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Introduction

I am pleased to be taking the reins as Editor-in-Chief of the *NY Business Law Journal*, as the *Journal* embarks upon its new working relationship with Dean Stephen J. Friedman and the Pace University School of Law. I want to express the appreciation of the NYSBA and its Business Law Section to Professor James Redwood, the outgoing Editor-in-Chief, and his colleagues at the Albany Law School for their faithful and dedicated service to the *Journal* and the State Bar. Professor Redwood has graciously agreed to continue with the *Journal* as Managing Editor, giving us the benefit of his knowledge and expertise and assuring a smooth transition. I also want to acknowledge the debt of gratitude of the Business Law Section to our colleague Stuart Newman, the founder and guiding spirit of the *Journal*, who will be continuing to offer his wise counsel to the *Journal* as Advisor Emeritus.

> Pace Law School is very pleased to be associated with the *NY Business Law Journal* of the New York State Bar Association. Our commitment to this area of the law is important to us; we have recently launched the Pace Directors' Institute, which is focused on the training of corporate and nonprofit board members. We look forward to a long and productive relationship with David Glass as Editor and the distinguished business lawyers in the Business Law Section.
>
> **Dean Stephen J. Friedman**
> **Pace University School of Law**

Recently retired as a partner of Debevoise & Plimpton, in his long and distinguished career Dean Friedman also has served as General Counsel of the Equitable Life Assurance Society of the United States and the investment firm E. F. Hutton. His commitment to public service has been no less impressive; he has served as a Commissioner of the Securities & Exchange Commission and as a Deputy Assistant Secretary of the United States Department of the Treasury, and is currently President of the Practising Law Institute, the nation's largest provider of continuing legal education; Chairman of the Asian University for Women Support Foundation and the New York City Project of the Appleseed Foundation; and a long-standing Member of the Council on Foreign Relations. I know that Dean Friedman will bring the same energy and commitment to his new role as Chair of the *NY Business Law Journal*'s Editorial Advisory Board and that the *Journal* will achieve new heights of excellence and prestige in the New York business law community. I am honored to have the opportunity to work with him and my colleagues on the Pace Law School faculty.

David L. Glass
Editor-in-Chief

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HeadNotes

Leading off our inaugural issue of the Pace era is a fine article by Professor Ronald Jensen, entitled "The IRS's Proposed Regulations on Partnership Interests Issued for Services." Professor Jensen, who teaches courses in Taxation, Corporations and Partnerships, Wills and Trusts and related subjects, writes engagingly about a problem of current and practical significance to all business lawyers involved in advising partnerships and other business entities. Issuing partnership interests in lieu of cash payments has advantages for cash-strapped partnerships—just as corporations may benefit from issuing stock in lieu of paying cash under similar circumstances. But the income tax treatment of partnership interests issued in return for services performed has been an ongoing subject of concern and uncertainty. Professor Jensen, formerly a senior tax partner at Buffalo-based Jaeckle, Fleischmann & Mugel, explains how proposed new IRS regulations may require partnerships to make a "safe harbor election" and provides useful and practical guidance to their attorneys.

The next two articles present contrasting, but equally compelling views, regarding the cutting edge ethical issues affecting corporate governance and business practitioners in the post-Enron age. In "This Is a Fine Mess You've Gotten Me Into: The Revolution in the Legal Profession," C. Evan Stewart delves into the practical effects of the rules adopted by the Securities & Exchange Commission (SEC), arguing that the SEC's approach overreaches its legislative mandate and effectively eviscerates the attorney-client privilege for corporations subject to the post-Enron corporate governance law known as the Sarbanes-Oxley Act. Mr. Stewart, a partner with Zuckerman Spaeder LLP in New York City, was recently featured by the *New York Law Journal* in "the top trials of 2005" for his successful representation of Theodore C. Sihpol, the first person in U.S. history to be criminally charged for "late trading" mutual funds. Mr. Stewart is also an adjunct professor of law at Fordham Law School and Brooklyn Law School, and a visiting professor in the government department at Cornell University. He has published over 100 articles on diverse legal subjects, and is a frequent speaker across the country on securities, professional responsibility, and complex litigation issues, including a presentation before the New York State Bar Association in January 2005.

Following Mr. Stewart's article is a thoughtful piece by Stephen H. Cooper, "Shareholders at the Gate: The Rise of Populist Capitalism." Observing that the concept of corporate democracy through shareholder voting historically has been more fiction than reality—with the Board of Directors as the primary governing body of corporations—the author analyzes the reasons for the rise in shareholder activism in recent years, noting such factors as concern over excessive executive compensation; the trend to majority, rather than plurality, voting for directors; and the increasing use of shareholder initiative by large institutional investors. Mr. Cooper, until recently a senior partner at Weil Gotshal & Manges LLP in New York City, is an adjunct professor at Pace Law School.

The next pair of articles were both presented by their authors earlier this year at the Business Law Section's Annual Meeting, as part of a panel discussion entitled "Redlining Revisited: Are the Fair Lending Laws Doing Their Job?" co-sponsored by the Section with the Metropolitan Black Bar Association. The first article, entitled "The 2004-2005 Amendments to the Community Reinvestment Act Regulations: For Communities, One Step Forward and Three Steps Back" by Professor Richard Marsico appeared earlier this year in the *Clearinghouse REVIEW Journal of Poverty Law and Policy* and is reprinted by permission. Professor of law at New York Law School and co-director of the Justice Action Center, Professor Marsico has been a leading advocate of using the Community Reinvestment Act (CRA) as a tool to promote bank lending and investment in inner city communities. In implementing the CRA, the bank regulators have sought to attain a delicate balance between the law's twin objectives of promoting community investment on the one hand, without compromising the safety and profitability of bank lending on the other. These sometimes inconsistent objectives have led to much regulatory tinkering with the implementation of the CRA over the quarter century since it was enacted. Professor Marsico argues that the latest iteration of regulatory fine-tuning has strengthened CRA in the areas of high-cost or "predatory" lending, but diminished its effectiveness in other respects.

In the following article, Warren W. Traiger and Joseph Calluori focus on a different aspect of the fair lending problem. The Home Mortgage Disclosure Act (HMDA) mandates collection of data from substantially all U.S. entities that make loans secured by residential mortgages, with the objective of identifying patterns of illegal discrimination. Federal regulations promulgated in 2004 for the first time required lenders to disclose not merely whether credit was extended or denied, but the price (annual percentage rate) at which it was extended. The authors analyze whether the new pricing data can be used to support charges of discrimination. Mr.

Traiger is a partner at Traiger & Hinckley LLP, a New York City-based law firm that counsels banks and other lenders on fair lending compliance. Mr. Calluori is of counsel to the firm. This article originally appeared in the BNA *Banking Law Journal* published by the Bureau of National Affairs, Inc., Washington, D.C., and is reprinted by permission.

Concluding our inaugural issue of the Pace Law School era is a fine and timely article on "Lenders and Environmental Issues: Liability and Opportunity" by Kevin Hopkins, a candidate for the JD degree at Pace. An evening student, Mr. Hopkins is Vice President, Timely Title Ltd. And his article is timely indeed: potential liability for environmental cleanup has been and continues to be a major concern for real estate lenders. At the same time, it creates opportunities for those lenders who exercise appropriate due diligence. After reviewing the history of lender environmental liability, Mr. Hopkins focuses on the Environmental Protection Agency's due diligence standards, scheduled to take effect November 1, 2006, and how a lender can develop an effective environmental compliance program.

A final note: the *NY Business Law Journal* is always seeking timely articles of interest to business law practitioners in New York State. If you or a colleague has an idea for an article, please contact the Editor to discuss it (david.glass@macquarie.com; 212-231-1583). Or better yet, if you have an article or client memo on a timely topic, why not share it with your colleagues in the Bar?

I look forward to hearing from you.

David L. Glass
Editor-in-Chief

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The IRS's Proposed Regulations on Partnership Interests Issued for Services

By Ronald H. Jensen

Historically, the Internal Revenue Service ("IRS") has taken the position that giving an interest in the future profits of a partnership in exchange for services creates taxable income for the services provider, which has created a number of problems. New proposed IRS regulations appear to address these problems by enabling a "safe harbor election." The author lays out the significance of the proposed new rules for partnerships and lawyers who advise them, and analyzes the effect of making the election under various scenarios.

One of the most vexing issues in tax law has been whether the issuance of a partnership interest in exchange for services (i.e., a "compensatory partnership interest") results in taxable income to the service provider. Recently, the IRS issued proposed regulations[1] and a proposed revenue procedure[2] (collectively "the proposed rules") that grant favorable tax treatment to service providers in most cases and clarify many unresolved issues. However, like any new proposals, they raise new issues and concerns. Business lawyers will want to keep abreast of these developments because the proposed rules, if finalized in their current form, will require partnerships and their partners to make a special "Safe Harbor Election" to take advantage of the favorable aspects of the proposed rules—and equally important—to avoid the negative consequences of not making the election.

I. Background

A. Treatment of a "profits" partnership interest issued for services

1. *The Position of the IRS*: From time to time, the IRS has asserted that, under general tax principles, the exchange of a "profits" partnership interest for services results in taxable income to the service provider in an amount equal to the fair market value of the interest. A profits interest is one that gives the holder no current interest in the capital of the partnership but only a share of future profits.[3]

The IRS's position raises many troubling problems, the most obvious being valuation. The valuation problem is particularly acute in the case of a fledgling partnership or where the partner's share of future profits is discretionary with the partnership as is frequently true in the case of a law partnership. The IRS's position also raises the specter of double taxation. Under its position, the partner must include in income the value of the profits interest at the time of receipt, but he must also include in income the profits as they are actually earned and allocated to him. The Internal Revenue Code (the "Code") contains no mechanism whereby the value of the partnership interest that was taken into income upon the receipt of the interest may be amortized to offset the profits as they are actually earned and allocated to the partner.[4]

Another contested issue is the role played by section 83 of the Code.[5] That section, enacted in 1969, requires that one who receives property for services recognize income when the property is no longer subject to a substantial risk of forfeiture or when the property may be transferred to one in whose hands the property would not be subject to a substantial risk of forfeiture, whichever occurs sooner.[6] Property is subject to a substantial risk of forfeiture when its vesting is conditioned upon the future performance of substantial services and there is a substantial possibility of forfeiture if the condition is not fulfilled.[7] The amount of income recognized when the risk of forfeiture lapses (or the property becomes transferable) is the property's fair market value at that time less any amount paid for the property.[8] Section 83(b) (described in more detail below) gives the recipient of property that is subject to a substantial risk of forfeiture and is non-transferable the option of immediately recognizing income upon receipt of the property.[9]

"Business lawyers will want to keep abreast of these developments because the proposed rules, if finalized in their current form, will require partnerships and their partners to make a special "Safe Harbor Election" to take advantage of the favorable aspects of the proposed rules—and equally important—to avoid the negative consequences of not making the election."

Since a partnership interest constitutes "property," there appeared to be a strong case that section 83 by its express terms applied to the issuance of such an interest for services. If so, the application of section 83 to such interests would raise the same practical problems described above—valuation and double taxation.

2. *The Courts:* In 1971, the Tax Court in *Diamond v. Commissioner*[10] endorsed the IRS's position that transfer of a profits interest for services resulted in taxable income to the recipient under general tax principles. This decision, which was affirmed on appeal, prompted a deluge of commentary, most of it critical,[11] and raised concern among practitioners. Over the years, however, the tax bar was comforted by the paucity of cases in which these issues arose and by the fact that the courts typically found the partnership interests—even if subject to section 83—either had no value or at least no determinable value for tax purposes.[12] This quiescence was shattered in 1990 when the Tax Court in *Campbell v. Commissioner*[13] reaffirmed its position in *Diamond* and further held that section 83—which had not been enacted when *Diamond* was decided—applied to the issuance of compensatory partnership interests. The decision was reversed on appeal but on the narrow ground that the partnership interests in the case were not susceptible of any realistic valuation, thus leaving the basic tax issues unresolved.[14]

3. *Revenue Procedure 93-27:* To the relief of the tax bar, the IRS removed much of the uncertainty created by *Campbell* by issuing Revenue Procedure 93-27.[15] Without addressing any of the underlying doctrinal issues, the IRS stated that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of such interest as a taxable event for the partner or the partnership."[16] The IRS reserved the right to assert that the issuance of a profits interest was taxable in only three narrowly defined cases:

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b) of the Internal Revenue Code.[17]

In the opinion of many practitioners, Revenue Procedure 93-27 has worked well.[18]

However, the proposed revenue procedure would render "obsolete" Revenue Procedure 93-27 (i.e., make it ineffective) when the proposed rules become final,[19] and thus it becomes necessary to understand the proposed new regime.

B. Treatment of a "capital" partnership interest issued for services

The issuance of a capital partnership interest for services poses relatively few issues. It is universally agreed that the issuance of such an interest for services results in taxable income to the service provider and a corresponding deduction for the partnership (unless the services produce a capital asset or improvement).[20] However, the courts have not developed any consistent methodology for valuing these interests. At least three different methods of valuation have been used by the courts.[21] As discussed below, the proposed rules resolve this uncertainty if the parties make the "Safe Harbor Election."

Most, but not all, authorities agree that the issuance of a capital partnership interest to a service provider should be treated as a constructive sale by the partnership of a fractional interest in each partnership asset to the service provider, thereby causing the partnership to recognize gain or loss.[22] For example, assume that a partnership's single asset is Blackacre, which has an "inside" basis of $12,000 and a fair market value of $60,000, and that the partnership has no liabilities. The partnership grants P a one-third fully vested capital partnership interest in exchange for services that P is to perform for the partnership. Under the conventional view, the partnership would recognize a gain of $16,000 [amount realized of $20,000 (one-third of $60,000) less adjusted basis of $4,000 (one-third of $12,000)].[23] The partnership would also be entitled to a deduction of $20,000 for compensation paid to P for his services (unless the expenditure must be capitalized).[24] Somewhat surprisingly, the proposed rules provide that the partnership recognizes no gain or loss on the issuance of a capital interest but is still entitled to a deduction (unless capitalization is required).[25]

II. The Proposed Rules

The proposed rules provide that section 83 governs the issuance of both profits interests and capital interests for services.[26] The apparent harshness of this rule is substantially mitigated if the partnership and its partners make the "Safe Harbor Election." In that case, the compensatory partnership interest would be valued at its so-called "liquidation value."[27] A partnership's liquidation value is the amount of cash the recipient of the interest would receive if, immediately after receipt of the interest, "the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated."[28] By definition, a profits interest gives the holder no immediate interest in the capital of the partnership but only a right to share in *future* partnership profits and income. Thus, the liquidation value of such an interest will be zero, and the recipient will not recognize any income under section 83.

The Safe Harbor Election might not be so favorable to a service provider who receives a capital interest. Note that the Safe Harbor Election is an "all or nothing" proposition; if made, it applies to *all* compensatory partnership interests issued by the partnership following the effective date of the election—whether they are capital or profits interests.[29] Under section 83 (and presumably under the proposed rules if the Safe Harbor Election is not made), the standard for valuing a compensatory property interest is its "fair market value," which apparently permits the recipient, where appropriate, to take a discount for lack of marketability and lack of control. The "fair market value" standard may therefore produce a lower valuation than "liquidation value."[30] This disadvantage may be more theoretical than real since most compensatory interests are structured as profits interests.[31]

In the discussion that follows, it is assumed, unless otherwise stated, that the Safe Harbor Election has been made.

Vested Partnership Interests. If the partnership interest issued to the service provider is non-forfeitable, the tax treatment is straightforward and simple. If the interest is a profits interest, the recipient recognizes no income upon receipt of the interest (since the interest has no liquidation value) and correspondingly has a starting capital account of zero. Likewise, the partnership is entitled to no deduction.[32] If it is a capital interest, the recipient recognizes compensation income upon receipt equal to the liquidation value of the interest (less any amount paid for the interest) and has a starting capital account equal to such liquidation value, and the partnership is entitled to a deduction equal to the liquidation value less any amount paid for the interest (unless the amount must be capitalized).[33] Regardless of the type of interest received, the recipient is treated as a partner from the moment he or she receives the interest. This means that the recipient, like any partner, must report his or her proportionate share of each item of the partnership's income, gain, deduction or loss.

The same treatment even applies to a service provider who receives a *forfeitable* profits interest so long as the profits allocated to him or her while a partner are non-forfeitable.[34] Thus, the service provider has no income upon receipt of the interest and no starting capital account, the partnership receives no deduction for a compensation payment, and the recipient must report each year his or her proportionate share of each item of partnership income, gain, deduction or loss.

Nonvested Partnership Interests. If a service provider's compensatory partnership interest is subject to a substantial risk of forfeiture, the tax consequences become considerably more complicated and depend, among other things, on whether the partner makes a section 83(b) election. It will be recalled that in the case of a section 83(b) election, the service provider recognizes income immediately upon the receipt of property, subject to a substantial risk of forfeiture instead of waiting until the risk lapses. The election can turn out to be a wise choice if the property appreciates and becomes vested; the downside is that no deduction or loss will be allowed for the amount of income recognized under the election if the property is ultimately forfeited.[35]

If *no* section 83(b) election is made, the tax consequences are as follows:

(1) *From receipt of interest until vesting or forfeiture.* The service provider will not recognize any income upon receipt of the interest and will not be treated as a partner until and unless the risk of forfeiture lapses. This means that the service provider will have no capital account in the partnership and that no partnership profit or loss will be allocable to him or her during this period. If any payments are made to the service provider during this time, they will be treated as compensation to the service provider, taxable to him or her as ordinary income and deductible by the partnership (unless they are required to be capitalized).[36]

(2) *On vesting*. When the risk of forfeiture lapses, the service provider will recognize compensation income equal to the then liquidation value of his or her partnership interest (less any amount paid for the interest), and will have a capital account equal to the liquidation value of such interest. The partnership will be entitled to a compensation deduction equal to the amount of income recognized by the service provider (unless such amount must be capitalized).[37]

(3) *On forfeiture*. There will be no tax consequences to either the service provider or the partnership if the service provider's interest is forfeited.

If a section 83(b) election is made, the tax consequences are as follows:

(1) *From receipt of interest until vesting or forfeiture.* Upon receipt of his or her interest, the service provider recognizes income equal to the liquida-

tion value of the interest (less any amount paid for it), and the partnership is entitled to a deduction in the same amount (unless capitalization is required). The service provider is treated as a partner from the time he receives his partnership interest. The service provider has a starting capital account equal to the liquidation value of his or her interest and must report each year during this period his or her allocable share of partnership income, gain, loss and deduction.[38]

(2) *On vesting.* There will be no tax consequences to either the service provider or the partnership when the risk of forfeiture lapses.

(3) *On forfeiture*. In accordance with section 83(b)(1), the service provider may take no deduction or capital loss for the income recognized by reason of the section 83(b) election. However, the partnership must report as income the deduction it took upon the issuance of the partnership interest to the service provider.[39]

The proposed rules contain special provisions to take account of the fact that the service provider has been treated as a partner from the time of the section 83(b) election until the time of forfeiture. To oversimplify, the amounts of partnership income and gain, or deduction and loss, in the year of forfeiture must be allocated to the service provider to reverse the net loss or net income that was allocated to him while a partner.[40] Notice that these so-called "forfeiture allocations" have the opposite effect on the remaining partners that they have on the service provider. Thus, if the items allocated to the service provider while he was a partner net out to a loss, items of gross income or gain must be allocated to him or her in the year of forfeiture to offset the loss. The shifting away of these items of gain or income from the remaining partners to the service provider has the effect of reducing the amount of such items they must report and thus effectively acts as a partnership deduction as to them.[41]

*The Safe Harbor Election***.** The principal effect of the Safe Harbor Election is to assure that any Safe Harbor Partnership Interest transferred while the election is in effect will be valued at its liquidation value for purposes of section 83. A Safe Harbor Partnership Interest is defined generally by the proposed revenue procedure to mean:

> any interest in a partnership that is transferred to a service provider by such partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided the interest is not (a) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b).[42]

Generally, a partnership interest will be presumed to have been transferred in anticipation of a subsequent disposition if it is sold or disposed of within two years of the time it was received by the service provider.[43]

The Safe Harbor Election may be made in a written document signed by the partner having responsibility for filing the partnership return if the partnership agreement contains provisions legally binding on all its partners stating that:

> (a) the partnership is authorized and directed to elect the Safe Harbor described in [the proposed] revenue procedure, and (b) that the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agree to comply with all requirements of the Safe Harbor described in [the proposed] revenue procedure.[44]

If the partnership agreement does not contain these provisions, or if they are not legally binding on all partners, then

> each partner . . . must execute a document containing provisions that are legally binding on each partner stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in [the proposed] revenue procedure, and (b) the partner agrees to comply with all requirements of the Safe Harbor described in [the proposed] revenue procedure.[45]

Although these provisions appear innocuous, they are among the most problematic in the proposed rules. The difficulty arises because the persons regarded as "partners" for tax purposes (and the above rules) may not be the same persons regarded as "partners" under state partnership law who are the ones bound by the partnership agreement. For example, entities that are disregarded for federal tax purposes (sometimes referred to by tax practitioners as "taxable nothings") may be the firm's partners as a matter of state partnership law while their beneficial owners may be considered to be the "partners" for tax law purposes. Such disregarded entities include one-member LLCs and one-member LLPs, grantor trusts (i.e., trusts governed by sections 671 through 678), a "qualified Subchapter S subsidiary" (as defined in section 1361(b)(3)(B)), or a "qualified REIT subsidiary" (as defined in section 856(i)(2)). Likewise, a retired partner who is entitled to one or more remaining payments is treated as a "partner" for tax purposes[46] but may be considered just a creditor for state partnership law purposes. Thus, partnerships may not be able to conclude that all "partners" (as that term is defined for tax purposes) are bound by the partnership agreement. They would then be confronted with the difficulty of obtaining signed statements from each of their "partners." This difficulty will be compounded because the partnership may not even be able to determine the identity of its "partners" for tax purposes. Even if all required signed statements are obtained, the partnership may encounter difficulty in retaining the Safe Harbor Election in effect. The proposed rules state that the election remains in effect only if a transferee of an existing partner either submits the required document or assumes the obligations of the transferring partner.[47] It will be difficult for the partnership to police or assure compliance with this requirement.[48]

The proposed rules also provide that a Safe Harbor Election terminates "if the partnership, a partner, or service provider reports income tax effects of a Safe Harbor Partnership Interest in a manner inconsistent with the requirements of [the proposed] revenue procedure, including a failure to provide appropriate information returns."[49]

This rule is extremely troubling. For example, it raises the possibility that the election might be terminated when a good faith difference of opinion between the partnership and the IRS on the "liquidation value" of a partnership interest leads to a different value being reported on the information return than the one approved by the IRS.

For these and other reasons, the Tax Section of the New York State Bar Association has proposed that a rule mandating the use of liquidation value be substituted in place of the Safe Harbor Election.[50]

III. What Should You Do?

A. *Keep informed.* No immediate action is required, since the proposed rules apply only to transfers of partnership interests occurring after the rules become final.[51] However, you should stay current on developments in this area so that you may take prompt action once it appears the rules will be finalized.

B. *Make the Safe Harbor Election.* The proposed rules provide exceedingly generous tax treatment to a service provider who receives a profits partnership interest. As stated above, the interest is valued at zero under the liquidation method of valuation at the time of receipt and thus the recipient of a profits interest will recognize no income. Moreover, the service provider will not recognize any income upon the vesting of a forfeitable interest if the income allocated to him or her while a partner is non-forfeitable. It is only where *both* the interest itself and the income allocated to the service provider through the date of vesting are subject to a substantial risk of forfeiture that the prospect of income upon vesting arises. Even then, the Safe Harbor Election at least provides the advantage of certainty by specifying that gain will be determined on the basis of liquidation value.[52]

Partnerships wishing to attract service providers with profits partnership interests will therefore wish to make the election. As stated above, it is possible that the Safe Harbor Election will provide less favorable treatment to a service provider who receives an interest in the capital of the partnership. However, since partnership interests issued to service providers are usually structured as profits interests, this concern appears to be more theoretical than real.[53]

An equally compelling reason for making the election is to avoid the uncertainty and potential costs that would ensue from not making the election. Revenue Procedure 93-27, which has provided a degree of certainty and comfort to practitioners, will be declared obsolete upon finalization of the proposed rules. Nothing in the proposed rules explains how compensatory partnership interests are to be valued if the Safe Harbor Election is not made. Essentially, one will be thrown back into the *Diamond/Campbell* morass if no election is made, with the resultant uncertainty and the prospect of costly and prolonged—even though unintended—conflicts with the IRS.

