has also voiced concern over the proposal and would like to keep earning projections voluntary and accurate.[70] Dale Cantone, the Chairman of the NASAA Franchise Project Group, believes an empirical study must be completed before any recommendation can be made to the NASAA Board of Directors.[71] What will happen if the FTC Franchise Rule, as revised, does not require such mandatory financial performance disclosure, but the states determine to mandate such disclosure, is the subject of much conjecture.

D. The NASAA Registration Diffusion Project

Every state requires franchisors to amend and/or renew their franchise registrations and their franchise disclosure documents annually in order to update the information contained in the disclosure documents and, most critically, to assure inclusion of the franchisors' most recent audited annual financial statements. Accordingly, franchise registrations in most states automatically lapse 90–120 days following the close of the franchisor's most recent fiscal year. In order for franchise sales to continue, the franchisor must update the disclosure documents with the latest set of audited financial statements. Because most franchisors are on a "calendar year" fiscal year, the vast majority of franchisors seek to renew their franchise registrations at the same time (usually the months of March–May).

NASAA is currently working on a registration diffusion project designed to disperse such annual renewal/amendment filings throughout the year. Although the NASAA Franchise Project Group and its advisors are diligently devoting a great deal of attention to this project, no changes are imminent. The complexity of the issues, the logistics of amending franchise registration laws and the intensity of the study will prolong any changes.

E. Franchising and the Internet

Five years ago, interest in the Internet was largely restricted to academicians. To business people, the notion of the Internet as a viable means of commerce fell under the category "topics to think about for the coming millennium." Three years ago, Internet commercial transactions became more common, but many businesses still shied away from e-commerce due to either unfamiliarity with the new technology and its possibilities or logistical problems that had yet to be overcome (such as encrypted "secure" transactions). Now, Internet commercial transactions are routine. From a computer you can read your morning newspaper, buy or sell stock, book plane, rental car and hotel reservations and place orders for every conceivable type of merchandise.

1. Offering Franchises Over the Internet

As noted above, the FTC Franchise Rule is about to undergo a significant alteration for the first time since that regulation took effect in 1979 and it appears certain that this overhaul will include an express sanctioning of "electronic disclosure." Perhaps as soon as 2003, franchisors will be able to fulfill their federal disclosure obligations through electronic means—over the Internet, utilizing computer disks and via e-mail. Indeed, as previously mentioned, prospective franchisees will be able to acknowledge receipt of disclosure documents using "electronic signatures" (including digital signatures and passwords).

As the commission observes in its NPR, electronic disclosure will reduce franchisors' disclosure compliance costs. More importantly, electronic disclosure will be of great benefit to those franchisees who desire to obtain a franchisor's disclosure document more quickly. Plus, the Internet facilitates cross-links between the 23 items in the UFOC and the subject franchise agreement. Such linking eliminates the time-consuming and often confusing task of having to shift back and forth between the disclosure document itself and the contract provisions it describes, thus affording a more intelligent review of the document by a prospective franchisee. Further, a prospective franchisee's ability to access a greater number of franchise disclosure documents will improve with electronic disclosure.

2. Internet Offer Safe Harbor

Even before the emergence of the World Wide Web, companies that sold their business through independent agents subjected themselves to the risk that they were, in fact, violating state and federal franchise laws.[72] NASAA's Franchise Committee is concerned with the effects that the Internet has, and will have on existing franchise laws across the country. Of particular concern is the offering of a franchise over the Internet in the form of offers and advertising.[73]

In 1998, the Franchise Committee recommended to NASAA a Statement of Policy Regarding Offers and Sales of Franchises On the Internet (the "Statement"). In particular, the Statement recommended that states should amend their franchise regulation laws to exempt franchisors from state registration requirements when franchisors simply post information regarding their franchise opportunities on the Internet. As of June 4, 2001, 10 of the 12 states that currently require registration of franchise offerings have adopted the NASAA proposal, or some similar derivation of it, including the exemption as part of their own laws.[74] The states adopted the proposal either through order or by regulation. One of the primary requirements, however, is that a franchisor who qualifies for an exemption must include a disclaimer on the franchisor's Web site that the franchisor is not offering franchises to residents of any jurisdiction in which the franchisor is not registered to sell franchises. The remaining states that have registration requirements have not formally indicated any opposition to the NASAA policy and will most likely adopt the proposal in the near future.

3. Internet Advertising Safe Harbor

While the issue regarding offers on the Internet has been resolved, a debate exists as to whether Internet advertisements that are intended to sell franchises should be filed with states requiring filing of Internet advertisements. On the one hand, proponents argue that Internet advertisements should be filed with states so that state enforcement authorities can investigate and pursue enforcement initiatives against those who display misleading or false information on the Internet. On the other hand, opponents argue that there are no laws specifically requiring the filing of Internet advertising and secondly, since the Internet is a global medium, any Internet advertisements should be exempt, since most states have laws that exempt the filing of advertisements which appear in media that have at least two-thirds of its circulation outside the state. In addition, they argue that because Internet Web sites have the ability to change so frequently, it would be unreasonable to require them to file copies of those Web sites with state authorities on a continuing basis.

As a result of the debate, NASAA's Franchise Committee has prepared a proposed safe harbor regarding Internet advertising. This safe harbor applies to passive forms of Internet communications, as opposed to advertising that is directed towards specific persons. For the safe harbor to apply, the following conditions must be met:

> A. The franchisor discloses to the [Administrator] the Uniform Resource Locator ("URL") addresses or similar address or device identifying the location of the Internet advertising: (1) on the cover page of a franchise offering circular included with an application for registration that is effective in [Jurisdiction]; (2) on the cover page of a franchise offering circular included with an application for exemption from registration that is on file with the [Administrator]; or (3) on a notice filed with the [Administrator]; and
>
> B. The Internet advertising is not directed to any person in the [Jurisdiction][75] by, or on behalf of, the franchisor or anyone acting with the franchisor's knowledge.[76]

On July 8, 2001, the Franchise Committee distributed the proposal internally to the NASAA board. After a vote by the NASAA Board of Directors on July 11, 2001, NASAA released the proposal and requested comments from the public until August 10, 2001. As of July 23, 2001, NASAA had not received any comments.[77] If no comments are received, NASAA will vote on the proposed statement in September 2001. In order for the proposal to be adopted by NASAA, a majority of NASAA's board of directors must approve it.[78] Upon approval, it will become a NASAA statement of policy. At that point, it is up to the states to approve it. The policy will be effective as accepted on a state-by-state basis.

4. Electronic Disclosure Project

NASAA is working on another initiative to program instructions for the delivery of disclosure documents electronically. Currently, the proposal requires that the UFOC:

1) be delivered in a single, integrated document or file;
2) be delivered in a form that can be preserved, stored, retrieved and printed;
3) may include customary devices for manipulating electronic documents, including scroll bars and search features, but not any extraneous content; and
4) contain no hyperlinks.

The proposal requires that the franchisor:

1) prove that it delivered the UFOC electronically; and
2) keep records of its electronic delivery of UFOCs.

NASAA predicts that the proposed policy will make it more likely that the prospective franchisee will read the disclosure document, because the prospective franchisee is required to print the document after analyzing it electronically. Further, new technology allows the franchisor to verify that the prospective franchisee has, in fact, viewed each part of the document.

"NASAA's Franchise Committee has prepared a proposed safe harbor regarding Internet advertising. This safe harbor applies to passive forms of Internet communications, as opposed to advertising that is directed towards specific persons."

F. Proposed Federal Legislation Governing Franchise Relationships

In late 1999, Representative Howard Coble, R-N.C.—joined by 31 bipartisan co-sponsors—introduced in the House of Representatives the proposed Small Business Franchise Act of 1999. The bill is a comprehensive franchise relationship bill that Congressman Coble stated was "aimed at leveling the playing field in the business relationship between corporations that sell franchises and the small businessmen and women who invest in them."[79] Since that time, the bill has garnered 19 additional co-sponsors. Representative Coble has not yet introduced the bill this year because he is awaiting the U.S. General Accounting Office's (GAO) report on the franchising industry. Representative Coble believes this study of the franchising industry, and in particular, the extent of the FTC's regulation of franchising, will inform representatives about franchising so that they can make a more informed decision the next time the bill is introduced and put to a floor vote.[80]

The Coble bill seeks to significantly alter the regulation of franchising in the United States. The proposed law would:

- make it unlawful for a franchisor to engage in any act, practice, course of business or pattern of conduct which operates as a fraud upon any person (with the term "fraud" being left undefined);
- make it unlawful for a franchisor to terminate a franchise agreement prior to expiration without good cause, with "good cause" being very narrowly defined;
- render illegal all franchise agreement post-term covenants not to compete;
- impose upon each party to a franchise agreement "a duty to act in good faith in its performance and enforcement";
- impose upon a franchisor a "duty of due care" (defined as meaning that a franchisor must exercise the skill and knowledge normally possessed by franchisors in good standing in the same or similar types of business);
- impose a fiduciary duty upon franchisors that perform bookkeeping, collection, payroll or accounting services on behalf of franchisees and/or administer, control or supervise an advertising, marketing or promotional fund or program to which franchisees contribute;
- severely restrict a franchisor's ability to block the sale, transfer or assignment of a franchise;
- allow franchisees to obtain equipment, fixtures, supplies, goods or services used by their franchised businesses from sources of the franchisees' own choosing, so long as such goods or services meet the franchisor's "reasonable" system-wide quality standards (except for products and services incorporating the franchisor's trade secrets, patents, copyrights or other intellectual property);
- preclude franchisors from establishing new company-owned or franchised outlets in "unreasonable proximity" to an established franchised business if the "probable effect" of doing so would be a diminution of the existing outlet's gross sales of five percent or more in the 12 months immediately following the establishment of the new outlet (unless the franchisor first offers to pay to the affected franchisee an amount equal to 50 percent of the gross sales of the new outlet for the first 24 months of its operation); and
- grant a private right of action to all franchisees complaining of franchisor violations of the proposed Act, affording to such franchisees the right to seek rescission, restitution, damages, injunctive relief and attorneys' and expert witness' fees.

IV. Significant New York Franchise Act Judicial Decisions[81]

New York has gone from "worst to first" nationwide when it comes to franchise fraud enforcement activity since Joseph Punturo's elevation to the post of the Attorney General's Franchise Section Chief, the election of Attorney General Spitzer, the appointment of his Chief of the Bureau of Investment Protection and Securities, Eric Dinallo, and the appointment of Assistant Attorney General William Estes. This team has dramatically increased enforcement activities.

A. United American Karate

For example, the case of *In re an Inquiry by the Attorney General of the State of New York Pursuant to Article 33 of the General Business Law Regarding the Practices of United American Karate Inc. et al.*,[82] yielded a bench decision of significant import. This decision is notable for its affirmation yet again of the unique extraterritorial jurisdiction of the New York Franchise Act. In addition, it confirmed the broad power of the Attorney General to conduct pre-action discovery under the Act.

In *United American Karate*, the Attorney General investigated United American Karate and its owner, Daniel "Tiger" Schulmann, to determine whether they were illegally selling franchises for Tiger Schulmann Karate Centers in violation of the franchise registration and disclosure requirements of the Act. In December 1997, the Attorney General obtained a temporary restraining order barring United American Karate from offering or selling franchises to operate Tiger Schulmann Karate Centers within the state of New York (the company is headquartered in New Jersey). The Attorney General also made a motion for pre-suit discovery.

United American Karate claimed that the operators of Tiger Schulmann Karate Centers were its employees rather than its franchisees. It also denied that the operators paid it any "franchise fee." United American Karate also claimed that the payments which operators made to Schulmann were for shares in his corporation rather than "franchise fees," and that the operators were therefore minority shareholders rather than franchisees. In addition, United American Karate claimed that New York courts had no jurisdiction to authorize the Attorney General to investigate it for violations of the Act, since United American Karate's officers were in New Jersey, where Schulmann also resided.

