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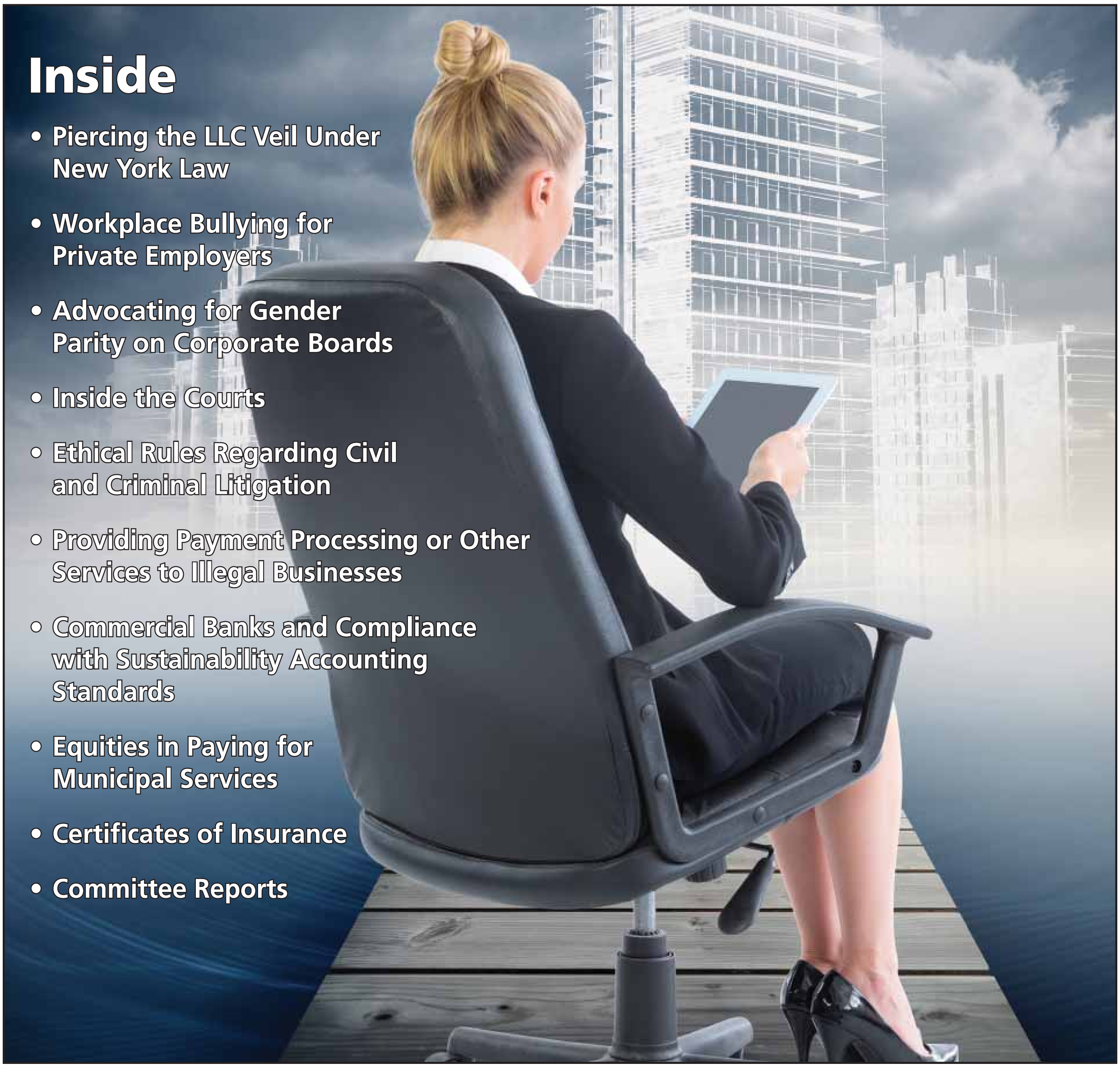

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NY BUSINESS LAW JOURNAL

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HeadNotes

One of the most satisfying aspects of editing the *NY Business Law Journal* is the opportunity to judge the Business Law Section's annual student writing competition. Open to all students enrolled in degree programs at accredited law schools, the competition has produced quality and cutting-edge contributions to the *Journal*. The 2014 competition was no exception; first prize, including a check for $1,500, went to Mr. Richard Jones, a student at New York Law School, for his article in the Summer 2014 edition of the *Journal*, "The Counterintuitive Effects of the Volcker Rule and the Push-Out Rule," which showed how two key provisions of the Dodd-Frank financial reform law could have the unintended effect of increasing systemic risk. Second prize went to Ms. Nithya Narayanan, for "America's Tweak to the Loser Pays Rule: A Board-Insulating Mechanism?" which appeared in the Winter 2014 issue. Ms. Narayanan, who graduated from Harvard Law School this spring, discussed a recent Delaware court decision upholding a by-law provision that would compel the plaintiffs in an unsuccessful shareholder derivative suit to pay the legal costs of the corporation, but would not require the corporation to pay legal costs if it loses. Both students received their awards in person at the Section's spring meeting in New York. At the same meeting, the Section's Executive Committee voted unanimously to increase the potential number of awards per year to three.

Also at the spring meeting, the Executive Committee voted unanimously to oppose legislation that would extend the reach of Section 630 of the Business Corporations Law (see the report of the Legislative Affairs Committee under Committee Reports). Section 630 makes the ten largest shareholders of a New York close corporation personally liable for unpaid wages incurred in the state. The predictable result has been to cause businesses to incorporate in other jurisdictions, usually Delaware. The proposed amendment would extend Section 630 to foreign corporations doing business in New York. While couched in terms of ending "discrimination" between New York and foreign corporations, the effect again is to discourage companies from doing business in New York. In December, with little or no notice to the public, the Legislature passed legislation extending Section 630 to LLCs as well as corporations. Coupled with New York's costly and onerous publication requirement, which benefits no one except a handful of newspapers that carry legal notices, the effect has been to drive essentially all new LLC formations out of state—again, to the primary benefit of Delaware. These enactments continue a discouraging trend of making the State unfriendly to business. They also violate the fundamental principle of limited liability that applies throughout the United States. Governor Cuomo has promoted a well-publicized business-friendly agenda in other areas, such as taxation; his views on this latest extension of Section 630 were not known when we went to press.

We are pleased to announce that, commencing with this issue, the *Journal* has renewed its historic ties to Albany Law School, after several years of working with New York Law School. Concurrently Mr. Stuart Newman, founder of the *Journal* and Advisor Emeritus, has been made Chair of the *Journal*'s Advisory Board. And appropriately, Mr. Newman also has provided our lead article for this issue. In "Piercing the LLC Veil under New York Law," Mr. Newman and Mr. Tyler Silvey, a partner and associate respectively of the New York City firm of Salon Marrow Dyckman Newman & Broudy LLP, examine the development of the doctrine of "piercing the corporate veil" as applied to LLCs. They note that, while only 20 years or so have elapsed since LLCs came into general use in the United States, this form of business organization has surpassed the corporate form in most states (but not New York, most likely reflecting the State's onerous publication requirement for new LLCs, noted above, which the Business Law Section has long opposed). However, while courts have looked to traditional corporate veil-piercing factors (inadequate capital, failure to keep records, et al.) in analyzing veil-piercing issues for LLCs, they have not consistently applied these factors in a way that recognizes the differences between the corporate and LLC forms. Messrs. Newman and Silvey conclude by providing a sensible and practical list of recommendations for lawyers who counsel LLCs to assist their clients in anticipating and avoiding possible veil-piercing scenarios.

Our next article deals with an employment law issue that is coming increasingly to the fore, with potentially significant implications for New York businesses and their attorneys. In "Workplace Bullying for Private Employers: FAQs About Workplace Bullying," Sharon Perella, a partner with Thompson Hines LLP and an expert on employment law, provides a clear and comprehensive overview of the emerging consensus as to what constitutes actionable bullying in the private workplace. While at present "bullying" per se is not prohibited under federal or state law, except to the extent it occurs within the context of otherwise actionable discrimination or tortious conduct, Ms. Perella notes that anti-bullying laws have been adopted in other countries, and legislation has been introduced in the New York State Assembly. As always, one risk of such legislation is the potential for frivolous litigation. But the lesson for businesses and their counsel is to get on top of this issue before bullying—which is increasingly defined to include interfering with an employee's ability to perform his or her responsibilities, as well as verbal or physical abuse—becomes a problem, and for this purpose Ms. Perella's FAQs offer an indispensable guide. The editors are pleased to announce that, in recognition of her ongoing contribution to the *Journal* and its readers in the area of employment law, Ms. Perella has been appointed as a member of the *Journal*'s Advisory Board.

An emerging issue in corporate governance is the relative stagnation of representation of women on corporate boards, which has held steady at around 16 percent in recent years, notwithstanding the demonstrated benefits to the bottom line for corporations with significant numbers of women on their boards. In "Successfully Advocating for Gender Parity on Corporate Boards: Cost Effective, Demand-Side Strategies and Shifting from 'Why' to 'How,'" Amanda Evans, a candidate for the JD degree at the University of Richmond School of Law, presents a thorough, well-written and well-researched discussion of the history of women being represented on corporate boards and the reasons their numbers have continued to lag. Noting that the large percentages of women earning JD, MBA and other advanced degrees have created a more than ample supply of qualified candidates, she goes on to discuss specific strategies focused on the demand side—increasing corporate board awareness of the desirability of adding women—and offers practical guidance on specific strategies to achieve this.

Prepared by the attorneys at Skadden Arps, "Inside the Courts" has been a regular and invaluable feature of the *Journal*, highly prized by our readers. The latest version is no exception, with the usual range of insightful, tightly written summaries of significant current litigation, spanning the gamut of corporate and securities law issues of which all business practitioners should be aware. The editors remain grateful to the team at Skadden for their willingness to share their knowledge and expertise with our readers.

And ditto, our ethics guru Evan Stewart, a partner at Cohen & Gresser LLP and visiting professor of law at Cornell and adjunct professor at Fordham, who continues to grace every issue with his witty insights into ethical questions all attorneys deal with (or, sometimes, fail to deal with) in day-to-day practice. In his latest entry, "Pigs Get Fat, Hogs Get Slaughtered: Keeping Lawyers Out of the Slaughterhouse," Mr. Stewart, as he has in the past, urges our readers to steer clear of buying the proverbial pig in a poke—in this case, enlightening us about two pigs for the price of one. The first revolves around the ethical rule that attorneys may not threaten criminal action in order to gain advantage in a civil litigation. But as always, Mr. Stewart warns that things are never as simple as they seem. Today there are three groups of states: the majority have no explicit ban on such conduct, a handful prohibit it outright, and the remainder—including New York—prohibit such conduct only if it is aimed "solely" at gaining an advantage in civil litigation. But what is meant by "solely?" And what is "threatening," as distinguished from "informing," "calling attention to," et al.? Mr. Stewart's second pig-in-a-poke is the seemingly bright-line rule that attorneys may not, as part of a settlement in litigation, enter into restrictive covenants whereby they agree not to represent certain parties in certain matters and the like. Noting that this rule is often honored in the breach, Mr. Stewart firmly cautions against buying this pig in a poke. As always, his witty and erudite footnotes alone are worth the price of admission.

As a senior counsel at Buffalo's M&T Bank, Sabra Baum brings an insider's practical perspective to issues of banking law, particularly those surrounding payment systems. In her latest contribution, "Providing Payment Processing or Other Services to Illegal Businesses? Beware of Financial Services (and Other) Regulators," Ms. Baum discusses two recent initiatives aimed at involving banks more closely with law enforcement attacks on illegal businesses. The first, "Operation Choke Point," involves efforts by regulators to "choke off" the ability of illegal payday lenders to originate automated clearing house (ACH) debits of customer accounts through the banking system. For this purpose, they invoke the responsibility of banks and other financial institutions to combat money laundering under the Bank Secrecy Act (BSA), an area in which the burden of compliance for all financial institutions continues to expand. The second involves a lawsuit by the Consumer Financial Protection Bureau (CFPB), created under the Dodd-Frank financial reform law of 2010, seeking to impose liability on non-bank payment processors for facilitating illegal or abusive practices by debt collection companies. In recognition of her ongoing contributions to the *Journal*, the editors are pleased to announce that Ms. Baum has accepted our invitation to join the *Journal*'s Advisory Board.

And just in case commercial banks and their lawyers think they finally have a handle on the plethora of federal and state regulators they have to deal with, a potential new one has emerged. In "Commercial Banks and Compliance with Sustainability Accounting Standards," Samuel Gunther, an attorney and CPA, along with attorney Richard Murray and Sheila Gunther, a professor at LIU, describe the structure and function of the new Sustainability Accounting Standards Board (SASB). The SASB traces its roots to the International Integrated Reporting Council (IIRC), an initiative undertaken by Britain's Prince Charles in 2010. Describing itself as a "global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs [non-governmental organizations]," the IIRC's self-appointed mission is to establish worldwide standards for organizations to report, in a single Integrated Report (IR), how they intend to create value over time. The IRs are intended to focus on environmental, social and governmental objectives—collectively often referred to as "sustainability" information—as well as profit-making. Established as a US-based nonprofit sister organization, the SASB has developed non-financial sustainability standards for some eighty types of businesses, including commercial banks. While to date its authority is self-proclaimed, the SASB is seeking to leverage its list of influential supporters to induce the Securities & Exchange Commission (SEC) to make sustainability standards a mandatory part of reporting through the 10-K annual reports filed by public companies with the SEC. Whether this initiative succeeds or not, it is evident that "sustainability" is an emerging issue for businesses, and this timely article by Messrs. Gunther and Murray and Professor Gunther is essential reading for business practitioners.