Failure to make the election also creates the danger that the capital accounts mandated by the proposed rules will not reflect the economic "deal" of the parties. Assume A and B are each 50% partners in AB partnership and that each has a capital account of $50,000. Assume further that AB partnership grants service provider SP a vested partnership interest which allocates to him one-third of all future profits and losses but no share of its existing capital. If the Safe Harbor Election is made, A and B's capital accounts will remain at $50,000 apiece and SP's capital account will be zero.[54] This reflects the agreement of the parties, since SP would receive nothing if the partnership liquidated immediately, while the amounts payable to A and B would be unaffected. On the other hand, if the election is not made and if SP's partnership interest is valued under section 83 at $10,000, SP's capital account under the proposed rules will be $10,000[55] and the capital accounts of A and B will each be reduced to $45,000.[56] The capital accounts no longer reflect the economic "deal" of the parties, since they show SP with a current interest in the partnership's capital of $10,000 when the parties intended that he not have any immediate interest in its capital. The capital account provisions in the Regulations generally require the capital accounts "to reflect the economic arrangement among the partners,"[57] yet the proposed rules give no guidance on how, or indeed whether, the initial capital accounts as mandated under the proposed rules are to be brought into conformity with the agreement of the parties.[58] Thus, once again, the price of not making the election is confusion and uncertainty.

In short, most partnerships will want to take advantage of the Safe Harbor Election. Hopefully, the IRS will ease the burden of making and then keeping the election in effect.

Endnotes

1. Partnership Equity for Services, 70 Fed. Reg. 29675 (proposed May 24, 2005) (to be codified 26 C.F.R. pt. 1), *also available at* 2005-24 I.R.B. 1244.
2. Notice 2005-43, 2005-24 I.R.B. 1221 [hereinafter the proposed revenue procedure appearing in this Notice shall be referred to as "Prop. Rev. Proc."].
3. 70 FR 29675, 29676.
4. The double taxation effect will be "reversed" if the partnership liquidates or if the profits interest is sold. Upon receipt of the profits interest, the service provider obtains a "tax cost" basis in such interest equal to the amount of income recognized at that time. This is true even though the service provider has no matching interest in the partnership's capital. Upon the liquidation of the partnership or the sale of the interest, this "excess basis" will result in a loss (or at least decrease the gain the service provider would otherwise recognize), thereby canceling out the earlier inclusion of income.
5. All "section" references herein are to the Internal Revenue Code of 1986, as amended to date, unless otherwise indicated.
6. I.R.C. § 83(a); Treas. Reg. § 1.83-3(d). For ease of expression, the time when a service provider may transfer property to one in whose hands the property is not subject to a substantial risk of forfeiture will be referred to simply as the time the property becomes transferable.
7. Treas. Reg. § 1.83-3(c)(1).
8. I.R.C. § 83(a).
9. I.R.C. § 83(b).
10. 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).
11. *See, e.g.,* Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case*, 27 Tax L. Rev. 161 (1972); and Norman H. Lane and Sol Diamond: *The Tax Court Upsets the Service Partner*, 46 S. Cal L. Rev. 239 (1973).
12. *St. John v. United States*, 84-1 U.S. Tax Cas. (CCH) ¶ 9158 (C.D. Ill. 1983) (holding that liquidation value was proper measure of taxpayer's profits partnership interest and since he would receive nothing on liquidation, interest had no value); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. (CCH) 1749 (1984) (IRS and taxpayer agreed that transferred profits partnership interest should be valued under the liquidation method; court found that value of partnership's assets did not exceed the partners' capital accounts and thus taxpayer's profits interest had no value); *National Oil Co. v. Commissioner*, 52 T.C.M. (CCH) 1223 (1986) (IRS conceded that a profits interest issued for services was not taxable).
13. 59 T.C.M. (CCH) 236 (1990), *rev'd*, 943 F.2d 815 (8th Cir. 1991).
14. *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991).
15. 1993-2 C.B. 343.
16. *Id.* § 4.01.
17. *Id.* § 4.02.
18. *See* New York State Bar Association Tax Section, *Report on the Proposed Regulations and Revenue Procedure Relating to Partnership Equity Transferred in Connection with the Performance of Services Introduction* (2005), *available at* LEXIS, 2005 TNT 214-19 [hereinafter "NYSBA Tax Section *Report*"] ("the system seems to work quite well under the Existing Revenue Procedures").
19. Prop. Rev. Proc. § 7, 2005-24 I.RB. 1221, 1228.
20. *See, e.g.,* 1 William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 5.01 (3d ed., 1997); 1 Arthur B. Willis et al., *Partnership Taxation* ¶ 4.05[1] (6th ed., 1997).
21. The courts have valued a capital interest issued for services on the basis of its: (1) liquidation value, *Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. (CCH) 1171 (1990), *aff'd*, 969 F.2d 669 (8th Cir. 1992); (2) the amount paid for other partnership interests sold about the same time, *Larson v. Commissioner*, 55 T.C.M. (CCH) 1637 (1988); *Johnston v. Commissioner*, 69 T.C.M. (CCH) 2283 (1995); and (3) the value of the services for which the interest was issued, *Hensel Phelps Constr. Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd*, 703 F.2d 485 (10th Cir. 1983). In Sheldon I. Banoff et al., *Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K*, 103 J. Tax'n 69, 73 (2005), the authors suggest another method, the "discounted value" approach, which would permit the value of an interest to be discounted, where appropriate, for lack of marketability and lack of control.
22. Commentators asserting that the partnership recognizes a gain or loss on transfer of a capital interest in exchange for services include 1 Willis et al., *supra* note 20, ¶ 4.05[5] and 1 McKee et al., *supra* note 20, ¶ 5.08[2][b]. However, in Alan Gunn & James R. Repetti, *Partnership Income Taxation* 27-28 (4th ed. 2005), the authors suggest that the issuance of a capital interest may be analogized to the payment of cash to the service provider followed by his or her contribution of the cash back to the partnership. Under this analysis, the partnership would recognize no gain or loss.
23. This result probably follows under general principles of tax law even if section 83 does not apply. Conceptually, the partnership is transferring a one-third interest in each of its assets to P, which P then immediately transfers back to the partnership. If the value of the capital interest received by P is $20,000 (its liquidation value), P's services may properly be valued at the same amount under the "exchange equivalency" approach endorsed by the Supreme Court in *United States v. Davis*, 370 U.S. 65 (1962). *See also International Freighting Corp. v. Commissioner,* 135 F.2d 310 (2d Cir. 1943). The "amount realized" by the partnership on the exchange, i.e., P's services, would thus be $20,000, and the partnership's gain, after subtracting its $4,000 basis in the one-third interest in Blackacre, would be $16,000. The section 83 regulations produce the same result. Treas. Reg. § 1.83-6(b).
24. I.R.C. § 83(h).

25. Prop. Treas. Reg. § 1.721-1(b)(2)(i), 70 Fed. Reg. 29675 (May 24, 2005) (no gain or loss to partnership on transfer or substantial vesting of a compensatory partnership interest). This aspect of the proposed rules is criticized in Martin J. McMahon, Jr., *Recognition of Gain by a P'Ship Issuing an Equity Interest for Services: The Proposed Regulations Get It Wrong*, 109 Tax Notes 1161 (2005) and Jasper L. Cummings, Jr., *Partnership Nonrecognition on Issuing a Capital Interest*, 110 Tax Notes 409 (2006), but is defended in Laura E. Cunningham & Noël B. Cunningham, *The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships* 136 n.29 (3d ed. 2006).

26. Prop. Treas. Reg. § 1.83-3(e), 70 Fed. Reg. 29675 (May 24, 2005).

27. Prop. Treas. Reg. § 1.83-3(l)(1).

28. Prop. Rev. Proc. § 4.02, 2005-24 I.RB. 1221, 1226.

29. Prop. Treas. Reg. § 1.83-3(l)(1)(i).

30. *See* Banoff *et al.*, *supra* note 21, at 78-79.

31. NYSBA Tax Section *Report*, *supra* note 18, Part II, B.

32. Prop. Rev. Proc. § 6 Example 1, 2005-24 I.RB. 1221, 1226-27.

33. Prop. Rev. Proc. § 6 Example 2, 2005-24 I.RB. 1221, 1227.

34. Prop. Rev. Proc. § 6 Example 1, 2005-24 I.RB. 1221, 1226-27.

35. § 83(b)(1), (last sentence).

36. Prop. Rev. Proc. § 6 Example 4, 2005-24 I.RB. 1221, 1227.

37. *Id.*

38. Prop. Rev. Proc. § 6 Example 5, 2005-24 I.RB. 1221, 1227.

39. Treas. Reg. § 1.83-6(c). *See also* Prop. Rev. Proc. § 6 Examples 6, 7, 2005-24 I.RB. 1221, 1227-28.

40. Prop. Treas. Reg. §§ 1.704-1(b)(4)(xii),–(b)(5) Example 29, 70 Fed. Reg. 29675 (May 24, 2005); Prop. Rev. Proc. § 6 Examples 6, 7, 2005-24 I.RB. 1221, 1227-28.

41. The regulations state that forfeiture allocation shall consist of a pro rata share of each item of gross income or gain, or of each item of gross deduction or loss, as the case may be, in the year of forfeiture. Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(c). This means that there may be little similarity between the types of income or loss originally allocated to the partner and the offsetting forfeiture allocations. The New York State Bar Association Tax Section has recommended that the proposed rules be changed to give the partnership "some flexibility" to make adjustments designed to ensure that "the character of the forfeiting allocation [will] match the character of the allocations giving rise to the Forfeiture Allocation." NYSBA Tax Section *Report*, *supra* note 18, Part VI, B (2).

42. Prop. Rev. Proc. § 3.02(1), 2005-24 I.RB. 1221, 1224.

43. *Id.*

44. Prop. Rev. Proc. § 3.03(1), (2), 2005-24 I.RB. 1221, 1225.

45. Prop. Rev. Proc. § 3.03(3), 2005-24 I.RB. 1221, 1225.

46. I.R.C. § 736(a).

47. Prop. Rev. Proc. § 3.03(3) (last sentence), § 3.04, 2005-24 I.RB. 1221, 1225.

48. For a comprehensive review of the problems of electing the Safe Harbor Election and keeping it in effect under the proposed rules, see NYSBA Tax Section *Report*, *supra* note 18, Part III, B (1).

49. Prop. Rev. Proc. § 3.04, 2005-24 I.RB. 1221, 1225.

50. NYSBA Tax Section *Report*, *supra* note 18, Part I.

51. REG-105346-03, 70 Fed. Reg. 29675, 2005-25 I.R.B. 1244, 1250 (May 24, 2005) ("regulations are proposed to apply to transfers of property on or after the date final regulations are published"); Notice 2005-43, 2005-25 I.R.B. 1221, 1221 ("this notice to be finalized and made effective in conjunction with the finalization of the related proposed regulations").

52. *See generally supra* notes 25-26, 30-38 and accompanying text.

53. *See supra* notes 27-29 and accompanying text.

54. Prop. Rev. Proc. § 6 Example 1, 2005-24 I.RB. 1221, 1226-27.

55. Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(b)(1), 70 Fed. Reg. 29675 (May 24, 2005) (requiring service provider to include in capital account the amount that he or she recognizes as income under section 83).

56. This assumes that the amount taxable to SP may be deducted (rather than capitalized) by the partnership and that such deduction will be allocated to the historic partners, A and B.

57. 1 McKee et al., *supra* note 20, ¶ 10.02[2][c][i].

58. For a discussion of this issue and possible solutions, see Banoff et al., *supra* note 21, at 76-80 and NYSBA Tax Section *Report*, *supra* note 18, Part VII, A-C.

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This Is a Fine Mess You've Gotten Me Into: The Revolution in the Legal Profession

By C. Evan Stewart

You say you want a revolution,
Well, you know . . .
We all want to see the plan.[1]

In the direct aftermath of the corporate scandals that marred the beginning of this decade (e.g., Enron, WorldCom, Adelphia, etc.), a number of people (mostly legal academics, some politicians, as well as a few others) believed that if lawyers had somehow acted as better "gatekeepers," the foregoing crises in capitalism could have been avoided.[2] This belief led to Section 307 being added to the Sarbanes-Oxley Act pretty much as an afterthought. As drafted, it appeared to be a fairly innocuous legislative initiative (seemingly just requiring that lawyers live up to pre-existing standards set forth in ABA Model Rule 1.13). For better or for worse, however, Congress also mandated that the Securities and Exchange Commission weigh in on what capital markets lawyers' duties should be; and the SEC did not shrink from that mandate—indeed, the Commission, by its own admission, went well beyond the language of Section 307.[3]

Federalizing lawyer conduct for the first time in American history, the SEC, *inter alia*, changed professional obligations vis-à-vis confidentiality/disclosure, withdrawal of work product, withdrawal of representation, what constitutes the appropriate standard for lawyer knowledge of client wrongdoing/conduct, as well as ratcheting up the sanctions to be imposed upon lawyers not complying with these new obligations and standards.[4] Not content to stop there, the Commission then used its bully pulpit to have the American Bar Association abandon many of its prior positions, so as to bring the ABA's Model Rules into line with the SEC's new standards.[5]

As I have previously written,[6] the foregoing has fundamentally changed the nature of a lawyer's relationship with her client. Rather than merely revisiting that analytical ground, however, this article will look at the *reality* of where we now find ourselves—here in the fourth year of the post-Enron era.

Barbarians Within the Walls of the City

The initial reality is that we live in a regulatory era where the watchword is "cooperation"—governmental entities from the Department of Justice on down have taken to issuing their own guidelines as to what constitutes cooperation.[7] What does this mean vis-à-vis the attorney-client relationship? At least two significant ramifications immediately come to the fore.

First off is that governmental agencies now routinely "ask for" (a/k/a demand) a waiver of attorney-client privilege and attorney work product. Besides the not insignificant facts that (1) this cooperation tack is basically surrendering up your client in the hope the government will not kill it (literally), and (2) such waivers can leave a corporation virtually defenseless in civil litigation that is either concurrent or soon to be filed,[8] one other message is sent by such waivers—a message to corporate employees.

If there is a reasonable presumption that most highly paid executives are intelligent and rational, then one aspect of the revolution in the legal profession can be well illustrated. Any corporate officer who remembers that the three principal witnesses against Frank Quattrone in his criminal trials were senior lawyers from Quattrone's corporation is more likely than not to conclude that interacting with such folks is not rational behavior.[9] And, of course, lawyers attempting to interact with and extract information from future Mr. Quattrones will have to do so subject to the ethical guidelines more popularly known as the "Corporate Miranda Warning"—i.e., advising corporate personnel that they are not clients and that the corporation may decide to turn over anything told to lawyers representing the corporation. Not to be further discouraging, but when this warning must be given differs from state to state. In New York, it must be given to employees at a very early stage—when it "appears that the organization's interests may differ" from those of the individual.[10] In light of all the foregoing roadblocks and hurdles, how likely is there to be a strong, vibrant attorney-client relationship within corporations, one designed to help companies ascertain key facts and make informed legal and business decisions?[11]

The other ramification to corporate "cooperation" is that corporations, besides being expected to get rid of any personnel implicated in the bad acts (alleged or real), are also now being expected to violate corporate law and their own by-laws by denying individuals their rights to advancement/indemnification; without such rights, few individuals can afford to defend themselves (something that pleases most prosecutors). Both the Justice Department and the SEC have taken public stances on this issue.[12] Even more aggressive has been the New York State Attorney General.[13]

Advising corporate clients on how to deal with this difficult choice—violate the law (and their by-laws) or fail to cooperate—will, if nothing else, prove to be a lively challenge (one not taught in law school). And watching the expressions of corporate officers who may, or may not, be impacted by such decisions will bring home to all concerned that corporate counsel really and truly do have only one client.[14]

The Knights Who Say Ni

In February 2004, the head of New York's Investment Protection Bureau stated that "we are living in a completely new regulatory world," and that the Attorney General "would not hesitate" to go after lawyers and/or law firms that were aware of, and approved, "improper" mutual fund trading. Not to be outdone, the head of the SEC's Enforcement Division later announced that "you can expect to see one or more actions against lawyers who . . . assisted their clients in engaging in illegal late trading or market timing arrangements that harmed mutual fund investors," and that the SEC would be looking to sue both in-house and outside lawyers who helped clients conceal mutual fund trading practices or who "prepared, or signed off on, misleading disclosures regarding [their clients'] conditions."

What is wrong with that? Well, plenty. Most fundamentally, the conduct at issue was either widely known and does not *today* constitute illegal conduct ("market timing"), or the conduct was never deemed to be illegal (as a number of prominent law firms so advised clients) prior to the New York Attorney General's attempted criminalization of it in September of 2003 by use of New York's Martin Act ("late trading").[15] Notwithstanding this, if these important regulators are to be believed, it appears that lawyers may soon be under the gun for failing, for example, to predict that activity relating to an obscure provision of the Investment Company Act of 1940 (as interpreted by the SEC staff in 1968), about which there had never been a criminal prosecution or an SEC regulatory enforcement proceeding ("late trading"), could give rise to a felony.[16]

And this assault is not limited to mutual fund lawyers. In the aftermath of Sarbanes-Oxley, the Commission has named lawyers as respondents or defendants in more than 30 proceedings.[17] Some of these are fairly unremarkable, insofar as they deal with conduct that (under any regime) would be considered unacceptable professional conduct—e.g., an in-house counsel backdating contracts, engaging in financial fraud, keeping material information from outside lawyers and the SEC staff.[18]

Less clear cut is the recent aiding and abetting case brought against a General Re Corp. assistant general counsel.[19] The gravamen of the Commission's action is that the General Re lawyer helped American International Group (AIG) commit accounting fraud by participating in the creation of a structure for two alleged sham/riskless transactions (and by drafting transaction documents). Whether the in-house lawyer knew of AIG's alleged fraud is unclear, as is what he could/should have done in his "gatekeeper" function to prevent *another* company from engaging in fraud. As this case is litigated, all lawyers (in-house and outside) should keep a vigilant watch.[20]

A Steamrolled "Profession"?

What has been the legal profession's response to the revolution in lawyer roles vis-à-vis clients, lawyers' liability,[21] etc.? Some, like the Black Knight in *Spamalot*, have not yet thrown in the towel.

One prominent example is the position of the state bars of Washington and California. When the SEC promulgated its regulations under Section 307, it stated that it did not intend to pre-empt conflicting or inconsistent state laws governing lawyer conduct, so long as those state laws met the minimum standards of the SEC's rules and regulations! One of the key provisions of those rules and regulations is the *permissive* disclosure of client confidences in order to (a) prevent a material violation of the securities laws which is likely to cause substantial financial injury; (b) prevent perjury or the perpetration of a fraud upon the Commission; or (c) rectify a material violation of the securities laws which caused (or may cause) substantial financial injury and which involved use of the lawyer's services.

Such disclosure(s), according to the state bars of Washington and California, would be directly contrary to those states' laws which bar lawyers from disclosing confidences. The California and Washington bars further told the SEC that they did not view things as settled because the Commission's disclosure rules (a) were contrary to sound and well-established public policy; (b) would hurt both clients and lawyers; (c) were unenforceable (unless a high state court ruled them to be enforceable); (d) may not pre-empt the field; and (e) may be successfully challenged in future litigation. The Commission fired back responses to the effect that (i) the rules and regulations mean what they say and (ii) no state licensed lawyers should proceed on the basis that the rules and regulations do not apply to them. Since this "eyeball-to-eyeball" exchange, neither side has yet blinked.[22] Stay tuned!

A somewhat more timid response has come from the American Bar Association. Faced with the undeniable withering of the attorney-client privilege, the ABA established a task force on the subject in October of 2004, and thereafter held numerous hearings. In June of last year, the task force delivered its report, recommending that the ABA adopt resolutions (i) expressing strong support for the privilege and work product doctrine, and (ii) expressing opposition to the government's actions undermining those privileges.[23] That's telling 'em!

Perhaps most interesting is the ultimate work product of the New York State Bar Association Committee on Standards of Attorney Conduct. After nearly three years of study, that Committee (on September 30, 2005) issued "Proposed New York Rules of Professional Conduct." Of greatest relevance to the subject of this article, the broad-based Committee did not propose adoption of the sweeping changes in disclosure of client confidences enacted by the SEC (and later the ABA).[24] And while the Chair of the Committee expects a "contentious debate" when the New York State Bar formally considers the proposed rules,[25] it is striking that New York—even in the face of the SEC's public challenge to Washington and California—appears to be standing with those states. The Committee's principled position on this key issue may well have profound consequences for the legal profession.

Conclusion

Over 30 years ago, Simon Rifkind—a great lawyer and leader of the bar—wrote that:

> One solution that has been proposed for [the ethical problems faced by lawyers] finds one in loud opposition. That is the attempt to convert the lawyer routinely into an informer against his client.
>
> When it is stated in this simplistic form, our revulsion is instantaneous, if not instinctive. . . . The merest suggestion that the lawyer become a stool pigeon against his client fills us with abhorrence. . . .
>
> . . . Access between attorney and client, uncensored and uninhibited, is indispensable to the independence of the bar; and the independence of the bar is a condition precedent to a free society and a democratic government.[26]

Fast forward to 2006, however, and what filled Rifkind with "instantaneous" and "instinctive" "revulsion" is now federal law. An illustration that crystallizes how far we have come is to imagine the fate of an in-house lawyer at Enron in 2000 charged with preparing various SEC disclosure documents—assuming Section 307 were applicable. If the in-house lawyer failed to exercise permissive disclosure and reveal wrongdoing to the SEC and/or withdraw her work product, she would face a career-ending enforcement proceeding. Her defense could not be based upon a lack of actual knowledge of what Mr. Fastow et al. were up to, because the knowledge standard has been changed by the SEC—from actual knowledge to an objective standard (i.e., what she should have known). If that is not a scary scenario, it is not clear what is!

Where the revolution under way in the legal profession will come to rest—especially in the context of client confidences, obligations and relationships—remains unclear. Maybe, as John Lennon sang: "it's gonna be all right." But then again, maybe not.

Endnotes

1. The Beatles, *Revolution*, *on* The White Album (Capitol Records 1968).
2. *See*, *e.g.*, Roger Cramton, George Cohen & Susan Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 Villanova L. Rev. 725 (2004). As I have elsewhere noted, there is no evidence (at least in the public record) that changing lawyer disclosure obligations, etc., would have had an impact on any of these corporate scandals. *See* C. Evan Stewart, *Holding Lawyers Accountable in the Post-Enron Feeding Frenzy*, BNA Securities Regulation & Law Report (September 30, 2002).
3. *See* C. Evan Stewart, *Sarbanes-Oxley: Panacea or Quagmire for Securities Lawyers?* N.Y.L.J. (2003).
4. *See* C. Evan Stewart, *The SEC and the Lawyer-Client Relationship: A Revolution in the Making*. Compliance Reporter (February 9, 2004). (As of the time of this article, the SEC has still not resolved the status of its highly controversial Noisy Withdrawal and Noisy Withdrawal Lite proposals.) *See id*.
5. *See* Jonathan Glater, *Bar Association in a Shift on Disclosure*, N.Y. Times, August 13, 2003 at A12; *see also* C. Stewart, *Liability for Securities Lawyers in the Post-Enron Era*, 35 Rev. Sec. & Com. Reg. 171 (September 11, 2002) (review of prior ABA votes against such positions). One area where the ABA did not make a change was the requirement of "actual knowledge" (as opposed to the SEC's adoption of the so-called objective standard—i.e., what a reasonable lawyer should have known).
6. *See supra* nn. 3 & 4. And it is not just me. *See Corporate Counsel Have Heightened Duties to Respond to Insider Wrongdoing*, BNA Lawyers' Manual on Professional Conduct 143 (March 22, 2006).
7. The New York Stock Exchange is the most recent promulgator on this score. *See* S. Merrill, *NYSE Chief of Enforcement on Sanctions, Investigative Cooperation*, N.Y.L.J. (2006).
8. *See* C. Evan Stewart, *Corporate Investigations: The Good, the Bad and the Ugly*, N.Y.L.J. (2006). More troubling than waiver of the privilege is waiver of "core" attorney work product. Even in the face of such waivers (or even more egregious conduct), a few courts have been reluctant to pass on such "core" work product to private plaintiffs' lawyers. *See In re Kidder Peabody Securities Litigation*, 168 F.R.D. 549 (S.D.N.Y. 1996) (no waiver of "core"

work product even when it was used as a "sword" *and* a "shield"); *Crowe Countryside Realty Association Co. v. Novare Engineers Inc.*, R.I., No. 2004-204-M.P. February 1, 2006) (no waiver of "core" work product even when it was shared with a testifying expert). Whether a lawyer should act in the hope of drawing one of these judges would be highly questionable professional judgment.