United American Karate and Schulmann refused to cooperate with the Attorney General's investigation and ignored his New York Franchise Act subpoenas for depositions and the production of records. The company made a motion to vacate the temporary restraining order, which was rejected in the October 26, 1998 bench decision under review herein:

> It is clear (that the defendants) have not been forthcoming in producing any of the requested books, records or other documentations here; that they have constantly and consistently attempted to flout the jurisdiction of the Court by raising objection after objection. So it seems to me it neither would be appropriate nor equitable for the Court to grant the respondents' application . . . I believe there is at least *prima facie* showing that has been made by the petitioner, Attorney General, on behalf of the state at this time that there may be at least questionable business practices which fall within the purview of the Franchise Act. As such, it would be inappropriate at this time for the Court to grant an application to vacate the TRO.[83]

Further, the court rejected the defendants' contention that the United American Karate agreements in question were employment contracts and not franchise agreements, holding:

> It seems to me despite the argument that has been made previously before the Court and is being made by the respondents, that one thing is very clear under the New York law and that is that labels are irrelevant. Labels don't determine whether or not a business falls within the jurisdiction or the ambit of the New York State Franchise Law. It is the substantive nature of the transaction which determines whether the business is a franchise. It goes back to the purpose of the Act. The purpose of the Act is to avoid fraud and the perpetration upon the public of fraudulent misconduct by those engaged in commercial activities.
>
> * * *
>
> So it seems to me the labels that the respondents use are really of no moment whether or not it is a franchise. The fact (that) "employment agreement" is used rather than "franchise agreement" is of no moment.[84]
>
> * * *
>
> Now, you know as a practical matter, if it looks like a duck and it smells like a duck and it quacks like a duck, it's usually a duck.[85]

Finally, rejecting the respondents' contention that the New York Franchise Act afforded the Attorney General no jurisdiction over their New Jersey-based operation, the court observed:

> I note the Franchise Act reaches all franchise sales activities that take place within the state but there is extraterritorial application in the Franchise Act. When those activities are interstate, the case law has said to give effect to the legislative intent of bringing these businesses within the regulation of the state, that there is extraterritorial application in the statutory proscriptions, registration and disclosure requirements. New York courts have jurisdiction over all offers and sales of franchise interests emanating from or directed to New York. The single fact (that) you have a New Jersey corporation and also Daniel Schulmann may reside in New Jersey, again is not sufficient to defeat a cause of action under the General Business Law.
>
> A New York base(d) franchisee (sic) whose intent is to sell franchises in California, according to the case law, must nevertheless register its franchise prospectus with the Attorney General of the State of New York. This is under *Mon-Shore Management, Inc. v. Family Media, Inc.* It held New York has an interest in protecting franchisees both within and without the state.[86]

Accordingly, the court rejected the defendants' motion to vacate the temporary restraining order; ordered presuit discovery to proceed; and, upon granting the defendants' motion to reargue the jurisdictional issue, declared that there was, indeed, jurisdiction over the defendants under both the New York Franchise Act and CPLR 302 (New York's long arm statute). Since then, the defendants settled the action through consent decrees calling for a $195,000 fine, franchise registration and referral to the National Franchise Council for franchise law compliance training and oversight.

B. Maricopa Products, Inc.

In mid-2000, Attorney General Spitzer announced the settlement of one of the largest franchise fraud cases ever brought by the Attorney General's office. The case, *State of New York v. Maricopa Products, Inc.*,[87] involved an alleged franchise scam in the snack and beverage industry in which franchisees were fleeced out of more than $1 million. According to the Attorney General, the scam preyed upon small business people in the tri-state area who invested between $20,000 and $50,000 each to purchase distributorships, believing that their snack and beverage product lines would be "exclusive." However, according to Spitzer, the franchisor never delivered and the investors lost their money.

According to the Attorney General, "exclusive territories" were sold to investors in New York City, Suffolk, Nassau and Westchester counties as well as 19 counties in New Jersey, Ohio, Connecticut and Washington. After taking franchise fees between 1993 and 1995, Maricopa allegedly encouraged its franchisees to purchase equipment and to lease warehouse space, which only further increased their losses. The state asserted that no franchisee ever made a profit, all lost money and two declared bankruptcy. Franchisor Maricopa allegedly never delivered on its promise to create an exclusive line of snacks and beverages. Instead, it only provided potato chips and a sparse line of flavored water. (Indeed, Attorney General Spitzer notes that franchised stores stopped purchasing the flavored water when the labels pealed off to reveal another beverage's label, and they stopped buying the potato chips when the bags deflated and leaked oil.) Not long after taking franchisees' money, the operation closed and franchisee calls went unanswered.

"Without submitting a prospectus and receiving approval from the Attorney General's office, these defendants provided investors with unregistered brochures that contained unsupported statements that franchisees could earn up to $780,000 annually," says Assistant Attorney General Punturo. "Additionally, the defendants falsely stated that Maricopa had twelve warehouses nationwide. Had proper disclosure been made, investors would have learned that (a principal of Maricopa) had previously been convicted of grand larceny and a scheme to defraud."

The result? A settlement with the franchisor—Maricopa Products, Inc.—and four of its principals (all related family members) permanently barring them from engaging in any business relating to the sale of franchises in New York and ordering them to make restitution of over $1 million (of which over $135,000 has already been collected).

C. Private Actions

A recent "private" judicial decision of note, *B & R Management & Leasing Corp. v. Triarc Restaurant Group et al.*,[88] involved a plaintiff-franchisee that operated four Arby's restaurants in upstate New York. Contending that plaintiff had reneged on its promise to make contractually-fixed contributions on behalf of its restaurants to an area advertising cooperative, the franchisor, Arby's, terminated plaintiff's franchises. In turn, the franchisee commenced this action for breach of contract, demanding injunctive relief and monetary damages.

The Supreme Court granted the franchisee's motion for a preliminary injunction blocking termination and denied Arby's motion to vacate the temporary restraining order which had been granted. On appeal, the Appellate Division unanimously reversed, granting Arby's motion to dismiss the complaint and vacating the preliminary injunction awarded by the Supreme Court. The court held that plaintiff-franchisee was ineligible to litigate in New York's courts because its franchise agreement featured a forum selection clause conferring venue only in a federal or state court having jurisdiction where Arby's principal office is located. The court further stated, "It is the policy of the courts of this State to enforce contractual provisions for . . . selection of a forum for litigation."[89]

Further, the Appellate Division held that the allegations of the franchisee's complaint were refuted by the very language of the subject franchise agreements and by the documentary evidence submitted. "The factual allegations in the complaint are refuted by documentary evidence. Thus, the complaint must be dismissed for failure to state a cause of action."[90] Accordingly, the Appellate Division reversed the Supreme Court's decision on the law; denied plaintiff-franchisee's motion for preliminary injunction; vacated the outstanding preliminary injunction, which had been granted by the Supreme Court; and, granted Triarc's motion by dismissing the franchisees' complaint.

Finally, experienced franchise counsel are always careful to make sure that the officers, directors and key employees of corporate franchisees themselves are required to individually enter into covenants not to compete with the subject franchisor, since they are not typically embraced by the covenant contained in the franchise agreement at issue (which usually is only executed by the corporate franchisee). This maxim appears not to have been observed in *ATC Healthcare v. Nurses Staffing*,[91] in which a franchisee officer was held not individually bound by the terms of the covenant not to compete contained in the subject franchise agreement, since he did not sign that agreement in an individual capacity. The court stated, "Specifically, he (the franchisee's officer) is not bound by any part of the contract language whatsoever contained in the franchise agreement."[92]

Again, wise counsel should always ensure that franchise agreements entered into with corporations oblige those corporations to procure from their officers, directors and key management employees separate and individual covenants not to compete (and restrictions on use of confidential information). Otherwise, as a matter of elementary contract law, those individuals, as in *ATC Healthcare,* will most frequently be found not bound by any covenant not to compete extant in the subject franchise agreement.

V. Conclusion

As the foregoing material suggests, engaging in the practice of franchise law is both remarkably stimulating and challenging. The franchise-specific laws, rules and regulations are relatively new (the oldest is but 30 years old). The business paradigms and protocols of franchising likewise change with lightning speed—in just 40 years franchisors have grown from small entrepreneurial concerns to large, multinational "mega" entities that have spread their presence and influence throughout the world.

This rapidly and ever changing business arena proves fascinating to the franchise practitioner, whether he or she is a government regulator or private practitioner. We hope this article has given you a flavor of just how exciting, challenging and demanding the field of franchise law can be.

Endnotes

1. FTC Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436.1 (FTC Franchise Rule).
2. Interpretive Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966 (Aug. 29, 1979).
3. California Franchise Investment Law, Cal. Corp. Code § 31114.
4. Hawaii Franchise Investment Law, Haw. Rev. Stat., tit. 26, § 482E-3.
5. Illinois Franchise Disclosure Act, 815 Ill. Comp. Stat. 705/16.
6. Ind. Code Ann. § 23-2-2.5-9. Last year, Indiana enacted a statutory amendment that relieves franchisers from having to register their disclosure documents with that state, instead only obliging them to accomplish a "notice filing" with Indiana to secure franchise registration. This statutory amendment also revises the circumstances under which Indian may issue a "stop order" denying, suspending or revoking franchise registration. The new franchise law took effect on Jul. 1, 2001.
7. Md. Code Ann., Bus. Reg. § 14-216.
8. Michigan Franchise Investment Law, Mich. Comp. Laws § 445.1508.
9. Minn. Stat. § 80C.02.
10. N.Y. General Business Law § 683 (GBL).
11. North Dakota Franchise Investment Law, N.D. Cent. Code § 51-19-08.
12. Rhode Island Franchise Investment Act, R.I. Gen. Laws § 19-28.1-9.
13. South Dakota Franchises for Brand-Name Goods and Services Law, S.D. Codified Laws § 37-5A-6.
14. Texas Business Opportunity Act, Tex. Bus. & Com. Code Ann. § 41.151.
15. Virginia Retail Franchising Act, Va. Code Ann. § 13.1-560.
16. Washington Franchise Protection Act, Wash. Rev. Code Ann. § 19.100.040.
17. Wisconsin Franchise Investment Law, Wis. Stat. § 553.27.
18. *Hearing on the New York Franchise Act Before the Senate Consumer Protection Committee*, 1980 Leg., 203rd Sess. (N.Y. 1980) (testimony of Attorney General Abrams presented by David Kaufmann).
19. Those interested in legislative history should note that the Act largely derives from the tenets and philosophies contained in the franchise laws of certain sister states (principally California, Illinois and Michigan [Michigan's law has since been significantly revised]); the FTC. Franchise Rule; and, the investigative and enforcement mechanisms contained in the Martin Act (New York's Blue Sky Law, GBL Article 23-A).
20. Arkansas Franchise Practices Act, Ark. Code Ann. §§ 4-72-201 *et seq*.
21. California Franchise Relations Act, Cal. Bus. & Prof. Code §§ 20000 *et seq*.
22. Conn. Gen. Stat. § 42-133f.
23. Delaware Franchise Security Law, Del Code Ann. tit. 6, § 2552.
24. Hawaii Franchise Rights and Prohibitions Act, Haw. Rev. Stat. Ann. § 482E-6.
25. Illinois Franchise Disclosure Act, 815 Ill. Comp. Stat. Ann. 705/18-705/20.
26. Indiana Deceptive Franchise Practices Law, Ind. Code Ann. § 23-2-2.7-3.
27. Iowa Code §§ 523H.7-.8.
28. Michigan Franchise Investment Law, Mich. Comp. Laws § 445.1527.
29. Minn. Stat. § 80C.14.
30. Miss. Code Ann. §§ 75-24-53, 75-24-57.
31. Mo. Rev. Stat. § 407.405.
32. Nebraska Franchise Practices Act, Neb. Rev. Stat. Ann. § 87-404.
33. New Jersey Franchise Practices Act, N.J. Stat. Ann. §§ 56-10-1 *et seq.*
34. South Dakota Franchises for Brand-Name Goods and Services Law, S.D. Codified Laws § 37-5A-51.
35. Virginia Retail Franchising Act, Va. Code Ann. § 13.1-564.
36. Washington Franchise Investment Protection Act, Wash. Rev. Code Ann. §§ 19.100.180-19.100.190.
37. Wisconsin Fair Dealership Law, Wis. Stat. § 135.03.
38. Virgin Islands Franchise Business Act, 12A V.I. Code Ann. §§ 130 *et seq*.
39. Puerto Rico Dealers' Contracts Act, 10 P.R. Laws Ann. §§ 278 *et seq*.
40. Alabama Seller-Assisted Marketing Plans Law, Ala. Code § 8-19-5.
41. California Contracts for Seller Assisted Marketing Plans Law, Cal. Civ. Code §§ 1812.200 *et seq*.
42. Connecticut Business Opportunity Investment Act, Conn. Gen. Stat. §§ 36b-60 *et seq*.
43. Florida Sale of Business Opportunities Act, Fla. Stat. §§ 559.80 *et seq*.
44. Georgia Business Opportunity Sales Law, Ga. Code Ann. §§ 10-1-410 *et seq*.
45. Indiana Business Opportunity Transactions Law, Ind. Code Ann. §§ 24-5-8-1 *et seq*.
46. Iowa Business Opportunity Promotions Law, Iowa Code §§ 523B.1 *et seq*.