It is no secret to New York practitioners and their clients that the State's tax structure, and in particular the real property tax, is among the highest in the country. In "Emerging Equities in Paying for Municipal Services—The Problem with the Real Property Tax," Amanda Godkin and Matthew Mobilia provide an eye-opening analysis of exactly why that is so. The State's Constitution exempts religious, educational and charitable organizations from such taxation; as a result, the State Comptroller has estimated that more than 40 percent of the State's real estate, by valuation, is exempt from taxation. At the same time, however, these organizations use and benefit from the municipal services paid for through such taxation. The authors, who recently received their JD degree at Albany Law School, discuss proposals to cause currently exempt organizations to share the cost of these services. Attorneys for both businesses and non-profits are urged to take heed.

Concluding this issue, Elio M. Di Berardino, whose law practice specializes in representing individuals, companies and insurers in litigation, discusses the pitfalls in relying on certificates of insurance. In "Certificates of Insurance: Worth the Paper Upon Which They're Written?" Mr. Berardino notes that such certificates are routinely requested by owners of real property or general contractors to ensure that the subcontractors they hire possess the requisite insurance to perform the work they are under contract to render. But in reality, such certificates do not confer any rights on the holder, and do not amend, extend or alter the underlying policy. So, for example, a certificate purporting to extend coverage to the general contractor as an additional insured may do nothing of the sort. And as in other areas of law, Mr. Berardino cautions that there is a split of authorities, even within the New York courts, on issues such as the significance of the certificate being issued by an authorized agent of the insurer. Bottom line: it is important for any attorney advising a property owner or general contractor to be aware of the limitations of a certificate of insurance.

David L. Glass

Piercing the LLC Veil Under New York Law

By Stuart B. Newman and Tyler Silvey

I. Introduction

The doctrine of piercing the corporate veil is well established across the country's courts and familiar to all attorneys practicing corporate law.[1] A business lawyer can provide advice to corporate clients with a high degree of certainty with regard to what factors a court will analyze and what best practices to employ in order to avoid personal liability for corporate debts and obligations.

Does the same degree of certainty hold true, however, when advising clients who chose to conduct their businesses in the form of a limited liability company, rather than as a corporation? The question is increasingly more relevant as the LLC business format continues to displace corporations as the business entity of choice.

Although it is less than forty years since the first state (Wyoming in 1977) adopted LLC legislation, and less than twenty years (1997) since LLCs were endorsed by legislative action in all fifty states, formation of new LLCs in the United States now outnumbers corporations being formed by nearly two to one, and even more than three to one in Delaware.[2]

In our own state of New York, although LLCs are popular, more new corporations continue to be formed than LLCs—one of only four states where this is still true. (Could this be the consequence of New York's dreaded Publication Requirement? Let's leave that question for another day and perhaps another article!)

The LLC's rapid rise to business stardom, coupled with flexible statutes that govern it, created a scenario in which the courts chose to fall back on various familiar corporate doctrines—like piercing the corporate veil—in parsing through similar problems arising from the governance of LLC entities. This does not work seamlessly across the board, however. Applying the doctrine of piercing the corporate veil in the LLC context, for example, has resulted in criticism.[3] This is because the piercing analysis remains awkwardly transposed onto the LLC context without much nuance or justification, creating uncertainty for both business owners and their lawyers, and hindering the development of an LLC-specific analysis.

To illustrate this, consider the fact that lawyers have always advised their corporate clients to keep the corporation's minute book current, hold periodic shareholder and director meetings and draft minutes for all meetings. A significant reason for doing so is to blunt any argument that corporate existence is a mere sham and should be pierced, with shareholders personally liable for business obligations. Yet, few lawyers advise their LLC clients to follow the same practices, or even draft explicit governance provisions—customary in shareholder agreements—for operating agreements.

New York LLCs and their lawyers could benefit from both clarification at the legislative level and a more LLC-conscious analysis by the courts. As one academic recently wrote, "Courts should put forth cogent reasons for their decisions, rather than blindly applying corporate law principles in what are seemingly analogous situations between LLCs and corporations."[4] For the time being, however, business lawyers should stress the use of safeguards, such as close attention to accounting practices that preserve the integrity of LLC financial statements, and to the drafting of LLC Articles of Organization and Operating Agreements, to minimize the probability of piercing in the LLC context. (See Section IV "Recommendations.")

II. Survey

Every state is affected, to varying degrees, by the issues connected to applying corporate veil-piercing principles to conflicts involving limited liability companies. Where states differ is how predictable the courts are in their analyses and whether—and to what extent—LLC veil-piercing legislation exists: there are states that have demonstrated an unpredictable willingness to pierce where other states would not (e.g., Massachusetts), states that have consistently refused to pierce a LLC's veil (e.g., Maryland), and states that have taken first steps towards clarification at the legislative level (Wyoming, California, Colorado, Minnesota, and North Dakota). Although the overall picture remains inconsistent, the good news is that at least the issue is getting addressed.

A recent Massachusetts appellate court pierced the veil of a single-member LLC for essentially one reason: failure to maintain business records.[5] The decision is particularly noteworthy because, paradoxically, although the court recited Massachusetts' basic test—"The right to look beyond the corporate form should be 'exercised only for the defeat of fraud or wrong, or the remedying of injustice'"—and then reviewed the twelve classic factors commonly examined in corporate veil piercing analyses,[6] it pierced the veil based on one factor without evidence of fraud, wrongdoing, or injustice. The court reasoned that the LLC's complete failure to maintain records hindered the court's ability to address any other factors.[7]

Maryland is at the other end of the spectrum and continues to be one of the states that is most resistant to piercing the LLC veil. The Maryland Court of Special Appeals recently reversed a trial court's decision to pierce a single-member LLC because the appellate court found that defendant did not fraudulently avoid any contractual obligations and that the plaintiff knew he was contracting specifically with the LLC.[8] The appellate court refused to pierce despite the fact that the LLC was inadequately capitalized, failed to live up to several basic contractual obligations, and the sole member lied about key facts pertaining to a transaction.[9] In doing so, the Court reiterated that Maryland is "more restrictive" than other jurisdictions and that the standard has been "so narrowly construed" that no Court of Appeals in Maryland "has ultimately found an equitable interest more important than the state's interest in limited shareholder liability."[10]

Several states have taken steps at the legislative level to clarify piercing the veil in the LLC context. Wyoming—the first state to enact LLC legislation in the 1970s—changed its "Liability of members and managers [of LLCs]" statute by adding: "The failure of a limited liability company to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations or other liabilities of the company."[11] California has similar legislation.[12] On the other hand, states such as Colorado,[13] Minnesota,[14] and North Dakota[15] have enacted definitive legislation that instructs courts to use the corporate veil piercing case law in the LLC context. These additions are not sea changes, but demonstrate that the tides may be turning in the direction of more guidance at the legislative level.

III. State of the Law in New York

New York's shortcomings with regard to piercing the veil of limited liability companies reflect the issues that can be seen across the country: New York's LLC statute does not provide any guidance relating to piercing the veil, while state courts consistently apply the test created for corporations without acknowledging the inherent differences in both entity and context, and at least one recent federal case created more questions than it answered.[16]

New York's LLC statutes do not reference or provide any direction with respect to piercing the corporate veil.[17] Section 609 addresses potential liability of members, managers, and agents, but piercing the veil is not mentioned.[18] Granted, piercing the veil is not referenced under New York's Business Corporation statutes either, but statutory clarification isn't necessary in that context.

Three recent cases paint an accurate picture of New York's LLC veil-piercing doctrine.[19] Two Appellate Division cases serve to show both ends of the spectrum: pierce-worthy malfeasance in the LLC context, and not. The facts of those cases make for relatively easy decisions, but where the facts become difficult the lack of a meaningful piercing analysis becomes more apparent.

New York state courts consistently apply the corporation-oriented analysis without acknowledging the inherent differences between the entities and their respective contexts.[20] Typically, the following test is applied: "[A] party seeking to pierce the corporate veil must establish that (1) the owners exercised complete domination of the corporation in respect to the transaction attacked; and (2) [] such domination was used to commit a fraud or wrong against the plaintiff which resulted in the plaintiff's injury."[21] The factors that a court will consider in determining whether to pierce the corporate veil include: "failure to adhere to corporate formalities, inadequate capitalization, commingling of assets, and use of corporate funds for personal use."[22] Courts aim to pierce the corporate veil "when necessary to prevent fraud or to achieve equity."[23]

In *Colonial Surety Company v. Lakeview Advisors, LLC*, the appellate court upheld a trial court's decision to pierce a single-member LLC.[24] In that case, the defendant admitted to dominating the LLC and further evidence existed that proved that: defendant established the LLC after a prior judgment had been entered against him in order to shield his assets; defendant used LLC funds to pay personal expenses, make payments to his wife "in lieu of his salary," and contributed to his IRA account; and defendant replaced his personal checking account with that of the LLC.[25] As a result of the overwhelming evidence in favor of piercing the LLC's protections, the court concluded that "inequitable consequences would result if we were to permit [defendant] to shield his assets" from his judgment creditor.[26]

In contrast, in *Bonacasa Realty Company, LLC v. Salvatore*, the appellate court refused to pierce the LLC's veil because the principal of the LLC did not exercise his dominion and control to commit a wrong or injustice against the plaintiff.[27] In that case, the defendant-chiropractor executed a five-year lease on behalf of an LLC, and seven months prior to the expiration of the lease term, the LLC vacated the premises and breached the lease agreement.[28] The court explained, "a simple breach of contract, without more, does not constitute a fraud or wrong warranting the piercing of the corporate veil"; the plaintiff did not raise any triable issues of fact as to whether the use of the LLC "was intended for the commission of a fraud or wrong upon plaintiff."[29] As a result, the court refused to pierce the veil.

A 2014 case involving a closely held construction company provides a good example of analysis by the courts in New York, and also underscores the importance of best practices when it comes to the current veil-piercing environment.[30] In *Vivir of L.I. Inc. v. Ehrenkranz*, a New York Supreme Court judge refused to pierce the veil of a small construction company to enforce a $2.2 million judgment in favor of a couple who had entered an agreement with the LLC to purchase land and construct a home.[31] Plaintiffs' argument to pierce was strong: the couple alleged that defendant dissipated all assets of the company in order to become judgment proof; the LLC was never adequately capitalized; defendant commingled funds for both business and personal purposes; defendant specifically took out a large sum of money to repay himself for a loan for which there was no evidence; and defendant made no effort to maintain sufficient documentation of the agreement between the parties.[32]

At trial, the testimony featured a battle of opposing experts—two accountants—and the court ruled against plaintiffs because "the testimony weigh[ed] so evenly that it is required to find that the [plaintiffs] have failed to meet their burden of demonstrating that they are entitled to the somewhat extraordinary relief requested in the context of piercing the corporate veil."[33] The court stated that despite the dominion and control exerted over the entity by defendant, and despite the intermingling of assets as well as underpaid incomes taxes for several years, the timeline and evidence demonstrated that any malfeasance was not done in furtherance of harm or wrong to the couple.[34] Thus, "[t]he real distinction between the case law the Court has reviewed which allows veil piercing and the case at bar lies in the 'purpose' element of the doctrine."[35]

The facts of *Vivir of L.I., Inc.* made for a difficult decision one way or the other, and the court chose to focus on the second, "purpose" prong. The result is not troublesome, but what is problematic in the analysis—particularly for LLCs—is that the four cases that the court used to portray the spectrum of piercing scenarios are not as clear as the court makes them out to be, and involve two single-member corporations, one closely held professional corporation, and an LLC. Of the four cases relied upon by the court, two present pierce-worthy facts and the other two demonstrate the other side of the spectrum. The four cases represent two extremes, and are cited in *Vivir of L.I., Inc.* without much meaningful insight, further delaying the entity-specific analyses that could be developing. The traditional "corporate formalities" cannot be expected of every type of business entity because of the inherent differences in each entity's purpose and setting, yet that fact is ignored in New York's state courts.

IV. Recommendations

New York should take note of the states that have enacted LLC statutes that address veil-piercing. This area of the law could be one in which New York steps to the forefront and goes beyond those other states by outlining a more LLC-conscious analysis. One author recently suggested that states "replace the current haphazard application of corporate veil-piercing doctrine to LLCs by adopting a meaningful standard…embodying an optimal level of complexity to foster socially beneficial—or just—results and further supports a legislatively enacted standard that could include, for example, a cap on damages."[36]

In the meantime, practitioners in New York would do well to institute several of the following practices to ensure that members of LLCs avoid personal liability:

First and foremost, a practitioner should advise a client against being a single-member LLC if at all possible. Aside from tax disadvantages, single-member LLCs inherently invite the piercing analysis and create risks (e.g., intermingling of funds) that could be avoided by having more than a single member. Also, an LLC could avoid similar issues by being manager-managed, rather than member-managed. This management structure could create brighter lines between the entity and its members, and may protect against the risks inherent in a close organization. In New York, the LLC's Articles of Organization should state expressly that the company is manager-managed, not member-managed.

A written operating agreement is also crucial. Although not required under New York's LLC statute—and many New York LLCs opt not to have one—a written operating agreement provides certainty and structure, and a practitioner can draft express language that may help protect the LLC and its members from potential lawsuits. For example, an operating agreement can (and should) expressly disclaim the need for annual meetings as a requirement so that a lack of meetings isn't used as fodder in a piercing analysis. Operating agreements should also expressly limit the personal liability of the manager. The LLC itself should be expressly named as a party to the operating agreement, solidifying the fact that it is an entity separate and distinct from its members.

The practitioner should also counsel LLC clients regarding other basic practices, like adequate capitalization, and, of course, keeping separate books and records. The client should be advised to consult with an accountant to help in those respects—we saw the court in *Vivir of L.I., Inc.* place huge importance on bookkeeping and it essentially shielded the defendant from liability. Lastly, the client should be cautioned to use the full LLC name on all correspondence, not just a "DBA," to underscore that third parties are dealing with a separate legal entity.

Above all, good drafting, common sense and good intentions can reduce the probability of losing or impairing the limitation on personal liability, which is certainly one of the primary reasons for organizing a limited liability company.