9. Mr. Quattrone has had two trials so far; and with the March 20, 2006 reversal by the Second Circuit of his conviction after the second trial, he may well face a third. Most corporations routinely require that employees cooperate with counsel as a condition of employment. Future Mr. Quattrones may well meet that requirement by having the corporation's lawyer deal directly with their personal lawyers; whether such "cooperation" will facilitate quite the same level of helpful information seems doubtful.

10. The A.B.A.'s Model Rule 1.13 (which many states have adopted) contemplates such a warning being given much later in the investigatory process—"when the lawyer knows or reasonably should know that the organization's interests are adverse" to the individual's.

11. As the U.S. Supreme Court has made clear, that is the principal rationale for having the attorney-client privilege in place within corporations. *See Upjohn v. U.S.*, 449 U.S. 383 (1981). The government today is taking this to new highs (or lows) by bringing on prosecutions against corporate employees who lie to corporate lawyers, based upon the theory that is the equivalent of lying to government officials. *See* C. Evan Stewart, *Corporate Investigations: The Good, the Bad and the Ugly*, N.Y.L.J. (2006). *See also U.S. v. Singleton*, Cr. No. H-04-514-55 (S.D. Tex. 2006).

12. *See* F. Hafetz & T. Sivitz, *Corporate Indemnification and Legal Expenses*, N.Y.L.J. (2006). The U.S. Deputy Attorney General has stated that federal prosecutors should weigh "whether the corporation appears to be protecting its culpable employees and agents . . . through the advancing of attorney's fees." The former head of the SEC's Enforcement Division, in one of his last public statements before leaving office, said: "If an individual can look to his/her employer to pay the freight, what good have we done?" *See* J. Emshwiller & K. Scannel, *Merrill Faces Issues of Enron Legal Fees: To Pay or Not to Pay?*, The Wall Street J. May 11, 2005 at C1.

13. *See, e.g.*, *Spitzer v. Soundview Health Center* (N.Y. Sup. Co.), N.Y.L.J. 18, col. 3 (January 27, 2005) (court rejected NYAG's motion to compel officers to furnish a bond to guarantee repayment in order to obtain advancement of fees); C. Mullenkamp, *Sihpol Seeks Legal Payment of Fees*, Wall Street J., October 24, 2004 at C9 (individual forced to sue former employer when NYAG objected to advancement of fees).

14. Large staffs of in-house lawyers are a reality of today's corporate world. And while ethically the one client rule is clear (and correct), it is more than a bit odd that these highly trained professionals have been turned into potential everyday adversaries of the business colleagues they have been hired to work with and advise. *See* Geoffrey Miller, *From Club to Market: The Evolving Role of Business Lawyers*, 74 Fordham L. Rev. 1105 (2005); Deborah DeMott, *The Discrete Roles of General Counsel*, 74 Fordham L. Rev. 955 (2005).

15. As a key member of the Attorney General's team once observed, the Martin Act is "one of the broadest anti-fraud statutes ever devised, at least in a democratic society." Eric Dinallo, *Prosecuting Securities Fraud from a New York Perspective*, 5 N.Y.U. J. Legis. & Pub. Policy 41, 43 (2001).

16. Or, even worse, in the case of "market timing," failing to predict that conduct that was well-known (and that even *today* is not illegal) could give rise to a felony, with such failure constituting grounds for sanctioning lawyers.

17. *See* Roberta Karmel, *Financial Fraud Cases Against In-House Counsel*, N.Y.L.J. (2006).

18. *See In re Steven Woghin*, Securities Exchange Act Release No. 50653 (November 10, 2004); *SEC v. Computer Associates International, Inc.*, Litigation Release No. 18892 (September 22, 2004).

19. *See SEC v. Ferguson et al.*, No. 06 Civ. 0778 (S.D.N.Y.).

20. The Justice Department subsequently (February 2006) went the SEC one better, bringing a criminal case against the General Re lawyer; according to the indictment, the lawyer's crime is that he knew the transactions were wrong, but thought only AIG could get into trouble. Another important case to watch is the criminal action going forward against, *inter alia*, an in-house lawyer at KPMG, which involves a multi-headed tax shelter controversy; the in-house lawyer's criminal liability is premised upon his role in reviewing the specific shelters and their documentation. That the government never determined such shelters to be infirm at the time of the lawyer's involvement seems to be of no moment. *See* Robert Weisberg & David Mills, *A Very Strange Indictment*, Wall Street J., October 12, 2005 at A16. Another issue in that criminal litigation is the governmental pressure on KPMG not to advance fees for their former employees. *See supra* nn. 12 & 13.

21. Beyond the scope of this article is the important attack on *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) by the plaintiffs' bar. *Central Bank* barred aiding and abetting liability under section 10(b) of the 1934 Act. Since then, the plaintiffs' bar has aggressively litigated one of the issues left open by the Supreme Court: that professionals (such as lawyers and accountants) should be held to the same standard of accountability for fraud in money damages suits as their clients. *See* C. Evan Stewart, *Liability for Securities Lawyers in the Post-Enron Era*, 35 Rev. Sec. & Com. Reg. 171 (2002).

22. This conjures up the image utilized by Secretary of State Dean Rusk in the 1962 Cuban Missile Crisis with the Soviet Union. Dean Rusk, *As I Saw It*, 237 (Norton 1990). One state that has "blinked"—in favor of the SEC's disclosure rules–is North Carolina. *See* North Carolina State Bar Ethics Comm., Formal Op. 2005-9 (January 20, 2006) (lawyers barred by state law from disclosing client confidences may disclose them pursuant to the SEC's Sarbanes-Oxley standards).

23. *See ABA is Urged to Express Opposition to Government Incursions on Privilege*, BNA Lawyers' Manual on Professional Conduct 303 (June 15, 2005).

24. Notwithstanding the active participation of some of the legal academics who championed Section 307, the Committee was leavened with numerous highly experienced legal professionals who know how difficult it is to have clients confide in lawyers, even with a certain (and unassailable) privilege.

25. *See NYSBA Panel Issues Reporting Proposing Adoption of Model Rules in New York*, BNA Lawyers' Manual on Professional Conduct 532 (October 19, 2005).

26. 30 *The Record* 534, 541 (1975).

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Shareholders at the Gate: The Rise of Populist Capitalism

By Stephen H. Cooper

Shareholder activism, long the almost exclusive province of a small cadre of bothersome but generally harmless and usually ineffective gadflies, has recently emerged into the mainstream. The once ubiquitous Gilbert brothers and the still indefatigable Evelyn Davis have been succeeded and eclipsed by a well-financed and far more powerful amalgam of seemingly strange bedfellows: labor unions, public employee pension funds, hedge funds and veterans of the takeover wars of the eighties, including such well known figures as Kirk Kerkorian, Carl Icahn and Nelson Peltz. Although pursuing a mixed agenda of objectives, this new band of brothers (and sisters) is marching steadfastly forward with ever-increasing momentum, enlisting support from academics, regulators, the media and self-appointed proxy advisory firms, under the seductively alluring banner of corporate democracy.

The American capitalist system has never been particularly democratic or, indeed, representative. The state statutes from which American corporations derive their existence and their primary governance structures—most notably that of Delaware—confer minimal power upon the common shareholder. In fact, the very term "common shareholder" is aptly descriptive. Holders of common stock are entitled to the residual, and obviously variable, value of the corporation's assets (including its retained earnings and goodwill) after provision has been made for the fixed interests of preferred shareholders and the claims of bondholders and other creditors. This is by no means a suggestion that they are second-class economic citizens, since there is no legislated ceiling on the potential "upside" value of the corporation's residual assets. However, they have no automatic entitlement to dividends (which are within the discretion of the board of directors) and are granted only the limited rights to vote for the election of the corporation's directors[1] and to veto (usually by the vote of a majority, but, in the case of some state statutes, as few as a third, of the outstanding shares) actions that threaten the continued existence of the corporation as a legal entity, such as its liquidation, merger or sale of all or substantially all assets. The power to manage the corporation's business—including the power to declare and pay dividends and to elect and determine the compensation of the corporation's executive officers—is vested entirely and exclusively in the board of directors.

Although nearly every publicly-held corporation holds an annual meeting of its shareholders at which directors are elected, and the majority of those corporations elect all of their directors annually for terms of one year, a sizable minority of corporations elect directors for multi-year (most commonly, three-year) terms, with only a third, or, in rare cases, a smaller percentage, of the entire board being voted upon each year: the so-called "staggered board." Most strikingly, and notwithstanding that the slate of nominees proposed for election is always equal in number to the number of board seats to be filled, the overwhelming majority of state statutes provide that directors will be elected by a plurality of the votes cast (with each share present at the meeting, in person or by proxy, having one vote), a concept that appears to have had its genesis in an expectation that the number of nominees would exceed the number of directors to be elected. In Delaware, where a majority of America's publicly-held companies are incorporated, the statute does authorize the corporation, on its own initiative, to adopt a different voting modality in its charter, but establishes plurality voting as the default standard in the absence of an alternative charter provision, and plurality voting remains the norm for the overwhelming majority of Delaware corporations. Because the accepted form of proxy—and, indeed, the standard ballot for those voting in person—permits a shareholder either to vote his or its shares ***for*** the election of the proposed slate of nominees or to ***withhold*** his or its vote from one or more of those nominees, it is theoretically possible for a nominee to be elected with only a single "for" vote, since a "withhold" vote is not deemed to have been cast. The slate of nominees is chosen by the incumbent board of directors, usually upon the recommendation of a nominating committee consisting solely of so-called "independent directors" (as that term is now formally defined in the SEC-approved rules of The New York Stock Exchange and Nasdaq). The nominating committee may solicit and consider, but is not obligated to accept, the suggestions of individual shareholders. As a consequence, the ultimate power to choose the directors of a publicly-held corporation ultimately rests with the directors themselves.[2]

The concept of director primacy, both in terms of managerial autonomy and effective control of the elective process, has survived intact, with only minimal tinkering, for more than a century, notwithstanding the "Great Depression," a succession of recessions, major stock market corrections and the bankruptcy of some of the most well-known companies in U.S. history. It has been respected and supported by state legislatures, the courts and many well-recognized corporate governance theorists, both within the legal academy and the corporate bar. While all have advocated enhanced director professionalism (including formal training), knowledge and understanding of the corporation's business and competitive environment, independence from the corporation's executive ranks (including the chief executive officer), activism and, where necessary, assertiveness, few have advocated the ceding of power to shareholders. Defenders of director primacy have stressed the need for a governing body that is, and perceives itself as, responsible to the corporation itself, as a "living organism," that exists to further not only the pecuniary interests of its shareholders but also those of its employees, customers, suppliers and community, as well as the national economy and the ultimate beneficiaries of the products, services, technologies and wealth that it creates.[3]

Until quite recently, the principal, if not sole, avenue for converting shareholder dissatisfaction into shareholder action has been what is commonly referred to as "voting with one's feet" or "the Wall Street walk," namely, the sale of one's shares. If a sufficient percentage of shareholders, particularly institutional holders with substantial stakes, start selling their shares, usually as the result of growing pessimism as to the ability of a corporation's management to right the listing ship, the market value of the corporation's shares declines, often steadily and sometimes precipitously, which usually, but not always, commands the attention of the board of directors and occasionally results in corrective action (such as the replacement of the chief executive officer and, ultimately, the installation of a new managerial "team"). Proxy contests, in which an alternative slate of candidates is put forward for election as directors, albeit not necessarily for all potential board seats, are rare and exceedingly costly and are usually the avenue for those seeking total control of the corporation, rather than enhanced influence over its direction. Litigation also is a last resort and, because of the strong judicial bias at the state level in favor of director primacy, is rarely successful.[4]

For more than sixty years, the primary outlet for the expression of stockholder views—other than via microphone at an annual meeting—has been the submission of a proposal for inclusion in the corporation's own proxy materials and ultimate action by the vote of shareholders at the meeting. The procedures for submitting a shareholder proposal were first established by the Securities and Exchange Commission in 1942 and are embodied in Rule 14a-8 of the commission's proxy rules under the Securities Exchange Act of 1934. Although amended from time to time, including republication in 1998 in so-called "plain English" in a question-and-answer format,[5] the rule has remained relatively intact. What has changed significantly in the last several years, however, is its utilization.

For most of its life, Rule 14a-8 was used only infrequently and, with the exception of the few but persistent gadflies[6], primarily by those seeking to advance a social or moral agenda (such as opposition to doing business in South Africa during the era of apartheid). Often, the proponents were religious orders,[7] which continue to be frequent sources of proposals with a moral focus.[8] During and following the corporate takeover boom of the 1980s, a number of shareholders began submitting proposals under Rule 14a-8 urging their corporations to dismantle various defensive measures (such as the so-called "poison pill" rights plan and staggered board). Proposals of this type continue to be submitted with some frequency and have gained increasing support, particularly from proxy advisory firms, such as Institutional Shareholder Services and Glass Lewis & Company, who not only urge their institutional clients to support such proposals but to withhold their votes for the election of directors of corporations that have installed or retained "poison pill" plans that have not been submitted to and approved by shareholders.

Since the 1990s, a new and increasingly prolific source of shareholder proposals has emerged: national labor unions or pension funds or other organizations affiliated with or owned by labor unions.[9] The proposals submitted by these entities—many of which have significant holdings of shares of the companies that are the recipients of their proposals—are not parochial and are only infrequently labor-focused, but, to the contrary, are very much in the mainstream and are frequently supported by the proxy advisory firms. Examples include: proposals encouraging the use of performance-based criteria for awarding executive compensation; seeking the elimination of a staggered board electoral policy; requesting shareholder approval of management severance agreements that provide benefits in excess of a specified multiple (usually 2.99%) of an executive's base salary and bonus; and, most recently and notably, seeking a shift from a plurality to a majority voting standard for the election of directors. The shareholder proposal avenue is less, if ever, traveled by managers of or advisors to corporate-sponsored pension plans, including employee 401(k) plans, nor do such firms generally vote the shares under their control in favor of proposals that may be opposed by management (opting, instead, to abstain) for fear of alienating those who may be influential in the decision to engage the services of those firms on behalf of the corporation's own sponsored plans. Nevertheless, proposals that are in the mainstream, while not necessarily receiving a majority vote of shareholders, are increasingly resulting in voluntary action by corporations to pursue the objectives sought by the proponents, particularly where the proposals are supported by the proxy advisory firms.

In the Spring of 2003, the Securities and Exchange Commission announced plans to conduct a full review of its proxy rules to develop possible changes to, in the Commission's words, "improve corporate democracy," including rules relating to the election of directors.[10] Following completion of that study and receipt of comments from the public, in August 2003, the Commission proposed proxy rule changes to require what it termed "more robust" disclosure of the procedures employed by the board's nominating committee for considering director nominee candidates recommended by shareholders as well as the methods by which shareholders might communicate with the directors.[11] Those rule changes were subsequently adopted in final form in November 2003.[12] More significantly, however, on October 14, 2003, the Commission proposed further proxy rule changes that would provide, in specified circumstances, direct access by certain institutional shareholders (those owning in excess of 5% of the corporation's outstanding voting shares for at least two years) to the corporation's own proxy soliciting "machinery" (including its proxy statement and form of proxy voting card) to include persons recommended by those shareholders as nominees for election as directors. The October proposal was perhaps the most controversial in the Commission's history, generating a torrent of critical commentary, including arguments by several legal scholars that the Commission lacked authority to promulgate substantive rules that effectively intruded into matters that were the province of state law. Ultimately, the proposal was allowed to die a quiet, if not necessarily dignified, death and it is not expected to be reissued anytime soon.[13]

Notwithstanding its failure to gain sufficient support, the Commission's October 2003 proposal seemed to invigorate shareholder activists, including major institutional investors, and the two major proxy advisory firms, to pursue more adventurous agendas than those with which they had been traditionally associated. The most significant of these has been the movement for majority (rather than plurality) voting in the election of directors.

During the last two proxy "seasons" there has been a significant upsurge in the frequency with which corporate proxy statements have included shareholder proposals for majority voting. While few of these proposals have received sufficient votes to assure adoption, they have had enormous impact and, at present, although only a few companies have formally amended their corporate charter or by-laws to mandate majority voting, approximately 20% of the companies in the "Fortune 500" have voluntarily adopted majority voting "policies" (which, theoretically, could be rescinded by action of the board of directors). These policies, a majority of which are based upon or similar to one adopted by Pfizer Inc., usually provide that, in an uncontested election (*i.e.*, where there are no nominees other than the slate proposed by the corporation's nominating committee), any nominee for whom the number of votes "withheld" exceeds the number of votes "for" must tender his or her resignation promptly following certification of the shareholder vote. The board's nominating or governance committee must then consider the resignation offer and make a recommendation to the full board whether to accept it, with the board being required to act on that recommendation within 90 days following the shareholder vote and to publicly announce its decision and, if it decides not to accept the resignation, its reasons for that decision. Some corporations, among them Intel, have modified their charters or by-laws to formally provide for a true majority vote procedure (*i.e.*, one with provision for both "For" and "Against" votes).

In mid-2005, the Committee on Corporate Laws of the Business Law Section of the American Bar Association promulgated a discussion draft of a proposed report, based on the efforts of a special task force, preliminarily recommending and seeking comment on a proposal to amend the Model Business Corporation Act relating to voting for directors that would facilitate various forms of majority voting that would be appropriate for various companies, depending on their particular circumstances. Comments, most of which have been supportive, were received from a range of interested parties, including TIAA-CREF, CalPERS (the California Public Employees Retirement System) and the Council of Institutional Investors, an association of 140 corporate, public and union pension funds collectively holding more than $3 trillion in pension assets.[14] The report devotes considerable attention to the procedural issues associated with majority voting and some commentators, such as Martin Lipton, while generally supportive of the principle of majority voting, would require a higher threshold for opponents of a nominee (*i.e.,* those who direct that their votes be "withheld" or, in a system such as that adopted by Intel, who vote "against' the nominee), namely, a majority of the total number of shares outstanding, not simply a majority of the votes cast in the election.[15] One of the issues addressed by the ABA's committee is the impact of state statutes that customarily provide that, once elected, a director shall serve until the next annual meeting at which directors are elected **and** until his or her successor is elected, a provision commonly referred to as the "holdover" rule, which unless modified could result in a "defeated" director remaining in office if he does not resign and thereby permit the board to elect a successor to fill the vacancy resulting from his resignation.

Irrespective of whether achieved through a board-promulgated "policy," or by amendment of state statutes that mandate plurality voting (unlike the Delaware statute, which establishes plurality voting as the default standard absent a different choice by the corporation through a charter or by-law provision), it is clear that the majority voting train has left the station and is rapidly gaining speed.

It is appropriate to ask just what has triggered the recent acceleration of shareholder activism and cries for a more effective voice in corporate governance, and, in particular, a shift to majority voting in elections of directors, after so many years of passive acceptance of plurality voting. It is easy to point to the corporate scandals that marked the early years of this decade and that are still making headlines: Enron, WorldCom, Global Crossing and Adelphia, to name only a few. Certainly, the speed with which Congress sought to wrap itself in the flag of reform by the enactment of the over-reaching and, in a number of respects, ill-considered provisions of the Sarbanes-Oxley Act, mandating promulgation by the SEC of more than 25 new rules within a two-year period, may have suggested to some that the time was ripe for greater assertiveness. However, crediting the revelations of massive corporate accounting fraud as the primary catalyst for shareholder empowerment demands is just too simplistic.

Most thoughtful observers recognize that the financial chicanery that dominated the headlines was not fairly attributable to the directors of the affected companies and it is certainly unlikely (and courts have been almost universally unwilling to view the non-executive directors of those companies as having sanctioned or unlawfully contributed to fraudulent conduct). In that regard, it is interesting to note that the lead plaintiff in the class action against the directors of WorldCom was New York State Comptroller Alan G. Hevesi, in his capacity as sole Trustee of the New York State Common Retirement fund. In March 2005, Mr. Hevesi took great pride in announcing settlements with eleven "outside" directors, who had agreed to contribute $20.25 million from their own pockets. Unfortunately, Mr. Hevesi neglected to point out that the sole reason for the settlement was the unfortunate fact that, between May 2000 and May 2001, WorldCom had publicly offered and sold nearly $17 billion of its debt securities. Because these public offerings were registered with the SEC under the Securities Act of 1933, investors could allege a failure by the directors to conduct adequate "due diligence," which would otherwise insulate them from liability. We will never know whether, in fact, such a failure would or could have been proved. We do know only that the presiding judge, in a decision on a preliminary motion for summary judgment brought by the directors, found that there was a triable issue of fact as to whether the directors, who had relied upon the opinions of the company's auditors, had ignored certain "red flags," principal among which was that WorldCom's "line costs," as a percentage of its revenues were substantially lower than those of its competitors (principally, AT&T and Sprint). Rather than risk an adverse verdict by a jury with little, if any, knowledge of securities laws or offering practices, the directors elected to settle for what most perceived to be a far lesser sum than what might have been levied by an angry jury. One might ask just why the managers of Mr. Hevesi's fund, whose job it was to carefully examine WorldCom's financial statements before investing and, presumably, to compare its performance to that of its competitors, did not notice those "red flags" or, indeed, just why the fund was investing its assets in the highly speculative and volatile telecommunications industry and a company with a long history of net losses.

The failure of the Commission to achieve the necessary political support for its shareholder proxy access proposal also may have been a stimulant. Certainly, it sent a clear message that federal regulators believed that shareholders should have an enhanced opportunity to convert their dissatisfaction into action. But that message alone doesn't seem to have been the primary cause of the sudden coalescing of shareholder demands for a change in the electoral system.

In my opinion, the biggest accelerant to the growing bonfire of shareholder activism has been what is currently perceived by nearly all shareholders, whether or not affiliated with union or public employee pension funds, as the single most egregious "sin" of corporate America: excessive management compensation. Unlike such issues as fraudulent accounting, long-term corporate strategy, failure to maintain the company's competitiveness or failure to develop new and successful products, all of which are complex and, with the exception of fraud, are not easily amenable to "sound bites," paying multiple millions of dollars to a CEO and providing him with even more outlandish pension and retirement benefits—a practice recently described by a leading corporate governance scholar as "entrepreneurial returns for managerial services"[16]—easily grabs the hearts and minds of even the most apathetic shareholders. A *New York Times* article by Joseph Nocera published shortly before the SEC published the details of its proposal to revamp proxy statement disclosure of executive compensation[17] quotes Nell Minow of the Corporate Library, a corporate governance monitoring firm, as saying it quite simply and bluntly: "I am very committed to the most significant shareholder initiative right now: majority vote." If shareholders could oust directors with a simple majority vote, she believes (according to Mr. Nocera), they would start voting against compensation committee members "who approve these absurd packages." Excessive management compensation is the perfect soundbite.

Support for democracy is embedded in the DNA of Americans and, like motherhood and baseball, is virtually unassailable. It is very difficult to argue in favor of plurality voting in an environment, unlike that in a governmental election, where, absent a full-blown proxy contest with a competing slate of nominees, there is only a single nominee for each position. The alternative—retention of a plurality voting system with the addition of competing candidates under all circumstances—would be unmanageable. Imagine the prospects of routine annual director elections with nominees having to campaign for votes.

The thought of director electoral campaigns, absurd as it may be, does serve to open inquiry into precisely how well shareholders are or will be served by a majority voting system. If one accepts the idea that routinely contested director elections would be inherently destructive to the effective management and conduct of business corporations, one may then ask just what is accomplished by a mechanism that simply facilitates the ability of the shareholders to "fire" those perceived to be underperforming directors, particularly if the sole reason for such action is an emotionally charged soundbite issue (such as excessive executive pay) without consideration of other benchmarks of performance.