47. Kentucky Sale of Business Opportunities Law, Ky. Rev. Stat. Ann. §§ 367.801 *et seq*.
48. Louisiana Business Opportunity Sellers and Agents Law, La. Rev. Stat. Ann §§ 51:1821 *et seq*.
49. Maine Regulations of the Sale of Business Opportunities Law, Me. Rev. Stat. Ann. tit. 32 §§ 4691 *et seq*.
50. Maryland Business Opportunity Sales Act, Md. Code Ann., Bus. Reg. §§ 14-129 *et seq*.
51. Mich. Comp. Laws §§ 445.901 *et seq*.
52. Minn. Stat. §§ 80C.01 *et seq*.
53. Nebraska Seller-Assisted Marketing Plan Law, Neb. Rev. Stat. §§ 59-1701 *et seq*.
54. New Hampshire Distributorship Disclosure Act, N.H. Rev. Stat. Ann. §§ 358E:1 *et seq*.
55. North Carolina Business Opportunity Sales Law, N.C. Gen. Stat. §§ 66-94 *et seq*.
56. Ohio Business Opportunity Purchasers Protection Act, Ohio Rev. Code Ann. §§ 1334.01 *et seq*.
57. Oklahoma Business Opportunity Sales Act, Okla. Stat. tit. 71, §§ 801 *et seq*.
58. South Dakota Business Opportunities Law, S.D. Codified Laws §§ 37-25A-1 *et seq*.
59. Texas Business Opportunity Act, Tex. Bus. & Com. Code §§ 41.001 *et seq*.
60. Utah Business Opportunity Disclosure Act, Utah Code Ann. §§ 13-15-1 *et seq*.
61. Virginia Business Opportunity Sales Act, Va. Code Ann. §§ 59.1-262 *et seq*.
62. Washington Business Opportunity Fraud Act, Wash. Rev. Code Ann. §§ 19.110.010 *et seq*.
63. NASAA, organized in 1919, is the oldest international organization devoted to investor protection. It is a voluntary organization whose membership consists of 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for efficient capital formation and grass-roots investor protection.
64. California is the only franchise registration state that does not participate in the program. The franchise registration states that are part of the program include Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, South Dakota, Rhode Island, Virginia and Washington.
65. Minnesota, for example, requires a franchisor to meet financial criteria as a requirement of registration. Minn. Stat. § 80C.12.
66. *Nieman v. Dryclean U.S.A. Franchise Co., Inc*., 718 F.3d 1126 (11th Cir. 1999).
67. *Mon-Shore Mgmt., Inc. v. Family Media, Inc*., 584 F. Supp. 186 (S.D.N.Y. 1984).
68. Telephone Interview with Dale Cantone, Chairman, NASAA Franchise Project Group (June 22, 2001).
69. *Id*.
70. *Id*.
71. *Id*.
72. Michael J. Lockerby, *Avoiding Collisions with Franchise Laws on the Information Superhighway,* Computer Law., Oct. 1998.
73. NASAA's *Proposed Policy Regarding Franchise Advertising on the Internet.*
74. These states include: California, Cal. Corp. Code § 31156; Illinois, Ill. Rev. Stat. Ch. 815 § 705/5; Indiana, Ind. Code § 23-2-2.5-25; Maryland, Md. Bus. Reg. § 14-225; Minneapolis, Minn. Stat. § 80C.09; New York, § 683(15) and N.Y.C.R.R. § 200-9; North Dakota, N.D. Cent. Code § 51-19-10; Rhode Island, R.I. Gen. Laws § 19-28.1-6; South Dakota, S.D. Codified Laws Ann. § 37-5A-44; and Washington, Wash Rev. Code § 19.100.100.
75. These states include: California, Cal. Corp. Code § 31156; Illinois, Ill. Rev. Stat. Ch. 815 § 705/5; Indiana, Ind. Code § 23-2-2.5-25; Maryland, Md. Bus. Reg. § 14-225; Minneapolis, Minn. Stat. § 80C.09; New York, § 683(15) and N.Y.C.R.R. § 200-9; North Dakota, N.D. Cent. Code § 51-19-10; Rhode Island, R.I. Gen. Laws § 19-28.1-6; South Dakota, S.D. Codified Laws Ann. § 37-5A-44; and Washington, Wash Rev. Code § 19.100.100.
76. See www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=72 (9/9/2001). For more information, see <http://www.nasaa.org>.
77. Telephone interview with John Veator, Associate Counsel, NASAA (July 23, 2001).
78. *Id.*
79. David J. Kaufmann, *Proposed Federal Legislation*, N.Y.L.J., Feb. 24, 2000, p. 3.
80. Telephone interview with Missy Branson, Legislative Director for Representative Howard Coble (R-NC) (June 4, 2001).
81. David J. Kaufmann, Esq., exclusively authored the remainder of this article.
82. Index No. 404446/97 (Sup. Ct., N.Y. Co. Oct. 26, 1998).
83. Transcript of Hearing at 47-48, *In re United American Karate, Inc.,* Index No. 404446/97 (Sup. Ct., N.Y. Co. Oct. 26, 1998).
84. *Id.* at 74-75.
85. *Id.* at 78.
86. *Id.* at 82-83.
87. Index No. 406542196, 1999 WL 1042313 (Sup. Ct., N.Y. Co. Sept. 3, 1999).
88. 269 A.D.2d 804, 703 N.Y.S.2d 635 (4th Dep't 2000).
89. *Id.*
90. *Id.*
91. Bus. Franchise Guide (CCH) ¶ 11,825 (E.D.N.Y. 2000).
92. *Id.*

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New Rules for Audit Committees and Auditor Independence

By Guy Lander and Lori Sullivan

Introduction

Over the past two years the Securities and Exchange Commission (SEC), in cooperation with the New York Stock Exchange (NYSE), Nasdaq and the American Stock Exchange (AMEX), have adopted new rules to improve disclosure of the functioning of corporate audit committees and enhance the reliability of financial statements of public companies.

This article discusses the new requirements for audit committees as a guide for what is needed for this proxy season.

Prior Amendments

At the end of 1999, the SEC adopted new rules for improving the effectiveness of audit committees and the reliability of interim financial statements. The rules require companies to: (1) have their independent auditors review their interim financial information starting with their Form 10-Q (or 10-QSB) for fiscal quarters ending on or after March 15, 2000; (2) include a report of their audit committee in their proxy statements; (3) provide disclosure concerning the independence of their audit committee members in their proxy statements; and (4) attach a copy of the audit committee's charter to their proxy statements every three years. The auditor's report concerning the review of the interim financial statements must be filed with the SEC with the interim financial statements.

> *"For proxy statements filed after February 5, 2001, the SEC amended the rules for disclosure concerning audit committees . . ."*

New Amendments

For proxy statements filed after February 5, 2001, the SEC amended the rules for disclosure concerning audit committees to require disclosure of: (1) audit fees, fees received for information technology services and other non-audit fees paid to outside auditors; (2) whether the audit committee considered whether the outside auditor's provision of information technology services or other non-audit services is compatible with the auditor's independence; and (3) whether the audit engagement was staffed primarily by leased personnel.

The SEC also amended its rules under section 2-01 of Regulation S-X under the Exchange Act for determining whether an auditor is independent.

New Rules

A. Proxy Disclosure Requirements

Type of Disclosure

1. The Audit Committee Report

The audit committee must now file a report in the company's proxy statement stating whether:

(a) the audit committee has reviewed and discussed the audited financial statements with management;

(b) the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61 such as the method used to account for significant annual transactions, the process used by management to formulate accounting estimates and the auditor's conclusion as to those estimates, and other accounting standards. (See Codification of Statements on Auditing Standards, AU § 380);

(c) the audit committee has received the written disclosures and the letter from the independent accountants required by the Independence Standards Board (ISB) Standard No. 1 (see ISB Standard No. 1, *Independence Discussions with Audit Committees*), disclosing to the audit committee all relationships between the accountants and the company (and each of their related entities) that may reasonably bear on independence, confirming the accountants' independence and confirming that the accountants discussed their independence with the audit committee; and

(d) based on the review and discussions of paragraphs (a) through (c) above, the audit committee recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K (or Form 10-KSB) for the last fiscal year.

The name of each member of the company's audit committee must appear below the disclosure. If there is no audit committee, then the names of the board committee performing equivalent functions or the names of the entire board of directors must appear.[1]

2. Audit Committee Charters

Companies must disclose in their proxy statements whether the audit committee is governed by a charter and, if so, include a copy of the charter as an appendix to the proxy statement at least once every three years.[2]

3. Independence of Audit Committee Members

Companies listed or quoted on the NYSE, Nasdaq or AMEX must now disclose in their proxy statements whether the audit committee members are independent (as defined in the applicable listing standards) and disclose certain information concerning any director on the audit committee who is not independent. With rare exceptions, all directors on the audit committee must be independent.

Companies, including small business issuers, whose securities are not listed or quoted on the NYSE, Nasdaq or AMEX must disclose in their proxy statements whether the company has an audit committee and, if so, whether the members of the audit committee are independent as defined under the listing standards of the NYSE, Nasdaq or AMEX, and which exchange definition was used.[3]

4. Disclosure of Fees

Fees paid by a public company to its outside auditors must now be disclosed in annual proxy statements. These disclosures must appear under the following three separate headings:

> **Audit Fees:** The aggregate fees billed for the annual audit and for the review of interim financial statements included in a company's Form 10-Q or 10-QSB for the most recent fiscal year.
>
> **Financial Information Systems Design and Implementation Fees:** The aggregate fees billed for specified information technology services rendered by the outside auditor during the most recent fiscal year. The specified information technology services include the operation or management of a company's information system or local area network and the design or implementation of a hardware or software system that aggregates data underlying the financial statements or otherwise generates information significant to a company's financial statements. Rule 2-01(c)(4)(ii) of Regulation S-X under the Exchange Act lists the information technology services and can be found under section B of Exhibit A attached.
>
> **All Other Fees*:*** Fees billed for all other non-audit services, including tax-related services, actuarial services, valuation services and other expert services rendered by the outside auditor during the most recent fiscal year.[4]

5. Non-Audit Services and Auditor Independence

The proxy rules now require disclosure of whether the audit committee considered whether the outside auditor's provision of information technology services or other non-audit services is compatible with maintaining the auditor's independence. This new rule only requires disclosure as to whether the audit committee *considered* the auditor's independence in light of services rendered and not any conclusions of the committee. The audit committee's charter should include this consideration as a responsibility.[5]

6. Leased Employees Disclosure

A company must now disclose the percentage of hours expended on the audit of the company's financial statements for the most recent fiscal year that were performed by persons other than the principal accountant's full-time, permanent employees, if such percentage is over 50 percent. The SEC believes that this disclosure requirement responds to a recent trend by some accounting firms to sell their non-audit practices to financial services companies. Often in these transactions, the partners and employees become employees of the financial services firm. The accounting firm then leases the professional auditors back from those companies to complete audit engagements. In such an arrangement, audit professionals become full or part-time employees of the financial services company, but work on audit engagements for their former accounting firm. They receive compensation from the financial services firm and, in some situations, from the accounting firm as well. The SEC is of the view that investors should be informed of arrangements whereby most of the auditors who work on an audit are employed elsewhere.[6]

Location of Disclosure

The SEC has given little guidance as to where the disclosure for the non-audit services fees should appear in the proxy statement. The SEC staff has indicated that they would be flexible in accepting where this disclosure appears. The fee information and the company's response as to whether it has considered the effect of non-audit services on auditor independence does not really fit in the audit committee report as these disclosures are not the responsibility of the audit committee and they are not protected by the safe harbor which otherwise attaches to the audit committee report. We therefore recommend that these disclosures be made in the audit committee discussion section or elsewhere in the proxy statement. Companies that have their shareholders ratify the selection of auditors may choose to present the required fee disclosure in this section. Those that do not, may consider including it in the required proxy statement disclosure concerning the company's outside auditors and whether they will be attending the annual meeting.

Negative Disclosure

The new rules do not specifically address whether negative disclosure (e.g., the fact that a company's auditors do not render non-audit services) is required. The SEC staff has indicated that negative disclosure need not be made if information technology services or other non-audit services are not provided by the outside auditor.

"We . . . recommend that these disclosures be made in the audit committee discussion section or elsewhere in the proxy statement."

Foreign Private Issuers

The new proxy disclosure requirements do not apply to foreign private issuers filing reports under the Exchange Act (i.e., companies that have securities registered under section 12 or companies filing reports under section 15(d) of the Exchange Act). The SEC has stated that it does not believe that it is appropriate to extend the new requirements to foreign private issuers as they are exempt from the proxy rules, need not file quarterly reports and are subject to different corporate governance regimes in their home countries.

B. Audit Committee Considerations for Auditor Independence

The SEC has also encouraged audit committees to more actively assess auditor independence. The SEC endorsed the following factors as guidelines for audit committees when exercising their business judgment about particular non-audit services:

1. whether the "service facilitates the performance of the audit, improves the client's financial reporting process, or is otherwise in the public interest;
2. whether the service is being performed principally for the audit committee;
3. the effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process;
4. whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support;
5. whether the service would be performed by audit personnel and, if so, whether it will enhance their knowledge of the entity's business and operations;
6. whether the role of those performing the service (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted) would be inconsistent with the auditor's role;
7. whether the audit firm's personnel would be assuming a management role or creating a mutuality of interest with management;
8. whether the auditors, in effect, would be auditing their own numbers;
9. whether the project must be started and completed very quickly;
10. whether the audit firm has unique expertise in the service;
11. the size of the fee(s) for the non-audit service(s); and
12. whether assertions of auditor independence rest on conservative or aggressive readings of the independence rules.

The SEC also suggested:

(a) that audit committees consider whether to adopt formal or informal policies concerning when or whether to engage the company's auditing firm to provide non-audit services; and

(b) that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. The threshold "should be at a level that ensures that significant services are pre-approved, but not so low a level that the audit committee assumes a management function." Adherence to this suggestion may require the audit committee to meet more often than it had in the past.

C. New Rules for Determining Auditor Independence

The SEC amended the rule for determining whether an auditor is independent in light of investments by auditors or their family members in audit clients, employment relationships between auditors or their family members and audit clients and the scope of services provided by audit firms to their audit clients.

The SEC's most significant modifications to the independence rules are in the area of non-audit services. The new rules include a nonexclusive list of non-audit services which, if performed by an accounting firm for an audit client, would render the auditor not independent. A nonexclusive list of the kinds of non-audit services that impair auditor independence is attached as Exhibit A.