Endnotes

1. Some academics disagree with respect to how well established the analysis really is. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036, 1036 (1991) ("Piercing the corporate veil is the most litigated issue in corporate law and yet it remains the least understood."); *see also* Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. Ill. L. Rev. 77, 77-78 (2005) (arguing that veil piercing should be abolished because it is "rare, unprincipled, and arbitrary.").
2. Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 Fordham J. Corp. & Fin. L. 460 (2009).
3. *See*, *e.g.*, Gregory Bell, *Veil Piercing and LLCs: Supporting the Case for a Meaningful, Legislated Standard*, 52 S. Tex. L. Rev. 615, 619 (2011) ("[A]n LLC is not a rehashed corporation; it is a fundamentally

different creation. It has its own parlance, statute, forms, requirements, and procedures. It is only natural that it needs its own independent body of law.").

4. Joshua P. Fershee, *LLCs and Corporations: A Fork in the Road in Delaware?* 1 Harv. Bus. L. R. Online 82, 86-87 (2011), *available at* http://ssrn.com/abstract=1858945.

5. *Kosanovich v. 80 Worcester St. Assocs., LLC*, 2014 Mass. App. Div. LEXIS 34, at *1, *8 (Mass. App. Div. May 1, 2014). In that case, plaintiff purchased a condominium from defendant's single-member LLC and both the trial and appellate courts pierced the LLC and held defendant liable for breaching various covenants in the purchase agreement. *Id*. at *3, *7.

6. *Id*. at *4–*5. The relevant factors to be considered when a court is faced with the issue of setting aside corporate formalities are: "(1) common ownership; (2) pervasive control; (3) confused intermingling of business assets; (4) thin capitalization; (5) nonobservance of corporate formalities; (6) absence of corporate records; (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning away of corporation's funds by dominant shareholder; (10) nonfunctioning of officers and directors; (11) use of corporation for transactions of the dominant shareholders; and (12) use of the corporation in promoting fraud." *Id*. at *5 n.2 (citing *AG v. M.C.K., Inc.*, 432 Mass. 546, 555 n.19 (2000)).

7. *Id*. at *7. Defendant did admit that his recordkeeping was "a bit informal." *Id*. at *6.

8. *Serio v. Baystate Props., LLC*, 60 A.3d 475, 489 (Md. Ct. Spec. App. Jan. 25, 2013).

9. *Id.* at 488–89.

10. *Id*. at 484 (internal quotations omitted). The Court also discussed the Maryland piercing standard, which dictates that piercing should be done when "necessary to prevent fraud or enforce a paramount equity"; the court refused to pierce based on "paramount equity" as the trial court had done, and recognized that no Maryland courts have pierced using that phrase. *Id*. at 484–87.

11. Wyo. Stat. Ann. § 17-29-304(b) (2010).

12. Cal. Corp. Code § 17703.04 (Deering 2013): "A member of a limited liability company shall be subject to liability under the common law governing alter ego liability…except that the failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that a member or the members have alter ego or personal liability."

13. Colo. Rev. Stat. § 7-80-107 (2009): "(1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law. (2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company."

14. Minn. Stat. § 322B.303 (2009): "The case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."

15. N.D. Cent. Code § 10-32-29 (2011): "The case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under North Dakota law also applies to limited liability companies."

16. This Section focuses on the decisions at the state court level, but in *Soroof Trading Development Co. Ltd. v. GE Fuel Cell Systems LLC*, the Southern District of New York uncharacteristically stretched to pierce the veil of an LLC. 842 F. Supp. 2d 502, 522 (S.D.N.Y. 2012) (noting that there was an "overall element of unfairness" to plaintiff).

17. *See* N.Y. Ltd. Liab. Co. Law §§ 101–1403.

18. *See* N.Y. Ltd. Liab. Co. Law § 609.

19. *See infra* notes 24, 27, 30 and accompanying text.

20. *See Colonial Sur. Co. v. Lakeview Advisors, LLC*, 93 A.D.3d 1253, 1255, 941 N.Y.S.2d 371, 373 (4th Dep't 2012) ("It is well settled that the doctrine of piercing the corporate veil…applies to limited liability companies.").

21. *Superior Transcribing Serv. LLC v. Paul*, 72 A.D.3d 675, 676, 898 N.Y.S. 2d 234, 235 (2d Dep't 2010) (internal quotations and citation omitted).

22. *Id.* at 676.

23. *See Morris v. State Dep't of Taxation & Fin.*, 82 N.Y.2d 135, 140, 603 N.Y.S.2d 807, 810 (1993).

24. *Colonial Sur. Co.*, 93 A.D.3d at 1253.

25. *Id*. at 1255.

26. *Id*.

27. 109 A.D.3d 946, 947, N.Y.S.2d 84, 86 (2d Dep't 2013).

28. *Id.* at 946.

29. *Id*. at 947.

30. *Vivir of L.I., Inc. v. Ehrenkranz*, 2014 N.Y. Misc. LEXIS 3222, 997 N.Y.S.2d 670 (N.Y. Sup. Ct. Suffolk Cnty. 2014).

31. *Id.*

32. *See id.* at *1–*2.

33. *Id*. at *40.

34. *Id*. at *41.

35. *Id*. at *42.

36. Bell, *supra* note 3, at 617.

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Employment Law Update
Workplace Bullying for Private Employers: FAQs About Workplace Bullying

By Sharon Parella

I. Introduction

In recent years, workplace bullying has gained increasing attention throughout the United States as a growing number of employees have publicly shared credible accounts of being subjected to extreme abuse by their supervisors and co-workers. Although illegal in several other countries (including Australia, Canada, France, Great Britain, Ireland and Sweden), workplace bullying in private workplaces is not currently prohibited in the United States unless the victim has also endured discriminatory or tortious conduct. Today, workplace bullying alone is not against the law.

Numerous states, including New York, are, however, considering new laws that would prohibit workplace bullying.[1] If enacted, these proposed laws would have grave consequences for workplace bullies and for employers that tolerate malicious conduct in their workplaces. While advocates against workplace bullying are working hard to ensure enactment of the proposed laws, many employers vehemently oppose these laws on the grounds that they are too broad and will invite a flood of frivolous claims from poorly performing employees who have been appropriately disciplined. The crux of the matter is whether a workplace law can be enacted which adequately distinguishes between maliciously targeting an employee for abusive workplace conduct and simply demanding hard work in order to run a profitable business.

The FAQs set forth below are intended as a practical resource for private employers seeking to ensure that their workplaces are free of bullying, as well as for those who assist and guide such employers in maintaining the integrity of their workplaces.

Part II. The Definition of Workplace Bullying

How is workplace bullying defined?

Although there is currently no federal or state law in the United States that prohibits workplace bullying alone in private workplaces, a clear definition of workplace bullying has nonetheless evolved as follows:

(1) Intentional and repeated verbal and/or non-verbal abuse which threatens, intimidates or humiliates an employee (*"abuse"*); and/or

(2) Intentional and repeated interference with an employee's ability to complete successfully work duties and assignments (*"work sabotage"*).

Note: In defining workplace bullying, proposed laws in various states additionally require that the conduct described above caused the target of the bullying to experience health-harming consequences (*please see below regarding proposed laws in the United States*).

What types of workplace conduct are intended to be excluded from the definition of workplace bullying?

First, workplace bullying is not intended to prohibit an employer from engaging in performance management of a poor performer. A manager or other appropriate individual may counsel, warn and/or discipline an employee for performance issues including, but not limited to, insufficient work product, excessive lateness, poor attitude and misuse of work time. In addition, disciplining an employee for engaging in illegal, unethical or dangerous conduct does not constitute workplace bullying. Nevertheless, any counseling, warning and/or disciplining must be executed in a professional manner and in accordance with the employer's applicable policies or procedures. A "tough" or demanding manager who, when enforcing high standards, is respectful and fair would not qualify as a workplace bully.

Furthermore, a prohibition against workplace bullying would not require that managers and co-workers engage in unusual workplace civility or artificial politeness. The concept of workplace bullying is not intended to regulate simple rudeness that is not abusive. In essence, workplace bullying generally does not encompass an employee's unpleasant personality or a random incident of an employee losing his or her temper on a given day. Accordingly, a workplace bully is more than just a "jerk" or an unpopular employee with whom others tend to have personality clashes. The workplace bully intentionally abuses his or her target and does so maliciously, often causing harmful health consequences to the target.

What is meant by "verbal abuse"?

Verbal abuse includes: (1) the target of the workplace bullying is screamed at (with or without profanity), including in front of other employees or in private settings where it is hard to leave (for example, the bully blocks the door); (2) the target's opinions and statements are belittled and ridiculed; (3) the target is subjected to temper tantrums and mood swings; and (4) the target receives excessive critical emails from the bully.

What is meant by "non-verbal abuse"?

Non-verbal abuse includes: (1) the target is physically touched, either by the bully's hands or feet or with the bully's body (e.g., shoving, poking, tripping and kicking), or by objects that are thrown at the target; (2) the bully glares at the target in a menacing way, and/or makes aggressive physical gestures; (3) the bully rips up work documents that have been created by the target in a manner that is physically intimidating; and (4) the target is threatened with physical abuse that does not occur.

What is meant by "work sabotage"?

Work sabotage includes: (1) the target is told that his or her work is unacceptable without any explanation (e.g., constant criticism and "nit-picking"), and/or is micro-managed, given unrealistic deadlines and is asked to do unrealistic amounts of work (e.g., set up to fail); (2) the target is given the "silent treatment," and/or does not get feedback on his or her job performance (e.g., no performance reviews), is excluded from important meetings and business decisions and does not get support or resources; (3) the target is forced to take the blame for another employee's work errors (if the target does well at work, however, the bully takes credit for the target's work product and accomplishments); (4) the target is arbitrarily denied promotions, transfers to other departments, training opportunities, vacations and/or sick leave without legitimate reasons (sometimes leading to job burnout); (5) the bully takes away the target's work functions and areas of responsibility without cause, and/or the target is forced to do menial tasks and is not given enough work to do (rendering him or her useless and putting his or her job at risk); and (6) the target is purposely given incorrect information relating to his or her job duties, and/or the target's work equipment is tampered with (e.g., computer and contents of desk).

What are other types of workplace bullying?

Cruel and constant "teasing" may also constitute workplace bullying. Examples of teasing that may constitute workplace bullying include: (1) the target is made fun of and mocked on a regular basis, and/or is subjected to mean pranks and offensive joking; (2) the bully attempts to exploit the target's known psychological or physical vulnerabilities; (3) the target is spied on or stalked so that the bully can gain personal information to tease him or her with; (4) the target's personal belongings are damaged (e.g., clothes and vehicles); and (5) the bully displays cruel photos or drawings of the target, and/or sends false communications, such as letters and emails, allegedly drafted by the target.

Isolation is another type of workplace bullying, such as the following: (1) the target is routinely ignored, and treated as invisible; (2) co-workers are told not to interact with the target, either at work or socially (co-workers comply because they are fearful; they do not acknowledge the bullying because they suspect that they will be bullied next if they speak up, or they simply do not want to get involved); and (3) the bully spreads false rumors about the target (or even true ones that are personal and spread as malicious gossip).

Cyberbullying is also a form of workplace bullying. The target is tormented on the internet and through email and text messages, even outside of work hours. The target (and sometimes even his or her family) may be ridiculed on social media sites. The target may also be displayed in embarrassing "photo-shopped" images.

Is the bully always the target's manager?

Employees may be subjected to workplace bullying by managers or co-workers. Managers may be subjected to workplace bullying by peers or subordinates. The term "mobbing" has been used to describe the situation where a group of co-workers target and bully another employee.

How does workplace bullying compare to schoolyard bullying?

Schoolyard bullying generally involves one child (or a group of children) tormenting another child. This is similar to workplace bullying where one employee (or a group of employees) engages in abusive conduct directed at another employee, and similar tactics are frequently used to execute the bullying and to intimidate. A child who endures schoolyard bullying may suffer from health harm and educational setbacks or interruptions. Likewise, a target of workplace bullying may suffer from health harm and career and/or financial setbacks or interruptions. In each situation, witnesses may look the other way, whether the witnesses are students, teachers or parents in a schoolyard bullying situation, or managers or co-workers in the case of workplace bullying.

How prevalent is workplace bullying in the United States?

According to studies performed over recent years, workplace bullying is unfortunately quite prevalent in workplaces throughout the United States. For example, a February 2014 survey commissioned by the Workplace Bullying Institute found that 27 percent of Americans have suffered abusive conduct at work, 21 percent have witnessed it and 72 percent are aware that workplace bullying occurs.[2]

Does abusive conduct have to occur on work premises in order to constitute workplace bullying?

Workplace bullying may occur in the workplace or also when employees interact off work premises. For example, a target may be bullied at social events where co-workers are present, or by cyberbullying during non-working hours. A target may also be stalked and tormented during his or her personal time.

Part III. The Current Law in the United States

Is workplace bullying illegal in the United States?

There is currently no law prohibiting workplace bullying alone in the United States. Federal and state courts prohibit workplace bullying only in cases where the bullying conduct relates to acts of discrimination and/or harassment based on protected categories under federal, state or local discrimination laws (such as race, color, religion, national origin, sex, age or disability) and/or retaliation based on the target of the bullying making a report of discrimination or harassment.[3]

In addition, in cases where discrimination or harassment did not occur, courts may protect against workplace bullying under tort laws (such as laws prohibiting the intentional infliction of emotional distress, civil assault and/or battery, intentional interference with the employment relationship, or negligent hiring, training or supervision), or pursuant to an employer's policies on professional conduct (finding a breach of contract if a policy prohibits workplace bullying and the employer does not take steps to correct a bullying situation).[4]

Have any states considered passing workplace bullying laws?