In large measure, advocates of shareholder empowerment proceed on the implicit assumptions that (i) the interests and objectives of shareholders are commonly shared and (ii) most shareholders can effectively assess the abilities of director nominees and the performance of incumbent directors who are standing for reelection. Critics of existing corporate governance models, particularly those focusing on executive compensation, frequently speak of seeking greater alignment of the interests of corporate management (including not only executive officers but the board of directors as well) with the interests of shareholders. Even such a noted symbol of corporate common sense as Warren Buffett, when praising the decision of The Coca-Cola Company (of which his company, Berkshire Hathaway, is the largest shareholder) to compensate its directors solely with a contingent grant of shares of Coca-Cola common stock conditioned upon the company's achievement of a targeted level of growth in earnings per share over a three-year period, is quoted as saying: "I can't think of anything else that more directly aligns director interests with shareholder interests."[18]

Somehow Mr. Buffett neglected to consider that, unlike Coca-Cola's directors, most shareholders are free to sell their shares at any time, that many shareholders own their shares for less than three years and that no shareholder's return on a share position held for three years is 100% or zero. The shareholder body is not static, but changes constantly. A seller of shares of a publicly-traded company in an ordinary-way transaction on the New York Stock Exchange has no idea of the identity of the purchaser, much less the purchaser's motives for buying or whether the purchaser will retain those shares for five years, one year, a month, a week or an hour. Shareholders are not expected to remain such indefinitely, unlike voters in a U.S. presidential election, who can be expected to remain citizens of the U.S. for the duration of their lives. Nor are governmental elections held annually. Some shareholders may have a long-term investment outlook and, therefore, a view of the corporation's business prospects and strategies that is similarly long-term, like that of Mr. Buffett. Others, hedge funds in particular, may look upon their decision to acquire a corporation's shares solely as a trading opportunity, driven as much, if not more, by market fundamentals and algorithms as by classic Graham & Dodd securities analysis. And many have little knowledge of, or interest in, the company's operations, financial results, relative standing vs. competitors or other valuation criteria and may be purchasing shares solely on the basis of the recommendation of a golfing buddy. Indeed, for many Americans, particularly the small individual investor, the securities market is a refined form of casino, hence the time-worn phrase: "playing the market."

It is easy to think that institutional investors, unlike the small individual investor, are well informed and thoughtful about the strategic decisions of the management and boards of the companies whose shares they purchase and own. But the share ownership decisions of most large portfolio managers, including advisors to mutual funds and common trust funds, are generally made solely on the basis of strict financial metrics, and they are neither well equipped nor particularly inclined to make thoughtful decisions as to the voting of those shares, preferring instead to abstain from voting on many issues or to rely on the recommendations of proxy advisory firms, such as Institutional Shareholder Services. In fact, by default, the proxy advisory firms, which usually own no shares of the companies that are the subject of their voting recommendations, have become a major voice in corporate governance, generally pursuing (as did Congress in enacting the Sarbanes-Oxley Act and the SEC in promulgating its various normative rules thereunder) a one-size-fits-all approach to matters of corporate governance. Most recommendations by those firms that their clients withhold votes from director nominees are based either on an overriding policy view with respect to a particular corporate plan or program (such as a "poison pill" or stock option plan) that exceeds certain parameters, or, in the case of individual nominees, simply because the nominee has also served on the board of another (unrelated) company that filed an earnings restatement.

Majority voting for directors is eminently appealing and, if employed judiciously and sparingly, may well contribute to a reduction in managerial excesses and to more responsive and hands-on oversight by boards of directors. But if used solely as a tool to further the goals of powerful but non-representative shareholders, it, like so many of the so-called "reforms" mandated by legislation and administrative rule-making in the wake of the Enron, WorldCom and other abuses of the early years of this century, may only fuel the growing disinclination of people of impeccable integrity and superb judgment to serve on corporate boards, the ongoing shift of the board's focus from imaginative strategic thinking to risk avoidance, an emphasis on process rather than substance and, perhaps most sadly, a move toward poll-directed decision making.

Endnotes

1. The right to vote is not customarily provided to preferred shareholders, although they may be granted the special right to nominate and elect one or two directors after a failure of the corporation to pay the dividends to which they are entitled.
2. A very small minority of publicly-held corporations, usually those founded by a dynastic family that wishes to assure its continued control, may have two classes of common stock, with the class held by family members having substantially more votes per share than the class that is publicly traded.
3. The most articulate expression of this view was made a quarter-century ago by the noted corporate lawyer, Martin Lipton, in his seminal article, "Takeover Bids in the Target's Boardroom," 35 BUS. LAW. 101 (1979).
4. The most striking example is provided by the decision of the Delaware Chancery Court finding that the directors of The Walt Disney Company had not breached their fiduciary duties in permitting the company to enter into an employment agreement with Michael Ovitz that, after a brief and unsuccessful tenure by Mr. Ovitz as President, yielded a severance package valued at nearly $140 million. *See In re Walt Disney Company Derivative Litigation*, 35 Employee Benefits Cas. 1705, 2005 WL 2056651 (Ch). This decision was affirmed by the Delaware Supreme Court on June 8, 2006. *See In re Walt Disney Company Derivative Litigation*, __ A.D.2d __, 37 Employee Benefits Cas. 2756, 2006 WL 1562466 (Supreme Court).
5. Use of the "plain English" Q&A approach reflects the SEC's predilection for making the shareholder proposal avenue more accessible to the non-professional shareholder, notwithstanding that institutional shareholders, because of the relative size of their holdings, have the most voting power and the greatest stake in the outcome of a vote on any proposal.
6. Evelyn Davis continues to be a prolific devotee of Rule 14a-8, most frequently submitting a proposal for the adoption of a system of cumulative voting, by which each shareholder's available votes consist of the product of the number of shares held by that shareholder multiplied by the number of directors to be elected. When effectively employed by a group of minority shareholders, cumulatively voting can enable them to concentrate their voting power in support of a single candidate for election. Ms. Davis has also branched out beyond cumulative voting, most recently submitting to Citigroup Inc., for the second year in a row, a proposal urging the board to refrain from issuing stock options to the company's management.
7. A recent example is a proposal submitted at the 2006 annual meeting of 3M Company by the Benedictine Sisters of Mount St. Scholastica, requesting the board to use all possible efforts to implement a defined set of principles to protect the rights of workers at the company's facilities in China.
8. Churches too have been direct proponents of shareholder proposals. For example, in 2002, The Presbyterian Church (USA), as the owner of more than 250,000 shares of American International Group, Inc., sought shareholder approval of what, in retrospect, appears to have been a fairly prescient proposal that the board of directors create a nominating committee comprised entirely of independent directors (defined by the proponent as meeting seven specific criteria, including not having served as an executive of AIG or any of its affiliates during the preceding five years, not being employed by a significant AIG customer or supplier, not being affiliated with an entity that serves as a paid advisor or consultant to AIG, and not being party to a personal service contract with AIG.
9. A prolific source of such proposals has been the United Brotherhood of Carpenters Pension Fund. Proposals on a variety of matters have been submitted by pension funds affiliated with such other unions as the International Brotherhood of Teamsters, the Sheet Metal Workers, the Communication Workers of America, The International Brotherhood of Electrical Workers and the American Federation of State, County and Municipal Employees. Another frequent submitter of proposals is the Amalgamated Bank Long-View Collective Investment Fund, an affiliate of a union-owned banking institution. The Long-View fund recently submitted to CA Inc. (previously known as Computer Associates, whose former CEO and another senior officer recently pleaded guilty to multiple counts of securities fraud) a proposal urging adoption of a majority voting standard and its use to unseat two incumbent directors—former Senator Alfonse D'Amato and Lewis Ranieri, the company's current board chairman)—both of whom served on the board during the period in which the fraudulent activity allegedly occurred.
10. SEC Press Release No. 2003-46 (April 14, 2003).
11. SEC Release No. 34-48301 (August 14, 2003).
12. SEC Release No. 34-48825 (November 24, 2003).
13. Some Washington "insiders" and media pundits have suggested that the intense opposition to the proposal on the part of virtually all chieftains of the Fortune 500 was among the factors that ultimately led to the resignation of William Donaldson as SEC Chairman. Nevertheless, one current member of the Commission, Roel Campos, has publicly expressed his continuing support for the proposal.
14. In June 2005, the Council wrote to approximately 1,500 companies urging them to adopt majority voting procedures.
15. Lipton also suggests that, with such a higher voting threshold, the director simply be deemed not to have been elected, rather than required to tender his or her resignation.
16. Professor Charles M. Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware.
17. Joseph Nocera, "Disclosure Won't Tame CEO Pay," The New York Times, January 14, 2006.
18. Floyd Norris, "Coke's Board to Get Bonus or Nothing," The New York Times, April 6, 2006.

The 2004-2005 Amendments to the Community Reinvestment Act Regulations: For Communities, One Step Forward and Three Steps Back

By Richard D. Marsico

Introduction

In 2001, the four federal banking agencies that enforce the Community Reinvestment Act ("CRA") began a review of CRA regulations they adopted in 1995.[1] The review lasted until they issued amendments in 2004 and 2005. The review process was controversial, tortuous, and divisive.[2] By the time it was over, residents of the communities the CRA was intended to benefit, including low- and moderate-income ("LMI") and predominantly minority neighborhoods (collectively "underserved communities"), gained a victory in their efforts to promote community reinvestment and economic development, but also lost significant ground. The victory was strengthened regulation of subprime and predatory lending. The losses included a reduction in the number of banks and savings associations subject to more rigorous CRA standards, a loss in the amount of publicly available data about small business and small farm lending, and the elimination of community development lending and investment and retail banking service requirements for large savings associations. As a result of the amendments to the CRA regulations, underserved communities face a reduction in loans, investments, and services.

This article describes the CRA and the 1995 CRA regulations, identifies some of the key issues in the CRA amendment process, describes the amendments to the regulations, evaluates the amendments' likely effect on underserved communities, and offers suggestions to advocates about how they can use the amended CRA regulations to help underserved communities and how to prevent further cutbacks in CRA protections.

The CRA

The CRA places on banks a "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered."[3] The CRA requires each federal banking agency to encourage each bank it regulates to help meet the credit needs of its local community.[4] The agencies enforce the CRA by evaluating each bank's record of meeting the credit needs of its entire community, including LMI neighborhoods, and issuing a written CRA performance evaluation report that contains a CRA rating.[5] The agencies also take account of a bank's CRA record when considering the bank's expansion applications, and can deny an application if the bank has a poor CRA record.[6]

The 1995 CRA Regulations

In 1995, the federal banking agencies adopted revised CRA regulations (the "1995 CRA regulations").[7] Under the 1995 CRA regulations, large banks, small banks, and wholesale banks are subject to different tests for CRA compliance.[8]

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Large Banks

Under the 1995 CRA regulations, large banks and savings associations with $250 million or more in assets are subject to the lending, investment, and service tests. The lending test evaluates a bank's:

1. number and dollar amount of home mortgage, small business, and small farm loans;
2. geographic distribution of loans, including
   a) proportion of the bank's lending in its community;
   b) dispersion of lending;
   c) number and dollar amount of loans in low-, moderate-, middle-, and upper-income census tracts;
3. loans to borrowers at different income levels, including
   a) home mortgage loans;
   b) small businesses and small farms with annual revenue < $1 million;
   c) small business and small farm loans by amount at origination;
4. community development loans, including their innovativeness and complexity;

5. innovative or flexible credit practices.[9]

The investment test measures:

1. dollar amount of community development investments;
2. their innovativeness and complexity;
3. their responsiveness to credit and community development needs;
4. the extent to which they are not provided by other investors.[10]

Finally, the service test measures a bank's:

1. branch distribution by neighborhood income level;
2. record of opening and closing branches, particularly in LMI neighborhoods;
3. alternative means such as ATMs for providing banking services to LMI neighborhoods;
4. range of services provided in neighborhoods by income level;
5. community development banking services.[11]

Large banks report three types of data under the 1995 CRA regulations:

1. **Small business and small farm loans—**by census tract, aggregate number and dollar amount at various amounts to businesses and farms with annual revenue < $1 million;
2. **Community development loans—**total number and dollar amount;
3. **Home mortgage lending—**location of each loan application or loan that is outside the metropolitan areas in which the bank has a home or branch office or outside any metropolitan area.[12]

Small Banks

Under the 1995 CRA regulations, a small bank or savings association with less than $250 million in assets is evaluated according to a test that is not as rigorous or demanding as the lending test for large banks and is not subject to an investment or service test. The small bank test evaluates the bank's:

1. loan-to-deposit ratio;
2. percentage of loans in its community;
3. record of lending to borrowers at different income levels and farms and businesses of different sizes;
4. geographic distribution of loans;
5. responsiveness to complaints.[13]

Small banks and savings associations are not required to report data under the CRA.

Rules Applicable to All Banks

Under the 1995 CRA regulations, two rules are applicable to all banks and savings associations. First, evidence that a bank is engaged in discriminatory or illegal credit practices will adversely affect its CRA evaluation.[14] Second, each bank must define the geographic area in which it has CRA obligations and in which its CRA record will be evaluated.[15]

Community Reinvestment Issues In the CRA Regulation Amendment Process

When the federal banking agencies adopted the 1995 CRA regulations, they committed to review them in 2002.[16] Beginning with the agencies' Joint Advance Notice of Proposed Rulemaking, underserved communities and banks raised several issues. Five issues were prominent. Underserved communities pressed for:

1. stricter regulation of subprime and predatory lending;
2. expanded CRA assessment areas and mandatory evaluation of bank affiliate loans;
3. increased data disclosure requirements.

Banks sought to:

1. reduce the asset threshold for defining small banks and savings associations;
2. weaken community development lending and investment obligations.

Subprime and Predatory Lending

Subprime home mortgage loans are loans at higher than prime interest rates to borrowers with less than perfect credit. While the subprime market serves the important function of making home mortgage loans available to borrowers who might otherwise not receive a loan, the subprime lending market is subject to abuse.[17] The first abuse takes two forms: "steering" and "targeting." Steering is referring borrowers to subprime loans even if they might qualify for prime loans. Targeting is marketing subprime loans aggressively in underserved neighborhoods. Data released in 2005 under HMDA, although not conclusive, suggest the existence of steering and targeting based on race, as higher percentages of African-Americans and Latinos than whites received high-cost subprime loans.[18] The second abuse is predatory lending, which is subprime lending that also includes any number of abusive characteristics, including excessive and hidden fees, prepayment penalties, single-premium credit insurance, mandatory arbitration, frequent refinancing of the same loan, and asset-based lending without regard to repayment ability.[19]

The CRA is potentially a far more valuable tool in regulating subprime and predatory lending than in the 1995 CRA regulations. The CRA's mandate that banks help "meet" the credit needs of their entire communities can be construed to mean that a bank that is hurting the community with discriminatory subprime or predatory lending is not helping to meet the community's credit needs.

Following the adoption of the 1995 CRA regulations, the subprime lending market—and with it the problem of predatory lending—grew significantly, especially in underserved neighborhoods.[20] During the amendment process, community groups called on the federal banking agencies to strengthen the CRA's role in fighting abusive subprime and predatory lending.[21] The National Community Reinvestment Coalition ("NCRC") proposed amendments to the CRA regulations that would strengthen the CRA's regulation of abusive subprime and predatory lending. NCRC proposed that the regulations include a comprehensive list of lending practices that constitute predatory lending, require fair lending audits to ensure that subprime lending is not discriminatory, cover all types of loans made by a bank and its affiliates, cover loans whether in the bank's CRA assessment area or not, and require mandatory penalties in CRA performance evaluations for violations.[22]

Affiliate Lending and Assessment Areas

The 1995 CRA regulations created two loopholes that allow a bank to avoid CRA regulation of a significant part of its lending. First, the loans a large bank's non-bank affiliate lenders make are not evaluated in the bank's CRA performance evaluation unless the bank elects them to be covered.[23] Community groups argued that this allows a bank to skew its CRA record favorably by engaging in CRA-related lending only while referring its wealthy applicants to a lending affiliate that is nothing more than an alter ego.[24] Community groups also argued that predatory and other abusive lending practices generally take place in the non-bank lending affiliates of banks and community groups proposed that to help prevent these practices all lending by a bank's affiliates be included in the bank's CRA evaluation.[25]

Second, a bank is evaluated for CRA compliance only in its self-defined CRA assessment area, which is the area in which it has branches and takes deposits.[26] Community groups, pointing out that many banks do a significant amount of lending outside the areas in which they have branches and take deposits, argued that this loophole allows banks to escape CRA regulation of a significant part of their lending and that banks subject to the CRA should not be allowed to ignore the credit needs of LMI communities outside of their CRA assessment areas.[27] They proposed that the definition of a CRA assessment area be expanded to include all areas in which a bank makes a significant portion of its loans.[28]

Data Disclosure

Data is one of the most important tools for promoting community reinvestment. The public disclosure of detailed data about bank home mortgage lending in 1991 pursuant to HMDA, showing that minorities were rejected for loans at much higher rates than whites, was followed by dramatic increases in lending to LMI and minority persons and neighborhoods.[29] The data about small business, small farm, and community development lending the 1995 CRA regulations require banks to disclose is not as detailed as HMDA data. Community groups have been seeking the disclosure of similarly detailed data about small business and small farm lending, expecting it to spur growth in this lending in underserved communities. They proposed requiring banks to make public more data regarding their small business and small farm loans, including applicant race, census tract of the small business or small farm, and the decision on the application.[30]

Small Bank Asset Threshold

Several banks asserted during the amendment process that the $250 million threshold for defining small banks was too low.[31] They argued that banks with assets slightly above the threshold had a difficult time competing with much larger institutions for investments, rarely qualified for an outstanding CRA rating, made investments that were inconsistent with their business strategy and financial interests, and faced disproportionately higher data collection and reporting costs.[32] Banks also argued that the $250 million asset threshold for defining a small bank was outdated because the percentage of banks that were small in 2001 was significantly lower than in 1995.[33]

Community Development Investments

Many banks criticized the investment test. They stated that there were an insufficient number of eligible community development investments, resulting in strong competition and low rates of return.[34] Bank proposals included treating investments as extra credit in the CRA performance evaluation, having investments count toward the lending or service tests, treating investments equally with community development loans and services as part of a new community development test, and expanding the definition of community development to include revitalization efforts that incidentally benefit LMI persons or neighborhoods.[35]

The CRA Amendments

The Federal Reserve, FDIC, and OCC (the "three agencies") adopted identical amendments to the CRA regulations, while the OTS parted ways with the three agencies and issued different amendments. The three agencies strengthened the CRA's regulation of abusive subprime and predatory lending, took no action regarding CRA assessment areas and affiliate lending, did not expand CRA data disclosure requirements, increased the asset threshold for defining small banks, and changed the definition of community development to include activities that target distressed middle-income rural areas and designated disaster areas. The OTS increased the asset threshold for defining a small savings association and allowed large savings associations to excuse themselves from the investment and service tests. The OTS did not make any changes relating to predatory lending, data disclosure, or CRA assessment areas and affiliate lending.

The following chart shows the key results of the CRA regulatory amendment process:

ISSUE	FRB, OCC, FDIC	OTS
Regulation of Subprime and Predatory Lending	—Covers all home mortgage loans a bank makes —Covers affiliate loans if a bank elected to include them in its CRA evaluation —Violation of non-exclusive list of statutes is an illegal credit practice	—No changes
CRA Assessment Area and Affiliate Lending	—No changes	—No changes
Data Disclosure	—Banks with assets <$1 billion no longer required to report small business, small farm, and community development loans and location of home mortgage loans outside of areas where they do not have a branch or home office or outside of any metropolitan area	—Same
Asset Threshold of Small Banks and Savings Associations	—Raised to <$1 billion —Community development test for intermediate small banks with assets of $250 million to <$1 billion	—Raised to <$1 billion
Definition of Community Development	—Includes revitalization efforts in —distressed middle-income rural census tracts —designated disaster areas	—Large savings associations excused from investment and service tests at their discretion

Regulation of Subprime and Predatory Lending

The three agencies made three significant amendments to the CRA regulations relating to predatory lending.[36] The OTS made none. The significant amendments are:

1. evidence of illegal practices by a bank in any census tract, whether in the bank's CRA assessment area or not, will have an adverse impact on the bank's CRA evaluation;
2. evidence of illegal practices by a bank's affiliate in the bank's CRA assessment area will have an adverse impact on the bank's CRA evaluation if the bank elected to have its affiliate's lending considered in its CRA record;
3. violations of any of the following non-exclusive list of statutes constitutes an illegal credit practice:
    a) Fair Housing Act or Equal Credit Opportunity Act;
    b) Home Ownership and Equity Protection Act;
    c) Federal Trade Commission Act;
    d) Real Estate Settlement Procedures Act;
    e) Truth in Lending Act.

The agencies did not adopt several key provisions community groups called for, including a mandatory downgrade for evidence of illegal credit practices, mandatory fair lending audits, and a comprehensive description of all practices that constitute predatory lending.[37]

CRA Assessment Areas and Affiliate Lending

None of the agencies required affiliate lending to be included in a bank's CRA performance evaluation. Nor did they make any changes to the definition of a bank's CRA assessment area. They stated that no definition of the CRA assessment area would address every bank, the current definition covered most situations, examiners could adjust for unusual circumstances, and it would be too difficult to determine the appropriate type of activity (loans, deposits, or investments) that would be measured and the amount of activity that would be sufficient.[38] The fact that the OCC, FRB, and FDIC amended their CRA regulations to penalize a bank for illegal credit practices anywhere, including outside its CRA assessment area, mitigates to some degree their failure to expand a bank's CRA assessment area. Nevertheless, banks still are not required to meet the credit needs of areas outside their CRA assessment areas, and thus in these areas can lend exclusively to wealthy individuals or make only subprime loans as long as they do not otherwise violate the law.

Data Disclosure

None of the agencies adopted community advocates' data disclosure proposals.

Asset Threshold and Performance Evaluations for Small Banks

The three agencies made three changes regarding the asset threshold for small banks: 1) increased it from less than $250 million to less than $1 billion; 2) created an intermediate small bank with assets from $250 million to less than $1 billion; 3) and subjected these asset thresholds to annual adjustments based on changes in the Consumer Price Index.[39]

Intermediate small banks, which were large banks under the 1995 CRA regulations, will no longer be evaluated according to the lending, investment, and service tests. Instead, they will be evaluated according to the streamlined lending test for small banks and a new community development test.[40] The new community development test evaluates the number and dollar amount of an intermediate small bank's community development loans and investments, the extent of its community development services, and its responsiveness to community development lending, service, and investment needs.[41] Under the services category, the agencies will evaluate an intermediate small bank's provision of banking services for LMI persons, including low-cost bank accounts and branches in LMI neighborhoods.[42] Intermediate small banks are not required to report data on their small business, small farm, and community development loans.

The increase in the asset threshold for the definition of small banks represents a victory for banks over the needs of underserved communities, particularly in rural areas and smaller cities. The NCRC found that as a result of this amendment, 1,508 banks with 13,643 branches and total assets of $679 billion are no longer subject to the more rigorous lending, investment, and service tests for large banks and no longer required to disclose data about their small business, small farm, and community development lending.[43] Communities where these banks are located face a reduction in lending, services, and investment, and a loss of the data they need to detect and oppose it. Residents of smaller cities and rural areas are particularly hard hit, as a high percentage of the banks that serve them are small.[44]

Asset Threshold for Small Savings Associations

The OTS increased the asset threshold for a small savings association from less than $250 million to less than $1 billion.[45] From now on, savings associations with less than $1 billion in assets will be evaluated according to the streamlined lending test for small savings associations and excused from the investment and service tests and CRA data collection and reporting requirements. The OTS did not create an intermediate small savings association as the other three agencies did for banks, meaning there is differential treatment by the agencies of banks and savings associations with similar assets.

Definition of Community Development

The three agencies amended their regulations to expand the definition of community development. In addition to activities that revitalize or stabilize LMI neighborhoods, community development includes activities that revitalize or stabilize 1) designated disaster areas, or 2) distressed or underserved rural middle-income census tracts.[46] Census tracts will be designated as distressed or underserved by the three agencies based on poverty and unemployment rates, and population size, loss, density, and dispersion.[47] The second change is intended to promote community reinvestment in rural areas. Many rural areas lack sufficient LMI census tracts to qualify as LMI, and although they need revitalization, banks did not get CRA credit under the 1995 CRA regulations for loans, investments, and services that revitalized rural areas that were not LMI.[48] Under the amendments, banks will get credit as long as the rural areas are distressed or underserved.