The new independence rules provide that the relationships and financial interests in an audit client that impair independence will not be the sole cause for a loss of independence if the auditor can demonstrate:

(a) the auditor did not know and was reasonable in not knowing of the circumstances giving rise to the impairment;

(b) the auditor's lack of independence was corrected as promptly as possible after the auditor became aware of it; and

(c) the auditor has in place a quality control system that provides "reasonable assurance" that the auditor and its employees do not lack independence.[7]

Foreign Private Issuers

While the SEC has made significant accommodations to foreign issuers in the area of accounting principles, it has not followed suit in the area of auditing. Consequently, foreign private issuers must comply with U.S. auditing standards, including U.S. auditor independence rules.

D. Audit Committee Composition

The audit committees of companies listed on the NYSE, Nasdaq and AMEX (the "Exchanges") must comply with the new independence and financial acumen requirements of these exchanges. The rules of the Exchanges are substantially similar, although, in some instances the rules of the NYSE differ slightly. These differences are noted below.

1. Composition and Skills

The Exchanges require the board to have an audit committee consisting of a minimum of three independent directors.

Under Nasdaq and AMEX rules, each director on the audit committee must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement. At least one director must have past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background, including a current or past position as a chief executive or financial officer or other senior officer with financial oversight responsibilities.

Under NYSE rules, each director on the audit committee must be financially literate, as that qualification is interpreted by the board of directors, in its business judgment. The NYSE rules also require that one director have accounting or financial management expertise, as that qualification is interpreted by the board of directors, in its business judgment.

"The SEC's most significant modifications to the independence rules are in the area of non-audit services."

2. Independence

The Exchanges have each adopted varying rules allowing the appointment of one non-independent director under limited circumstances if the board of directors determines that membership by that individual on the audit committee is required in the best interest of the company and its shareholders. However, the reason for this determination must be disclosed in the next annual proxy statement.

The Exchanges have each amended their listing standards concerning the "independence" of directors who are members of the audit committee. Under Nasdaq and AMEX rules, an independent director is not considered independent if he or she has:

(a) been employed by the corporation or its affiliates in the current year or the past three years;

(b) accepted any compensation from the corporation or its affiliates in excess of $60,000 during the previous fiscal year (except for board service, retirement plan benefits or non-discretionary compensation);

(c) an immediate family member who is, or has been in the past three years, employed by the corporation or its affiliates as an executive officer ("immediate family" includes a person's spouse, parents, children, siblings, mother-in-law, father-in-law, brother-in-law, son-in-law, sister-in-law, daughter-in-law and anyone who resided in that person's home);

(d) been a partner, controlling shareholder or an executive officer of any for-profit business to which the corporation made, or from which it received, payments that exceed five percent of the organization's consolidated gross revenues for that year, or $200,000, whichever is more, in any of the past three years (excluding payments that arise solely from investments in the corporation's securities); or

(e) been employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

Under NYSE rules, an independent director is one who has no relationship to the company that may interfere with the exercise of his or her independence from management and the company. The NYSE leaves the determination up to the board. As part of the listing process, at least once a year and when changes are made to the audit committee's composition, the company must inform the NYSE, in writing, of any determination of the board concerning the independence of directors, the financial literacy of the audit committee members, the financial management expertise of at least one audit committee member and the annual review of the audit committee charter.[8]

Small Business Filers

Nasdaq companies that are small business filers under SEC rules are exempt from rules governing the composition of the audit committees. Instead, they must maintain an audit committee that is composed of a majority of independent directors. However, they must comply with the new definition of "independent director."

AMEX small business filers under SEC rules are also exempt from the rules governing the composition of audit committees. Instead, they must establish and maintain an audit committee of at least two members and a majority of the members must be independent directors.

The NYSE does not exempt small business filers from the rules governing the composition of audit committees.

Under the Exchange Act, a small business filer is an issuer that (i) has revenue of less than $25 million; (ii) is a U.S. or Canadian issuer; and (iii) if a majority-owned subsidiary, the parent corporation is a small business issuer.

Foreign Private Issuers

The NYSE, Nasdaq and AMEX have excluded foreign private issuers from these audit committee composition requirements so long as the existing structure and composition of the audit committee is not contrary to any law, rule, regulation or generally accepted business practice in the issuer's country of domicile.

Conclusion

This article is intended to provide a guide to the new requirements for preparing proxy statements and retaining auditors. Companies should begin adopting procedures to ensure continued compliance, such as preparing an action list for the audit committee listing each task to be performed. Any additional meetings with management and auditors, or additional policies or procedures adopted by the audit committee, including any pre-approvals, should be included. Periodic follow-up to assess the effectiveness of the audit committee and its charter should also be scheduled and implemented.

Last, while generally these new rules do not apply to foreign private issuers, foreign private issuers may want to use them as "best practices" so they do not stray too far from domestic standards of the capital markets.

Exhibit A

Non-Audit Services that Impair Auditor Independence

An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides the following non-audit services to an audit client:

A. Bookkeeping or Other Services Related to the Audit Client's Accounting Records or Financial Statements.

(a) Any service involving:

(i) maintaining or preparing the audit client's accounting records;

(ii) preparing the audit client's financial statements that are filed with the SEC or form the basis of financial statements filed with the SEC; or

(iii) preparing or originating source data underlying the audit client's financial statements.

Exceptions: The accountant's independence will not be impaired when the accountant provides these services:

(i) in emergency or other unusual situations, provided the accountant does not undertake any managerial actions or make any managerial decisions; or

(ii) for foreign divisions or subsidiaries of an audit client, provided that:

- the services are limited, routine or ministerial;
- it is impractical for the foreign division or subsidiary to make other arrangements;
- the foreign division or subsidiary is not material to the consolidated financial statements;
- the foreign division or subsidiary does not have employees capable or competent to perform the services;
- the services performed are consistent with local professional ethics rules; and
- the fees for all such services collectively (for the entire group of companies) do not exceed the greater of one percent of the consolidated audit fee or $10,000.

B. Financial Information Systems Design and Implementation

(a) Directly or indirectly operating, or supervising the operation of, the audit client's information system or managing the audit client's local area network; and

(b) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements taken as a whole, unless:

(i) the audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee (or if there is no such committee then the board of directors) the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with the Exchange Act of 1934 § 13(b)(2);

(ii) the audit client's management designates a competent employee or employees, preferably within senior management, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;

(iii) the audit client's management makes all management decisions with respect to the design and implementation of the hardware or software system including, but not limited to, decisions concerning the systems to be evaluated and selected, the controls and system procedures to be implemented, the scope and timetable of system implementation, and the testing, training and conversion plans;

(iv) the audit client's management evaluates the adequacy and results of the design and implementation of the hardware or software system; and

(v) the audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls and financial reporting systems.

Exceptions: Nothing above shall limit services an accountant performs in connection with the assessment, design and implementation of internal accounting controls and risk management controls, provided the auditor does not act as an employee or perform management functions.

C. Appraisal or Valuation Services or Fairness Opinions (Effective After August 5, 2002)

Any appraisal service, valuation service or any service involving a fairness opinion for an audit client, where it is reasonably likely that the results of these services, individually or in the aggregate, would be material to the financial statements, or where the results of these services will be audited by the accountant during an audit of the audit client's financial statements.

Notwithstanding the foregoing provision, the accountant's independence will not be impaired when:

(i) the accounting firm's valuation expert reviews the work of the audit client or a specialist employed by the audit client, and the audit client or the specialist provides the primary support for the balances recorded in the client's financial statements;

(ii) the accounting firm's actuaries value an audit client's pension, other post-employment benefit or similar liabilities, provided that the audit client has determined and taken responsibility for all significant assumptions and data;

(iii) the valuation is performed in the context of the planning and implementation of a tax-planning strategy or for tax compliance services; or

(iv) the valuation is for nonfinancial purposes where the results of the valuation do not affect the financial statements.

D. Actuarial Services

Any actuarially oriented advisory service involving the determination of insurance company policy reserves and related accounts for the audit client, unless:

(i) the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities;

(ii) management accepts responsibility for any significant actuarial methods and assumptions; and

(iii) the accountant's involvement is not continuous.

Exceptions: Subject to compliance with certain specified requirements, the accountant's independence will not be impaired if the accountant:

(i) assists management to develop appropriate methods, assumptions and amounts for policy and loss reserves and other actuarial items presented in financial reports based on the audit client's historical experience, current practice and future plans;

(ii) assists management in the conversion of financial statements from a statutory basis to one conforming with generally accepted accounting principles;

(iii) analyzes actuarial considerations and alternatives in federal income tax planning; or

(iv) assists management in the financial analysis of various matters, such as proposed new policies, new markets, business acquisitions and reinsurance needs.

E. Internal Audit Services

Either of:

(a) internal audit services in an amount greater than 40 percent of the total hours expended on the audit client's internal audit activities in any one fiscal year, unless the audit client has less than $200 million in total assets. (For purposes of this paragraph, the term "internal audit services" does not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements); or

(b) any internal audit services, or any operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements for an audit client, unless:

(i) the audit client's management has acknowledged in writing to the accounting firm and the audit client's audit committee, or if there is no such committee then the board of directors, the audit client's responsibility to establish and maintain a system of internal accounting controls in compliance with the Exchange Act § 13(b)(2);

(ii) the audit client's management designates a competent employee or employees, preferably within senior management, to be responsible for the internal audit function;

(iii) the audit client's management determines the scope, risk and frequency of internal audit activities, including those to be performed by the accountant;

(iv) the audit client's management evaluates the findings and results arising from the internal audit activities, including those performed by the accountant;

(v) the audit client's management evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the accountant; and

(vi) the audit client's management does not rely on the accountant's work as the primary basis for determining the adequacy of its internal controls.

F. Management Functions

Acting, temporarily or permanently, as a director, officer or employee of an audit client, or performing any decision-making, supervisory or ongoing monitoring function for the audit client.

G. Human Resources

(a) Searching for or seeking out prospective candidates for managerial, executive or director positions;

(b) Engaging in psychological testing, or other formal testing or evaluation programs;

(c) Performing reference checks of prospective candidates for an executive or director position;

(d) Acting as a negotiator on the audit client's behalf, such as determining position, status or title, compensation, fringe benefits or other conditions of employment; or

(e) Recommending or advising the audit client to hire a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate's competence for financial accounting, administrative or control positions).

H. Broker-Dealer Services

Acting as a broker-dealer, promoter or underwriter on behalf of an audit client; making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments; executing a transaction to buy or sell an audit client's investment; or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

I. Legal Services

Providing any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a U.S. jurisdiction.

Endnotes

1. 17 C.F.R. § 240.14a-101 (paragraph (e)(3) of Item 7 of Schedule 14A to Regulation 14A).
2. *Id.*
3. *Id.* (Item 7(e)(3)(iv) of Schedule 14A to Regulation 14A).
4. *Id.* (Item 9(e)(1) through (3) of Schedule 14A to Regulation 14A).
5. *Id.* (Item 9(e)(4) of Schedule 14A to Regulation 14A).
6. *Id.* (Item 9(e)(5) of Schedule 14A to Regulation 14A).
7. 17 C.F.R. § 210.2-01.
8. See the NYSE, Nasdaq and AMEX listing requirements, effective June 14, 2001.

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New York Adopts Revised Article 9 of the Uniform Commercial Code

By Nancy K. Ota

I. Introduction

With little time to spare, Governor Pataki signed S.5404-A[1] into law on June 26, 2001, thereby bringing New York in line with the other 50 jurisdictions to have enacted revised Article 9 of the N.Y. Uniform Commercial Code (UCC) before the July 1 effective date.[2] The much-ballyhooed revision modernizes legal practice to conform to contemporary financing and communication methods and accommodates a broader variety of transactions. So, what is the impact of the revision? This article will highlight some of the changes in the new law, then briefly discuss choice-of-law issues with respect to jurisdictions where the new law is not yet effective, and finally it will discuss a few of the non-uniform changes adopted in New York.

II. What's New?

First, unless you are concerned with litigation that was pending prior to July 1, 2001, the revised law governs all transactions within its scope, even those entered prior to the effective date of the act.[3] As a practical matter, if you have done nothing to plan for the new law and you have clients involved in secured transactions created before July 1, the transition rules give you some breathing room to conform transactions created under the former law to the new law if necessary.[4] However, you should be using the new law for all transactions entered into since July 1. Although many of the old rules remain, the revision changes the scope of Article 9's coverage, adds and revises many definitions, clarifies rules in consumer transactions, streamlines filing, alters perfection, default and enforcement rules, and changes forms.

A. Scope of Revised Article 9

The revised law expands the scope of Article 9 by expanding the kinds of property in which a secured party can take a security interest. Noteworthy is the inclusion of deposit accounts as collateral in nonconsumer transactions. Also, the revised law brings more transactions into Article 9 by broadening the definitions of "accounts." "Accounts" now cover sales of payment intangibles, license fees receivables, credit card receivables and health care insurance receivables. In addition, the new law covers commercial tort claims, agricultural liens and most consignments.[5] Other definitions have been amended, which have an expansive effect on Article 9's coverage.[6] Moreover, these changes may also impact language contained in security agreements, and in some cases, the changes may render a secured party unperfected because the collateral descriptions fail to meet the requirement for attachment under Revised section 9-203(b)(3)(A).