Numerous states, as well as Puerto Rico and the U.S. Virgin Islands, have introduced workplace bullying legislation, and several of these states have active bills pending. For example, on January 22, 2015, New York Assemblymember Steve Englebright reintroduced a workplace bullying bill for the 2015-2016 Legislative Session.[5]

In addition to introducing its workplace bullying bill, in September 2014, California enacted an amendment to its Fair Employment and Housing Act[6] which added prevention of "abusive conduct" as a required component of the two hours of sexual harassment training and education that employers with 50 or more employees are currently required to provide to all supervisory employees within the first six months of an employee's assumption of a supervisory role and every two years thereafter. Under the new law, which was effective January 1, 2015, "abusive conduct" is defined as "conduct of an employer or employee in the workplace, with malice, that a reasonable person would find hostile, offensive, and unrelated to an employer's legitimate business interests." Furthermore, "abusive conduct" may include "repeated infliction of verbal abuse, such as the use of derogatory remarks, insults, and epithets, verbal or physical conduct that a reasonable person would find threatening, intimidating, or humiliating, or the gratuitous sabotage or undermining of a person's work performance." Finally, the new law provides that a single act will not constitute abusive conduct unless such act is especially severe or egregious.

Note: In June 2014, the Puerto Rico legislature passed a bill prohibiting workplace bullying in both the public and private sectors, and requiring employers to prohibit, prevent and remedy workplace bullying. The Governor of Puerto Rico, however, vetoed the bill, which otherwise would have been the first law prohibiting workplace bullying by private employers enacted in a United States jurisdiction.

Note: Tennessee and Utah have enacted workplace bullying laws pertaining to public employers. Specifically, in June 2014, Tennessee enacted a law, known as the Healthy Workplace Act,[7] to incentivize public sector employers to adopt policies to prevent workplace bullying. This law provides that the Tennessee advisory commission on intergovernmental relations will create a model policy for public employers to prevent abusive conduct in the workplace. If a public employer adopts this model policy (or its own equivalent policy), the employer will be immune from lawsuits arising from any employee's abusive conduct that results in negligent or intentional infliction of mental anguish upon another employee (this does not affect the personal liability of the workplace bully). Likewise, effective July 1, 2015, a recently enacted Utah law[8] requires state agencies to train supervisors and employees about how to prevent abusive conduct. Under this law, the required bi-annual training must include the definition of abusive conduct, its ramifications, resources available and the employer's grievance process. In addition, professional development training must also cover ethical conduct and leadership practices based on principles of integrity.

Note: The Healthy Workplace Campaign, which lobbies for the enactment of anti-bullying laws, tracks the status of workplace bullying bills that are introduced in the United States.[9]

Are the laws that have been introduced in the various states similar to one another?

The states have introduced substantially similar bills that are based on a template that was created by Professor David Yamada of Suffolk University School of Law. Specifically, in 2001, Professor Yamada proposed legislation, entitled the "Healthy Workplace Bill" ("HW Bill"), with the intent that it would be enacted in each state throughout the United States. The text of this original bill was based on Professor Yamada's extensive research on workplace bullying and conclusion that there is a need for "status blind" harassment laws (i.e., protection from harassment in the workplace regardless of whether the harassment is based on one or more of the protected categories under federal, state or local discrimination laws). The text of the bill was later revised in 2009.

What are the provisions contained in a typical workplace bullying bill?

The proposed New York HW Bill is illustrative in this regard. The proposed NY HW Bill establishes a civil cause of action for employees who are subjected to an "abusive work environment," and provides, among other things, that: (1) It is unlawful to subject an employee to an "abusive work environment." Affected employees may bring legal actions in court against their employers and/or the bullies who target them; (2) "Abusive conduct" is conduct (acts and/or omissions) that "a reasonable person would find abusive." The severity, nature and frequency of the behavior at issue are relevant when determining whether such conduct is "abusive." "Abusive conduct" includes (i) repeated verbal abuse (such as derogatory remarks, insults and epithets); (ii) verbal or physical conduct that a reasonable person would find threatening, intimidating or humiliating; and/or (iii) the sabotage or undermining of an employee's work performance. Conduct that exploits an employee's known psychological or physical illness or disability is considered an aggravating factor; (3) A single act will not constitute "abusive conduct," unless such single act is especially severe or egregious; (4) An "abusive work environment" is a workplace where an employer or one or more of its employees, acting with intent to cause pain or distress to an employee, subjects that employee to "abusive conduct" that causes physical and/or psychological harm to the employee; (5) One possible remedy is that employers must remove the bullies from their workplaces; (6) Additional remedies include reinstatement, reimbursement for lost wages, front pay and medical expenses, compensation for pain and suffering, compensation for emotional distress, punitive damages and attorneys' fees; (7) Affirmative defenses are available to both employers and purported bullies, and retaliation against an employee who complains about "abusive conduct" is prohibited; and (8) Any action in court must be commenced by the targeted employee within one year of the last incident of "abusive conduct" which is the basis of the allegation of an "abusive work environment."

What qualifies as sufficient health harm under the proposed laws?

Since the laws have not yet been enacted, it is instructive to refer to the types of health harm that targets have claimed to suffer to date. These health consequences include physical and stress-related conditions such as post-traumatic stress disorder, depression, colitis, high blood pressure, cardiovascular problems, chronic fatigue syndrome, skin conditions and panic attacks.

Is there a major difference between the remedies available under the HW Bills and those available under existing federal, state and local discrimination laws?

One significant difference between the remedies available under the HW Bills and those available under existing federal, state and local discrimination laws is that under the HW Bills, a court can order that the bully be removed from the workplace. Specifically, many of the HW Bills state that where a defendant has been found to have engaged in abusive conduct, or caused or maintained an abusive work environment, the court may enjoin such defendant from engaging in the unlawful employment practice and may order any other relief that is appropriate, including, but not limited to, removal of such defendant from the plaintiff's work environment.

Part IV. The Reasons Why Workplace Bullying Occurs

Why does workplace bullying occur in certain companies?

There are several reasons why workplace bullying may occur at a particular organization. These reasons include, among others, that: (1) senior management is too far removed from day-to-day interactions with employees, and therefore is unaware of the bullying ("out-of-touch"); (2) the organization's mandate to maintain a fair and respectful work culture may not be sufficiently conveyed to candidates during the recruiting process (deficient screening process); (3) core values need to re-examined and revised, or restated in a meaningful way (as such, workplace policies are not up-to-date and, therefore, do not include policies which are crafted to protect against workplace bullying) (behind in workplace learning); (4) workplace bullying is not considered in the performance evaluation process (underperforming evaluation process); (5) bullying is part of the corporate culture (senior management regards bullying as useful to increasing productivity, and refuses to terminate, reassign or discipline otherwise well-performing bullies) (institutional bullying); (6) members of senior management are personally loyal to bullying managers, or the bully may readily have management's "ear" (poor management structure); (7) the bully feels insecure about his or her own status at work, causing the bully to diminish a more skilled employee or an employee who challenges the bully's methods for conducting business (schoolyard bully now in the workplace); (8) the bully is immature and/or brings personal problems to the workplace, and his or her conduct is either not detected or ignored by managers (insufficient counseling, training and coaching resources); (9) because workplace bullying is not currently illegal, senior management focuses only on complaints and training about unlawful discrimination and harassment (lack of foresight as to future legal issues); (10) workplace bullying is simply dismissed as one employee acting like a "jerk" towards others (equal opportunity harasser); and (11) without resources to obtain relief from workplace bullying, the target reacts by engaging in "counter-bullying," thereby increasing the degree of bullying in a given workplace (cumulative bullying).

Why are certain employees targeted?

Experts have stated that certain employees are targeted for reasons including: (1) they are very open and share a lot of information about themselves at work; (2) they are threatening to their bullies, either due to their superior skills or for another reason; and (3) they are non-confrontational.

Part V. The Consequences of Workplace Bullying

What are the consequences of workplace bullying?

Targets of workplace bullying may suffer physical and/or psychological harm, including serious physical disorders and stress-related conditions. Among other things, targets have reported feeling ill prior to going to work, feeling disconnected from family and friends, suffering from depression, feeling overwhelming guilt, feeling exhausted and unmotivated, experiencing a loss of interest in anything that they previously enjoyed (such as hobbies), acute stress and anxiety, digestive disorders, high blood pressure, insomnia, post-traumatic stress disorder, reduced self-esteem, musculoskeletal problems, weight fluctuations, panic attacks and phobias. In addition, targets may suffer economic harm. A target may lose his or her job (e.g., get fired, become constructively discharged or resign out of desperation), and/or experience professional or financial setbacks (including due to absences caused by health harm).

For employers, the integrity of the workplace may be significantly affected, and productivity, profitability, morale, absenteeism, retention, recruiting and/or hiring may be impacted. In this connection, millennials, who likely have grown up with anti-bullying campaigns in school, are less likely to tolerate workplace bullying. In addition, co-workers may feel compelled to join in due to their fears of being targeted if they object to the bullying. They may feel a lack of trust in management that has failed to protect the target, and may also suffer health harm (such as stress and depression) based on the bullying that they have witnessed. In addition, workplace bullying results in targets filing workers' compensation and/or unemployment insurance claims. Accordingly, employers experience increased costs relating to these claims and administrative costs to deal with the claims.

Part VI. The Practical Solution to Workplace Bullying

How can an employer avoid and/or eliminate workplace bullying?

To avoid and/or eliminate workplace bullying, employers can take steps including: (1) *training all employees*—from senior management to the most junior staff—on workplace bullying; (2) *enacting clear workplace policies*—against workplace bullying and requiring professional workplace conduct; (3) *emphasizing core values*—those that focus on maintaining an ethical workplace with integrity; and (4) *investigating*—immediately and thoroughly, all claims of workplace bullying, and address bullying behaviors immediately.

How can an employer avoid false claims?

An employer who undertakes a prompt and thorough investigation will be more likely to work out misunderstandings and discover false claims before litigation is commenced.

Endnotes

1. Assemb. 3250, 2015 Leg., Gen. Asssemb. (N.Y. 2015).
2. Workplace Bullying Institute, www.workplacebullying.org (last visited Apr. 29, 2015).
3. *See, e.g., Rivera v. Rochester Genesee Reg'l Transp. Auth.*, 743 F.3d 11 (2d Cir. 2012) (plaintiff was subjected to race discrimination and bullying when taunted with racial slurs and physical gestures by his supervisor and co-workers); *Soto v. El Paso Natural Gas Co.* 942 S.W.2d 671 (Tex. App. 1997) (plaintiff sued for sex discrimination when bullied by a co-worker based on her recent breast cancer and related surgeries). *See also Wasek v. Arrow Energy Servs.*, 682 F.3d 463 (6th Cir. 2012) (bullying not actionable where plaintiff could not demonstrate that sexually explicit jokes and physical touching occurred because of his sex); *Yancick v. Hanna Steel Corp.* 653 F.3d 532 (7th Cir. 2011) (plaintiff could not demonstrate race discrimination by confrontational, rude and disruptive co-worker so no remedy was available for workplace bullying).
4. *See, e.g., LaBozzo v. Brooks Brothers, Inc,* 2002 N.Y. Slip Op. 40222(U), 2002 WL 1275155 (Sup. Ct., N.Y. County, Apr. 25, 2002) (workplace bullying of plaintiff included intentional infliction of emotional distress through derogatory sexual comments, overloading her with work and concealing information necessary for her to do her job); *O'Brien v. New England Tel. & Tel. Co.*, 422 Mass. 686 (1996) (supervisor's malicious bullying of plaintiff by screaming at her, referring to her by derogatory names, reassigning her work to others and giving her poor performance appraisals led to her termination and claim for intentional interference with her contractual relations with her employer).
5. Assemb. 3250, 2015 Leg., Gen. Assemb. (N.Y. 2015).
6. Cal. Gov. Code § 12950.1.
7. T.C.A. §§ 50-1-501 *et seq*.
8. Utah Code Ann. § 67-19-44.
9. Healthy Workplace Bill, http://www.healthyworkplacebill.org/ (last visited Apr. 29, 2015).

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Successfully Advocating for Gender Parity on Corporate Boards: Cost Effective, Demand-Side Strategies and Shifting from 'Why' to 'How'

By Amanda Evans

I. Introduction

The first woman set foot in a U.S. boardroom as a director in 1900,[1] but more than one hundred years later the percentage of women that occupy seats on boards of U.S. publicly traded companies has not yet reached 20%.[2] For the past three years, the numbers have held steady, with women holding around 16% of U.S. board seats.[3] This is a noteworthy statistic, not just because it is strikingly low, but because each year more women than the year before are graduating from MBA and JD programs. There is a plethora of research on how women help the bottom line and decision-making of a company,[4] and more women are "leaning in" through marriage and motherhood.

Additionally, supply is no longer the greatest obstacle to women reaching the boardroom. As of 2013, women earned the majority of bachelor's, master's, and doctoral degrees and also more than one-third of MBA degrees.[5] Thus, the problem now largely stems from the lack of demand and the institutional obstacles in place preventing women from accessing boardrooms of corporations across the country. And as logic would have it, it is now time for advocacy groups concentrated on increasing the presence of women on U.S. corporate boards to shift from the current supply-side strategies to demand-side strategies that focus on changing the corporate perspective and answering the question of how to get women on boards, not just why. This article explores those strategy options and recommends a comprehensive strategy that will most likely turn around the deteriorated advocacy efforts for corporate women directors.

Part II summarizes the history and development of advocacy groups focused on women directors and discusses their recent programs and lack of effectiveness. Part III outlines and analyzes various options that advocacy groups can employ to increase the representation of women on corporate boards, such as expanding the professional networks of men directors, targeting nominating committee members, advocating for term limits, and making use of internet and social media campaigns. Part IV continues this analysis by providing a cost benefit summary and recommending specifically where advocacy groups should commit their resources. Finally, Part V briefly concludes.

II. Background of Advocacy Groups for Women on Corporate Boards

A. History and Development

The wife of Wallace Abbott was elected and served two terms as the first woman director in this country's history in 1900.[6] Thirty-four years later, Lettie Pate Whitehead was elected as the first woman to serve as a director on the board of a U.S. publicly traded corporation.[7] Mrs. Whitehead managed the first Coca-Cola bottler for years before she was finally asked to join the board of the Coca-Cola Company.[8] These first steps by women into the corporate boardroom by Mrs. Whitehead and Mrs. Abbott can largely be attributed to their status as corporate wives;[9] nevertheless, decades later not much has actually changed in the makeup of the average corporate board. Boards continue to be largely dominated by males, mostly white, and mostly middle-aged.[10] As a response to this, in the 1970s, after decades of extremely slow growth in female representation, advocacy groups emerged to focus specifically on women as directors.