The CRA Performance Evaluation of Large Savings Associations

The OTS amended its regulations governing the performance evaluation of large savings associations with $1 billion or more in assets. Large savings associations can now elect the weight that the lending, investment, and service tests will have in their CRA performance evaluations, provided that the lending test is worth at least 50%.[49] Large savings associations can opt out of the investment and service tests entirely, meaning they can excuse themselves from making community development loans and investments and providing banking services in LMI neighborhoods. Like small savings associations, large savings associations are now treated differently from large banks.

Community groups opposed this amendment because it will result in a reduction in investments and services by large thrifts.[50] NCRC estimated that large savings associations hold $1.3 billion in community development investments and that this amount could drop by more than half under the OTS amendment.[51]

A Parting of the Ways

For the first time in the CRA's history, the four federal banking agencies that enforce the CRA now have significantly different CRA regulations. This split among the agencies will most likely be harmful for communities and cause further reductions in loans, investments, and services than just the changes in the regulations themselves. For example, citing the absence of investment and service requirements for their large savings association cousins, large banks might pressure their regulatory agencies to use weaker standards to evaluate investments and services. Similarly, intermediate small banks, comparing themselves with their small savings association relatives who do not have community development lending, investment, and service requirements, might press their regulators to ease up on the new community development test. In addition, now that the precedent for departure has been set, it might be easier for any one of the three agencies to break away from the others and create its own weaker standards.

What Next for the CRA? Questions and Suggestions for Advocates for Underserved Communities

Several questions arise about the future of the CRA in light of the 2004-2005 regulatory amendments:

1. How can advocates use the amendments to help underserved communities?
2. How can advocates work to restore the cutbacks in CRA protections?
3. How can advocates preserve the proposals they made during the amendment process that the agencies did not adopt?
4. How can advocates prevent more cutbacks?

Using the CRA Amendments to Help Underserved Communities: Predatory Lending

Although the protections against abusive subprime and predatory lending in the amended CRA regulations are not as strong as community advocates had hoped, they are useful for advocates who are representing individual victims of predatory lending or communities that are harmed by predatory lending. If a bank is violating the new regulations, there are three ways that advocates can raise this: in CRA performance evaluations; in CRA challenges to bank expansion applications; and in individual litigation.

CRA Performance Evaluations

If a bank is engaging in abusive subprime lending or predatory lending in violation of the CRA, advocates can submit comments in connection with the bank's CRA performance evaluations. Advocates can also submit comments about lending practices even if they are not explicitly prohibited by the amended regulations. For example, a bank might have a relationship with a predatory lender that facilitates its efforts, such as purchasing loans from it. If the agency agrees that the bank has engaged in abusive subprime or predatory lending, the agency might lower the bank's CRA rating. This could result in a denial of any subsequent bank expansion applications, the risk of which could lower the bank's stock price. Even if the bank's rating is not lowered, the agency might comment negatively in the evaluation report or might work informally with the bank to change its practices.

CRA Challenges to Bank Expansion Applications

When a bank submits an application to its regulatory agency to expand its business, members of the public can "challenge" the application by filing written comments with the relevant agency. The comments can raise all issues related to the CRA, including practices that violate the CRA's predatory lending rules. Comments can also raise issues relating to whether the convenience and needs of the community will be met by the merger, including predatory lending practices that are not explicitly prohibited by the regulations such as purchasing predatory loans. There are several possible results of a CRA challenge. The agency can deny the application, although this is rare. The bank can commit to change its practices. The agency can condition approval of the application on the bank changing its practices. The agency can convince the bank informally to change its practices. Finally, of course, it is possible that the agency will approve the application and take no action regarding the predatory lending.

Individual Litigation

The amendments might provide leverage to attorneys who are representing clients in individual foreclosure cases. The leverage comes from the regulatory provision that allows a bank to avoid CRA penalties for predatory lending practices if the bank takes steps to end its practices and make sure they do not recur. Settling a particular case alleging predatory lending, both as to the individual borrower and systemic illegal practices, can help a bank with its CRA rating.

Another issue is whether the new CRA regulations can be used in predatory lending litigation. The CRA has been found not to create a private cause of action.[52] It seems unlikely that the new regulations will change this. However, the regulations may be useful in litigation, by, for example, helping to develop discovery requests or establish industry standards.

Rural Areas

Probably the greatest beneficiaries of the amendments are residents of distressed middle-income census tracts in rural areas. Bank loans, investments, and services in these census tracts are now eligible for CRA credit. Advocates for these communities can use this to encourage banks to make investments and loans and services in their neighborhoods. One possible downside of this change is the potential loss of community development loans, investments, and services from LMI rural census tracts, and advocates should monitor for this.

Restoring the CRA Cutbacks

At some point, community advocates will have an opportunity to restore the cutbacks in CRA protections. In order to be ready, it would be useful to document the harms the amendments cause. For example: did overall lending, service, and investment levels drop in a community where a large proportion of banks and savings associations were reclassified as small? How did home mortgage lending change for reclassified banks? Did a large savings association close a branch in an LMI neighborhood? Stop offering services tailored to the needs of LMI persons such as a basic banking account? Withdraw from a low-income housing tax credit project?[53] One useful way to discover this would be to compare the pre-amendment CRA performance evaluations of banks reclassified as small with their first evaluations after the amendments were adopted. This comparison could show, for example, whether a particular bank reclassified as an intermediate small bank decreased its investments, services, or lending. The comparison could also document whether large savings associations opted out of the investment and service tests and how their records changed.

It would also be useful to document any changes in the standards the OCC, FRB, and FDIC apply to large banks and to identify the standards they use for the community development test for intermediate small banks. Reviewing CRA performance evaluation reports for these banks before and after the 2004-2005 amendments should once again be helpful. For example, did an agency give the same rating on the investment test or the service test to a large bank whose investment or service levels dropped? What standards did the agency apply to an intermediate small bank's community development loans, investments, and services, and how did the standards and the bank's performance as an intermediate small bank compare with the standards and performance when it was a large bank?

Keeping Community Proposals Alive

Advocates can keep community group proposals that were not adopted in the amended regulations alive by documenting the consequences of the agencies' failure to adopt the proposals. This includes information about the continuing extent of and harm from abusive subprime and predatory lending, abusive subprime and predatory lending by bank affiliates that is not included in a bank's CRA performance evaluation, and the extent of bank lending outside CRA assessment areas and the income and race of loan recipients.

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Preventing More Cutbacks

The risk to the CRA has not ended with these amendments. Banks will continue to press for regulatory relief. And if trends over the last several years hold, they will continue to get it. Starting with the passage of the Economic Growth and Paperwork Reduction Act ("EGPRA") in 1996,[54] there have been several cutbacks in the CRA and HMDA, including increasing the asset threshold for lenders required to report HMDA data and creating an annual increase based on the increase in the Consumer Price Index,[55] limiting the frequency of CRA performance evaluations for small banks with satisfactory CRA ratings,[56] and creating reporting requirements for CRA agreements.[57] Additionally, when Congress repealed the Glass-Steagall Act and permitted banks to expand into the insurance and securities business, it did not subject banks' applications to engage in these business to CRA scrutiny, nor did it extend CRA obligations to the securities or insurance businesses of banks.[58]

There are several steps advocates can take to prevent more cutbacks. In addition to using the CRA to help communities, working to restore the cutbacks, and working to implement the proposals that the agencies did not adopt, advocates can also show the usefulness of HMDA and CRA data by using and publicizing them. For example, new data reported under HMDA allow advocates to study subprime lending patterns. Advocates can use these data to issue reports about subprime lending patterns in their neighborhoods, particularly if they show evidence of steering or targeting. Advocates can also participate in future administrative rulemaking processes. According to the NCRC, which spearheaded letter-writing efforts during the CRA amendment process, letters from communities and community advocates helped convince the three agencies not to adopt some of the most damaging CRA provisions adopted by the OTS and to institute a community development test for intermediate small banks.[59]

Conclusion

For nearly thirty years, the CRA has been a source of loans, investment, and banking services for underserved communities. The federal government's commitment to enforcing the CRA has waxed and waned, but community support for the CRA has never wavered. Community group tenacity and commitment will bring the CRA through this low period and eventually restore and improve it.

Appendix—Organizations that Can Provide Assistance with CRA

Several organizations with expertise in the CRA and community reinvestment may be available to provide assistance, information, or advice. They include:

- California Reinvestment Coalition
- Center for Community Change, www.communitychange.org
- Community Reinvestment Associates of North Carolina, www.cra-nc.org
- Delaware Community Reinvestment Action Council, http://www.njcitizenaction.org, www.drcac.org
- Economic Justice Project at New York Law School, (212) 431-2180
- Greenlining Institute, www.greenlining.org
- Inner City Press, http://www.innercitypress.org
- National Community Reinvestment Coalition, http://www.ncrc.org
- New Jersey Citizen Action, http://www.njcitizenaction.org
- Neighborhood Economic Development Advocacy Project, www.nedap.org
- Pittsburgh Community Reinvestment Group, www.prcg.org
- Woodstock Institute, www.woodstockinst.org

Endnotes

1. 12 U.S.C. §§ 2901-2908 (2001). Four federal agencies (collectively "the agencies") enforce the CRA for different types of banks: the Office of the Comptroller of the Currency ("OCC") for national banks; the Board of Governors of the Federal Reserve System ("Federal Reserve") for state-chartered banks that are members of the Federal Reserve System; the Federal Deposit Insurance Corporation ("FDIC") for state-chartered banks and savings banks that are not members of the Federal Reserve; and the Office of Thrift Supervision ("OTS") for savings associations. *Id*. § 2902(1).
2. A timeline of the review process follows: July 19, 2001—the agencies issue Joint Advance Notice of Proposed Rulemaking, 66 Fed. Reg. 37,602; February 6, 2004—the agencies issue a joint notice of proposed rule making, 69 Fed. Reg. 5,729 ("Joint Notice of Proposed Rulemaking"); August 18, 2004—the Office of Thrift Supervision announces that it is amending its CRA regulations to define a small savings association as having assets less than $1 billion, 69 Fed. Reg. 51,155 ("Office of Thrift Supervision Small Savings Association Regulations"); August 20, 2004—the FDIC issues a notice of proposed rule making to define a small bank as having assets up to $1 billion and proposes adding a community development test to the CRA performance evaluations of small banks with assets greater than $250,000 up to $1 billion, 69 Fed. Reg. 51,611; November 24, 2004—the Office of Thrift Supervision issues a notice of proposed rule making defining community development to include efforts in rural areas and allowing a large savings association to determine the weights that its lending, investments, and services would have in determining its CRA rating, 69 Fed. Reg. 68,257 ("Office of Thrift Supervision Large Savings Association Proposal"); March 2, 2005—the Office of Thrift Supervision adopts the Large Savings Association Proposal, 70 Fed. Reg. 10023 ("Office of Thrift Supervision Large Savings Association Regulations"); March 11, 2005—the FDIC reunites with the Office of the Comptroller of the Currency and the Federal Reserve Board to issue another joint notice of proposed rule making, similar to the notice that the FDIC issued on August 18, 2004, 70 Fed. Reg. 12,148 ("Second Joint Notice of Proposed Rulemaking"); August 2, 2005—the Office of the Comptroller of the Currency, Federal Reserve Board, and FDIC issue a joint final rule amending their CRA regulations, 70 Fed. Reg. 44,256 ("hereinafter Final CRA Regulations").
3. 12 U.S.C. § 2901(a)(3).
4. *Id*. § 2901(b).
5. *Id*. §§ 2903(a)(1) and 2906(a)(1), (b)(1)(A). The possible ratings are outstanding, satisfactory, needs to improve, and substantial non-compliance. *Id*. § 2901(b)(2).
6. *Id*. §§ 2903(a)(2) and 2902(3); 12 C.F.R. § 25.29(4)(2005).
7. The 1995 regulations are available at 12 C.F.R. pts. 25 (OCC), 228 (Federal Reserve), 345 (FDIC), and 563e (OTS) (2005). Because the agencies' 1995 regulations were substantially identical, citations to the 1995 regulations are to the OCC's regulations only.
8. A wholesale bank is a bank that is not in the business of extending loans to retail customers. 12 C.F.R. § 25.12(w). Wholesale banks are not discussed in this article because the amendments did not involve them.
9. *Id*. § 25.22(b)(1)-(5). Community development is defined as affordable housing for LMI individuals, community services targeted to LMI individuals, activities that promote economic development by financing small businesses or small farms, and activities that revitalize or stabilize LMI areas. *Id*. § 25.12(h).
10. *Id*. § 25.23(e)(1)-(4).
11. *Id*. §§ 25.21(d)(1)-(4), (e)(1)-(2). Community development banking services include providing technical expertise to not-for-profits involved in economic development, serving on the board of directors of a community development organization, credit counseling, or low-cost government check cashing. Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156, 22,160 & n.2 (Apr. 19, 1995) [hereinafter 1995 CRA Notice of Rulemaking].
12. 12 C.F.R. § 25.42(b)(1)-(3). These reporting requirements are in addition to home mortgage lending data reporting requirements for lenders under the Home Mortgage Disclosure Act. 12 U.S.C. §§ 2801-2808 (2001)("HMDA").
13. 12 C.F.R. § 25.26(a)(1)-(5).
14. *Id*. § 25.28(c).
15. *Id*. § 25.41(a).
16. 1995 CRA Notice of Rulemaking, *supra* note 11, at 22,177.
17. *See* Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,739.
18. Edmund Andrews, *Blacks Hit Hardest by Costlier Mortgages*, N.Y. Times, Sept. 14, 2005, at C1.
19. *See* Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,739.
20. *See* The Joint Committee for Housing Studies, *The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System* 1-18 (2002). In 2005, subprime lending constituted 10-15% of home mortgage lending. Letter from John Taylor, President and CEO, National Community Reinvestment Coalition, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System; Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation; Office of the Comptroller of the Currency 11 (May 6, 2005) [hereinafter Taylor Comments] (on file with author).
21. Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,739.
22. Letter from John Taylor, President and CEO, National Community Reinvestment Coalition, to Communications Division, Office of the Comptroller of the Currency; Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System; Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation; Chief Counsel's Office, Office of Thrift Supervision 15 (April 12, 2004) [hereinafter Taylor Letter] (on file with author).
23. 12 C.F.R. § 25.22(c)(1)(2005). Many banks are owned by holding companies that also own lenders that are not banks. These non-bank lender affiliates of banks are not subject to the CRA.
24. *See* Memorandum of Josh Silver, Vice President of Research and Policy, National Community Reinvestment Coalition, to NCRC Members (February 17, 2004) [hereinafter Silver Memo] (on file with author); Taylor Letter, *supra* note 22, at 20.
25. Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,739; Silver Memo, *supra* note 24; Taylor Letter, *supra* note 22, at 20-21.
26. 12 C.F.R. § 25.41(c).
27. *See* Silver Memo, *supra* note 24; Taylor Letter, *supra* note 22, at 21.
28. Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,735. *See* Taylor Letter, *supra* note 22, at 21.
29. Richard D. Marsico, *Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act* 166-172 (2005).
30. Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,737.
31. *Id*. at 5,737.
32. *Id*. at 5,737-5,738.
33. *Id*. at 5,738.

34. *Id*. at 5,732.

35. *Id*. at 5,733.

36. Final CRA Regulations, *supra* note 2, at 44,266-44,270 (to be codified at 12 C.F.R. §§ 25.28(c)(1)(i)-(iv)(OCC), 228.28(c)(1)(i)-(iv) (Federal Reserve), 345.28(c)(i)-(iv)(FDIC)).

37. Silver Memo, *supra* note 24.

38. Joint Notice of Proposed Rulemaking, *supra* note 2, at 5,735-5,736.

39. Final CRA Regulations, *supra* note 2, at 44,266-44,270 (to be codified at 12 C.F.R. §§ 25.12(u)(1)-(2)(OCC), 228.12(u)(1)-(2)(Federal Reserve), 345.12(u)(1)-(2)(FDIC)).

40. *Id*. (to be codified at 12 C.F.R. §§ 25.26(a)(2)(OCC), 228.26(a)(2) (Federal Reserve), 345.26(a)(2)(FDIC)).

41. *Id*. (to be codified at 12 C.F.R. §§ 25.26(c)(OCC), 228.26(c)(Federal Reserve), 345.26(c)(FDIC)).

42. *Id*. at 44,260.

43. Taylor Comments, *supra* note 20, at 3, 12. These banks controlled 16.8% of all branches owned by banks regulated by the three agencies. *Id*. at 12

44. For example, in 2004, intermediate small banks controlled 40% of rural bank assets in 16 states and 25% of rural bank assets in 33 states. Taylor Comments, *supra* note 20, at 3. Intermediate small banks constituted at least 30% of all banks in 16 states. *Id*. In 12 states, they held at least 25% of all bank assets. *Id*.

45. OTS Small Savings Association Regulations, *supra* note 2, at 51,161 (to be codified at 12 C.F.R. § 563e.12(t)).

46. Final CRA Regulations, *supra* note 3, at 44,266-44,270 (to be codified at 12 C.F.R. §§ 25.12(g)(4)(i)-(iii)(A)-(B)(OCC), 228.12(g)(4)(i)-(iii)(A)-(B) (Federal Reserve), 345.12(g)(4)(i)-(iii)(A)-(B)(FDIC)).

47. *Id*. (to be codified at 12 C.F.R. §§ 25.12(g)(4)(i)-(iii)(A)-(B)(OCC), 228.12(g)(4)(i)-(iii)(A)-(B) (Federal Reserve), 345.12(g)(4)(i)-(iii)(A)-(B)(FDIC)).

48. Second Joint Notice of Proposed Rulemaking, *supra* note 2, at 12,152. Fifty-seven percent of rural counties had no LMI census tracts and LMI census tracts constituted only fifteen percent of all tracts in rural counties. *Id*.

49. OTS Large Savings Association Regulations, *supra* note 2, at 10,030 (to be codified at 12 C.F.R. § 563e.28(d)). *See* OTS Large Savings Association Proposal, *supra* note 2, at 68,262.

50. Letter from John Taylor, President and CEO, National Community Reinvestment Coalition, to Chief Counsel's Office, Office of Thrift Supervision 3 (January 21, 2005)(on file with author); Taylor Letter, *supra* note 22, at 7-8.

51. Letter from John Taylor, President and CEO, National Community Reinvestment Coalition, to Chief Counsel's Office, Office of Thrift Supervision 3 (January 21, 2005) (on file with author); Taylor Letter, *supra* note 22, at 7-8.

52. *See* Marsico, *supra* note 29, at 35-36.

53. *See*, *e.g*., Silver Memo, *supra* note 24; Taylor Letter, *supra* note 22, at 3.

54. Pub. L. No. 104-208, 110 Stat. 3009 (1996).

55. 12 U.S.C. § 2808(b)(2001).

56. *Id.* § 2908(a).

57. *Id.* § 1831y(a).

58. *See* Marsico, *supra* note 29, at 26.

59. Memorandum of Josh Silver, Vice President of Research and Policy, National Community Reinvestment Coalition, to NCRC Members (August 23, 2005) (on file with the author).

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The Fair Lending Implications of the New Home Mortgage Disclosure Act Data

By Warren W. Traiger and Joseph Calluori

The Home Mortgage Disclosure Act (HMDA) mandates collection of data from substantially all U.S. entities that make loans secured by residential mortgages, with the objective of identifying patterns of illegal discrimination. Federal regulations promulgated in 2004 for the first time required lenders to disclose not merely whether credit was extended or denied, but the price (annual percentage rate) at which it was extended. The authors analyze whether the new pricing data can be used to support charges of discrimination. In January 2006, Warren Traiger addressed these issues as part of a panel discussion entitled "Are the Fair Lending Laws Doing Their Job?" presented before the Business Law Section's annual meeting.

For the first time, pricing information on mortgage loans made by essentially every U.S. lender is about to be made public.[1] The 2004 data, collected pursuant to the Home Mortgage Disclosure Act (HMDA),[2] will show the extent to which each lender made higher-priced loans, as well as the volume and cost of such loans by borrower race, ethnicity, and sex. Because preliminary analyses of data released by individual lenders have shown that minority and women borrowers were more likely to receive higher-priced mortgages,[3] many have predicted, and some advocacy groups have called for, enforcement actions by government regulators and private lawsuits brought by aggrieved borrowers. In this article, we will examine these accusations and expectations while attempting to answer the following questions:

- Did regulators initially intend that data collected pursuant to the new HMDA regulation would be used as evidence of discrimination?
- To what extent are the new HMDA data reliable evidence of lending discrimination?
- How are federal and state regulators likely to use the new HMDA data, and would the public be better served if regulators followed a different course?
- Are dire predictions about the new HMDA data fostering a wave of private lawsuits well-founded, and how much do the new data really help the plaintiff's bar?
- How should lenders, particularly banks, prepare to meet these challenges?

What Did the Regulators Envision?

In 2000, the Federal Reserve Board first proposed expanding the information reported under HMDA to include pricing.[4] The 2000 proposal would have required lenders to report each loan's annual percentage rate (APR). The Board noted that such information would help identify higher-priced or "subprime" loans and might "also help the public and supervisory agencies identify practices that potentially raise fair lending concerns and warrant further investigation."

Based on comments received on the 2000 proposal, the Board modified its approach to require that lenders report the spread between a loan's APR and the comparable Treasury yield, only when that spread is at least three percentage points for first-lien loans and five percentage points for junior-lien loans. The Board again noted that "[o]btaining loan pricing data is critical to address fair lending concerns related to loan pricing and to better understand the mortgage market."[5] The revised regulation took effect on January 1, 2004.

"Because preliminary analyses of data released by individual lenders have shown that minority and women borrowers were more likely to receive higher-priced mortgages, many have predicted, and some advocacy groups have called for, enforcement actions by government regulators and private lawsuits brought by aggrieved borrowers."

While the revised regulation was prompted by fair lending concerns related to loan pricing, a strong case can be made that the new HMDA data are not a reliable indicator of discrimination. Both regulators and the courts have stated repeatedly that HMDA data alone can never conclusively prove or disprove discrimination.[6]

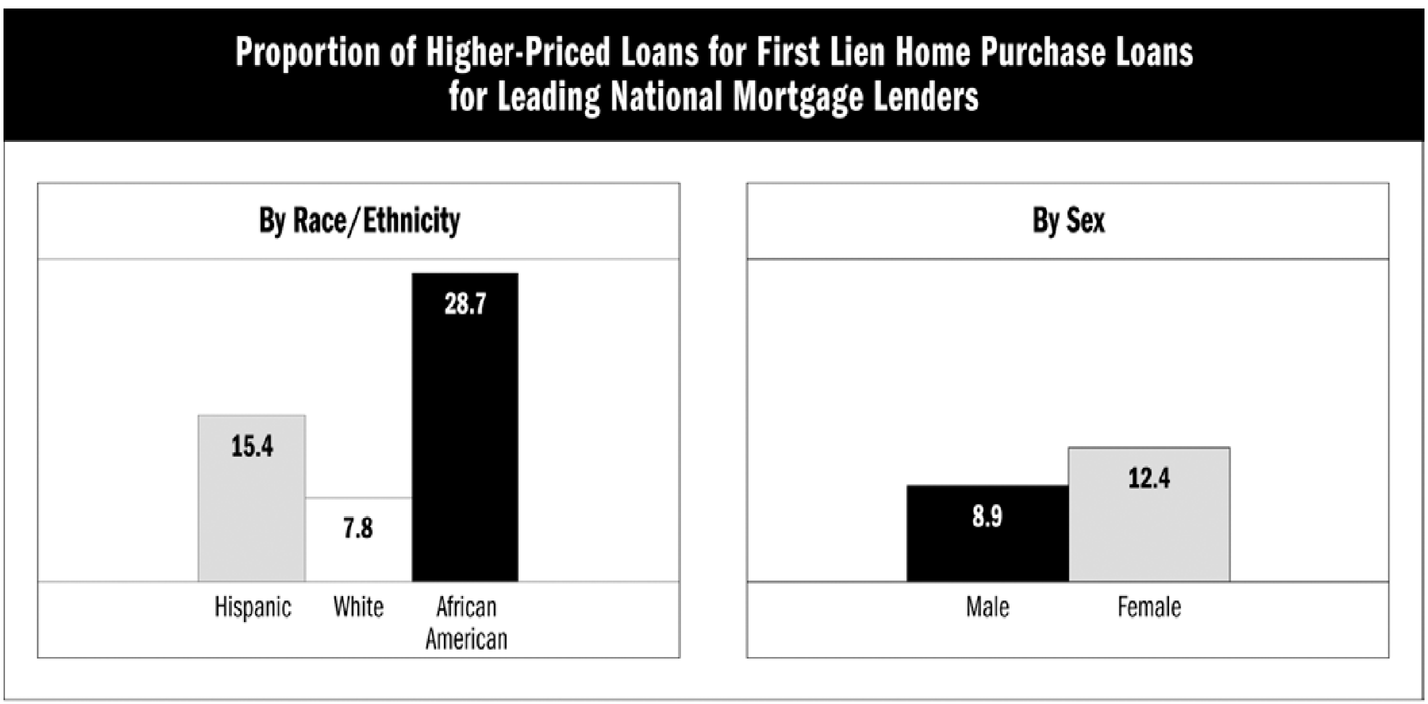
Moreover, the regulators themselves have consistently stated that compliance with the anti-discrimination laws can only be assessed through extensive statistical analyses of borrower credit quality and other loan particulars, followed by a case-by-case review of credit decisions made on individual loans.[7] Given the state of the law, the regulators should not be stampeded into bringing enforcement actions based on the new HMDA data alone, especially since the meaning of the HMDA data is still far from clear. The reasons for disparities in the distribution of higher-priced loans are manifold; the disparities may be the result of a combination of factors which cannot all be identified; and at least some of the factors contributing to these disparities will vary from lender to lender and from region to region.