B. Filing

1. What?

Under the revision, you are required to use the National Uniform Commercial Code Financing Statement Forms. The initial filing form is still called the "UCC1," while any changes (including terminations, but excluding corrections) are filed on a "UCC3." In addition, the N.Y. Department of State (DOS) has added a Uniform Commercial Code Financing Statement Cooperative Addendum available for use when the collateral is a cooperative interest. These forms are available from the DOS. Web site (see sidebar on page 35) or by calling 518-486-4075.

2. Content?

You must file the financing statement with the exact legal name of the debtor. For registered business entities, the name must be the name indicated on the public record of the debtor's jurisdiction of organization.[7] You should not add trade names, d/b/a, "a New York Corporation," or abbreviate words not abbreviated in the legal name of the business. A debtor's trade name alone is insufficient, but you can enter the trade name on Line 2 of the UCC1.[8] For individuals, you should indicate the correct name only and do not include titles or other similar designations (e.g., Esq., M.D., C.P.A., debtor in possession, a/k/a).

Failure to provide the correct spelling or name on the financing statement could result in a financing statement that is seriously misleading. Under the revision, a financing statement is seriously misleading if a search of records of the filing office under the debtor's correct name, using the filing office's standard search logic, would fail to provide the name of the debtor.[9] The DOS Filing Office will enter the name exactly as it appears on the financing statement. For example, if the financing statement shows the debtor's name as "Smith and Jones Corporation" and the registered name of the corporation is "Smith & Jones, Inc.," the statement will be seriously misleading under UCC § 9-506(b). But if a subsequent search for "Smith & Jones, Inc." returns the record for "Smith and Jones Corporation," then the error will not render the statement seriously misleading.[10] On the other hand, if the filing shows "Smyth & Jones, Inc.," the statement will be seriously misleading because it does not conform to the requirement that the statement list the legal name and it will not be returned in a search for Smith & Jones, Inc. To help predict whether or not a filing will be deemed seriously misleading, the filing office search logic will disregard common words such as "Inc." or "Corp.," capitalization, abbreviations located at the end of a name such as PC and common words such as "the," "of," "and" and "&" in a search.[11]

The revision simplifies filing by eliminating the requirement for the debtor's signature, permitting generic collateral descriptions on the financing statement and simplifying the rules governing the location of filing a financing statement. The elimination of the requirement of a debtor's signature is a change designed to facilitate electronic filing when it becomes available. Nevertheless, in order to make an effective filing, the secured party must be entitled to file. A secured party is entitled to file if the debtor authorizes filing in an authenticated record.[12] Alternatively, the secured party will be deemed to be authorized for an *initial* financing statement when the debtor signs a security agreement.[13]

The revision clarifies that collateral descriptions on the financing statement are sufficient if they describe the type of property, for example, "equipment" (except in certain consumer transactions).[14] However, if the interest is in a commercial tort claim, the description should specify the claim.[15] For example, "all commercial tort claims" will be insufficient. Instead, a description needs to indicate the claim with some specificity, such as, "all claims arising out of the accident on Track 4 behind debtor's property on January 10, 2001."

3. Where?

The general rule for where to file financing statements is to file with the state's central filing office (the DOS), except for real estate related filings (e.g., fixtures, timber to be cut, minerals, cooperative interests).[16] Whereas former Article 9 required filings against ordinary goods in the jurisdiction where the collateral is located, under the new law, the general rule is to file in the location of the debtor for all types of collateral.[17] This welcomed change eliminates the problematic "last event" test under former UCC § 9-103, eliminates the category of "mobile goods," eliminates the distinction between tangible and intangible property and eliminates the special choice-of-law rule for foreign debtors in former section 9-103(3)(c). And under the new law, the location of the debtor, if the debtor is a "registered organization," is the state in which the debtor is chartered.[18]

C. Perfection, Priority, Default and Enforcement

Under the revised law, attachment of a security interest remains the same as under the old law.[19] Perfection still requires attachment, but the new law revises certain perfection methods. For example, filing will perfect a security interest in an instrument.[20] In addition, UCC § 9-314 provides for perfection of security interests in investment property, deposit accounts, letter-of-credit rights or electronic chattel paper "by control of the collateral." Control of each type of collateral is defined in Part 1 of Article 9.[21] Thus, to create an enforceable security interest in a deposit account, the secured party must have control as follows: (1) be "the bank with which the deposit account is maintained"; (2) agree with the debtor and the bank in an authenticated record "that the bank will comply with instructions originated by the secured party directing disposition of the funds in the account without further consent by the debtor"; or (3) become "the bank's customer with respect to the deposit account."[22] (The latter means having the account maintained in the secured party's name. However, the debtor would be able to write checks on the account by being an authorized signatory.) Another change involves goods held by a third person (other than a bailee holding goods covered by a document of title). Perfection requires an authenticated acknowledgment by the third person that it holds the goods for the benefit of the secured party.[23]

The changes affecting perfection work to modify priority rules. Thus a secured party that perfects in investment property by control will have priority over a secured party that earlier perfected by filing,[24] and possession of an instrument by a purchaser without notice that the purchase violates the secured party's rights trumps the filing.[25] UCC § 9-320(e), together with section 9-317(b), change New York law decided in *Tanbro Fabrics Corp. v. Deering Milleken, Inc*.[26] In *Tanbro*, the Court of Appeals held that a buyer of goods in the ordinary course had priority over a secured party who, before the sale, had perfected its security interest in the same goods by possession. Revised Article 9 now gives a buyer of goods in the ordinary course of business priority over the holder of a perfected security interest only if the buyer receives delivery of the goods.

Where a deficiency or surplus after disposition of collateral was at issue under the old regime, New York courts have adopted three alternative outcomes: (1) the deficiency stands unless the debtor can show a causal connection between the deficiency and the secured party's error; (2) the rebuttable presumption test; and (3) the erring secured party is barred from collecting the deficiency (the absolute bar test). Revised Article 9 clarifies this result for nonconsumer transactions. If the debtor or a secondary obligor raises the issue of the secured party's failure to comply with Article 9 in the collection, enforcement, disposition or acceptance of collateral under Part 6, UCC § 9-626(a) establishes the "Rebuttable Presumption Rule" with respect to debtor's deficiency or surplus. That is, the secured party bears the burden of proving that the collection, enforcement, disposition or acceptance complied.[27] If the secured party is unable to meet this burden, then the debtor or obligor will be credited with the greater of the actual proceeds of the disposition or the proceeds that would have been realized had the secured party complied with the relevant provisions.[28] The new law leaves the matter to the courts with respect to consumer transactions, thus the three alternatives mentioned earlier remain possible results.

In addition to the changes specified in UCC § 9-626, Part 6 of Revised Article 9 (formerly Part 5) alters the secured party's rights and duties in event of default. Section 9-607(a) allows a secured party to collect payments and/or demand performance directly from an account debtor or other person obligated on collateral. Section 9-611 expands the secured party's notification obligation before disposing of collateral. The secured party must comply with the requirements for "reasonable notification" and send an "authenticated notification of disposition" to the debtor, any secondary obligor, and other parties, including other secured parties. Furthermore, now a secured party can accept collateral, with the debtor's consent, in full or partial satisfaction of the underlying debt.[29]

Need Help?

Numerous resources are available to help you make the transition to revised Article 9. These aids run the gamut of CLE courses and materials, books, articles and Web sites. Listed below are just a few resources available on the World Wide Web. These resources appear in no particular order and you should not imply any endorsement or vouch for the accuracy of a particular source by its appearance in this list.

The National Conference of Commissioners on Uniform State Laws
http://www.nccusl.org/nccusl/default.asp

A Quick Tour of Revised Article 9
hpt://www.brooklaw.edu/zaretsky2001/

New York Department of State, Important UCC-9 Information
http://www.dos.state.ny.us/corp/ucc9info.html

Consumers Union: Summary of Changes in Article 9 Relating to Consumer Secured Transactions
http://consumersunion.org/finance/summwc100.htm

Corinne Cooper, ed., *The New Article 9*, 2d ed. (2000). (Available from the ABA)
http://www.abanet.org/buslaw/catalog/5070360.html

Commercial Finance Association: Revised Article 9
http://www.cfa.com/revised_article_9/revised_article9.htm

Revised Article 9 Resource Center
http://www.intercountyclarance.com/ra9/ra9.html

Bankers Online Revised Article 9 Resource Center
http://www.bankersonline.com/lending/article9.html

Possible Implications of Revised UCC Article 9 for Canadian Personal Property Security Acts
http://www.law.ualberta.ca/alri/ulc/99pro/eppsaucc.htm

III. Transition Rules

Part 7 of Article 9 details the transition rules, which affect handling of security interests created under former Article 9. If a security interest perfected under the old law would comply with perfection under the revision, then the security interest remains perfected. Filings made before July 1, 2001 remain effective until the earlier of the normal lapse of the financing statement or five years from the effective date of the revision.[30] You can file a continuation statement under revised Article 9 only if the continuation statement is filed in the state where the financing statement was filed under former Article 9 and that state is the correct state for filing a new financing statement under the revision.[31] If the filing under the old law was made in a state where you would not file under the revision, then you should file a new financing statement before July 1, 2002 in the correct state to continue the previous filing.[32]

The Permanent Editorial Board for the Uniform Commercial Code (PEB) issued a report discussing choice of law issues where revised Article 9 is not in effect.[33] Four states have opted to make revised Article 9 effective after the uniform start date of July 1, 2001. In Connecticut, the revised article will become effective on October 1, 2001. Alabama, Florida and Mississippi selected January 1, 2002 as the effective date. These delays raise the question whether to apply former Article 9 or revised Article 9. Where a secured party may be required (by the choice of law rules in each jurisdiction) to file a financing statement in both the jurisdiction where revised Article 9 is effective and a jurisdiction where former Article 9 remains effective, the PEB report suggests that the secured party file in both jurisdictions.

Why dual filing? For ordinary goods, if the goods are located in a different jurisdiction than the jurisdiction in which the debtor is located, you would file where the goods are located under the former Article 9 rather than where the debtor is located under revised Article 9. For accounts and general intangibles, the location of the debtor may be determined by the debtor's executive office under former Article 9 rather than the state of the debtor's incorporation under revised Article 9. And for instruments, filing may be ineffective if the instruments are located in one of the jurisdictions where former Article 9 remains in effect.

IV. New York Non-Uniform Amendments

New York adopted non-uniform amendments to certain sections of Revised Article 9. Many sections have been amended to accommodate security interests in cooperative apartments consistent with New York's previous adoption of non-conforming amendments for cooperative apartments, and at the same time these non-uniform amendments bring about some improvement in the law.[34] Included among these amendments is the provision of an addendum to the UCC1 financing statement specifically for cooperative filings[35] and the addition of non-uniform definitions in UCC § 9-102.[36] In addition, sections 9-310(b) and (d) codify the practice that a security interest in a cooperative interest is subordinate to the interest of the cooperative organization. Also, the priority rule in section 9-323 protects second priority home equity lenders against future advances made by a first priority lender subsequent to the initial advance. Section 9-513(e) facilitates termination of security interests in cooperative ownership interests.

Apart from the non-uniform language relating to cooperative interests, New York adopted several additional non-uniform provisions. Many of these amendments have negligible impact and will not be discussed here.[37] UCC § 9-109(d)(8) excludes from Article 9's scope a transfer of an interest in, or an assignment of, a claim under a policy of insurance (other than health care receivables). New York's version of section 9-109(d)(8) adds "contract for an annuity including a variable annuity" to this exclusion. In addition, revised Article 9 in New York eliminates section 9-406(f) of the uniform law, which is designed to nullify all laws (case law, statutes or regulations) that prohibit or otherwise limit the assignment or transfer of, or creation of a security interest in, an account or chattel paper. Likewise, New York's revised Article 9 does not include § 9-408(c) of the uniform law, which again nullifies all laws that would prohibit or limit assignment, transfer or creation of a security interest in promissory notes, health care insurance receivables or general intangibles. The elimination of these sections is subject to amendment once the full impact of the nullification measures is understood. That is, the New York Law Revision Commission has begun a study of the statutes and rules affected by the nullification measures in order to determine specifically which laws these sections of Revised Article 9 will override.[38]

V. Conclusion

This article discusses a few of the many changes brought about by the revision. The changes discussed here streamline perfection and clarify rights and duties of the secured party and debtor. However, this article provides only a glimpse of the changes involving commercial secured transactions and did not review any of the many changes impacting consumer transactions. So, whether you are preparing a new security agreement or updating an old transaction, you must thoroughly review revised Article 9.