One of the very first was Catalyst, in 1962, a non-profit advocating initially for greater equality in the workplace for part-time working mothers and women wanting to break into the corporate world.[11] In 1975, Catalyst broadened its constituency to include women at all levels of the corporate ladder and focused particularly on women board directors.[12] Catalyst is still very active and is one of the most influential organizations, along with several more recently developed groups including DirectWomen, 2020 Women on Boards, and The Thirty Percent Coalition.

DirectWomen was founded in 2007, with the mission of increasing the representation of women lawyers on U.S. corporate boards.[13] DirectWomen focuses on identifying qualified women lawyers for board positions and providing them the resources to get their qualifications into the right hands to become board candidates.[14] Two women corporate professionals organized 2020 Women on Boards ("2020"), another active nonprofit, in 2010.[15] 2020 strives to mobilize all corporate stakeholders in its crusade to raise the number of women on U.S. corporate boards.[16] Its main focus is a national campaign to increase the percentage of women on U.S. corporate boards to 20% by the year 2020.[17]

A similar non-profit organization started in 2011, The Thirty Percent Coalition (the "Coalition"), pushes the goal of "attaining at least 30% female representation across public company boards by the end of 2015."[18] The Coalition consists of several committees made up of institutional investors, elected officials, senior executives, and other corporate governance and market actors that work together to help bring awareness to the lack of women on U.S. corporate boards.[19]

B. Current Focus and Effectiveness

Since Catalyst sparked advocacy group support for the inclusion of women on corporate boards several decades ago, the style of advocacy has remained relatively stagnant. Catalyst began by raising awareness about the capabilities of educated women and providing resources directly to women about employment opportunities.[20] The current focus of advocacy groups is still almost entirely on raising awareness and inspiring discussion about gender equality in the boardroom.

2020 expends its efforts mainly in conferences and events that discuss the benefits that women bring to the corporate boardroom.[21] 2020 hosts the National Conversation on Board Diversity, which is a one-day, simultaneous event in several cities across the country that highlights a conversation about what it will take for the U.S. to increase the representation of women on its public company boards.[22] DirectWomen takes a similar discussion-based approach in organizing the DirectWomen Board Institute.[23] The institute is a two-day program for twenty selected women attorneys, with the goal of positioning this elite group for service as directors of major U.S. corporations.[24] But, this event solely focuses on educating women lawyers on resources and opportunities to *position themselves* as director candidates.[25] It does not touch on educating or mobilizing the corporate actors and institutional systems that are currently involved in preventing the selection of women as corporate directors.

While in 1975 these awareness and resource campaigns were an appropriate and useful tactic for change, these efforts have clearly not succeeded in increasing the percentage of women on boards to anywhere near the advocacy groups' goals. Producing programs focused on why corporate boards should select women as candidates, and not on how to specifically make this happen, is no longer an effective use of resources. Interestingly, advocacy groups outside of the U.S. have already shifted from this "awareness" strategy to a more direct one.[26]

In Europe and Australia specifically, advocates are actively pursuing change by mobilizing male corporate directors, petitioning governments, and achieving considerable progress as a result. Australia is a particularly relevant example for the U.S. because Australia has a fairly low representation of women in corporate boardrooms, but it has in recent years seen measurable progress that the U.S. has yet to achieve.[27] Since development of a new approach to gender diversity efforts, the number of women on the boards of the Australian Stock Exchange (ASX) 200 increased by an impressive six hundred percent.[28]

Internationally, the popularity of mandatory quotas for women on corporate boards has drastically increased in recent years. Unsatisfied with the large support for gender diversity and lack of anything to enforce it, several countries over the last decade have administered quotas to require corporate boards to elect a specific number of women to their boards.[29] Globally the support for these quotas has gone up nearly 10%, from 37% in 2013, to 45% in 2014.[30]

Norway was the first country to introduce such a quota in 2003.[31] It requires that "where there are nine or more members of the board, each gender should be represented with at least 40%."[32] Since introduction of this quota, Norway has seen an extreme jump in numbers, as required by the law.[33] In 2004 women made up only 15.9% of corporate boardrooms (very similar to the numbers in the U.S.), but by 2009 that number was up to the goal of 40%.[34] While quotas are the most direct way to essentially force change, they are not right for every country and culture.

In America's individualistic society, where each citizen is theoretically entitled to equal opportunity as an individual rather than as a member of a group, this type of hardline regulation will likely not be a good fit. While imposing a quota seems like the natural reaction to the years of excuses and lack of progress, enforcing such a regulation in the U.S. would be extremely difficult given the culture. American women want to be added to a corporation's board because of their ability to contribute and based on their skills, not simply because they are women.

The main advocacy groups, such as the Coalition and 2020, seem to understand that quotas are likely not the best answer to the boardroom gender diversity problem in the U.S.[35] Both organizations expressly state in their marketing materials that they do not advocate for quotas to enforce female board representation.[36] These groups are advocating for a more inclusive workplace environment for women professionals. Arguably, quotas might raise the numbers artificially, but they would have a negative impact on gender diversity with regard to the boardroom environment. When companies are forced to reach a gender quota, the women board members will almost inevitably experience crippling tokenism.[37] Tokenism will force these women to withdraw from the group, as they will be highlighted as "the women" on the board and face excessive scrutiny.[38] This effect prevents women directors from reaching their full potential, and from being able to work in an inclusive environment that fosters their success.[39] Consequently, more market-based and institutional solutions need to be explored by advocacy groups.

The Coalition has emerged in the last two years with the most demand-side strategic programs to support their female board representation advocacy efforts. In 2012, the Coalition sparked its campaign to send public letters to the companies on the S&P 500 that do not yet have women on their boards.[40] The Institutional Investor Committee followed up the letters with the filing of twenty shareholder resolutions during the 2013 proxy season.[41] The resolutions urged the companies to adopt charter language that commits them to diversity and to include women on their boards.[42] Eighteen of those resolutions were withdrawn, but withdrawal was accompanied by a mutual agreement to adopt a commitment to gender diversity.[43] Three resolutions went to a shareholder vote, and one actually received a majority of the votes cast.[44]

This shows the beginning of a shift in focus from equipping women with the right resources to succeed to pursuing corporate boards to make a commitment and actually seek out qualified women board candidates. The next step is to further target these solution efforts; shareholder proposals urging gender diversity don't speak to the very specific reasons that women are often left off of director ballots in the first place. This type of general campaign for gender diversity does not reach the precise corporate actors or mechanisms that can most effectively produce change.

III. Strategies for Advocacy Groups Going Forward: Whom to Target and How to Target Them

What is immediately clear upon surveying the current state of advocacy groups focused on increasing the number of women in U.S. boardrooms and the lack of progress is that the fix will not be a simple one. Advocacy groups need to craft a balance of targeted solutions that will most productively use the time and money available. Among the possible solutions that address specific stumbling blocks to women's access to corporate boards are: (1) expanding the networks of male board members; (2) targeting nominating committees through proxy advisors and shareholders; (3) advocating for term limits and/or benchmarks to increase board turnover; and (4) general market-based, social media campaigns.

A. Expanding the Professional Networks of Men Directors

It might sound simple, but what is one very effective way to get a male-dominated field to become more inclusive of women? Target those men and get them more intricately involved in the solution to this problem.

A sizable barrier to qualified women finding their way onto corporate boards in the U.S. is the process of candidate selection. The corporate elite of predominately male directors drives the board nomination process. Generally, board candidates are selected from the personal network of current board members.[45] The selection process has become significantly more investor friendly in recent years, but the bottom line is that current board members have extreme control over new director candidate selections. This poses a significant threat to diversity when the current board members don't have qualified women in their immediate professional network. Consequently, advocacy groups would benefit from a nationwide gender diverse networking program, which will open women up to board seat opportunities (like some already existing initiatives), but will also provide many sitting directors across the country with more women in their professional networks and thus in their "pool" of potential board candidates.

The Australian Institute of Company Directors organizes a program of this type that has proven successful.[46] The concept is a practical and targeted way to increase the number of women in corporate boardrooms. What is characterized as a "mentoring" relationship is structured every twelve months, and mentees are matched with mentors in their preferred industry and region.[47] The program is specifically designed not only to mentor corporate women but also to "enhance the connections of chairmen and experienced directors…with experienced and skilled women who may be suitable for director roles."[48] Essentially, the benefit that emerges from this program is the placement of professional women in the network of men directors who likely can get them into a director seat.

Advocacy groups in the U.S. should emulate this idea of a mentoring program, which essentially functions as a networking group. The program's goal can be stated as diversifying the currently male-dominated director network and ideally placing women professionals with men director "mentors" whose overarching goal is to place them on a corporate board as soon as possible. Another aspect that will increase the success of such a program is expressly providing each man involved with the goal of placing his networking partner in a board seat. The names of each director who accomplish this goal should be published in a yearly report that is circulated to participating directors and posted publicly online. Corporate directors are inevitably motivated by their instinctual competitive nature and by fear of personal fault.[49] Ideally, in a new role as a mentor/networking partner a director will not want to be held personally liable for failing his partner, and will feel a competitive urge against his peers to accomplish this goal.

Seemingly, this program will take relatively few resources, as it can likely be coordinated online, with potentially one or two in-person events annually. But irrespective of any resources expended, it will have a great impact in providing men the needed opportunity to expand their networks. Many men on corporate boards across the U.S. support the need for gender diversity and believe women will benefit the corporate governance of their organization.[50] The problem lies in their lack of involvement in becoming part of the solution to the problem. If advocacy groups can provide them the infrastructure to foster relationships with women corporate professionals, then quantifiable change will occur.

B. Targeting Nominating Committees

Another option is for advocacy groups to target nominating committees and their chairs directly. Even if all other efforts are in place to provide the network of women, provide the motivation to include women, and provide women the resources to make it to the board level, nominating committees must actually select these women as candidates. Among the steps which advocacy groups should take are the following: (1) lobby for proxy advisors to recommend voting against a nominating chair if the chair continues to fail to nominate women; and (2) specifically target shareholders at strategically chosen corporations to withhold votes from nominating committee members.

i. Proxy Advisors and Voting Recommendations

Many institutional investors in the U.S. that have comparatively small holdings in a very large number of stocks subscribe to proxy advisors to obtain research and recommendation services on how to cast their proxy votes.[51] Proxy advisory firms research proxy issues, make voting recommendations to clients, and often electronically submit their client's votes.[52] Most institutional investors that use these firms hire one of the two largest firms, Glass, Lewis & Co ("Glass Lewis") or Institutional Shareholder Services (ISS). Accordingly, these two advisory firms have great weight and essentially set corporate governance standards.[53]

Proxy advisory firms affect corporate governance all the way down to the committee level, recommending votes for or against committee members based on their performance. Therefore, advocacy groups can and should lobby for proxy advisors to recommend voting against the chair of a nominating committee if the committee is consistently failing to nominate women as board candidates and has taken no steps to make a change. Advocacy groups should target solely Glass Lewis and ISS, as the most influential firms. This approach will use fewer resources, but if successful will have a powerful impact because ISS and Glass Lewis effectively set the proxy votes for thousands of investors.

This could be viewed as an impractical goal to be taken on by a comparatively small group of advocates, but public opinion and outside pressures (such as advocacy groups) can and *have* influenced proxy advisors. ISS states directly, "they attempt to incorporate the views of the corporate governance community and the market in formulating their policies."[54] Advocacy groups and public opinion are clearly part of the corporate governance community that ISS is likely considering.

The recent uproar over executive compensation proves this point. Currently, Glass Lewis, along with ISS, recommends voting against the chair of the compensation committee at a corporation if the committee continually "maintain(s) poor compensation policies year after year, without showing they have taken steps to address the issue."[55] A June 2014 study on public opinion and proxy advisor voting recommendations found that negative public opinion concerning executive compensation was directly associated with ISS's recommendation decisions on the subject.[56] Focusing on obtaining this voting recommendation from ISS/Glass Lewis, along with increasing media coverage and public support for gender diversity, would use resources well because the possible reward is so great.

ii. Influence of Shareholder Voting

Advocacy groups could supplement these lobbying efforts by initiating direct contact with shareholders of specific large corporations with no women on their boards to encourage shareholders to withhold their votes from nominating committee members. In a 2009 study on the process of electing directors at U.S. corporations, Jie Cai noted how important shareholder votes can be, even in a corporate governance environment where most directors run uncontested.[57] He found that just a "1% decrease in the average vote" for compensation committee members, because shareholders were not happy with compensation committee performance, resulted in a decrease in CEO pay.[58]

While it may be hard for shareholders to oust individual nominating committee members who continuously fail to increase gender diversity and run uncontested, they can make a difference in a board member's actions through withholding votes. This sends a message that the shareholders are unhappy, and arguably even without a direct threat of being removed from the board, human nature will motivate directors to take action to increase their votes. Advocacy groups need to determine the best corporations to target and contact those shareholders through a pairing of letters and emails to inform them of their nominating committee's failing gender diversity record, encouraging them to withhold votes from their nominating committee members in an effort to incite a change in their selection of board candidates.

To help decide which corporations to target, advocacy groups should research which large corporations have nominating committee members who are parents of one or more daughters. An extensive report published by a Yale University Professor in 2008 found that a legislator's inclination to vote liberally on issues involving women increases with the number of female children parented.[59] She hypothesizes this is because the legislator views that vote as one that will have a direct impact on his or her daughter.[60] If parenting a female child affects legislative decision-making, it follows that it would also affect corporate decisions made by board members.