What Do the New HMDA Data Actually Show?

Depending upon which aspect of the preliminary data one focuses, the data suggest diametrically opposed conclusions. As Federal Reserve Board Governor Edward M. Gramlich noted in a June speech:

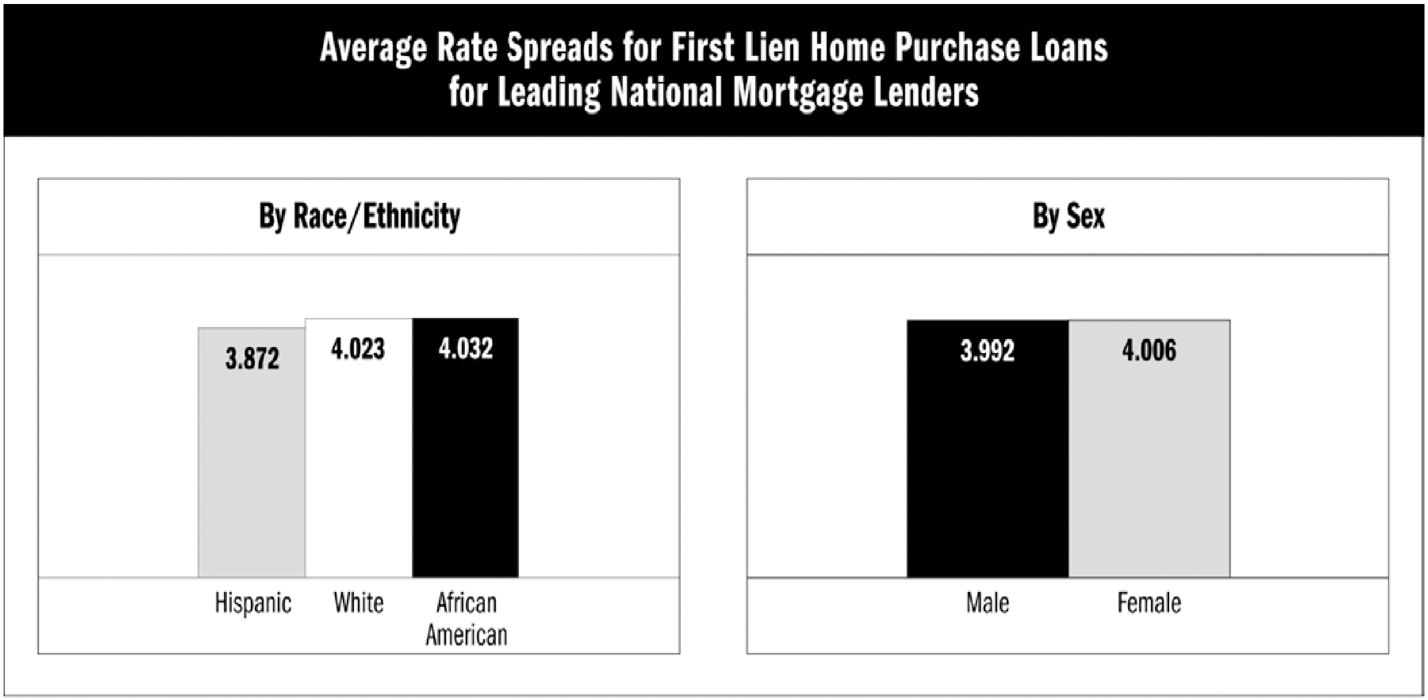
> The initial data also suggest that prevalence of higher-priced loans differs notably across racial and ethnic groups. As some press accounts have implied, the data indicate that blacks and Hispanics are more likely to take out higher-priced loans than non-Hispanic whites, and that Asians are the least likely to have higher-priced loans. These preliminary data also seem to indicate that the actual prices paid by those taking out higher-priced loans are about the same for different racial groups.[8]

Emphasizing the greater likelihood of blacks and Hispanics to have higher-priced loans, borrower advocates have declared the new HMDA data to be evidence of widespread lending discrimination. For example, based on data it received from leading mortgage lenders summarized in the chart below, the National Community Reinvestment Coalition concluded that "price discrimination and widespread price disparities are present in minority and working class communities."[9]



Source: National Community Reinvestment Coalition, *Preapprovals and Pricing Disparities in the Mortgage Marketplace: A NCRC Follow-Up Report for National Homeownership Month*, June 2005, available at <http://www.ncrc.org/pressandpubs/press_releases/documents/Preapproval_Report_June05.pdf>.

In contrast, a Traiger & Hinckley LLP study of leading mortgage lenders supported Governor Gramlich's second observation, that the cost of higher-priced loans was essentially the same for all borrowers. Based on data received from leading mortgage lenders summarized in the chart below, we concluded that "among first lien home purchase borrowers with rate spreads, lenders are treating minority and female homebuyers fairly."[10]



Source: Traiger & Hinckley LLP, *A Study of Reported Rate Spreads by Borrower Race and Sex*, May 31, 2005, available at <http://www.traigerlaw.com/includes/hdma/hdma_rate_spread_study.pdf>.

Federal Regulators' Likely Use for the Data

Despite the conflicting inferences one can draw from the new HMDA data, federal regulators have announced their intent to use these data as a "screening tool":

> Though the price data do not support definitive conclusions, they are a useful screen, previously unavailable, to identify lenders, products, applicants, and geographic markets where price differences among racial or other groups are sufficiently large to warrant further investigation. Enforcement and supervisory agencies can use this screen to better target their resources. HMDA price data can also be a valuable part of any mortgage lender's self-evaluation program.[11]

The screening tool analogy may underestimate the impact the new HMDA data will have upon regulators' interactions with lenders. For example, the Office of the Comptroller of the Currency's Senior Counsel has told lenders that even "if the new data does nothing more than show concentrations of high cost loans in minority neighborhoods," a lender will bear the burden of showing that "this result was the product of nondiscriminatory lending decisions."[12] These comments appear to shift to lenders the burden of proving that disparities reflected in their HMDA data are not the result of discrimination.

Accordingly, we anticipate that some lenders will face tough scrutiny from regulators intent on identifying a discriminatory practice or policy that explains the distribution of a lender's higher-priced loans. Indeed, the OCC has suggested that it already has made some preliminary decisions on which lenders will receive heightened scrutiny.[13] Dire consequences await those whose lending activities are suspect. The worst case scenario would occur under a provision of Federal Reserve Board Regulation B, which mandates referral to the Attorney General. If a regulator has "reason to believe that one or more creditors [are] engaged in a pattern or practice of discouraging or denying applications in violation of the [Equal Credit Opportunity Act], the agency shall refer the matter to the Attorney General."[14] Regulators also have the option of a referral to the Attorney General for lesser violations.

Even if the new data do not lead regulators to conclude that a violation of the Equal Credit Opportunity Act or the Fair Housing Act has occurred, they could use the Community Reinvestment Act (CRA) to penalize banks that fail to present a persuasive explanation for disparities in the distribution of higher-priced loans. For example, a regulator might find an extreme concentration of higher-priced loans in a lower-income neighborhood in a bank's assessment area, but a file review and interviews may fail to establish a causal link between that statistical disparity and a discriminatory policy. Although these circumstances would militate against a finding of discrimination, a regulator could still conclude that the bank had not done enough to meet the credit needs of the neighborhood where the higher-priced loans are concentrated. The latter conclusion could adversely impact the bank's CRA rating.

How Are State Regulators Likely to Use the Data?

Like their federal counterparts, state regulators will be likely to use the new HMDA data as a screening tool for identifying lenders that warrant more extensive scrutiny. The new HMDA data could also affect evaluations under state analogues of the CRA.

For example, shortly after the release of the preliminary data, New York Attorney General Eliot Spitzer, invoking his authority to enforce state anti-discrimination law,[15] sent letters to several banks asking for information regarding their lending practices and policies, and for their 2004 HMDA data. Both the OCC and the Clearinghouse Association, acting on behalf of its member banks, responded with lawsuits for injunctive relief,[16] arguing that compliance with New York's requests would contravene 12 U.S.C. § 484, which, according to the OCC's interpretation, grants the OCC exclusive "visitorial" authority over national banks and their operating subsidiaries. The case is still pending in the district court. However, we believe that *Wachovia v. Burke*,[17] a recent case in which the Second Circuit essentially deferred to the OCC's broad interpretation of its authority to preempt state law, prefigures a victory for the OCC and Clearinghouse Association.

Although the OCC's opponents argue that a ruling in its favor will seriously undercut the enforcement of fair lending laws, such ominous predictions are probably just rhetorical excess. While the turf war between the OCC and the state attorneys general does raise some important issues of statutory construction and the future of the dual state and federal banking system, the reality is that regardless of the outcome of the lawsuits, state attorneys general will still have substantial authority to inquire into the lending activities of a host of banks and bank subsidiaries that are not regulated by the OCC. For example, there are 5,265 banks that fall under the jurisdiction of the Federal Deposit Insurance Corporation, the primary federal regulator of federally insured state-chartered banks that are not members of the Federal Reserve System.[18] The Federal Reserve Board is the primary federal regulator for another 926 banks. All of these banks are fair game for state attorneys general.

Moreover, the states are in many instances the primary or sole regulator of other major participants in the mortgage lending industry, for example mortgage companies not affiliated with banks and mortgage brokers. Although some of these entities also fall within the jurisdiction of the United States Department of Housing and Urban Development (HUD), these non-bank entities have for the most part operated "under the radar."

The failure of both state and federal regulators to subject mortgage brokers and non-bank lenders to the same sort of scrutiny that banks receive on a regular basis in all likelihood contributes to the higher price of credit for certain protected classes. For example, in 2000, the United States Treasury Department and HUD concluded:

> The subprime mortgage and finance companies that dominate mortgage lending in many low-income and minority communities, while subject to the same consumer protection laws, are not subject to as much federal oversight as their prime market counterparts—who are largely federally supervised banks, thrifts, and credit unions. The absence of such accountability may create an environment where predatory practices flourish because they are unlikely to be detected.[19]

The new HMDA data could serve as both an incentive to state regulators to take a closer look at non-bank participants in the home mortgage market and as a screening tool to target those lenders whose activities warrant closer scrutiny.

How Are Private Litigants Likely to Use the Data?

A recent series of lawsuits alleging that automobile financing companies unjustifiably charged higher rates to blacks and Hispanics[20] suggests that the new HMDA data may lead to a wave of class action lawsuits against banks and other mortgage lenders. However, while the new HMDA data do provide potential litigants with important information that the plaintiffs in the automobile finance cases had to work very hard to acquire, it is far from certain that the data will spawn massive private litigation over home mortgage lending.

In the automobile lending cases, plaintiffs' lawyers argued that blacks and Hispanics routinely paid substantially higher interest rates as a result of automobile lenders' tactics, in particular "dealer markups" that were often split between the dealer and the lender. Unlike mortgage lenders, automobile finance companies are not required to keep records of a borrower's race or ethnicity. To the contrary, outside the home mortgage context, the collection of such data is expressly prohibited by Regulation B.[21] Therefore, to prove that black and Hispanic borrowers suffered an adverse impact as a consequence of the dealer markups, plaintiffs' attorneys would have had to employ other means to obtain borrower race, including combing loan files for photocopies of drivers licenses. Obviously, the new HMDA data will save time and effort for lawyers seeking to demonstrate a disparate impact on protected class home mortgage borrowers.

However, the new HMDA data do not establish a prima facie case with respect to each and every element of a disparate impact claim. The data do not establish a causal link between higher credit costs for protected class borrowers and a particular practice or policy. As the Supreme Court recently reminded plaintiffs in an age discrimination suit, it is not enough to simply allege that there is a disparate impact on a particular protected class "or point to a generalized policy that leads to such an impact."[22] Rather, the plaintiff is "responsible for isolating and identifying the specific . . . employment practices that are allegedly responsible for any observed statistical disparities."[23]

In addition, a variety of nondiscriminatory factors including FICO scores, loan-to-value ratios, and debt-to-income ratios may explain at least some of the disparities indicated by the new HMDA data. However, none of this information is reflected in the new HMDA data. Thus, a reasonably prudent plaintiff's lawyer is unlikely to conclude on the basis of the new HMDA data alone that there is a viable fair lending claim against a particular lender. On the other hand, undertaking the sort of statistical analysis that is necessary to help prove that discriminatory factors are the cause of disparities in a lender's HMDA data is a formidable task, especially since much of this information is not publicly available.

Furthermore, notwithstanding the apparent successes of the plaintiffs' bar in class actions against automobile finance companies, class actions may have lost some of their luster for plaintiffs' lawyers. Obtaining class action certification in the automobile lending lawsuits was often fraught with difficulty, and plaintiffs had mixed success. Even when they succeeded in obtaining class certification, some plaintiffs found the relief available to them limited. For example, in *Coleman v. General Motors Acceptance Corp.*,[24] the Sixth Circuit held that class certification was improper because the plaintiffs sought monetary relief, a request which, because it required individualized determinations of fact, "was fatal to class certification under Federal Rule of Civil Procedure 23(b)(2)." The plaintiffs ultimately gained class certification by limiting themselves to declaratory and injunctive relief.[25]

Thus, while the new HMDA data may in some instances help plaintiffs define a class, the limited availability of monetary damages[26] may still be a significant economic disincentive to federal class action lawsuits. One strategy plaintiffs have utilized to overcome the pitfalls of and restrictions on federal class lawsuits is to file suit in state court, where the law is often more favorable.[27] However, the Class Action Fairness Act of 2005[28] makes it easier for defendants to remove a state class action to federal court, and consequently, state class actions may become a less effective strategy for plaintiffs' lawyers.

Lenders Need to Analyze the New HMDA Data

The need for lenders to analyze their own HMDA data cannot be emphasized too strongly.[29] Federal and state regulators and the public will soon have ready access to essentially every lender's 2004 data sorted by state, metropolitan statistical area, county, and census tract.[30] Rightly or wrongly, regulators will impose on the regulated the burden of proving that disparities are the result of nondiscriminatory factors. Lenders can prepare to meet this challenge by analyzing their HMDA data. Moreover, such analyses will aid a lender in assessing its vulnerability to lawsuits, and, assuming they refute discrimination, provide strong defenses against potential lawsuits.

To start, lenders should heed regulators' exhortations to examine their data, focusing on the proportion of higher-priced loans made to protected class borrowers and the average rate spreads for those loans. Appropriate control groups should be selected and a lender's performance should be contrasted to that of its peers.[31] Distinct analyses should be performed for each geographic area in which the lender does a meaningful amount of business.

A lender with a greater proportion of higher-priced loans and/or higher average rate spreads to protected class borrowers should investigate the reasons for the disparities, particularly if they exceed those of its peers. A lender's investigation should include statistical analyses (such as multiple linear regressions) of its proprietary data affecting loan pricing, like credit scores, loan-to-value ratios, debt-to-income ratios, and prevailing interest rates. The purpose of these analyses is to determine whether, after controlling for borrower qualifications and relevant loan characteristics, protected class and similarly qualified control group borrowers paid comparable average APRs. If the statistical results indicate that a protected class paid meaningfully higher average APRs, then the lender will need to dig deeper.

> *"[A]lthough the fallout from public release of the new HMDA data will create more burdens for lenders, it may also open new opportunities if, as credit advocates seem to suggest, there are substantial numbers of protected class borrowers who are sufficiently creditworthy to qualify for prime mortgages."*

A lender should test negative statistical findings by reviewing a sample of loan files involving similarly qualified protected class and control group borrowers, where the protected class borrowers paid higher APRs. For each of these loans, the reason for and magnitude of the unexplained pricing disparity should be recorded. Those pricing adjustments resulting from factors that were not, or could not, be included in the statistical analysis should be identified and their fair lending ramifications evaluated. If the file review indicates that a protected class paid higher APRs based on prohibited factors, a lender will need to expeditiously change its policies and procedures.

More Constructive Approach Needed

The accusations of discrimination that accompanied the preliminary release of the new HMDA data are particularly troubling, because the actual reasons why certain protected class borrowers were more likely to take out higher-priced loans have yet to be determined. Moreover, these accusations are contradicted, at least in part, by analyses of the new HMDA data which show that the cost of higher-priced loans was essentially the same for all borrowers. Hopefully, a more constructive approach will prevail when all the data are released. Most importantly, regulators and credit advocacy groups need to acknowledge that banks are not the only participants in the home mortgage industry, and that the vast majority of abuses in the lending market are committed by other participants that seem almost perennially immune to regulatory scrutiny.

Decades of fair lending enforcement should have taught regulators that a coordinated approach by federal and state agencies is necessary to address unfairness in the lending industry. Instead, the release of the new HMDA data precipitated a lawsuit over whether the OCC or the states should have the right to investigate and sanction certain lenders. Given the shrinking resources available to government generally and the enormous challenges involved in making sure that all persons have equal access to credit, federal and state regulators ought to coordinate their efforts to insure proper scrutiny of all participants in the lending process.

Finally, although the fallout from public release of the new HMDA data will create more burdens for lenders, it may also open new opportunities if, as credit advocates seem to suggest, there are substantial numbers of protected class borrowers who are sufficiently creditworthy to qualify for prime mortgages. Lenders ought to be able to devise a way to penetrate this market, and those lenders who move first are likely to reap the greatest rewards.

Endnotes

1. The Federal Financial Institution Examination Council is expected to publish 2004 HMDA data in September 2005 at <http://www.ffiec.gov/hmda/publicdata.htm>.
2. 12 U.S.C. §§ 2801-2810.
3. Pricing data from individual lenders have been available upon request since March 31, and the media, advocacy organizations, and others, including our law firm, have analyzed the data and publicized their conclusions.
4. 65 Fed. Reg. 78,661 (December 15, 2000).
5. 67 Fed. Reg. 7,228 (February 15, 2002).
6. *Lee v. Bd. of Governors,* 118 F.3d 905, 915 (2d Cir. 1997).
7. *See* Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, "Answers to Frequently Asked Questions About New HMDA Data" Q.14 at 5 (March 31, 2005), available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050331/attachment.pdf>.
8. Remarks by Governor Edward M. Gramlich to the National Association of Real Estate Editors, Washington, D.C., June 3, 2005, available at <http://www.federalreserve.gov/boarddocs/speeches/2005/20050603/default.htm>.
9. *Testimony of National Community Reinvestment Coalition: Before the Congressional Black Caucus Regarding the New HMDA Data*, June 27, 2005, available at <http://www.ncrc.org/pressandpubs/press_releases/documents/Henderson_CBC_Testimony_June05>.

10. Traiger & Hinckley LLP, *A Study of Reported Rate Spreads by Borrower Race and Sex*, May 31, 2005, at 8, available at <http://www.traigerlaw.com/includes/hdma/hdma_rate_spread_study.pdf>.

11. Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, "Answers to Frequently Asked Questions About New HMDA Data," Q.16 at 5-6 (March 31, 2005), *supra* note 7.

12. "OCC Vows Early Activist Stance on HMDA," *BNA Banking Report*, Vol. 83 No. 12, p. 501 (October 4, 2004).

13. *Id*. (noting that the OCC "is already contacting a group of banks that includes high-volume home mortgage lenders, institutions with a heavy focus on subprime lending, and banks with previously identified compliance weaknesses in their mortgage lending business").

14. 12 C.F.R. § 202.17(b)(3).

15. N.Y. Exec. Law § 296-a (unlawful discriminatory practices in relation to credit).

16. *Office of the Comptroller of the Currency v. Eliot Spitzer*, No. 05 Civ. 5636 (S.D.N.Y.) (SHS); The *Clearing House Association, L.L.C. v. Eliot Spitzer*, No. 05 Civ. 5629 (S.D.N.Y.) (SHS).

17. No. 04-3770-cv, 2005 U.S. App. LEXIS 13904 (2d Cir. July 11, 2005).

18. <http://www.fdic.gov/about/strategic/strategic/banking industry.html>.

19. Departments of Housing and Urban Development and the Treasury, "Curbing Predatory Home Mortgage Lending: A Joint Report" 17–18 (June 2000), available at <http://www.treas.gov/press/releases/report3076.htm>.

20. *See, e.g., Claybrooks v. PRIMUS Automotive Financial Services, Inc*., Civil No. 3:02-0382 (M.D. Tenn. Jan. 18, 2005) (Trauger, J.); *Coleman v. General Motors Acceptance Corp.*, 220 F.R.D. 64, 73-74 (M.D. Tenn. 2004) (disparate impact challenge to GMAC's markup policy presented common issues of law and fact); *Cason v. Nissan Motor Acceptance Corp*., 212 F.R.D. 518, 520 (M.D. Tenn., 2002) (disparate impact challenge to NMAC's markup); *Jones v. Ford Motor Credit Co*., 00 Civ. 8330 (RJH) (KNF) 2005 U.S. Dist. LEXIS 5381 (S.D.N.Y. March 31, 2005).

    Rodriguez v. Ford Motor Credit Co., 2002 U.S. Dist. LEXIS 7280, 2002 WL 655679, at *3 (N.D. Ill. 2002) (Rule 23(a)(2) (allegation that Ford's finance company allowed dealers to impose higher finance charge markups on Hispanic customers).

21. 12 C.F.R. § 202.5(b).

22. *Smith v. Jackson*, 125 S. Ct. 1536; 161 L. Ed. 2d 410, 422 (2005), citing *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642, 656 (1989).

23. *Id*.

24. 296 F.3d 443, 449 (6th Cir. 2002).

25. *Coleman v. General Motors Acceptance Corp*., 220 F.R.D. 64 (M.D. Tenn. 2004).

26. This factor may, however, vary depending upon the federal court where the action is brought. Some circuits employ a "bright line" test, where certification under Fed. R. Civ. Pro. 23(b)(2) is limited to claims involving no more than "incidental damages." *See, e.g., Allison v. Citgo Petroleum Corp.*, 151 F.3d 402, 415 (5th Cir. 1998); *see also Barabin v. Aramark Corp*., 2003 U.S. App. LEXIS 3532, 2003 WL 355417, at *1-*2 (3d Cir. 2003) (adopting the *Allison* approach to incidental damages); *Jefferson v. Ingersoll International Inc.*, 195 F.3d 894, 898 (7th Cir. 1999) (same). In the Second Circuit, however, compensatory damages (and by implication, disgorgement) remain available in a (b)(2) action where the "positive weight or value [to the plaintiffs] of the injunctive or declaratory relief sought is predominant even though compensatory . . . damages are also claimed." *Robinson v. Metro-North Commuter R.R. Co.*, 267 F.3d 147, 164. n19 (2d Cir. 2001).

27. For example, in California a demand for damages is not fatal to class certification. *See, e.g., Daar v. Yellow Cab Co*., 67 Cal.2d 695 (1967) (discussing difference between California and federal class action law on this point).

28. P.L. 109-2, § 2, 119 Stat. 4.

29. Although the scope of this article is limited to the new pricing data, a lender's analysis should also focus on the HMDA data relating to the source of applications and application outcome. A lender should compute its share of applications and denial rates for protected classes and control groups and compare them to peer figures and to its own performance over the past several years. A significantly lower share of applications from protected classes than peers and higher denial rates to protected classes than control groups, especially as compared with peers, may be indicia of discrimination.