Endnotes

1. 2001 N.Y. Laws ch. 84.
2. All of the states plus the District of Columbia have enacted revised Article 9.
3. UCC §§ 9-702, 9-109 .
4. *See* UCC § 9-703(b) (allowing one year to perfect security interests effective under former Article 9, but ineffective under revised Article 9). Section 9-705(c) creates an exception to this general rule whereby it continues the effectiveness of an effective filing under former Article 9 until the earlier of the date the filing lapses or June 30, 2006. As a practical matter, this means searches for revised Article 9 filings alone may miss former Article 9 filings made prior to July 1, 2001 under former Article 9. *See* UCC § 9-706(a) (continuing a pre-effective date filing in another jurisdiction with the filing of an initial financing statement in the appropriate revised Article 9 jurisdiction).
5. UCC § 9-109.
6. *See, e.g.*, UCC §§ 9-102(a)(11) (defining "chattel paper"), 9-102(a)(34) (defining "farm products").
7. UCC § 9-503(a).
8. UCC § 9-503(c).
9. UCC § 9-506(c).
10. *Id*.
11. N.Y. C.C.R. & Regs. tit. 19, § 143-4.3.
12. UCC § 9-509(a).
13. UCC § 9-509(b).
14. *See* UCC §§ 9-504(1) (allowing description that complies with UCC § 9-108), 9-108(b)(3) (allowing description by type). Also note that UCC § 9-504(2) allows super generic collateral descriptions on the financing statement. *See* UCC § 9-504(2) (stating that a financial statement is sufficient if collateral is stated as all assets and personal property).
15. UCC § 9-108(e)(1).
16. UCC § 9-501.
17. UCC § 9-301.
18. UCC § 9-307(e). For unregistered organizations, the debtor is located at its place of business or at its chief executive office if it has more than one place of business. Individuals are located at the individual's principal residence. UCC § 9-307(b).
19. UCC § 9-203(a),(b). But, keep in mind that with revised and new definitions, collateral descriptions in security agreements may need to be revised.
20. UCC § 9-312(a).
21. *See* UCC §§ 9-104 (establishing control for deposit account), 9-105 (establishing control for electronic chattel paper), 9-106 (establishing control for investment property), 9-107 (establishing control for letter-of-credit right).
22. UCC § 9-104(a).
23. UCC § 9-313(c).

24. UCC § 9-328(1).
25. UCC § 9-330(d).
26. 39 N.Y.2d 632, 385 N.Y.S.2d 260 (1976).
27. UCC § 9-626(a)(2).
28. UCC § 9-626(a)(3).
29. UCC § 9-620.
30. UCC §§ 9-703(a), 9-705(c).
31. UCC § 9-705(d). Likewise, any amendments of pre-effective date financing statements will be effective so long as the financing statement filed under former Article 9 would be effective under the revision. UCC § 9-707(c).
32. UCC § 9-703(b).
33. Report of the Permanent Editorial Board for the Uniform Commercial Code: Article 9 Perfection Choice of Law Analysis Where Revised Article 9 Is Not in Effect in All States by July 1, 2001 (June 13, 2001), *available at* http://www.ali.org.
34. In addition, corresponding sections of Article 8 have also been amended to conform to the adoption of these provisions. *See, e.g.,* UCC § 8-102(e) (adding Article 9 definitions for "Cooperative Interest," "Cooperative Organization," and "Cooperative Record").
35. UCC § 9-521(c). *See* UCC § 9-502-(b),(e) (describing the required contents of the addendum).
36. UCC § 9-102(27a)–(27f).
37. NY State Law Revision Commission, 2001 Report on the Proposed Revised Article 9–Secured Transactions-of the Uniform Commercial Code 14 (noting N.Y. eliminated UCC § 9-516(b)(5)(C)(iii) requiring the inclusion of the debtor's organizational identification number on the financing statement because the number is infrequently used and unlikely to be known by an officer or employee of the debtor).
38. *Id.* at 20-26, 112-117,118-126 (identifying 20 statutes affected by UCC § 9-406 and 51 statutes affected by UCC § 9-408).

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The Registration Process for Going Public

By Guy P. Lander

Set forth below in outline form is an overview of the public offering registration process.

I. Introduction

A. Why Consider a Public Offering?

1. The Company has reached a stage in its development where it needs funds to grow.
2. Shareholders want to sell part of their interest in the Company and obtain cash for their investment.

B. Advantages and Disadvantages of a Public Offering

1. Advantages:
   a. Compared to debt, there is no obligation to repay principal and no interest payments.
   b. A trading market is established for the Company's securities which enables shareholders to realize gains and obtain cash for their investment in the Company.
   c. An aftermarket facilitates later financings, i.e., future public offerings and private placements.
   d. Securities of a public company can be used to build the Company through acquisitions.
   e. Securities of a public company can be used to create incentives for employees.
   f. A public company is believed by many to be more prestigious than a private company.
2. Disadvantages:
   a. Previously confidential information must be disclosed.
   b. Ownership is shared with public investors and management must deal fairly with them.
   c. Management loses flexibility.
   d. Management is usually preoccupied with keeping the Company's stock price up.
   e. Company incurs continuing increased costs once it is public.
   f. Founders risk a possible loss of control, depending on the circumstances.

C. Once a Company Decides on a Public Offering, Two Issues Arise

The underwriting process and the registration process.

1. The Company usually needs a professional to sell its securities—the underwriter.
2. By law, the securities must be registered before the underwriter can sell them.

   (Becoming more popular with smaller, more speculative companies—direct public offerings, usually over the Internet. While these offerings don't require an underwriter, the principles below remain the same.)

D. Role of the Lawyer

1. Counsel advises Company management throughout the underwriting process.
2. Counsel assists the Company in registering its securities.

II. The Securities Laws and Registration of Securities

A. Statutory Scheme

1. The two basic statutes are: the Securities Act of 1933[1] (the "Securities Act") and the Securities Exchange Act of 1934[2] (the "Exchange Act").
   a. The Securities Act covers public offerings, i.e., the public distribution of securities offered on a relatively large scale.
   b. The Exchange Act regulates securities and related matters after the securities have been issued, i.e., when they are trading in the markets.

B. Section 5 of the Securities Act Prohibits Offers or Sales of Securities Without Registration. Generally, the Securities Act Prohibits Public Distributions of Securities Without Registration and Requires the Disclosure of Relevant Information to Investors.

1. Registration and Disclosure.
   a. Registration.

      Before the underwriter can sell securities, the Company must register the securities. The Securities Act prohibits anyone from selling securities to the public unless a registration statement is in effect covering the securities or an exemption from registration is available.

b. Disclosure.

The Securities Act does not evaluate investments, i.e., it does not permit good investments and prohibit bad investments. Rather, the Securities Act forces the disclosure of all relevant information so that each investor can make an informed decision whether or not to buy the security.

The Securities Act is a Truth-In-Securities Statute.

2. Section 5(c)—The Pre-filing Period.

a. Preliminary Negotiations

Prior to the filing of a registration statement, it is unlawful to "offer to sell or offer to buy . . . unless a registration statement has been filed as to such security."[3] However, preliminary negotiations with the proposed underwriter may be conducted. Under section 2(3) of the Securities Act, an "offer to sell" does "not include preliminary negotiations or agreements between an issuer . . . or underwriter or among underwriters who are in privity of contract with an issuer."

b. Letter of Intent, Also Called an Engagement Letter.

Frequently, but not always, the Company will enter into a letter of intent with the underwriter. Once the Company has selected an underwriter, the Company will negotiate the terms of the offering with the underwriter and sometimes the parties will outline the terms of the offering in a letter of intent. However, even when a letter of intent is used, it is usually not binding.

(1) The letter of intent identifies the nature of the underwriting commitment.

There are basically two types of underwriting commitments: the firm commitment and best efforts.

(A) Firm Commitment: the stronger of the two and the type usually used by reputable underwriters.

In a firm commitment underwriting, the underwriter buys the securities from the Company at slightly less than the public offering price and then resells the securities to the public at the offering price. Any shares the underwriter can't sell, it owns.

The "spread" between the purchase price and the resale price is the underwriter's commission.

(B) Best Efforts: the weaker of the two.

The underwriter makes no commitment to buy any securities. Rather, it agrees to use its "best efforts" to sell the securities as agent for the Company. If buyers can't be found, the securities remain unsold.

(2) The letter of intent identifies the conditions which the underwriters expect the Company to meet, e.g., a certain level of earnings.

(3) It provides who pays expenses, particularly if the underwriting is completed. Frequently, the Company pays all the expenses. Sometimes the underwriter will pay its legal and other out-of-pocket expenses or agree to a maximum amount of such expenses to be paid by the Company.

(4) It is not a binding underwriting commitment. The underwriting agreement contains the actual binding underwriting commitment and it is not signed until just before the registration statement becomes effective.

c. Negotiations With Selling Stockholders.

Negotiations with selling stockholders are not explicitly exempt from registration. A non-insider selling stockholder cannot make a decision to sell without seeing the preliminary prospectus, but practical considerations frequently require mailing a notice prior to filing the registration statement.

d. Rule 135—Notice of a Proposed Offering.

(1) Rule 135 permits a limited public announcement of an offering. A notice of a proposed offering is not deemed an "offer" if: (1) it states the offering will be made by prospectus only; and (2) it contains no more than the following information: name of issuer, title, amount and basic terms of the offering, the amount of the offering to be made by selling securityholders, the anticipated time of the offering and a brief statement of the manner and purpose of the

offering without naming the underwriters.

(2) The pre-filing notice may be necessary if the shares of the Company are publicly traded because the existence of the proposed offer may be material information. For an initial public offering (IPO), such a notice may end inquiries and conjecture and facilitate lining up selling stockholders.

C. The Registration Statement

1. Description.

   a. The registration statement is the document used for both registering the securities and disclosing to investors all relevant information necessary to enable them to make an informed investment decision. The disclosure given to investors is in the form of a prospectus included within the registration statement.

   b. The registration statement (actually the prospectus within it) describes the Company's business, the securities offered and the terms of the offering.

2. Process and Lawyer's Role.

   a. A Company registers its securities by preparing a registration statement, filing it with the SEC and the SEC declaring it to be in "effect."

   b. One of the lawyer's roles is to assist the Company in registering its securities. The lawyer assists the Company in preparing the registration statement, ushers it through the SEC review process and arranges for it to be declared effective by the SEC.

   c. Preparing the registration statement is a cooperative endeavor. The Company's attorneys prepare the registration statement working with management, Company accountants, the underwriter and its counsel.

3. Forms of Registration Statements for Domestic Companies.

   The SEC has published numerous forms and rules which specify the information required to be in the registration statement. Those forms used by U.S. companies are as follows:

   a. Form S-1.

   Form S-1 is the most commonly used form of registration statement. This registration statement and the related prospectus must contain a complete description of the Company's business, the securities to be issued and the terms of the offering. This form requires three years' audited financial statements, unaudited financial statements for the interim "stub" period and five years' summary financial information.

   b. Form S-2.

   Form S-2 may be viewed as Form S-1 without the financial statements. The Company's financial statements may be furnished by delivering the Company's most recent annual report to stockholders and the most recent quarterly report on Form 10-Q filed with the SEC. The Company's most recent annual report on Form 10-K is incorporated by reference and available on request. Form S-2 is available if the registrant has been a reporting company under the Exchange Act for 36 months, has made all filings for such period, has made all filings in a timely manner for the last 12 months and, since the end of the most recent fiscal year for which a Form 10-K annual report has been filed, has not defaulted with respect to a preferred dividend or sinking fund payment, payment of any indebtedness or long-term lease rentals which defaults in the aggregate are material to the financial position of the registrant. Only those material defaults not previously reported, and therefore not absorbed by the market, disqualify the Company from using this Form.

   c. Form S-3.

   Form S-3 permits extensive incorporation by reference to Exchange Act reports and generally requires that only information relating to the specific offering be included in the prospectus. All other disclosures may be provided by incorporation by reference to the Company's Form 10-K, Form 10-Q, Form 8-K and the proxy statements. Form S-3 is available if the registrant has been a reporting company under the Exchange Act for at least 12 months, has made all filings in a timely manner for the last 12 months, and, since the end of the most recent fiscal year for which a Form 10-K annual report has been filed, has not defaulted with respect to a preferred dividend or sinking fund payment, payment of any indebtedness or long-term lease rentals which defaults in the aggregate are material to the financial position of the registrant. Additionally, the offering must fit within one of the applicable transaction requirements. Form S-3 may be used to register any debt or equity offered for cash in primary offerings by, or on behalf of, the registrant or in secondary offerings by a person other than the registrant if the aggregate market value of the voting and non-voting common stock held by non-affiliates (i.e., the "float") is $75 million or more. Form S-3 may also be used for primary offerings for cash of investment-grade non-convertible debt or preferred stock, certain secondary offerings, rights offerings, dividend or interest reinvestment plans and conversions, warrants and options. *Note:* the requirement of a $75 million float need not be satisfied in secondary offerings by someone other than the issuer if the class of securities is listed and registered on a national securities exchange or quoted on Nasdaq.

d. Form SB-2.

Form SB-2 may be used by a "small business issuer" as defined in Rule 405 of the Securities Act, i.e., a U.S. or Canadian company with less than $25 million in revenues and under $25 million in public float. In case of an IPO, public float is computed on the basis of the number of shares outstanding before the offer and the estimated IPO price. This form requires less disclosure information, including less financial statements (for only two years), than required by Form S-1.

e. Form SB-1.

Form SB-1 may also be used by a small business issuer (see d. immediately above) that registers no more than $10 million of securities (which must be sold for cash) in any 12-month period. This form cannot be used after the Company files certain other Securities Act forms or Exchange Act reports. Form SB-1 permits the use of several alternative disclosure formats (including a question and answer format).