This type of campaign would follow up on some of the work already done by the Coalition in sending letters to corporations in the S&P 500 that, as of 2013, did not have any women board members.[61] The Coalition, as recently as October 20, 2014, broadened this public letter campaign by adding another 100 corporations from the Russell 1000 index that also lack women on their board.[62] In 2013, the letter writing campaign resulted in eight companies electing women board members and nearly forty other companies engaging the issue of gender diversity.[63] Pursuing nominating committee members on a more direct and personal level, by pressuring them through their shareholders, will likely be a better use of resources than sending out hundreds of impersonal letters that accomplish mostly awareness, not active change.

If this outreach strategy is paired with a planned social media blitz,[64] then it will likely not only affect those corporations, but also will threaten other corporations that the same attack might be launched against them, causing them to make gender diversity a priority on their own.

C. Term Limits and Board Turnover

The board level gender parity problem can also in large part be attributed to the lack of turnover on corporate boards in the U.S. According to a recent study by Ernst & Young, 45% of *all board seats* in the U.S. are held by directors with at least 10 years of tenure, and 88% of those directors are men.[65] Therefore, similar to the networking issue, even if an all-male board is aware of the benefits women bring, the nominating committee is willing, and the committee has women in mind to nominate, they simple cannot nominate women directors until spots are available on the board.

Currently, only 3% of corporations in the S&P 500 have term limits; that means only sixteen corporations out of five hundred set a term limit for their directors.[66] Almost all corporations in the S&P 500 have terms of one year, with annual director elections.[67] But, in reality, directors run uncontested and almost always receive the votes of every shareholder.[68] So the power really lies with the board and the nominating committee, which routinely re-nominates sitting directors. Therefore, without term limits these directors could serve for decades with no challenge.[69] And with the retirement age increasing over the past two decades, the board turnover rate is drastically decreasing.[70] The turnover rate in 2013 is a full 14% lower than it was a decade ago.[71]

Director tenure and experience are often beneficial for corporate performance and a board's decision-making process, since a tenured director becomes intricately aware of the industry and the board's processes. But, natural director turnover invigorates the board with fresh perspective, and entrenched boards are often adverse to change to the detriment of their shareholders. Thus, *reasonable* term limits could help to meld these two competing interests by opening the door for boards to start filling seats with women professionals who hold new perspectives, while also holding on to directors with necessary experience that benefits the board's decision-making.

There is a long tradition of support for tenured and experienced directors,[72] but it is clear that support exists within the director community for increased board turnover. PricewaterhouseCoopers ("PwC") surveyed directors across the country and found that 35% of directors believe that someone in their boardroom needs to be replaced because of aging, lack of care, or diminished performance.[73] If advocacy groups push for term limits, in tandem with expanding the personal networks of men directors to include professional businesswomen, qualified women are the most likely demographic to step into the shoes of these spent board seats that need refreshing.

When considering the board makeup of the sixteen S&P 500 companies that do have term limits, the case becomes even stronger that this will actually occur:

- Wal-Mart's board of directors has one of the shortest term limits in the country, at ten years.[74] Four of the company's board members are women, and one of those women chairs the nominating committee.[75]
- The term limit at Varian Medical Systems is slightly above the lowest, at twelve years,[76] and its board includes two women, one of whom chairs the compensation committee.[77]
- Frontier Communications has a slightly longer term limit, at fifteen years,[78] and its board has five women, one of whom is the Chairman of the Board.[79]
- Target has a term limit of twenty years,[80] and its board includes three women, two of whom chair the audit and nominating committees.[81]

These numbers are striking when you consider that across the country the average number of women in a boardroom is 1.9.[82] The corporations that have decided on their own to institute term limits are consistently exceeding this average.

In order to advocate successfully for more corporations to institute term limits, the positive attributes of experienced, tenured directors must be recognized. Accordingly, a reasonable term limit to push for that will still allow for necessary director experience is likely in the range of eight to ten years. Eight years allows for sufficient time for experience to be acquired, and allows for enough board refreshment to positively affect female representation numbers.[83] In fact, only 9.38% of male directors with ten-plus years of tenure would need to be replaced to reach 20% female representation on corporate boards in the S&P 500.[84]

i. Shareholder Proposals for Term Limits

The Securities and Exchange Commission (SEC) allows investors who have continuously held stock worth $2,000 in market value or 1% of the corporation to file a shareholder proposal recommending a certain course of action for the corporation.[85] Therefore, institutional investors, who certainly meet these criteria, are able to file shareholder proposals on issues they desire to change in corporate governance. The relevant advocacy groups should organize and sponsor institutional investors they are affiliated with to file shareholder proposals for director term limits or mandatory benchmarks.

The Coalition could partner with other advocacy groups, such as 2020 and Catalyst, to task its own Institutional Investor Committee with pushing forward this type of shareholder proposal initiative. The Coalition is clearly aware of term limits as a barrier to gender equality. Charlotte Laurent-Ottoman, the executive director of the Coalition, characterizes term limits as a stumbling block for women, stating that "[i]f you are not renewing your board, regardless of who your candidates are, except for every 10 to 20 years, then you are obviously not going to bring any new candidates in."[86]

Shareholder proposals regarding term limits are the next logical and more pointed step following the Coalition's successful proxy season in 2013, where after twenty-five shareholder proposals, eighteen companies made agreements to commit to diversity and one proposal received majority support from the company's shareholders.[87] It would be productive for these new proposals to begin at corporations with no term limits *and* no women directors, in order to have the most impact. Generally, shareholder proposals have gained popularity and success in recent years. Corporations are taking corrective action as a result of these proposals, evidenced by the disappearance of some of the most historically popular shareholder proposals in the 2014 proxy season because those corporate governance changes were actually made.[88]

Considering the fact that only 3% of corporations currently have term limits and that feelings are mixed about what long tenure means for corporate governance, corporations are unlikely to happily accept and vote on these proposals.[89] But submitting the proposals for term limits in the name of board refreshment to allow greater gender diversity will turn heads. The proposals could also result in mutual agreements to institute benchmark commitments, which will at least highlight the issue of board turnover as a stumbling block for women attempting to obtain boardroom seats.

Various countries have enforced through regulation this type of benchmark, where corporate boards must recognize and consider director tenure after nine to ten years.[90] At this benchmark, often the corporation must communicate with its shareholders if it decides not to remove the relevant director, providing the corporation the flexibility to make an informed decision to keep a director on after nine years of service.[91] If shareholders are looking to the board to increase gender diversity, then at each benchmark the board will be held accountable to consider diversity seriously. This is a very practical thing that companies can do themselves (without being forced by regulation) in response to term limit proposals, in order to show commitment to gender diversity, while also alleviating some director independence concerns that come with long board tenure. Considering recent proxy season history, benchmark commitments from at least a portion of the companies targeted with shareholder proposals is a realistic possibility.

ii. Proxy Advisors' Support for Term Limits

During the 2014 proxy season ISS recommended voting against director term limits.[92] But it did recommend special consideration for directors that have a tenure of more than fifteen years, to allow reflection about sufficient independence and also to consider if there are sufficient perspectives on the board.[93] Interestingly, when asked for comment on ISS's 2014 proxy season recommendations, 74% of investors responded by saying that long tenure is clearly problematic.[94] This indicates that while institutional shareholders have not yet proposed or voted for director term limits, they are concerned about "board refreshment."

As previously discussed, proxy advisors carry great weight with regards to corporate governance, so lobbying for a harder stance on term limits will benefit advocacy group efforts. Groups should start to lobby for ISS/Glass Lewis to recommend a more specific and aggressive benchmark or to recommend voting for reasonable term limits. At least recommending a benchmark for special consideration at ten years, as opposed to fifteen, would push corporations to sooner consider board refreshment as an important corporate governance matter.[95] Lobbying for a recommendation to vote for term limits may be a low probability undertaking, but it is an undertaking that would realize great reward. This reward will be amplified if advocacy groups are successful in gaining ISS and Glass Lewis's support to both recommend voting against nominating chairs that have poor gender diversity policies *and* for term limits and/or benchmarks.

At first glance, term limits appear ancillary to the gender parity issue, as opposed to issues like professional networks and nominating committees. But they are still very important to successful advocacy at this stage, because opening up board seats is an essential step in getting more women in the boardroom. Therefore, bringing the term limit issue to the attention of specific large corporations will be necessary in order to help corporate directors make the important connection between term limits and gender parity in their boardrooms.

Advocacy groups should first pinpoint which corporations in the S&P 500 have one or more directors that have been in service for fifteen years or more.[96] These corporations should receive letters identifying this long tenure as problematic, informing them that ISS/Glass Lewis will be targeting these directors and may soon be recommending votes against directors with long tenure and for instituting term limits. The letter should also present the opportunity to now nominate women to replace these long-tenured directors and how term limits could help their gender diversity. The lobbying efforts discussed above, in tandem with these direct outreach efforts, will bring measurable change in adding to both the list of corporations that have term limits and to the list of corporations that have women on their board.

iii. Possibility of SEC Regulation on Term Limits

The SEC will likely not support a bright-line rule for term limits without significant institutional investor support. In 2009, the SEC enacted a disclosure requirement on diversity generally.[97] This new rule was motivated by the SEC's desire to require American corporations to address the commitment "to developing and maintaining a diverse board."[98] The SEC wanted to enable investors to make better voting decisions, by allowing them access to how diversity is being considered by issuers.[99]

PwC's 2010 annual corporate director survey reported that directors simply did not take the disclosure requirement seriously.[100] When asked if the new proxy disclosure rule on diversity caused the board to "re-think the mix of directors currently on the board," two-thirds of directors simply answered "no."[101] Given these challenges to the diversity requirements and how many constituencies are encompassed in the term "diversity," committing resources to lobbying the SEC is likely not a fruitful exercise. Additionally, many advocacy groups do not support regulation as the best way to attack the gender parity issue in the U.S. if groups hope for long-term, sustainable change.[102]

D. Market-Based Solutions and Social Media Use

While the strategies for increasing the number of women on corporate boards have not changed much in thirty years, technology and the ways in which society obtains news and information certainly have. With the advent of the Internet and the increasingly pervasive nature of social media, advocacy groups are beginning to make use of social media and publicity campaigns, and need to continue to do so in tandem with other strategies outlined above.

Consider, for example, the influence of a print advertisement placed in the *Wall Street Journal* more than a decade ago. Activist shareholder Robert Monks bought a full-page advertisement to promote his shareholder proposals to Sears, after the board fought against and rejected his suggestions.[103] The advertisement included the pictures and names of every board member, titling them "Non Performing Assets."[104] Five months after the advertisement ran, the proposals had not only been considered, but many were adopted.[105]

If this one-time, "seen and gone" print advertisement could have such an effect, then the current forms of social media will have a remarkable effect on corporate boards if advocacy groups make better use of them. Advocacy groups should craft an advertisement, similar to Monks' advertisement, that depicts the board members of large corporations that lack women directors and have particularly long-tenured directors. In order to foster the connection between the small number of women in boardrooms and the absence of term limits, a caption atop the picture could read something similar to: "These Directors Have Been in Service for a Combined 150 Years," paired with phrasing at the bottom of the advertisement that reads "What Is Missing From this Picture?" or "Find the Woman in This Picture." If the advertisement was then circulated on social media, online business journals, and blogs it would undoubtedly impact the actions of those corporate boards, similar to the impact on the Sears board.

Negative corporate governance publicity is the enemy of a corporate board in the aftermath of the financial crisis of 2008 and the scandals of the early 2000s. A study published in the *Journal of Financial and Qualitative Analysis* in 2009 posits that negative exposure surrounding corporate governance[106] is likely to have a significant effect on a board, resulting in swift corrective action.[107] This is also consistent with a corporate survey performed by Harris Interactive that ranked negative press as the greatest threat to corporate reputation.[108] Using resources to target those few large corporations with the worst gender diversity records will hopefully trickle down to affect the entire market. If advocacy groups can have such an effect through the media on larger corporations, then smaller companies will likely be threatened to make gender diversity changes on their own accord.

Advocacy groups can also use various kinds of online campaigns separate from other initiatives at a very low cost, with high reward. Despite labor costs to craft these marketing campaigns, making use of social media platforms to garner support for more women on corporate boards is essentially free. Each of the most influential advocacy groups has an Internet and social media presence, but it is important to note how ineffectively they are currently using it, with the exception of Catalyst.

Catalyst recently launched their "Men Who Get it" campaign to help accomplish the goal of including more men in the gender parity conversation. The campaign has sparked a wildly successful Twitter movement with the hashtag *#menwhogetit*.[109] Twitter users place the hashtag *#menwhogetit* on their posts about women becoming successful in male-dominated boardrooms. Two hundred and eighty-four million Twitter users[110] can access each post that is tagged *#menwhogetit* in mere seconds; consequently, this type of campaign reaches constituencies the organization may never otherwise reach.

"Men Who Get It" also has a video blog series that highlights interviews with male professionals discussing specific anecdotes about the importance of gender diversity, the current obstacles, the benefits of women as directors, and how they have successfully changed their businesses structure to be more inclusive of women.[111] By their very nature, board members want to keep up with their peers, so an online video series such as this encourages directors to become involved in advocacy efforts and shows how they are helping the issue along with their peers.

2020 and the Coalition, two of the other most active and influential groups advocating for women corporate directors, are simply not making use of social media to the level of Catalyst. 2020 has a mild Twitter presence with 11,000 followers,[112] but the Coalition has a minuscule following with only 378 users subscribing to their page.[113] In the age of campaigns like KONY 2012,[114] these groups need to realize that online and social media presence is one of the most cost effective ways to engage stakeholders and influence public policy. With one marketing idea, such as *#menwhogetit*, an advocacy group can reach millions of people in virtually seconds, many of whom are on boards, have daughters, are businesswomen, and are active players in the corporate world.

While there are clearly more "formal" ways to trigger change in corporate structure and influence public policy, reality tells us that social media, despite its seemingly infantile nature, is a productive way to reach a wide audience and interact with a wide range of constituencies.

IV. Cost-Benefit Analysis[115]

In order to accomplish their goals and be the most cost effective, advocacy groups should focus their resources on the strategies that have the most hope for quick reward and use the fewest resources possible. Overall, the initiatives chosen should be paired with an increase in social media campaigns, which can be done for very low cost and an essentially guaranteed high benefit. Specifically, the strongest truths about the lack of gender diversity on corporate boards are that in order for women to more consistently make it into the boardroom at higher numbers, there must be (a) spots available to them and, considering the realities of the director election process, they (b) must be in the networks of some of the most powerful men directors in the country.