30. The Federal Financial Institution Examination Council is expected to publish this data in Sept. 2005 at <http://www.ffiec.gov/hmda/publicdata.htm>.

31. Prior to public release of HMDA data, lenders can compare their data to the already available analyses performed by such sources as the *Wall Street Journal*, Traiger & Hinckley LLP, and the National Community Reinvestment Coalition.

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Lenders and Environmental Issues: Liability and Opportunity

By Kevin Hopkins

Potential liability for environmental cleanup has been and continues to be a major concern for real estate lenders. At the same time, it creates opportunities for those lenders who exercise appropriate due diligence. This article reviews the history of lender environmental liability, and then focuses on the Environmental Protection Agency's due diligence standards, scheduled to take effect November 1, 2006, and how a lender can develop an effective environmental compliance program.

Lenders engaged in real estate financing are exposed to many environmental risks in their daily course of business. Some environmental risks are inherently manageable, such as a lender's management plan for its own facilities. However, more burdensome environmental risks such as lender liability for contamination of secured property are difficult to identify at the outset of financing commitments and thus require a system for assessment and management. As environmental laws evolve, lenders are faced with ever-changing limits of liability and increasing demand by governmental agencies to enforce environmental statutes.

Most lenders have developed sophisticated methods of assessing credit risk, but few have integrated comprehensive environmental risk assessment into the credit decision-making process.[1] However, those lenders that have taken a proactive approach to environmental issues have found that environmental risk can indeed be managed, allowing them to proceed with profitable opportunities that otherwise might have been passed up. Further, recent developments such as the Environmental Protection Agency's (EPA) Brownfields Program[2] and New York State's Brownfields Cleanup Program[3] have not only enabled lenders to see a return on the financing of previously contaminated properties, but have also insulated lenders from much of the liability that was formerly attached to such projects. Such programs also enable the lender to actively participate in urban redevelopment, furthering both the interests of the community and enhancing the perception of the lender, thus ultimately creating more business for the lender.

This article provides a comprehensive overview of the history of environmental legislation relevant to lenders. It then discusses the EPA's due diligence standards, scheduled to take effect on November 1, 2006, and suggests ways that lenders can effectively manage their environmental risk.

Environmental Legislation History

Although environmental legislation began with the Air Pollution Control Act[4] (APC) in 1955, lenders would still enjoy years of minimal exposure to loss as a result of their borrower's environmental actions on secured property. The subsequent 1970 amendments to the APC, known as the "Clean Air Amendments of 1970" or Clean Air Act (CAA),[5] empowered the newly formed federal Environmental Protection Agency (EPA) with enforcement powers for violations of the CAA, including the power to pursue civil judicial enforcement[6] and criminal penalties[7] against violators. For the first time, there existed a federal administrative body with the authority to enjoin activity or fine individuals and organizations for exceeding federally mandated limits of environmental pollution. Other federal acts soon followed, such as the Federal Water Pollution Control Act (FWPCA) in 1972,[8] which left enforcement of the federally mandated water quality standards to the individual states, but reserved enforcement powers to the EPA when a state failed to initiate enforcement of violations within thirty days.[9] By the late 1970s, there existed a web of multi-jurisdictional environmental statutes that imposed compliance standards for air, water and soil contamination. Although administrative fines under CAA and FWPCA could be significant, there still existed only a minimal chance that the administrative action could cause such economic harm to a borrower that it actually affected the ability to make loan payments.[10]

The Advent of Lender Liability

The period of limited lender liability in environmental compliance came to an abrupt halt in 1980, with the passage of the Comprehensive Environmental Response, Compensation and Liability Act, (CERCLA).[11] Prior to CERCLA, environmental legislation was primarily enforced by civil and administrative penalties. CERCLA, however, in addition to providing for civil penalties,[12] also introduced the "Potentially Responsible Party" (PRP), the individual or entity that could be held liable for all remediation costs, regardless of whether or not it physically caused the release of contaminants under CERCLA.[13] Lenders immediately took notice because even in early CERCLA enforcement actions, a small to mid-size corporation could easily be faced with an average single-site remediation cost of thirty million dollars,[14] thus seriously affecting the ability to continue routine operations and ultimately affecting the ability to make timely loan payments. Multiple-site remediation costs carried the potential to affect larger corporations as well, not only in terms of remediation and defense costs, but also in other costs such as the loss of business resulting from poor public opinion. To make matters worse for lenders, CERCLA § 107(a), which defines PRPs, did not specifically exclude holders of security interests from being "owners" or "operators" under the statute,[15] thus raising the possibility that lenders could be found directly liable for remediation costs under CERCLA.

The Lender as a PRP Under CERCLA

Although the 1985 amendments to CERCLA[16] (SARA) included a secured creditor exemption, lenders' fears regarding CERCLA liability would soon be realized in 1990, when the Eleventh Circuit held in *U.S. v. Fleet Factors Corporation* (Fleet Factors)[17] that a creditor who had foreclosed under a factoring agreement with a now bankrupt PRP had crossed the threshold of the secured creditor exemption under CERCLA and may have functioned as an "operator" of the facility under CERCLA § 107(a), thus invoking full liability for remediation costs under the statute.[18] Needless to say, the Fleet Factors decision forced lenders to immediately evaluate their involvement in the business of their borrowers and almost immediately impacted industrial lending decisions. The result of the Fleet Factors holding was that a lender who acted to enforce a security interest, either by foreclosure or by other means such as installing a manager to oversee operations pursuant to a financing agreement, could be found to be a PRP under CERCLA § 107(a) and thus subject to full remediation liability. Worse yet, the Fleet Factors decision, being very broad in terms of what exactly defined an owner/operator under CERCLA, left the entire financial community in a position of uncertainty, thus creating a chilling effect on the extension of credit.[19]

The Fleet Factors decision did little to promote effective environmental stewardship. Real property lenders generally include property condition maintenance as part of the mortgage commitment.[20] By doing so, the lender had an incentive to see that borrowers, especially those engaged in lines of business with potential environmental risks, were complying with the loan requirements. In industrial properties, lenders may even evaluate compliance monitoring or require third-party compliance assessments as a funding requirement. Such incentive to monitor a borrower's environmental compliance was completely removed by the Fleet Factors decision, as lenders quickly withdrew from any involvement in the borrower's business operations in an effort to remain insulated from CERCLA liability.[21] Environmentalists and EPA professionals alike soon realized that not only was the incentive for lenders to monitor environmental compliance shattered by the Fleet Factors decision, but also that lenders began to cease conditioning credit on borrower promises to maintain environmental compliance.[22] The end result was the effective removal of private sector compliance monitoring and an increased chance for polluters to evade enforcement.

EPA's Lender Liability Rule

Lenders and lawmakers alike were obviously distressed by the Fleet Factors decision and the potential effect on the real property lending market. The EPA responded to the Fleet Factors decision in 1991 with a revised "Lender Liability Rule" (LLR),[23] which greatly narrowed the lender liability holding under Fleet Factors. The LLR was promptly challenged by the Chemical Manufacturers Association (CMA) and the Attorney General of Michigan[24] in *Kelley v. Environmental Protection Agency*,[25] where the D.C. Circuit Court vacated the LLR, holding that the EPA had no authority to issue regulations defining liability under CERCLA.[26] In response, both the EPA and the Department of Justice (DOJ) stated that they would narrow their enforcement to the confines of the LLR. Although the EPA and DOJ statements were welcomed by lenders, they did little to assure lenders that courts would apply the provisions of the LLR. The end result at the time was that lenders were now returned to the same position of uncertainty as they were when the Fleet Factors decision came down. Once again, with such uncertainty as to liability, lenders were reluctant to finance commercial and industrial projects, with some lenders leaving the industrial loan market completely.[27]

Legislative Response to Fleet Factors

Lenders and EPA professionals once again pressed for legislative reform, and in 1996 the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 (ACA)[28] was passed. The ACA added a revised security interest exemption to CERCLA[29] and basically adopted the provisions of the LLR by listing activities that a lender could participate in without falling under the "owner" or "operator" provisions of CERCLA § 107(a).[30] One of the most crucial ACA clarifying rules for lenders dealt with liability as a result of foreclosure on contaminated property. Prior to ACA, a lender that had assumed ownership of contaminated property by foreclosure would likely be found to be an owner under CERCLA § 107(a), and thus liable for the costs of remediation. The ACA, however, introduced the rule that where a lender is the record owner of the premises as the result of foreclosure of a security interest, the lender is permitted to wind up the affairs of the business and undertake remediation without triggering CERCLA liability, if the lender is actively attempting to divest itself of the facility.[31] The ACA also allows for market considerations in such an event, as it is obviously very difficult to divest one's interest in a property that is under mandated CERCLA remediation.[32]

CERCLA Security Interest Exemption

The ACA, although providing additional stability for lenders, did not abrogate lender liability under CERCLA. Under the revised CERCLA "owner" provision, an owner "does not include a person, who without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."[33] A security interest under CERCLA is defined as "a right under a mortgage, deed of trust, assignment, judgment lien, pledge, security agreement, or lease and any other right accruing to a person to secure the repayment of money, the performance of a duty, or any other obligation to a non-affiliated person."[34] The security interest exemption, as applied in New York, has been held to be a narrowly drafted exemption, while the definition of "owner" under CERCLA has been held to be broad in scope, under the remedial purpose of CERCLA.[35] A lender seeking to invoke the security interest exemption has the burden of establishing entitlement to the exemption by proving that it holds indicia of ownership primarily to protect its security interest and that it did not participate in management of the subject property.[36]

In a recent U.S. District Court case in the Eastern District of New York, the Court held that a limited partner in a real estate partnership, who had joined as a limited partner solely as a requirement of the lender that the partnership provide additional security, was not exempt from CERCLA liability under the secured creditor exemption.[37] Illustrating the narrow interpretation in New York[38] of the security interest exemption, the Court noted that whereas the lender, by requiring the co-borrower to join as a limited partner, was acting to ensure its security interest in the property, the co-borrower, as a limited partner, was not acting to protect his own security interest in the property and was therefore liable as an owner under CERCLA.[39] Thus the notion of "lenders acting as lenders"[40] and not "owners" or "operators" was exemplified in this case, where the lender was found to have only acted to protect a security interest in the property and was therefore insulated from CERCLA liability.

Lender Participation in the Business Activities of the Borrower

Courts have closely scrutinized the actions of lenders in the day-to-day operations of secured properties since the Fleet Factors decision.[41] Unlike Fleet Factors, later cases have focused not on what the capacity of the lender was, but on what actions the lender actually took in participating in the management of the property.[42] Under the ACA revisions to CERCLA, a lender that has foreclosed on property to protect a security interest will not be found to have participated in the management of a facility if the lender divests itself of the property "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."[43] Further, the once ambiguous "participation in management" provision was narrowed down to actions where the lender actually "exercises decision making control" over environmental compliance related to the facility,[44] while the borrower remains in possession of the facility.[45] Although the ACA amendments to CERCLA practically create a presumption of non-liability for lenders,[46] lenders continue to be faced with the liability of being named as either a PRP or a contributing defendant under CERCLA and thus forced to fight a costly legal battle in raising the affirmative defense of the secured creditor exemption.[47] Critics of CERCLA liability continue to maintain that the ACA amendments did not provide absolute certainty of non-liability for the banking industry and have thus created a reluctance to grant loans to industrial projects.[48] However, as a result of the ACA amendments, lenders at least have a narrower window of liability under which they can assess their exposure and therefore account for their potential losses in the financing offer.

Affirmative Defenses and All Appropriate Inquiries under CERCLA

Since the inception of CERCLA, owners, operators and lenders have been on notice that a defendant in a CERCLA action, who did not by any act or omission "cause[] or contribute[] to the release or threatened release of a hazardous substance,"[49] may be entitled to the affirmative defenses of "innocent landowner,"[50] "bona fide prospective purchaser"[51] and "contiguous property owner."[52] These affirmative defenses for CERCLA liability are of great significance to lenders, as they form the first line of defense against CERCLA liability for their borrowers. Lenders are generally dragged into PRP status once they acquire the property through foreclosure, or when a borrower either exhausts its resources or declares bankruptcy as a result of its CERCLA liability.[53] Although the lender will then attempt to prove entitlement to the security interest exemption under the ACA, the fact is that the lender is now faced with a potentially costly legal battle as well as potentially negative press.

Regardless of whether the secured property is commercial or residential,[54] lenders can minimize the risk that their borrower will be found liable under CERCLA if the borrower conducts due diligence under the "[a]ll appropriate inquiries"[55] (AAI) provision of CERCLA. Under AAI, the purchaser of a property is required to follow the standards and practices for site inspection and past use[56] in order for the purchaser to raise any of the affirmative defenses to CERCLA liability in the future. Lenders generally require proof of AAI on commercial transactions, but rarely on residential transactions.[57] In a bankruptcy case in the Eastern District of Pennsylvania, where the debtor was one of several homeowners whose properties were listed on the EPA Superfund National Priority List (NPL) as a result of radioactive tailings[58] from a nearby mine, although the Court found the lender to be insulated from CERCLA liability under the secured creditor exemption, the lender was still faced with a borrower who obviously was not making loan payments and a radioactive property on which it would surely not want to foreclose.[59] Such a case makes a strong argument for AAI requirements on residential property, especially when the premises are located in a former mining or industrial area.

EPA's New All Appropriate Inquiry Rule

On November 1, 2006, the new EPA rules for AAI (AAI-06)[60] will go into effect,[61] setting forth detailed standards for AAI due diligence. The AAI-06 provision addresses many of the criticisms of the old standards, by firmly establishing AAI standards for the affirmative defenses under CERCLA[62] and setting forth education and work experience standards for Environmental Professionals (EP)[63] who conduct environmental site assessments. The AAI-06 also sets forth the scope of the "innocent landowner,"[64] "bona fide prospective purchaser"[65] and "contiguous property owner"[66] defenses, while establishing the course of action for due diligence to establish entitlement to the defenses.[67] In order for a borrower to preserve liability defenses under the revised CERCLA liability provisions, due diligence must be guided by AAI-06.[68] An EP must be retained pursuant to AAI-06 § 312.10(1), and all of the provisions set forth in AAI-06 § 312.1(c)[69] must be met in order to claim any one of the three affirmative liability protections provided for in AAI-06 § 312.1. However, even if due diligence is conducted accordingly, AAI-06 § 312.28 through AAI-06 § 312.31 make it extremely difficult for experienced real estate professionals to claim one of the preceding liability protections under AAI-06 § 312.1. In determining whether or not a liability protection is applicable pursuant to AAI-06 § 312.28, the purchaser's business experience is taken into consideration, relative to the due diligence results; AAI-06 § 312.29 weighs the relationship of the purchase price to fair market value as an indicator for consideration of whether or not the purchase price is related to the presence of or threatened release of hazardous substances, while AAI-06 § 312.30 and AAI-06 § 312.31 take common knowledge and the degree of obviousness of the presence or likely presence of contamination on the subject premises into consideration. Even in the very early stages of a project, if an experienced real estate developer, acting as a purchaser, could have some indication that the premises may have once harbored some activities that may incur liability under CERCLA, the likelihood of a successful affirmative defense to CERCLA liability may be curtailed by AAI-06 provisions § 312.28 through § 312.31. Performing due diligence under AAI-06 is still imperative, however, not only to establish potential defenses for the borrower, but also to identify potential liabilities to be accounted for in the lender's credit-making decision.

CERCLA Lien Provision and State Superlien Statutes

In addition to the risk that a borrower will become insolvent as a result of CERCLA liability, lenders are also faced with real property liens in the form of the CERCLA lien provision[70] and state "Superlien" statutes.[71] The CERCLA lien is superior only to unsecured creditors, but several states have Superlien statutes that create a superior environmental lien on real property.[72] Although New York repealed the lien provisions of its Inactive Hazardous Waste Disposal Site statute in 1992, which had previously required the listing of both NPL and New York State Superfund sites in a lien index available in all of the County Clerk offices in the state,[73] both New Jersey[74] and Connecticut[75] have Superlien provisions in their State Superfund statutes which give the state a first priority lien which is superior to prior perfected liens and is levied to cover the state's cost of assessment and remediation.[76]

Although New Jersey[77] and Connecticut[78] both have secured creditor exemptions to their State Superfund statutes, the lender's risk of loss as a result of the Superlien provisions remains a significant issue in lending decisions, as the amount of a Superlien could easily exceed the market value of the secured property.[79] The policy behind the Superlien statutes is to nullify any windfall increase in the value of a secured property after the site has been remediated.[80] When a property is identified as the source of a hazardous substance release, the market value of the property obviously plummets. In the case of an insolvent property owner, the cost of remediation is generally paid by the state, with such costs typically exceeding the now diminished market value of the property. However, once the property has been cleaned up and the environmental action closed, the property may see a significant increase in value, not only because it has been given a clean bill of health by the authorities, but also because environmental remediation can take years, and thus property values in proximity to the site may have increased as well. As a matter of policy, it is arguable that a lender who foreclosed on an insolvent owner of a contaminated property which it could not divest itself of as the result of an environmental action, would not be entitled to a windfall increase in the market value of the property after remediation was complete. Although the lender would have incurred substantial carrying costs during remediation, a state with a Superlien statute would be first in priority for restitution of costs, leaving the lender with the surplus, if any. It is arguable that a lender finds itself in such a position because of a business decision and therefore should not be permitted to pass any risk along to the taxpayers, who would ultimately be paying for remediation where there was no solvent party to whom remediation liability would attach.

Lenders and Environmental Risk Management

As a result of CERCLA and state environmental laws, environmental risk management has become vital to real estate lending decisions. Environmental risk includes: (1) the quantifiable costs of carrying and/or remediating sites with known or perceived environmental conditions; (2) civil, criminal and administrative law consequences of defined environmental conditions; and (3) the lender's exposure to unknown or yet to be found conditions, unpredictable regulators and changing legal standards.[81] One method to control environmental risks in lending is to develop a transactional management system, where uncertainties are controlled or mitigated by environmental insurance, public financing (e.g., Brownfields) and developer indemnification for liability.[82] Although uncertainty abounds as a result of the inherent nature of negative environmental conditions which manifest themselves over time, planning for environmental risk assessment in the credit decision process can open new lending opportunities where value can be extracted from properties that would otherwise be left out of the market.[83] Public programs such as the EPA's Brownfields Program[84] and New York's Brownfields Cleanup Program[85] have provided both public financing and limits of liabilities for developers and lenders in projects where former contaminated sites are developed into everything from retail to multi-family housing.[86] Such programs open up properties that would never have been considered for development just a few years earlier. Further, Brownfields programs may also offer tax incentives and other public financing incentives that could greatly enhance the borrower's return,[87] thus making the transaction more attractive to lenders. Such incentives, coupled with recent developments in the insurance industry such as cleanup cost cap insurance and contractor pollution liability insurance,[88] enable lenders to build a framework to effectively manage their environmental risk in secured properties.

In addition to assessing the environmental risks associated with a property, lenders must also "factor in the environmental compliance record of the borrower as an element of credit-worthiness and ability to repay."[89] Obviously, a borrower with an unfavorable environmental track record presents a great risk to a lender. With the many federal and state environmental databases available to the public, such as the federal NPL, Toxics Release Inventory (TRI), and state databases such as New York Department of Environmental Conservation's (DEC) Spill Incidents Database, lenders can assess the environmental compliance history of a borrower much the same as they assess credit history. However, initiating a system for the compilation of the information found in the many environmental databases is necessary for the lender, as such information is not currently compiled commercially, unlike credit reporting databases.

Lenders and Global Environmental Issues

In addition to statutorily mandated environmental liability risks, lenders are faced with the possibility of loss as the result of global environmental conditions as well as sustainability issues. The United Nations Environment Programme Finance Initiative (UNEPFI) is a program that seeks to develop and promote the role of the environment and sustainability issues in the private financial sector.[90] The UNEPFI is based upon the notion that "environmental risks that confront a financial institution's clients such as violations of laws, responsibility for cleaning up contamination or loss of franchise and brand reputation" impact the client's ability to conduct business and therefore pose significant risks to financial institutions.[91] The UNEPFI has identified two types of environmental risks to financial institutions: direct and indirect.[92] Indirect risks, such as compliance liability resulting from a borrower's actions that lead to either direct lender environmental liability or financial loss as a result of the borrower's inability to make loan payments, have received much attention in the financial industry since the inception of CERCLA, but global issues such as climate change also pose a risk of loss to lenders.[93] Whatever one's opinion as to climate change theory, the fact that the frequency and cost of global natural disasters has increased dramatically in recent history should not be overlooked in assessing environmental risk. The 2005 hurricane season alone cost U.S. insurers approximately sixty billion dollars, a figure more than double that of any previous year,[94] not to mention the indirect losses to lenders as a result of their borrowers' inability to pay because their businesses and homes had been devastated. As a result of such risk of loss, lenders have a two-fold responsibility with respect to climate change: (1) assess risks as a result of the negative effects of climate change on their customers, including both the risk of loss from natural disasters and the cost of emission reduction policies, and (2) provide products and services to aid the low-carbon economy[95] including providing financing for renewable energy technologies.[96]

Direct risks may include environmental liability as a result of a lender's actions regarding its own facilities and operations, or "publicly supporting an unpopular public policy position that impacts reputation."[97] Lenders, whether operating in national, regional or local markets are subject to certain public expectations fueled by growing concerns about environmental issues that could affect reputation. Thus, a lender's extension of credit to environmentally controversial projects, the in-house screening process for such projects, as well as the lender's incorporation of environmental assessment in its own investment decisions and internal operations could greatly impact public perceptions about the lender and affect business opportunities.[98]

Environmental Risk Management Strategy

In seeking the goal of a more stable global economy, the UNEPFI promotes the notion that environmental risk management and conventional credit management can be integrated into a lender's risk management strategy. Such a strategy should include: (1) identification of environmental risks prior to loan approval, including possible environmental impacts on the borrower's cash flow, the borrower's ability to service debt in the event of a compliance or contamination action, the possible diminution in value of the secured property as the result of an environmental action, and the borrower's environmental history; (2) assessment of the identified environmental risks, including conducting due diligence under AAI-06; (3) implementation of risk control measures to prevent losses from occurring to both the lender and borrower (such risk control measures can include environmental insurance, indemnities and loan covenants that require evaluation of environmental conditions throughout the life of the loan); (4) mitigation of risks prior to loan approval or during the life of the loan (mitigation can include transfer of risks to insurers or joint venture partners, indemnifications, escrow agreements and letters of credit); and (5) monitoring of environmental risks throughout the life of the loan (a monitoring plan could include requiring the borrower to submit proof of compliance on a continuing basis or, in some cases, requiring continuing assessment over the life of the loan to ensure compliance).[99] Lenders are already engaged in credit risk management, so the notion of integrating environmental risk management with systems that the lender already has in place, although a complex project, could greatly minimize environmental risks while improving returns.

Environmental Opportunities for Lenders

In addition to environmental risk management, the UNEPFI also encourages lenders to identify environmental opportunities in the market. Environmental opportunities for lenders include: (1) diminished operation costs by implementing policies which ensure maximum energy use or generating recycling revenues from their facilities management; (2) participation in positive community reinvestment programs such as Brownfields programs, which can greatly benefit urban communities while extracting income for both lender and borrower from a site that would otherwise be left dormant; (3) creation of a marketing strategy which exemplifies the lenders' commitment to provide positive solutions for environmental challenges, including a track record of compliant borrowers that benefit the community with minimal loss to stockholders as a result of environmental liability; and (4) creation of a voluntary environmental reporting system which not only helps to identify areas of environmental risk exposure, but also boosts both employee and public perception about the lender's environmental record.[100]

Developing an Environmental Risk Management Program

As a result of potential losses, many institutional lenders have likely initiated some sort of environmental risk management process to mitigate both direct and indirect environmental risks. However, a 1997 report prepared for the EPA that reviewed environmental risk management at banking institutions found that the systematic use of environmental risk management was still not widespread throughout the banking industry.[101] As the primary reason a lender makes a loan is to receive a return on its investment, it follows that the lender would have a strong interest in seeing that environmental due diligence was performed prior to disbursal of funds and a similar interest in monitoring compliance throughout the life of the loan. In order to adjust lending practices to reflect such interests, the lender would need access to accurate and reliable environmental information on both the mortgagor and the proposed project.[102] One tool that can aid lenders in developing an environmental risk management program is ISO 14000, which is an international standard for environmental management developed by the International Organization for Standardization.[103] Although ISO 14000 is a voluntary standard, close to 800,000 corporations worldwide implement ISO 14000 and related ISO standards, thus creating a database for lenders where an organization's record for both compliance[104] and continuing environmental performance[105] can be evaluated.[106] In addition, the Office of Thrift Supervision, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have all issued guidance to banking institutions regarding lender environmental liability.[107] However, the AAI-06 due diligence guidelines have already effectively superseded all other due diligence standards, including ASTM Standard E1527-05,[108] although compliance with AAI-06 is not mandatory until November 1, 2006.