4. Regulation A: An Exemption For Small Offerings.

a. Regulation A is an exemption from registration that works like a registered offering with an offering statement similar to a registration statement and an offering circular similar to a prospectus.

b. Expenses are lower than for a registered offering.

c. Non-reporting companies may use Form 1-A to conduct public offerings under Regulation A of up to $5 million a year, $1.5 million of which may be sales of securities by stockholders. Regulation A is not available to reporting companies.

5. Contents of Registration Statement.

a. Generally.

The registration statement consists of 2 parts: Part I—the Prospectus, and Part II—Supplemental Information.

(1) Part One—the Prospectus.

(A) The prospectus, which comprises most of the registration statement, is a booklet the underwriter must give to prospective investors.

(B) The prospectus describes the Company, the securities to be offered and the terms of the offering.

(2) Part Two—supplemental information. This is not given to investors, but it is available for inspection at the SEC's offices or at the SEC's Web site.

b. The Prospectus.

The prospectus should be in plain English and contain, among other matters, the following:

(1) Risk Factors.

Initial public offerings of newly-established companies generally contain a separate section which describes the special risks of investing in the venture, such as:

(A) absence of operating history;

(B) absence of profitable operations in the past and expectation of continued losses;

(C) tenuous financial position;

(D) speculative nature of the business.

See Item 503 of Regulation S-K.

(2) Dilution.

Generally, there is a significant difference between the public offering price and the effective cash acquisition cost of shares held by officers, directors, promoters and affiliated persons. A comparison of this difference must be disclosed.[4] The amount of dilution suffered by new investors must be disclosed in terms of the difference between the public offering price and the net book value of their shares of the Company after the offering. Additionally, disclosure is required of the aggregate purchase price paid by insiders and the public investors for their respective interests in the Company. This information is reviewed by "merit review" states and may raise "cheap stock" issues. See "Blue Sky Laws" below.

(3) Available Shares.

If there is no established trading market, the amount of common stock subject to options, warrants or convertible securities and the amount of common stock that could be sold pursuant to Rule 144 under the Securities Act or that the Company has agreed to register, must be disclosed.[5] The purpose of this disclosure is to enable investors to evaluate the possibility that future sales of a substantial number of shares by existing stockholders could have an adverse impact on the market price of the stock.

(4) Certain Transactions.

Often there is a significant number of transactions between the Company and its officers, directors and other affiliates. These transactions must be disclosed.[6] Merit state reviewers may examine such transactions to determine whether their terms are as favorable to the Company as those it may have obtained from third parties.

(5) Capital Stock and Charter Provisions.

Anti-takeover provisions must be disclosed.

(6) Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").

The disclosure provided by the MD&A section of the prospectus must go beyond merely reciting numbers and doing computations on the financial statements. Disclosure must be given of management's expectations for trends as well as management's explanation for material changes in line item information between fiscal years. Also, disclosure must be specific for sources of liquidity and capital commitments, both long and short term.

(7) Management; Beneficial Owners.

Disclosure must be made of the identities, business background and employment agreements (or other compensation arrangements) of each of the Company's officers and directors. The prospectus must disclose the equity holdings of each of those persons in the Company, as well as the identity and equity position of any beneficial owner of 5 percent of the Company's equity securities.

D. SEC Review of the Registration Statement

1. Review Process.

   a. Once prepared, the Company's CEO, CFO and at least a majority of directors sign the registration statement and it is filed with the SEC. Filing is done electronically, through the SEC's EDGAR system.

   b. The SEC assigns two staff members to review the registration statement. Each reviews the registration statement to see whether it appears to comply with the proper form and appears to provide proper disclosure. One staff member reviews and prepares comments on legal matters and the other reviews and prepares comments on accounting matters. When they complete their review, they send a Letter of Comments to the Company and its attorneys.

2. Replying to Comments.

   The Company's attorneys and accountants either comply in full with the comments or negotiate their reply to difficult comments with the staff. The registration statement is amended and refiled. Usually, there is a second and third round of comments and amendments.

3. Length of Time of SEC Review.

   The SEC review may take one or two months. Within a couple of weeks after filing, the staff will inform you of the schedule. For IPOs, the initial SEC review will take at least 30 days. SEC review of the first amendment to the registration statement generally takes two weeks or so, with the review time shortening somewhat for further amendments as the number of comments diminishes. However, these time periods may vary widely depending on many factors including the complexity of the filing and the workload of the staff at a particular time.

4. Going Effective.

   Once the staff is satisfied with the registration statement, the SEC orders the registration statement to be in effect (technically by acceleration of effectiveness).

E. Due Diligence—Making Sure the Registration Statement Is Accurate and Complete on the Effective Date

1. Section 11(a)—Liability.

   a. Section 11(a) of the Securities Act creates an express right of action for investors when a registration statement contains untrue statements of material fact or omissions of material fact. Section 11(a) is a strict liability provision, subject only to the defenses described below.

   b. When the SEC declares a registration statement effective, it has not approved the registration statement; it has merely completed its review of the registration statement to see whether, on the surface, it appears to comply with the proper form and appears to provide the proper disclosure. The SEC does not really know whether the registration statement discloses all it should, or whether the disclosure made is accurate.

2. Those Liable for Misstatements or Omissions.

   The Company, all signers of the registration statement, all directors, all underwriters, and all accountants, engineers, appraisers and other named experts, may be held liable for misstatements or omissions in the registration statement. Therefore, all must make sure that the registration statement is accurate and complete when effective. The registration statement must disclose all information that may be material to an investor.

3. Section 11(b)—A Defense.

   a. Section 11(b)(3) of the Securities Act provides a defense to section 11(a) liability for misstatements or omissions found in a registration statement. Any person other than the Company is absolved of section 11(a) liability for any part of the registration statement not made under the authority of an expert provided that the defendant "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." The defense is the same with respect to any portion of the registration statement purporting to be made on the authority of an expert (e.g., financial statements) except there is no requirement of a "reasonable investigation" (unless the person asserting the defense is the expert in question).

   b. The "reasonable investigation" referred to in section 11(b)(3) is called the "due diligence" investigation.

   c. The due diligence investigation verifies each material fact in the registration statement before going effective and serves two functions:

      (1) To establish the section 11(b)(3) defense; and

      (2) To find potential problem areas and disclose them to protect against future litigation.

F. Publicity

1. Pre-filing and Waiting Periods.

   During the pre-filing period and waiting period (i.e., after filing the registration statement and before effectiveness), a publicity campaign related to the offering is prohibited. This includes interviews related to the Company.

2. Waiting Period.

   During the waiting period, some communications are permitted (and even necessary): a sales pitch by securities salesmen, seminars and road shows. An internal memorandum for underwriters is permitted but distribution must be limited. Otherwise, no written materials may be used except the preliminary prospectus, called a "red herring." Oral statements do not violate section 5, but if they are false or misleading, they may cause liability under section 12 of the Securities Act and Rule 10b-5 of the Exchange Act.

3. Statutory Scheme.

   The above is based on the following: Section 5(b)(1) of the Securities Act prohibits transmitting "any prospectus relating to any security with respect to which a registration statement has been filed . . . unless such prospectus meets the requirements of section 10."[7] Section 5(a) of the Securities Act makes it unlawful to sell any security by a prospectus or to carry a security in interstate commerce for sale, unless a registration statement is in effect with respect to such security. A prospectus is defined in section 2(10) of the Securities Act to mean any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. (Rule 134 provides that "prospectus" does not include a notice that contains only the items of information permitted by the Rule and contains the legends required by the Rule.)

4. Remedies for "Gun Jumping."

   The SEC may delay the effectiveness of the registration statement or the underwriter may be forced to withdraw as such if there are violations of the publicity rules described above.

G. Prospectus Delivery

1. Circulation of the Preliminary Prospectus.

   The SEC usually requests information about distribution of the prospectus. If the distribution is insufficient, effectiveness may be delayed. For IPOs, a preliminary prospectus must be delivered "to any person who is expected to receive a confirmation of sale at least 48 hours prior to the mailing of such confirmation."

2. Recirculation of a Preliminary Prospectus.

   Recirculation of the prospectus is required as a practical matter when there has been a material change to the information contained in the preliminary prospectus. Recirculation is done to minimize potential liability. It also may be required in order to obtain the SEC's grant of acceleration of effectiveness.

3. After Effectiveness of Registration Statement.

   a. Section 5(b)(2) of the Securities Act provides that it is unlawful to use the mails or interstate commerce for the purpose of sale or delivery after sale of any security unless "accompanied or preceded" by a prospectus which meets the requirements of section 10(a). Section 2(10) of the Securities Act provides that a communication sent or given after the effective date is deemed not a prospectus if a prospectus meeting the requirements of section 10(a) is sent or given with or prior to the communication. Therefore, confirmations may not be mailed by the underwriters without a final prospectus.

   b. Furthermore, for an IPO, the final prospectus must be delivered in connection with offers and sales which occur during the 25 days after the effective date.

III. The Underwriting Process

A. Binding Agreement: Underwriting Agreement

Generally, the only binding agreement between the company and the underwriter is the underwriting agreement. Although it defines the underwriter's obligations, it is subject to many conditions and outs.

B. Procedure

Before the registration statement is declared effective, the underwriter is pre-selling the offering. By the time the registration statement is ready to become effective, the underwriter should have presold the offering. If the offering appears pre-sold, the underwriting agreement is signed within 24 hours before the registration statement becomes effective, and usually that morning. First, pricing is agreed upon; then the underwriting agreement is signed; then the registration statement becomes effective; and lastly, the underwriter commences selling the securities.

C. Closing

In firm commitment underwritings, final settlement usually takes place 3-5 days after the registration statement becomes effective. This gives the underwriter time to collect funds from its customers. The company then receives the proceeds of sale less the underwriter's compensation.

IV. NASD Review

A. Purpose

The National Association of Securities Dealers, Inc. (NASD) reviews the underwriting arrangements to make sure that the underwriter's compensation is not excessive under NASD rules.

B. NASD Opinion

The SEC will not declare a registration statement effective until it has received the NASD's opinion that the underwriter's compensation is not excessive.

V. Blue Sky Laws

A. Described

1. The Blue Sky Laws are the securities laws of the 50 states.

2. Each state has adopted its own securities laws. Although there are many similarities, the laws do vary in important respects from state to state.

B. Importance to an Offering

In an offering, securities must be registered not only with the SEC but also with each state in which they will be offered.

C. Merit Statutes

Unlike the 1933 Act, many state statutes are “merit statutes,” i.e., the state securities commissioner may prohibit the sale of a security if he determines that the sale would not be fair, just or equitable to residents of his state.

D. Listing Exemption

Exchange listed and Nasdaq NMS securities are preempted from registration or qualification, review or imposition of conditions on offering materials, and prohibitions or conditions based on the merits of the offering or issuer, by any state.

IPO Timetable

4-8 Weeks	Organizational Meeting Document Drafting and Due Diligence
4-5 Weeks	Filing of Registration Statement SEC Comment Period
3-4 Weeks	Distribution of Preliminary Prospectus (“Red Herring”), Marketing and Roadshow
1 Week	Pricing and Execution of Underwriting Agreement Selling Completion of Closing Documents
	Closing

Total: 12-18 Weeks

Endnotes

1. 15 U.S.C. §§ 77a *et seq.*
2. 15 U.S.C. §§ 78a *et seq.*
3. Securities Act § 5(c).
4. *See* Item 506 of Regulation S-K.
5. *See* Item 201(a)(2) of Regulation S-K.
6. *See* Item 404 of Regulation S-K.
7. 15 U.S.C. § 77e (b)(1).

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Case Note

By Whitney Magee Phelps

In re Penepent Corp.

New York Business Corporation Law § 1104-a (BCL) provides that a shareholder, owning at least 20 percent of a company's stock, may petition a court for the dissolution of that company if the shareholder suspects that the people in control of the company are guilty of illegal, fraudulent or oppressive actions or if company property is being looted, wasted or diverted for noncorporate purposes.[1] However, other shareholders can prevent the company from being dissolved by electing to purchase the shares of the person petitioning for dissolution, at fair value and with court approval.[2]

A company's shareholders can also deal with the dissolution of a company, due to the death of a shareholder, by agreeing among themselves to have the corporation buy a deceased shareholder's stock at a set price. New York courts have held as a general rule that shareholders' agreements should be upheld and enforced.[3]

What happens when there is an election to purchase shares at fair value in order to prevent dissolution and the corporation has a contractual obligation to buy the shares back at a set price when a shareholder dies? What price prevails and who must buy the shares? The Court, in *In re Dissolution of Penepent Corp.*,[4] grappled with this very issue. The Court of Appeals had to decide whether a mandatory buyout provision in the shareholders' agreement trumped an election to buy shares to prevent dissolution.[5]

Anthony Penepent started a family business in 1937, and in 1952, he and his four sons, Philip, Richard, Angelo and Francis, formed a close corporation with each having a 20 percent interest.[6] The five men entered into a shareholders' agreement which stated that if one of the shareholders died, the corporation would buy the deceased's corporate stock for a set price.[7] The four brothers bought out their father, making each of them a 25 percent shareholder.[8]

Unfortunately, the brothers did not get along. Philip petitioned for dissolution and Richard and Angelo elected to buy Philip's shares. However, Angelo died before the court determined the fair value for Philip's stock. Angelo's estate revoked his election to buy half of Philip's shares, which allowed the corporation to buy Angelo's stock as agreed upon in the shareholders' agreement.[9] Before Angelo died, Francis also sought dissolution of the corporation and Richard elected to purchase Francis' shares in hopes of becoming the sole shareholder. The court conducted a joint valuation hearing to determine the fair value for both brothers' shares.[10]

Unfortunately, Francis died before the court could establish the fair value. At this point, Richard wanted the corporation to buy Francis' shares at $200 per share as contracted in the shareholders' agreement. The estate refused, arguing that Richard was bound by his election to purchase Francis's shares at fair value.[11]

Richard attempted to dismiss Francis' dissolution proceeding on the basis that the shareholders' agreement obligated Francis' estate to turn over his shares to the corporation for $200 per share. In addition, Richard attempted to revoke his election to buy Francis' shares.[12]

The trial court rejected both arguments. The Supreme Court held that Francis had a right to be paid the fair value, even though he had died, because the right was vested at the time that Richard made the election and there was no reason to allow Richard to revoke his election.[13]

Richard appealed and the Appellate Division and the Court of Appeals affirmed the trial court's decision.[14] The Court had to determine if Francis' death made the shareholders' agreement controlling over the BCL § 1118 election. Richard argued that the corporation, pursuant to the shareholders' agreement, had the right to acquire Francis' shares at the agreed price because Francis was still a shareholder when he died.[15] On the other hand, Francis' estate argued that the BCL § 1118 election is controlling because the election to buy Francis' shares was irrevocable.[16]

The Court looked at B.C.L. § 1118, which states that an election "shall be irrevocable unless the court, in its discretion, for just and equitable considerations, determines that [it] be revocable."[17] In addition, the court distinguished this case from other cases where the court dismissed petitions for dissolution because shareholders' agreements had already operated to divest the shareholder's interest.[18] In this case, Francis's death, which would trigger the shareholders' agreement, occurred after the section 1118 election.