First, this should make the board member networking program an almost guaranteed beneficial strategy. Second, encouraging more corporations to institute term limits should be a high priority, paired with targeting nominating committees members to ensure that when spots do open up, nominating committees members will in fact choose women as board candidates.

The resources put towards encouraging term limits should focus primarily on lobbying ISS/Glass Lewis, instead of pushing a number of shareholder proposals on the issue. In 2014, ISS reported that 901 shareholder proposals were submitted, but only 432 of them went to a vote and those proposals only averaged support of about 32%.[116] Although these numbers showed a positive trend from the preceding year's statistics on shareholder proposals,[117] it is still a low value strategy. The number of successful shareholder proposals that could potentially emerge from this effort would likely increase awareness more than anything else[118]—but it is clear that more than just awareness is needed at this stage. Even just obtaining a more hardline benchmark recommendation from these powerful advisory firms would likely have a more concrete impact than a collection of shareholder proposals that may or may not even make it to a vote.[119]

Lobbying for ISS/Glass Lewis to not only support term limits but also to recommend voting against nominating committee chairs that have poor gender diversity records is likely the best tactic for targeting nominating committees. While this strategy doesn't speak *directly* to the networking or board turnover mega issues, threatening nominating committee chairs with removal is a more aggressive tactic that will encourage male board members to actually use their new network of women professionals when selecting candidates. Additionally, the lobbying effort will likely use fewer resources, since it doesn't require planning, advertising, and coordinating an effective program.

Overall, lobbying ISS/Glass Lewis holds great potential, considering the power of ISS/Glass Lewis and their recent influence over executive compensation. In a study by The Conference Board, it was revealed that a staggering 70% of companies shaped their compensation programs to conform to proxy advisor recommendations.[120] Pushing for dual recommendations (on nominating committee chairs and term limits) is also a profitable tactic because it does not require splitting up resources to target a completely different corporate process.

While focusing on particular corporations with low gender diversity records and encouraging those shareholders to withhold votes from nominating committee members is certainly worth consideration, it may not be the most fruitful choice. Logic says that if advocacy groups can be successful in forcing gender diversity progress at large prominent corporations through their shareholders, then smaller corporations will follow suit, even if only out of fear of being called out in the media, but there is no way to hedge against the risk that this won't happen. Additionally, social media campaigns targeting specific boards will likely have a greater impact, for a much lower cost. Sponsoring a few media campaigns (with advertisements like the one outlined in Part III.D) against specific large companies is a much more certain and effective way to pressure nominating committee members to take action.

Considering the overall risks and rewards, advocacy groups are best off expending resources to: (1) develop a nationwide networking program; (2) lobby ISS/Glass Lewis for support on term limits and voting recommendations against nominating committee chairs; and (3) significantly increase and target social media advocacy campaigns. With this cost-benefit strategy, advocacy groups have a better chance of actually increasing the number of women in U.S. boardrooms and changing the current pattern of failed strategies.

V. Conclusion

No longer can corporate actors in the U.S. avoid the fact that there is something missing from the boardrooms of corporations across the country. Notwithstanding significant education, professional success, and political attainment, women and their perspectives are often absent from a company's board of directors. Advocacy groups must shift their focus if they plan to have an influence on female board representation so that corporations, boardrooms, and the U.S. market can reap the rewards of gender diversity.

Since the U.S. is likely to continue to resist the mandatory quota solutions employed internationally, this shift needs to happen soon if the U.S. intends to stay a corporate governance leader around the world. If advocacy groups take a more direct approach that considers cost, risk, and high rewards, then they can likely make prompt and positive changes to the subpar number of women sitting in boardrooms across the country as directors. Whether the old boy's club of the American boardroom is ready or not, it is time to shift the question of gender parity from *why* the women need to be there, to *how* we are going to get them there quickly.

Endnotes

1. *See infra* text accompanying note 6.
2. *Women on Boards Quick Take*, CATALYST (Mar. 3, 2014), http://www.catalyst.org/knowledge/women-boards.
3. According to data compiled by Catalyst, the percentage of women on corporate boards in 2013 was 16.9%, essentially unchanged from 16.6% in 2012 and 16.1% in 2011. *2013 Catalyst Census Fortune 500 Women Board Directors*, CATALYST (Dec. 10, 2013), http://www.catalyst.org/knowledge/2013-catalyst-census-fortune-500-women-board-directors.
4. This article does not attempt to prove the point that women help the bottom line of a corporation. But in the last few decades, many studies and articles have emerged to claim this.
5. Judith Warner, *Fact Sheet: The Women's Leadership Gap, Women's Leadership by the Numbers*, CTR. FOR AM. PROGRESS (Mar. 7, 2014), http://www.americanprogress.org/issues/women/report/2014/03/07/85457/fact-sheet-the-womens-leadership-gap/.
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7. *Id.*
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15. *Working Hard to Raise the Bar: The Idea*, 2020 WOMEN ON BOARDS, http://www.2020wob.com/about (last visited Apr. 21, 2015).
16. *Id.*
17. *Id.*
18. *About*, THIRTY PERCENT COALITION, http://www.30percentcoalition.org/about (last visited Apr. 21, 2015).
19. *Id.*
20. *See Our History Timeline*, *supra* note 11.
21. *Take Action, The National Conversation on Board Diversity*, 2020 WOMEN ON BOARDS, http://www.2020wob.com/take-action (last visited Apr. 21, 2015).
22. *Id.*
23. *What We Do*, DIRECTWOMEN, http://www.directwomen.org/what-we-do (last visited Apr. 21, 2015).
24. *Id.*
25. *See id.*
26. *See* Shelley DuBois, *Why the U.S. Lags Europe (and Others) on Board Diversity*, FORTUNE (Jan. 4, 2013, 5:04 PM), http://fortune.com/2013/01/04/why-the-u-s-lags-europe-and-others-on-board-diversity/; *see also* Karyn L. Twaronite, *Women On Boards: Moving From 'Why to 'How*,' FORBES (Jan. 8, 2013, 11:59 AM), http://www.forbes.com/sites/forbeswomanfiles/2013/01/08/women-on-boards-moving-from-why-to-how/ (describing how America is stuck on the question of why women should be on boards, while Europe and other regions have moved on to the question of how).
27. *See* Tara K.Giunta, *Foreword* to PAUL HASTINGS, BREAKING THE GLASS CEILING: WOMEN IN THE BOARDROOM 3 (Tara K. Giunta ed., 3d ed. 2014), *available at* http://www.paulhastings.com/assets/pdfs/Gender_Parity_on_Corporate_Boards.pdf.
28. While this is a large increase, the overall numbers are still relatively small. This was an increase from ten women on corporate boards in 2009 to fifty-nine women in 2010. *Getting on Board: Quotas and Gender Equality (2011)*, AUSTL. HUM. RTS. COMM'N (Apr. 29, 2011), https://www.humanrights.gov.au/news/speeches/getting-board-quotas-and-gender-equality-2011 (providing a transcript of Elizabeth Broderick's—the Sex Discrimination Commissioner on the Australian Human Rights Commission—speech presented at the Gender Matters Third Women on Boards Conference).
29. Including Norway, Spain, Italy, and France, among others. *See generally* DELOITTE, WOMEN IN THE BOARDROOM: A GLOBAL PERSPECTIVE (2011), *available at* http://www.deloitte.com/assets/Dcom-Tanzania/Local%20Assets/Documents/Deloitte%20Article_Women%20in%20the%20boardroom.pdf (detailing the state of gender diversity in boardrooms around the world).
30. Alice Lee, *Gender Quotas Worked in Norway. Why Not Here?*, NEW REPUBLIC (Sept. 5, 2014), http://www.newrepublic.com/article/119343/impact-quotas-corporate-gender-equality.
31. AAGOTH STORVIK & MARI TEIGEN, WOMEN ON BOARD: THE NORWEGIAN EXPERIENCE 4 (Friedrich Ebert Stiftung ed. 2010), *available at* http://library.fes.de/pdf-files/id/ipa/07309.pdf.
32. The Companies Act, §§ 6-11a (Nor.) (2003). The statute also gives requirements for smaller boards. The rule reads in part:

    > (1) In the boards of publicly listed…companies both genders should be represented, as follows:

1. Where there are two or three board members, both genders should be represented.
2. Where there are four or five board members, both genders should be represented with at least two members each.
3. Where there are six to eight board members, both genders should be represented with at least three members each.
4. Where there are nine or more members of the board, each gender should be represented with at least 40 percent each.

Id. (emphasis added).

33. *See* Storvik & Teigen, *supra* note 31, at 8.

34. *Id.*

35. *See* David A. Katz et al., *Developments Regarding Gender Diversity on Public Boards*, Harv. L. Sch. Forum on Corp. Governance & Fin. Reg. Blog (Nov. 12, 2013, 9:23 AM), http://blogs.law.harvard.edu/corpgov/2013/11/12/developments-regarding-gender-diversity-on-public-boards/ ("Advocacy groups such as these do not generally support mandatory quotas as a means of achieving their objective.").

36. *See The Q Question: Should the U.S. Adopt Quotas to Increase Board Diversity?*, 2020 Women on Boards, http://www.2020wob.com/blog/q-question-should-us-adopt-quotas-increase-board-diversity (last visited Apr. 21, 2015); *CalSTRS and The Thirty Percent Coalition Expand Campaign for More Women on Corporate Boards*, Thirty Percent Coalition (Oct. 22, 2014), http://www.30percentcoalition.org/news [hereinafter *Campaign for More Women*] ("'We are not advocating for quotas,' says Joe Keefe, [] Chair of the Coalition's Institutional Investors Committee.").

37. *See generally* Rosabeth Moss Kanter, Men and Women of the Corporation (1977) (providing an explanation of tokenism as applied to women in the workplace).

38. *See* Alison Konrad, Vicki Kramer, & Sumru Erkut, *Critical Mass: The Impact of Three or More Women on Corporate Boards*, 37 Org. Dynamics 145, 146–148 (2008) (describing the effects of being the 'token' woman on a board).

39. *Id.*

40. They sent 168 letters in all. *See Campaign for More Women*, *supra* note 36. A copy of the most recent letter can be found on the Catalyst website. *Letter from The Thirty Percent Coalition to Corporations With No Women on Their Boards*, Catalyst (Oct. 20, 2014), http://www.30percentcoalition.org/images/Initiatives/Letter%20to%20R1000%20Companies%2010-09-14%20F.pdf.

41. *Institutional Investors File Shareholder Resolutions Encouraging Diversity in Company Charter Language and in the Corporate Boardroom*, Reuters (Feb. 28, 2013, 8:45 AM), http://www. reuters.com/article/2013/02/28/ma-thirty-percent-idUSnBw9ccfzda+100+BSW20130228.

42. *Id.*

43. *Institutional Investors Note Progress as Eight Companies Appoint Women to Their Boards*, Thirty Percent Coalition (Sept. 18, 2013), *available at* http://www.30percentcoalition.org/news/99-institutional-investors-note-progress-as- eight-companies-appoint-women-to-their-boards.

44. This was the very first time that a gender diversity resolution received majority support from the shareholders. *Id.*

45. *See* Boris Groysberg & Deborah Bell, *Joining Boards: It's Not Just Who You Know That Matters*, Harv. Bus. Rev. (July 16, 2013), http://blogs.hbr.org/2013/07/joining-a-board-who-you-know-m/. ("Many boards still rely on their own (mostly white, mostly male) networks to fill seats.").

46. *See Chairmen's Mentoring Program*, Austr. Inst. Co. Dirs., http://www.companydirectors.com.au/Director-Resource-Centre/Governance-and-Director-Issues/Board-Diversity/Mentoring-Programs (last visited Apr. 21, 2015).

47. *Id.*

48. *Chairmen's Mentoring Program 2013 Guidelines and Selection Criteria*, Austr. Inst. Co. Dirs., http://www.companydirectors.com.au/Director-Resource-Centre/Governance-and-Director-Issues/Board-Diversity/Mentoring-Programs (follow link to "Guidelines and Selection Criteria") (last visited Apr. 21, 2015).

49. Suzanne Rich Folsom, *Strategic Motivating Terms: Encouraging Boardroom Change*, Corp. Secretary (Oct. 23, 2014), http://www.corporatesecretary.com/articles/boardrooms/12819/strategic-motivating-terms-encouraging-boardroom-change/.

50. *See Moving Mind-sets on Gender Diversity: McKinsey Global Survey Results*, McKinsey&Company (Jan. 2014), http://www.mckinsey.com/insights/organization/moving_mind-sets_on_gender_diversity_mckinsey_global_survey_results (finding that three-quarters of men support gender diversity at the top of corporations, but they often fail to recognize the challenges for women).

51. *See* James R. Copland et al., *Proxy Monitor Report: A Report on Corporate Governance and Shareholder Activism*, Proxy Monitor (2012), http://www.proxymonitor.org/forms/pmr_04.aspx.

52. *See id.*

53. *See id.* (stating that ISS, as of 2012, had a sixty-one percent dominant market share position and that its only competitor is Glass Lewis); *see also* Robert D. Hershey, *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. Times (June 18, 2006), http://www.nytimes.com/2006/06/18/business/yourmoney/18proxy.html?pagewanted=all&_r=0. It is important to note the controversy surrounding the influence of proxy advisors and the lack of SEC regulation of this close-knit industry. In June of 2014, the SEC posted a legal bulletin outlining the responsibilities of proxy advisors and institutional investors. *See Client Alerts: At Long Last, SEC Staff Issues Proxy Advisory Firm Guidance: Will It Calm the Controversy*, Cooley LLP (July 9, 2014), http://www.cooley.com/sec-issues-proxy-advisory-firm-guidance. But, at least for the foreseeable future proxy advisors are more influential than ever, and considering the quick pace with which this change in advocating for women directors needs to occur, proxy advisors will still be a big player in the advocacy efforts.