Although environmental due diligence has largely become standard operating procedure for lenders, at least on many commercial transactions, few lenders have instituted procedures for annual compliance monitoring.[109] However, an ISO 14000 compliant borrower would provide the lender with a relatively simple monitoring opportunity, by providing the lender with an annual ISO 14031 Environmental Performance Measurement report. Such a monitoring method, however, can be frustrated because the ISO guidelines are voluntary, meaning that the borrower can drop ISO certification. To complicate matters, a parent company can be ISO-compliant, while certain subsidiaries may not be.[110] In addition, the SEC requires environmental reporting in the required Form 10-K Annual Report, where major environmental liabilities must be disclosed, but such disclosures are very broad in scope and focus primarily on current litigation.[111]

Although environmental databases are readily available to lenders, the problem remains that a lender must develop a system for evaluating a borrower's environmental risk by combining information from a large number of sources, unlike credit assessment sources which are much more consolidated. However, if lenders pursue environmental risk assessment as part of the overall credit decision, environmental risk management will become a standard operating procedure in the credit process, thus minimizing loss as a result of environmental issues.

Endnotes

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22. *Id*.
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24. The motivation for both plaintiffs would appear to be maintaining the broad parameters for lender liability under Fleet Factors in order to keep the door open for contribution actions against lenders. The CMA's members obviously wanted additional parties to share the cost of remediation for self-interested reasons, while the Michigan AG's likely motivation was to ensure remediation to the benefit of the state's citizens by increasing the likelihood that multiple contributing PRPs would be identified.
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34. 42 U.S.C. § 9601(20)(G)(vi) (1996).

35. *New York v. Westwood-Squibb Pharmaceutical Co, Inc.*, 138 F. Supp. 2d 372 (W.D.N.Y. 2000).

36. William B. Johnson, *Secured Lender Liability: Application of Security Interest Exemption from Definition of "Owner or Operator" under CERCLA*, 131 A.L.R. Fed. 293 (2005), *see also U.S. v. Fleet Factors Corporation*, 901 F.2d 1550 (11th Cir. 1990).

37. *U.S. v. 175 Inwood Associates, LLP*, 330 F. Supp. 2d 213 (E.D.N.Y. 2004).

38. New York does not have a security interest exemption under the "State Superfund," N.Y. Envtl. Conserv. Law §§ 27-1301, 1323 (1972).

39. *Id*.

40. William B. Johnson, *Secured Lender Liability: Application of Security Interest Exemption from Definition of "Owner or Operator" under CERCLA*, 131 A.L.R. Fed. 293 (2005), *see also U.S. v. Fleet Factors Corporation*, 901 F.2d 1550 (11th Cir. 1990).

41. *See generally Waterville Industries v. Finance Authority of Maine*, 984 F.2d 549 (1st Cir. 1993), *and Kemp Industries, Inc. v. Safety Light Corporation*, 857 F. Supp. 373 (D.N.J. 1994).

42. Joanne S. Liu, *Lender Liability Protection in the Aftermath of CERCLA's Security Interest Exemption Crisis: Treating Lenders Like Lenders*, 17 Ann. Rev. Banking L. 575 (1998), *see also Monarch Tile, Inc. v. City of Florence*, 212 F.3d 1219 (11th Cir. 2000), *and Canadyne-Georgia Corp. v. Bank of America*, 174 F. Supp. 2d 1360 (M.D.G.A. 2001).

43. 42 U.S.C. § 9601(20)(E)(ii)(II) (2002).

44. 42 U.S.C. § 9601(20)(F)(ii)(I) (2002).

45. 42 U.S.C. § 9601(20)(F)(ii) (2002).

46. *Id*.

47. William B. Johnson, *Secured Lender Liability: Application of Security Interest Exemption from Definition of "Owner or Operator" under CERCLA*, 131 A.L.R. Fed. 293 (2005).

48. Joanne S. Liu, *Lender Liability Protection in the Aftermath of CERCLA's Security Interest Exemption Crisis: Treating Lenders Like Lenders*, 17 Ann. Rev. Banking L. 575 (1998).

49. 42 U.S.C. § 9601(35)(D) (2002).

50. 42 U.S.C. § 9601(35) (2002) and 42 U.S.C. § 9607(b)(3) (2002).

51. 42 U.S.C. § 9601(40) (2002).

52. 42 U.S.C. § 9607(q) (2002).

53. *See generally U.S. v. Gurley*, 434 F.3d 1064 (8th Cir. 2006).

54. *See In re DuFrayne*, 194 B.R. 354 (E.D.P.A. 1996).

55. 42 U.S.C. § 9601(35)(B)(i) (2002).

56. *Id*.

57. Walter E. Mugdan, *Environmental Liability Under Superfund For Lenders and Fiduciaries*, SC56-ALI-ABA 175 (1998).

58. Tailings are the uneconomic waste left over from mining operations.

59. *In re DuFrayne*, 194 B.R. 354 (E.D.P.A. 1996).

60. 40 C.F.R. § 312 (2005).

61. Note that since their release on November 1, 2005, the new AAI rules have effectively replaced ASTM Standard E1527-05 as the industry standard.

62. 40 C.F.R. § 312.1 (2005).

63. 40 C.F.R. § 312.10 (1) (2005).

64. 40 C.F.R. § 312.1(a)(1)(i) (2005).

65. 40 C.F.R. § 312.1(a)(1)(ii) (2005).

66. 40 C.F.R. § 312.1(a)(1)(iii) (2005).

67. 40 C.F.R. § 312.20(2) (2005).

68. 40 C.F.R. § 312.1(a) (2005).

69. Includes specific actions of the inquiry as well as disclosure obligations of the seller, proposed purchaser and EP.

70. 42 U.S.C. § 9607(l)(1) (2002).

71. Manuel G. Grace and Karen A. Caffee, *Environmental Problems in Financing and Securities Disclosure: Avoiding the Risks*, 596 PLI/Comm 475 (1991).

72. Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securization*, 59 Wash. & Lee L. Rev. 127 (2002).

73. N.Y. Comp. Codes R. & Regs. Tit. 6, § 375.1-375.11 (1987) (repealed 1992).

74. N.J.S. § 58:10-23.11(f) (1992).

75. C.G.S. § 229-452(a) (1995).

76. Manuel G. Grace and Karen A. Caffee, *Environmental Problems in Financing and Securities Disclosure: Avoiding the Risks*, 596 PLI/Comm 475 (1991).

77. N.J.S. § 58:10-23.11(i) (1992).

78. C.G.S. § 22a-451(d) (1995).

79. Reed D. Rubinstein, *Financing Environmental Risk: A Transactional Response*, 17 No. 1 Prac. Real Est. Law 47 (2001).

80. Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securization*, 59 Wash. & Lee L. Rev. 127 (2002).

81. *Id*.

82. *Id*.

83. *Id*.

84. United States Environmental Protection Agency, *Brownfield Cleanup and Redevelopment*, *available at*: <http://www.epa.gov/brownfields/about.htm>.

85. N.Y. Envtl. Cons. Law § 27-1401 (2003).

86. United States Environmental Protection Agency, *Brownfield Cleanup and Redevelopment*, *available at*: <http://www.epa.gov/brownfields/about.htm>.

87. Reed D. Rubinstein, *Financing Environmental Risk: A Transactional Response*, 17 No. 1 Prac. Real Est. Law 47 (2001).

88. Ann M. Waeger, *Current Insurance Policies for Insuring Against Environmental Risks*, SL034 ALI-ABA 815 (2005).

89. Manuel G. Grace and Karen A. Caffee, *Environmental Problems in Financing and Securities Disclosure: Avoiding the Risks*, 596 PLI/Comm 475 (1991).

90. United Nations Environment Programme Finance Initiative, *available at*: <http://www.unepfi.org/about/index.html>.

91. United Nations Environment Programme Finance Initiative, *Your Financial Institution and the Environment*, *available at*: <http://www.unepfi.org/fileadmin/documents/natf_eba_fin_inst_enviro_2003.pdf> (2003).

92. *Id*.

93. United Nations Environment Programme Finance Initiative, *The Future of Climate Policy: The Financial Sector Perspective*, *available at*: <http://www.unepfi.org/fileadmin/documents/CEO_briefing_future_2005.pdf> (2005).

94. *Id*.

95. The “low-carbon economy” (LCE) is a policy of the Kyoto Protocol, ratified in 2005 by 156 countries, with the notable exception of the U.S. The LCE is an initiative where the ratifying countries agree to reduce carbon emissions according to specified time frames under the Kyoto Protocol, while creating incentives for promoting sustainable technologies and practices; *see id*.; *see also* CDM Watch, *The World Bank and the Carbon Market: Rhetoric and Reality* (2005), *available at* <http://www.cdmwatch.org/files/World%20Bank%20paper%20final.pdf#search=’carbon%20market’>, which details many of the criticisms of the World Bank Group (WB) and its role in the LCE, including the WB’s continued use of carbon finance initiatives to support non-sustainable technologies and fossil fuel development.

96. *Id*.

97. United Nations Environment Programme Finance Initiative, *Your Financial Institution and the Environment*, *available at*: <http://www.unepfi.org/fileadmin/documents/natf_eba_fin_inst_enviro_2003.pdf> (2003).

98. *Id*.

99. *Id*.

100. *Id*.

101. Brian C. Murray, Sheryl J. Kelly and John T. Ganzi, *Review of Environmental Risk Management at Banking Institutions and Potential Relevance of ISO 14000*, Research Triangle Institute, RTI Project Number 5774-4 (1997).

102. *Id*.

103. International Organization for Standardization, ISO 9000 and ISO 14000—in brief, *available at*: <http://www.iso.ch/iso/en/iso9000-14000/understand/inbrief.html>.

104. ISO 14010 Environmental Auditing.

105. ISO 14031 Environmental Performance Measurement.

106. *Id*.

107. Brian C. Murray, Sheryl J. Kelly and John T. Ganzi, *Review of Environmental Risk Management at Banking Institutions and Potential Relevance of ISO 14000*, Research Triangle Institute, RTI Project Number 5774-4 (1997).

108. Largely regarded as the industry standard for environmental due diligence, pre-AAI-06.

109. Brian C. Murray, Sheryl J. Kelly and John T. Ganzi, *Review of Environmental Risk Management at Banking Institutions and Potential Relevance of ISO 14000*, Research Triangle Institute, RTI Project Number 5774-4 (1997), citing *Global Survey on Environmental Policies and Practices of the Financial Services Industry*, Environment and Finance Research Enterprise (1994).

110. *Id*.

111. United States Securities and Exchange Commission, Form 10-K, *available at*: <http://www.sec.gov/answers/form10k.htm>.

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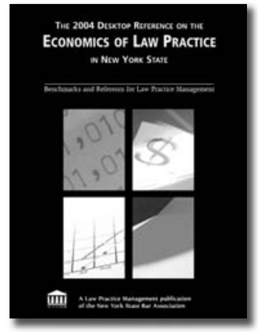

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Spring 2006 Committee Reports

Editor's Note: The work of the New York State Bar Association's Business Law Section is carried out through nine separate Committees devoted to different functional areas of business law. The Committees are an invaluable resource for practitioners, and all members of the Association are encouraged to consider membership in one or more Committees. The following reports highlight significant Committee activities since the last issue of the *Journal*.

Banking Law Committee

The Banking Law Committee began exploring in 2005 the possibility of working more closely with the Consumer Financial Services ("CFS") Committee. At our Committee meeting on January 25, 2006, the Banking Law Committee jointly sponsored, with the CFS Committee, two programs on topics of interest to members of both committees, both of which qualified for Continuing Legal Education (CLE) credits for the attendees. The first CLE program featured Roberta Kotkin, Esq., General Counsel and COO of the New York Bankers Association, on current federal and state legislative developments in the financial services area. The second program featured a presentation by Randy Henrick, Esq., the Associate General Counsel of Dealer Track, Inc., on the subject of data security and identity theft. Also in January, a new Subcommittee was formed on Commercial Financial Transactions, chaired by Ray Seitz, Esq., of Phillips Lytle.

A meeting of subcommittee chairs was held on March 24 to plan the program for the Spring Meeting.

The Spring Meeting was held on Wednesday, May 10, 2006 in New York City. The program once again included two CLE programs: a presentation by Paul Lee, Esq., of Debevoise & Plimpton on developments involving the Bank Secrecy Act and anti-money laundering laws and regulations; and a program by Ray Seitz, Esq., and Deborah Doxey, Esq., of Phillips Lytle on commercial transactional developments. Ray spoke about the new ABA Model Deposit Control Agreement and Deborah discussed the new Article 9 transition rules and other UCC developments.

Bruce J. Baker, Chair
Nixon Peabody LLP, Rochester

Bankruptcy Committee

Formal educational presentations:

September 2005—New Bankruptcy Reform Act, CLE panel presentation to the Business Section members at the Fall Meeting with CLE course manual and redlined Bankruptcy Code book.

October 2005—New Bankruptcy Reform Act, CLE panel presentation, with local panels, including Judges and U.S. Trustee, in Long Island, City of New York, Westchester, Albany, Syracuse and Buffalo, with CLE course manual and redlined Bankruptcy Code book.

January 2006—Bankruptcy Claims, tips and tricks in buying and selling, CLE panel presentation at the Bankruptcy Committee meeting held during the Annual Meeting of the Business Law Section.

May 2006—Preference Recovery Actions, defending and prosecuting, CLE course by an expert in this field at the Bankruptcy Committee meeting held during the Spring Meeting of the Business Law Section.

Informal educational communications: Throughout the year, on a periodic though unscheduled basis, the membership receives webmail advisories of new cases, advice, and rules that will assist members in their everyday practice. Also, a subcommittee on the reform of the Reform Act is in formation.

Consumer Financial Services Committee

The Consumer Financial Services ("CFS") Committee held a joint meeting with the Banking Law Committee during the NYSBA Annual Meeting on January 25, 2006. Randy Henrick, a member of the CFS Committee, provided an excellent report on developments in the area of privacy, data security breaches and identity theft. Randy discussed several enforcement actions resulting from high visibility data security breaches that affected an eye-opening number of consumers. Randy also reported on an extraordinary number of identity theft cases, vividly demonstrated by a show of hands from the attendees at the meeting who have been victims of some form of identity theft. Randy discussed the federal and state laws that have been enacted to deal with this growing problem. At the Business Law Section CLE Program, Barbara Kent and Warren Traiger, members of the CFS Committee, participated in a spirited discussion in a segment entitled "Redlining Revisited: Are the Fair Lending Laws Doing Their Job?"

The CFS Committee held its spring meeting May 10, 2006. New member Jose Perez, an attorney at the New York State Office of the Attorney General, brought Anikah Singh, an attorney for the Urban Justice Center, as his guest. We were encouraged by their attendance that we might see greater participation on the CFS

Committee by consumer advocate attorneys. Phil Veltre gave a very informative review of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in the context of delivery of retail financial services. Vince Amato led a discussion of the potential impact of SEC Regulation AB on originators and servicers of consumer loan products. Randy Henrick provided an update on his excellent January presentation on privacy, data security breaches and identity theft.

The CFS Committee is encouraging new members representing financial service providers, regulatory agencies, consumer advocate attorneys, and all attorneys interested in this area of the law. Please contact the Chair, Geoff Rogers, at grogers@hudco.com or (518) 383-9591 if you are interested in attending a meeting or in joining our Committee.

Geoffrey C. Rogers, Chair
Hudson Cook LLP, Clifton Park

Corporations Law Committee

Our Committee meetings have continued to be well attended with a head count of approximately 25 to 30 attorneys. We have changed the format substantially over the last year and a half so that we are providing for substantive informal education sections on some of the more cutting areas for corporate practitioners. We have had presentations and panel discussions on the following:

- Opinions in Commercial Transactions—Attorneys' Exposure
- Evolving Standards of Fiduciary Duty
- Directors and Officers Liability Insurance and Indemnification Agreements

The last seminar received CLE credit and this was quite appealing to the membership.

Our Not-for-Profit Subcommittee is moving forward to present its proposed revisions to the Not-for-Profit Corporation Law to the NYSBA Executive Committee in Cooperstown this summer. That Committee has had meetings with a lead attorney in the Charities Bureau who generally indicated agreement with our major proposals for changes.

The work looks promising and we seem to be at the forefront of a number of other groups looking at not-for-profit corporation laws such as the ALI-ABA.

We have a new project which involves dealing with the "majority voting for directors issue" and we are working on that project in tandem with the Securities Law Committee. We also have started a project to examine the New York BCL with respect to changes needed to accommodate technology changes that are occurring in the corporate meeting process: e.g., electronic voting, etc.

At our last meeting in April, we invited Mr. Robert Thornton, who is counsel to the Speaker of the Assembly, and we explored ways of working more closely with legislative committees. He showed interest in a number of areas we were discussing, especially the majority voting for directors topic.

The proposed infamous Publication Bill remains a hotbed of controversy. We have worked in tandem with the representatives of the Real Property Law Committee, the New York County Lawyers Association and the Bar Association of the City of New York. We have had meetings with the Governor's counsel. We have written letters to the Governor's counsel and submitted a formal report on behalf of the Business Law Section. The last activity was a conference call with the Governor's counsel in which representatives of the foregoing committees offered different alternatives to help the Governor's office find a method to increase compliance without creating havoc by imposing joint and several liabilities on the members of non-compliant LLCs. The situation is still a mess and no one is quite sure what will come out of Albany. In all, this is a sad commentary on the legislative process.

Frederick G. Attea, Chair
Phillips Lytle LLP, Buffalo

Derivatives and Structured Products Committee

The Derivatives and Structured Products Committee holds monthly lunch meetings, which generally include a CLE presentation on a relevant topic by a guest speaker. Over the past year, we have heard presentations on the energy markets; the 7th Circuit decision in *CFTC v. Zelener*; prime brokerage and give-up agreements; recent litigation involving derivatives; whether recent cases brought by the CFTC evidence the Commission's attempt to regulate OTC derivatives; Reg AB; the new ISDA CDS on ABS templates; and the ISDA Novation Protocols. The June meeting focused on tax issues affecting derivatives. Our speakers consist of partners at law firms, in-house lawyers, business professionals and regulators, all of whom are experts in their respective fields.

This year, the Committee changed its name from the Futures and Derivatives Law Committee to the Derivatives and Structured Products Committee to reflect the evolution of the derivatives markets and, consequently, the expanded mission of the Committee.

Please refer to the BLS website for our revised mission statement.

Sherri Venokur, Chair
Stroock & Stroock & Lavan LLP, New York City

Franchise, Distribution and Licensing Committee

The Franchise, Distribution and Licensing Committee has been paying close attention to pending changes in the Federal Trade Commission's Trade Regulation Rule on Franchising (the "FTC Rule"). The FTC Rule covers both franchises and business opportunities. What's a business opportunity? In very simplistic terms, a business opportunity is a franchise without a trademark element.

In August 2004, the FTC staff issued a final Notice of Proposed Rulemaking that would make a number of revisions to the FTC Rule. The Commission has not yet adopted the proposed revised FTC Rule.

One of the changes envisioned by the FTC staff is the creation of a separate rule covering business opportunities. In April 2006, the FTC staff issued a Notice of Proposed Rulemaking covering business opportunities. This proposed rule broadens the definition of a business opportunity but simplifies the disclosure requirements. In other words, if the new rule becomes effective, many suppliers who have never been required to make disclosures to potential customers will now be required to make disclosures before they begin doing business with new customers. Unless the comment period is extended, the deadline for written comments was June 16, 2006.

The Franchise, Distribution and Licensing Committee will continue to follow both the progress of the FTC's new franchise rule and its new business opportunities rule. Although we have not made comments to the FTC, we may consider commenting on pending rules in the future. We also intend to look at ways in which New York law might be revised in light of changes at the federal level.

Thomas M. Pitegoff, Committee Member
Pitegoff Law Office, White Plains

Information and Technology Law Committee

On May 10, 2006, the Section's Information and Technology Law Committee held its Spring Meeting at the Harvard Club of New York City. The Committee's Chair, Martin J. Ricciardi of the law firm Whiteman Osterman & Hanna LLP, Albany, New York, led the meeting and discussed the Section's recognition of the Committee's recent actions to change its name from the Internet and Technology Law Committee to the more inclusive Information and Technology Law Committee, and to modernize and broaden its mission statement. Committee member David Shapiro updated the Committee on the status of the software litigation survey we sponsored last year. The Committee authorized Mr. Shapiro to explore ways to complete the survey and fulfill the Committee's intent to make the survey results a useful tool for practitioners.

The Committee heard informative and practical presentations by Thomas A. Cohn, Senior Assistant Regional Director of the Federal Trade Commission, Northeast Region, and Stephen A. Kline, Assistant Attorney General, Internet Bureau, of the New York State Office of the Attorney General. Mr. Cohn gave a thorough overview of the federal CAN-SPAM Act of 2003 (Controlling the Assault of Non-Solicited Pornography and Marketing Act) and its associated regulations, which establish requirements for those who send commercial email, and penalties for those who do so without complying with the law. Mr. Cohn distributed useful informational materials on protecting oneself from illicit spammers and Web marketers. Mr. Kline also made an engaging presentation about the efforts of New York State Attorney General Eliot Spitzer's office to guard New Yorkers against losses of privacy and breaches of data security. Mr. Kline covered in detail the provisions of New York's data breach notification laws (the Information & Security Breach Notification Act, New York General Business Law Art. 39-E) as well as similar efforts in effect in 27 other states. The intimacy of the Committee forum allowed for dynamic exchanges between Committee members and the presenters. More than a dozen Committee members and their guests earned 1.5 CLE credits by attending our session.

Martin Ricciardi, Chair
Whiteman Osterman & Hanna LLP, Albany

Committee on Securities Regulation

The Committee on Securities Regulation had a full schedule of monthly meetings during the last 12 months, with presentations by Committee members and outside speakers. Topics included recent developments and regulatory issues regarding hedge funds and private equity funds, SEC Securities Offering Reform, proposed changes in accounting for pensions and other post-retirement benefits, proposed legislation regarding corporate pension funding requirements, expensing of stock options, implementation of Sarbanes-Oxley internal control of financial reporting requirements, proposed regulation of shelf offerings by The National Association of Securities Dealers (NASD), election of corporate directors by shareholders, waiver of attorney-client privilege in connection with governmental enforcement actions, and proposed SEC regulation of short-term trading in mutual funds.

In addition, during the last 12 months, the Committee has filed comments on 13 proposed regulatory changes and requests for public views with the SEC, the NASD, the United States Sentencing Commission ("USSC"), and the Committee on Corporate Laws of the ABA Section of Business Law. These included a letter urging the USSC to consider changes to the provisions of the United States Sentencing Guidelines for corporations regarding waiver of attorney-client privilege and work product protections. This letter was filed in conjunction with the Executive Committee of the Commercial and Federal Litigation Section and of the Corporate Counsel Section of the Association. Thereafter, President A. Vincent Buzard filed with the USSC the Report of the Association's Task Force on Attorney-Client Privilege urging such changes. The USSC acted favorably on the Report. Members of the Committee participated in the preparation of the Task Force's Report, and the Business Law Section joined in the Report.

Michael J. Holliday, Chair
Lucent Technologies, Inc., Murray Hill, New Jersey

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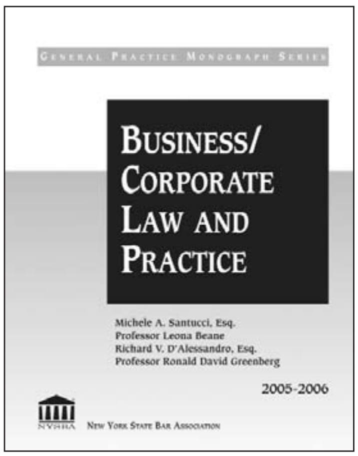

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The Section's Committees are also encouraged to submit for publication in the *Journal* notices of committee events, Annual Meeting notices, information regarding programs and seminars and other news items of topical interest to the members of the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

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