The Court held the election was controlling because the election is irrevocable under BCL § 1118 and the election was made before the shareholders' agreement was triggered by Francis' death. Therefore, the Court held Francis had a "vested right to recover fair value for his corporate stock and that right survived his death."[19]

Richard also argued that the value of Francis' stock should be discounted because of Philip's pending dissolution proceeding. The Court rejected this argument for two reasons. First, the pending litigation did not affect the fair value of the stock. After all, the corporation was not paying for the litigation and the corporation was not in jeopardy of being dissolved.

Second, the Court held that Francis' minority stock could not be discounted merely because of its minority status. Richard became a controlling shareholder after Angelo's death and purchasing Philip's stock, which made Francis a minority shareholder.[20]

In the end, Richard had to pay Francis' estate the fair value for his shares as determined by the outcome of the petition for dissolution. This result means that a shareholders' agreement will not be enforced, contrary to the general rule, when a petition for dissolution has been made *before* an event that triggers a contractual agreement.

Endnotes

1. BCL § 1104-a.
2. BCL § 1118.
3. *See Gallagher v. Lambert*, 74 N.Y.2d 562, 567, 549 N.Y.S.2d 945 (1989) (stating that all parties enter into shareholders' agreements for their own benefit to avoid costly litigation).
4. 96 N.Y.2d 180, 726 N.Y.S.2d 339 (2001).
5. 96 N.Y.2d 186, 192 (2001).
6. *Id.* at 189.
7. *Id.* (stating the price started out at $10 per share and was last increased to $200 per share in 1984).
8. *Id.* (indicating the buyout happened in 1979).
9. *Id.* at 189-90.
10. *Id.* at 190.
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at 191.
15. *Id.* at 192 (arguing that the mandatory buyout provision in the shareholders' agreement was controlling because the fair value for the stock had not been set).
16. *Id.* (stating that once a party makes an election both the buyer and seller are bound to the fair price).
17. BCL § 1118.
18. *See Penepent*, 96 N.Y.2d at 193 (distinguishing *Weiner v. Anesthesia Assocs. of W. Suffolk, P.C.*, 203 A.D.2d 455, 610 N.Y.S.2d 608 (2d Dep't 1994); *Hesek v. 245 S. Main St., Inc.*, 170 A.D.2d 956, 957, 566 N.Y.S.2d 127 (4th Dep't 1991); *Martin Enter. Inc. v. Janover*, 140 A.D.2d 587, 528 N.Y.S.2d 855 (2d Dep't 1988).
19. *See id.* (pointing out that the election to purchase Francis' share occurred a year and a half before Francis' death).
20. *Id.* at 193-94.

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Case Highlights

Compiled by Whitney Magee Phelps

Agency/Fiduciary Duty

Dubbs v. Stribling & Assocs.
96 N.Y.2d 337, 728 N.Y.S.2d 413 (2001)

The Court of Appeals affirmed the lower court's decision to dismiss the plaintiffs' claim for breach of a fiduciary duty. Plaintiffs hired the defendants to be their real estate broker for the sale of their apartment. Plaintiffs told the defendants that they would keep the apartment and expand the space with the adjacent neighbor's apartment, but the neighbor refused to sell. The defendants (the agents for the plaintiffs) decided to buy the plaintiffs' apartment and the two couples entered into a contract agreement in December. The defendants' brokerage commission was waived. Three weeks before the closing, the defendants made an oral agreement with the plaintiffs' neighbor to purchase the adjacent apartment. The plaintiffs did not discover this arrangement until after the closing and after the defendants entered into a written contract with the neighbor. The Court of Appeals held that the brokers did not breach their duty of loyalty to the plaintiff by not disclosing to the plaintiff their personal interest in the adjacent apartment. The facts indicated that the defendants did not withhold information at the time that the contract was signed. In addition, the broker/principal relationship ended when the purchase contract was signed, which precluded the brokers from having to reveal any information to them after the contract was signed. Therefore, the plaintiffs had no reason to expect that a fiduciary relationship existed between them and the defendants, making it impossible for the Court to conclude that there was a claim for a breach of a fiduciary duty.

Sonnenschein v. Douglas Elliman-Gibbons & Ives
96 N.Y.2d 369, 729 N.Y.S.2d 62 (2001)

The Court of Appeals granted summary judgment dismissing the complaint because the Court concluded that no broker/principal relationship existed and therefore there was no breach of a fiduciary duty. The defendants acted as co-brokers and found a purchaser. The plaintiffs had a contract written, giving the defendants a commission for finding the plaintiffs a purchaser. The contract was never signed because the defendants found a superior apartment for the purchaser in the same building. The Court held that the reference in the contract to the commission agreement was insufficient to find any intent to create a broker/principal relationship. In addition, the Court found there to be no fiduciary duty given that the plaintiffs never listed their property with the defendants nor did the defendants take any affirmative steps to help the plaintiffs sell the apartment.

Contracts

Global Telesystems, Inc. v. KPNQwest, N.V.
151 F. Supp. 2d 478 (S.D.N.Y. 2001)

The court granted an injunction preventing a former officer from continuing employment as the CFO at a competitor's company. The two companies had entered into a "confidentiality agreement" with "no solicitation" and "no-hire" provisions. The contract prohibited KPNQ from soliciting employees of Global Telesystems (GTS) except by general advertisements. The employee, formerly a Senior V.P. at GTS, was unaware of the "confidentiality agreement" and was contemplating resignation from GTS when a headhunter hired by KPNQ talked to him about becoming the CFO for KPNQ. The employee left GTS to work for KPNQ and GTS petitioned the court for an injunction based on breach of contract. The court held that "the use of headhunters . . . simply does not constitute as 'general advertisement.'" The court granted the preliminary injunction based upon the factors that GTS could be irreparably harmed by the employee giving away knowledge he learned while working at GTS; GTS demonstrated a *prima facie* breach of contract case against KPNQ; and the hardships to GTS outweighed those to KPNQ.

Disclosure of Tax Returns

Shabasson v. Greenberg, Trager, Toplitz & Herbst
__A.D.2d__, 726 N.Y.S.2d 552 (1st Dep't 2001)

A partner sued the partnership claiming that he did not receive his allotted share of the firm's profits and requested the disclosure of the firm's K-1 forms to prove his assertion. Generally, tax returns are not disclosed. However, the court held that the law firm had to disclose the partnership K-1 forms for the time for which the plaintiff was a partner. The court decided that the disclosure was reasonable because the request was limited in scope to the partnership's information and did not include the individual partners' tax returns.

Ethical Duty of Confidentiality

Wise v. Consolidated Edison Co. of New York
282 A.D.2d 335, 723 N.Y.S.2d 462 (1st Dep't 2001)

An attorney can disclose confidential information of a client to defend against accusations of wrongful conduct. An in-house attorney tried to extend this exception to the confidentiality rule, in a suit against his company for his wrongful discharge. The court, however, forbade the attorney from disclosing confidential information he had obtained while working for the employer as an attorney.

Evidentiary Attorney-Client Privilege

Viacom Inc. v. Sumitomo Corp. (In re Copper Market Antitrust Litigation)
200 F.R.D 213 2001 U.S. Dist. LEXIS 5269 (S.D.N.Y. 2001)

Here the court protected information exchanged between the corporation's attorney and the public relations firm that the corporation hired, under the attorney-client privilege. The court held that there was no difference between a consultant hired by the company and an employee. In addition, the court held that the information was also protected by the work-product privilege because the consulting firm was hired in anticipation of litigation.

In re F.T.C.
2001 U.S. Dist. LEXIS 5059, 2001 WL 396522 (S.D.N.Y. Apr. 19, 2001)

The court ruled that 15 draft advertisements, with handwritten notes by the attorney for the client of the advertising agent, were not protected by the attorney-client privilege. The Federal Trade Commission (FTC) accused the client of false advertising and the court ordered that the drafts be turned over to the FTC because the drafts were reviewed for commercial purposes and not by the attorney as an attorney for the advertising agency. The communications between the attorney and the client were protected, but it was not reasonably understood that the communications by the attorney to the advertising agency were confidential.

Limited Liability Company

450 West 14th St. Corp. v. 40-56 Tenth Ave. LLC
187 Misc. 2d 735, 724 N.Y.S.2d 243 (Sup. Ct., N.Y. Co. 2001)

Plaintiff sued a limited liability company and the executrix of a deceased member of the LLC seeking to end an easement on his property. The court dismissed the action against the executrix because, pursuant to N.Y. Limited Liability Company Law §§ 609 and 610 (LLCL), a member of a limited liability company is not a proper party for a suit against the company.

Limited Partnership

Maine v. Jay Street Realty Assocs.
187 Misc. 2d 376, 722 N.Y.S.2d 726 (Sup. Ct., N.Y. Co. 2001)

The court had to determine whether service of process was sufficient to grant jurisdiction. In a suit against a limited partnership, service was made on the doorman of the apartment building of the general partner. If the partnership were a general partnership, service would be sufficient pursuant to N.Y. Civil Practice Law and Rules § 308 (CPLR). CPLR 310-a was enacted to provide for service upon limited partnerships, limited liability partnerships and limited liability companies. However, the court concluded that the intent of CPLR 310-a was to incorporate the same means for service provided for in CPLR 308. Service would have been sufficient for a general partnership, therefore such service on the general partner of the limited partnership was sufficient.

RICO

Cedric Kushner Promotions, Ltd. v. King
121 S. Ct. 2087 (2001)

The U.S. Supreme Court resolved a circuit split regarding the definitions of "person" and "enterprise" in the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1961. RICO makes it illegal "for any person employed by or associated with any enterprise . . . to conduct or participate . . . in the conduct of such enterprise's affairs through a pattern of racketeering activity." All courts agree that the language of the statute requires proof of two separate entities, a person and an enterprise, and not just the same person with a different name. The Court held that the president of a corporation, who is also the sole shareholder, constituted a person with a separate legal identity as the corporation, making the defendant a person distinct from the enterprise. The Court looked to basic linguistics and the purpose of incorporation to conclude that the corporation has a different legal status, with different rights and responsibilities, than the corporate owner/employee.

Workers' Compensation Law

Castro v. United Container Machinery Group, Inc.
2001 N.Y. LEXIS 1869, 2001 WL 721399 (June 28, 2001)

In this case, the N.Y. Court of Appeals interpreted N.Y. Workers' Compensation Law § 11 (WCL) very literally. The law relieves an employer from liability for injuries sustained by an employee, unless the injuries are grave. The legislation provides that the loss of multiple fingers is grave injury. Looking to the plain language of the statute and the Legislature's intent to narrowly define grave injury to limit the number of lawsuits against employers, the Court held that the loss of five fingertips is not the same as the loss of multiple fingers and as such does not constitute grave injury. Therefore, the motion for summary judgment was granted leaving the plaintiff with no cause of action.

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Taxation for the General Practitioner

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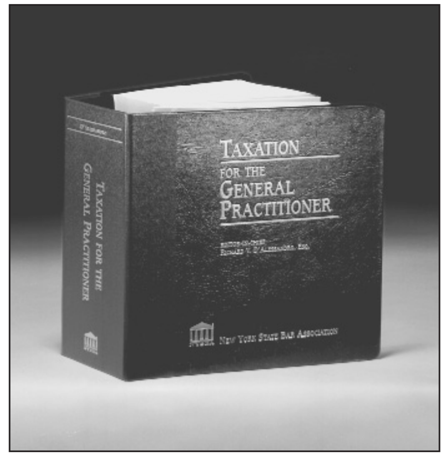

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