54. Renna Aggarwal et al., *Influence of Public Opinion on Investor Voting and Proxy Advisors* 3, 21 (The Ohio State University Fisher College of Business Working Paper Series, No. 12, 2014).

55. *See Say-on-Pay FAQs*, Glass Lewis & Co., http://www.glasslewis.com/issuer/say-on-pay-faqs/ (last visited Apr. 21, 2015).

56. *See* Aggarwal et al., *supra* note 54, at 6, 22. The study examined how public opinion affects proxy advisors based on media coverage of executive compensation. Media was measured by the number of monthly articles from major news and business publications that contained words similar to "CEO" and "compensation." They found the correlation to be positive and significant with ISS recommendations on the subject. *Id.* at 15-6, 22.

57. Jie Cai et al., *Electing Directors*, 64 J. Finance 2389, 2408, 2410 (2009).

58. *Id.* at 2410.

59. Ebonya L. Washington, *Female Socialization: How Daughters Affect Their Legislator Fathers' Voting on Women's Issues*, 98 Am. Econ. Rev. 311, 311, 318–19 (2008). The study used congressional voting record scores of the 105th through 108th Congresses compiled by the AAUW and NOW. *Id.* at 313–14. The organizations identified legislation critical for women, and then each vote in accordance with the organizations' position was awarded five points to produce a score between zero and one hundred. *Id.* at 314. She found that conditioned on the number of children parented, each female child was associated with a score increase. *Id.* at 318.

60. *Id.* at 326.

61. *See Campaign for More Women*, *supra* note 36.

62. *See List of Russell 1000 Companies Receiving The Thirty Percent Coalition Letter on Board Diversity*, Thirty Percent Coalition (Oct. 22, 2014), http://www.calstrs.com/sites/main/files/file-attachments/list_of_russell_1000_companies_receiving_the_thirty_percent_coalition_letter_on_board_diversity.pdf; *see also Letter from The Thirty Percent Coalition*, *supra* note 40.

63. Michael London, *Gender Parity Supplement: United States*, PaulHastings, http://www.paulhastings.com/genderparitysupplement2014/countries/unitedstates.html (last visited Apr. 21, 2015).

64. *See generally infra* Part III.D.

65. Ernst & Young, Diversity Drives Diversity: From the Boardroom to the C-Suite 13 (2013), *available at* http://www.ey.com/Publication/vwLUAssets/EY-Diversity-drives-diversity/$FILE/EY-Diversity-drives-diversity.pdf.

66. Additionally, out of the 16, none have term limits less than 10 years. *See* SpencerStuart, SpencerStuart Board Index 2013 15 (2013), *available at* http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/USEng/Documents/Nominating-Corporate%20Governance%20Committee/Board%20Composition%20and%20Recruitment/SpencerStuartBI%202013_04Nov2013-lowres.pdf.

67. *Id.* at 4.

68. *See* Cai et al., *supra* note 57, at 2389–90.

69. And in many cases they are. The Spencer Report in 2013 found that board tenures on average last anywhere from 8.6 to 24 years, with the longest director tenure being 50 years. *See* SpencerStuart, *supra* note 66, at 17.

70. *Id.* at 15–16.

71. Jena McGregor, *The Science of Getting Women on Boards*, Wash. Post (Dec. 6, 2013), http://www.washingtonpost.com/blogs/on-leadership/wp/2013/12/06/the-science-of-getting-women-on-boards/.

72. *See generally* David A. Katz et al., *Renewed Focus on Corporate Director Tenure*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. Blog (May 22, 2014, 8:30 PM), http://blogs.law.harvard.edu/corpgov/2014/05/22/renewed-focus-on-corporate-director-tenure/ (discussing the controversy over director tenure and arguing against term limits in support of the value of tenured directors).

73. PricewaterhouseCoopers, Boards confront an evolving landscape: PwC's Annual Corporate Directors Survey 1 (2013), http://www.pwc.com/us/en/corporate-governance/publications/boardroom-direct-newsletter/september-2013-issues-in-focus.jhtml.

74. SpencerStuart, *supra* note 66, at 15.

75. *Board of Directors*, Walmart, http://corporate.walmart.com/our-story/leadership/board-of-directors/ (last visited Apr. 21, 2015); *see also* Aida M. Alvarez, Walmart, http://corporate.walmart.com/our-story/leadership/board-of-directors/aida-alvarez/ (last visited Apr. 21, 2015).

76. SpencerStuart, *supra* note 66, at 15.

77. *Board of Directors*, Varian Medical Systems, http://investors.varian.com/boardofdirectors (last visited Apr. 21, 2015); *see also Susan L. Bostrom*, Varian Medical Systems, http://investors.varian.com/boardofdirectors?item=3 (last visited Apr. 21, 2015).

78. SpencerStuart, *supra* note 66, at 15.

79. *Board of Directors*, Frontier Communications, http://investor.frontier.com/directors.cfm (last visited Apr. 21, 2015).

80. SpencerStuart, *supra* note 66, at 15.

81. *Board of Directors*, Target, http://investors.target.com/phoenix.zhtml?c=65828&p=irol-govboard (last visited Apr. 21, 2015).

82. SpencerStuart, *supra* note 66, at 17.

83. Additionally, 45% of directors have at least 10 years of tenure. *See* Ernst & Young, *supra* note 65, at 13 and accompanying text. This would put a large portion of directors in the U.S. on the cusp of a potential term limit, in order to hopefully open up a large number of board seats for women to fill.

84. Kimberly Gladman & Michelle Lamb, *Director Tenure and Gender Diversity in the United States: A Scenario Analysis*, GMIRatings (June 2013), http://www3.gmiratings.com/wp-content/uploads/2013/06/GMIRatings_WOB_TenureGender_062013.pdf.

85. "Continuously" refers to the one-year holding requirement. The investor must also hold the stock through the date of the next board meeting. 17 C.F.R. § 240.14a-8 (2012).

86. Kelly Wallace, *No Movement For Women at the Top in Corporate America*, CNN (Dec. 11, 2013, 8:56 AM), http://www.cnn.com/2013/12/11/living/no-change-on-women-board-seats-parents/.

87. *See supra* notes 41–44 and accompanying text.

88. It seems that external factors must be paired with these proposals to foster their success. Environmental proposals in 2012 and 2013 were very successful because of the Deepwater Horizon oil spill in 2010. As a result, pairing these proposals with social media campaigns that will garner attention could help ensure the success of these proposals. *See Shareholder Proposals 2014 Proxy Season*, Proxy Mosaic (July 24, 2014), https://www.proxymosaic.com/uncategorized/shareholder-proposals-2014-proxy-season/.

89. *See* Katz et al., *supra* note 72.

90. South Africa and Singapore enforce regulations similar to this. *See* Janet McFarland, *Countries Set Out Rules on Directors' Tenure*, Globe & Mail (Nov. 24, 2013 10:02 PM), http://www.theglobeandmail.com/report-on-business/careers/management/board-games-2013/countries-set-out-rules-on-directors-tenure/article15574442/ (providing examples of foreign countries that regulate director tenure).

91. *Id.*

92. Institutional Shareholder Services, 2014 U.S. Proxy Voting Summary Guidelines 17 (2014), *available at* http://www.issgovernance.com/file/files/ISS2014USSummaryGuidelines.pdf.

93. *Id.*

94. Institutional Shareholder Services, 2013-2014 Policy Survey Summary of results 11 (2013), *available at* http://www.issgovernance.com/file/files/ISS2013-2014PolicySurveyResultsReport.pdf.

95. Note that just because proxy advisors recommend something, that doesn't mean that it will automatically be done. But considering their current influence, it will make a mark.

96. Some of these corporations include Nike, Inc., Level 3 Communications, and Century Link. Joann S. Lublin, *The 40-Year Club: America's Longest-Serving Directors*, Wall St. J. (July 16, 2013, 7:45 PM), http://online.wsj.com/articles/SB10001424127887323664204578607924055967366.

97. Corporate Governance, 17 C.F.R. §229.407(c)(2)(vi)(2012). The text of the rule reads:

> Describe the nominating committee's process for identifying and evaluating nominees for director, including nominees recommended by security holders, and any differences in the manner in which the nominating committee evaluates nominees for director based on whether the nominee is recommended by a security holder, and whether, and if so how, the nominating committee (or the board) *considers diversity in identifying nominees for director. If the nominating committee (or the board) has a policy with regard*

> *to the consideration of diversity* in identifying director nominees, describe how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy.

Id. (emphasis added).

98. Luis A. Aguilar, *Speech by the SEC Commissioner: The SEC and Corporate Governance—An Overview in the Wake of Dodd-Frank*, U.S. Sec. & Exch. Comm'n (Nov. 18, 2010), *available at* http://www.sec.gov/news/speech/2010/spch111810laa.htm (providing a transcript of Commissioner Aguilar's speech).
99. *See id.*
100. See PriceWaterhouseCoopers, Annual Corporate Directors Survey: The 2010 Results 15 (2010), *available at* http://www.pwc.com/us/en/corporate-governance/assets/annual-corpporate-directors-survey-2010.pdf.
101. *Id.*
102. *See supra* notes 35–39 and accompanying text.
103. Alexander Dyck & Luigi Zingales, The Corporate Governance Role of the Media, in Roumeen Islam et al., The Right to Tell: The Role of Mass Media in Economic Development 107 (2002).
104. *Id.*
105. *Id.*
106. Specifically in this study, a negative ranking in Business Week's analysis of board effectiveness. Jennifer R. Joe et al., *Managers' and Investors' Responses to Media Exposure of Board Ineffectiveness*, 44 J. Fin. & Qualitative Analysis 579, 580 (2009).
107. *Id.*
108. *Id.* at 581.
109. Hashtags are used on Twitter to categorize Tweets by keyword. Twitter users will place the hashtag (#) before a keyword in their Tweet to link it to all other Tweets on the same topic. If a Twitter user clicks on the hashtagged word in any Tweet, then all other Tweets marked with that keyword will appear. *See Using Hashtags on Twitter*, Twitter, https://support.twitter.com/articles/49309-using-hashtags-on-twitter (last visited Apr. 21, 2015).
110. *Twitter Users and Company Facts*, Twitter, https://about.twitter.com/company (last visited Apr. 21, 2015).
111. *See* Guy Outen, *Men Who Get It; Successful Teams Who Embrace Diversity*, Catalyst Blog (Feb. 18, 2014), http://www.catalyst.org/blog/catalyzing/men-who-get-it-successful-teams-embrace-diversity.
112. *2020 Women on Boards Twitter Page*, Twitter, https://twitter.com/2020wob (last visited Apr. 21, 2015). It is important to note that this increases daily; for example, from the time this author started this article until 'last visited,' the number of followers increased by 400.
113. *Thirty Percent Coalition Twitter Page*, Twitter, https://twitter.com/30PercentCo (last visited Apr. 21, 2015).
114. In 2012, Invisible Children began a social media video campaign called "KONY 2012" to bring public attention to a Uganda war criminal. Within days, the videos drew millions of viewers and quickly spurred action in Washington with a resolution condemning the war criminal. *See Kony 2012*, Invisible Children, http://invisiblechildren.com/kony-2012 (last visited Apr. 21, 2015).
115. This analysis moves forward with the assumption that not only is federal regulation (in the form of quotas or regulating term limits) unlikely to succeed in the U.S., it is not something advocacy groups support at this stage. *See supra* Part III.C.iii and notes 35–39 and accompanying text.
116. Shareholder Proposal Developments During the 2014 Proxy Season, Gibson Dunn Publications (2014), *available at* http://www.gibsondunn.com/publications/pages/Shareholder-Proposal-Developments-During-2014-Proxy-Season.aspx.
117. *Id. See also* Amy L. Goodman & John F. Olson, *Shareholder Proposal Developments During the 2014 Proxy Season*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. Blog (July 2, 2014, 9:02 AM), http://blogs.law.harvard.edu/corpgov/2014/07/02/shareholder-proposal-developments-during-the-2014-proxy-season/.
118. *See supra* notes 41–44 and accompanying text.
119. Only 5% of shareholder proposals on gender diversity have made it to a vote since 2005. *See* Twaronite, *supra* note 26.
120. David F. Larcker et al., *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions*, Conference Board (Mar. 2012), https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite.

Inside the Courts

An Update From Skadden Securities Litigators

U.S. Supreme Court

Supreme Court Decision Rejects Sixth Circuit Holding and Clarifies Pleading Standard for Section 11 Claims

*Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fun*d, 135 S. Ct. 1318 (2015)

On March 24, 2015, the U.S. Supreme Court held that an issuer may be held liable under Section 11 of the Securities Act for statements of opinion made in a registration statement if the issuer failed to hold the belief professed or failed to disclose material facts about the basis for the opinion. In so doing, the Court vacated the Sixth Circuit's decision, which had held that a Section 11 plaintiff need only allege that an opinion in a registration statement was "objectively false." The Court held that, with respect to potential misstatement liability under Section 11, "a sincere statement of pure opinion is not an 'untrue statement of material fact,' regardless whether an investor can ultimately prove the belief wrong." As to the omissions prong of Section 11, the Court further held that an issuer may be liable under Section 11 for omitting material facts about the inquiry into or knowledge concerning a statement of opinion if those facts "conflict" with what a reasonable investor would "understand an opinion statement to convey" with respect to "how the speaker has formed the opinion" or "the speaker's basis for holding that view."

The issue presented in *Omnicare* has been raised in at least two other petitions for *certiorari*. In *Freidus v. ING Groep N.V.*, 135 S. Ct. 1698 (2015), the Supreme Court summarily vacated and remanded the case to the Second Circuit for further consideration in light of *Omnicare*. The Second Circuit subsequently vacated part of the judgment of the district court and remanded for further proceedings consistent with the Supreme Court's opinion. The petition for *certiorari* in *Belmont Holdings Corp. v. Deutsche Bank AG,* No. 14-1052 (U.S. Feb. 13, 2015) is still pending.

After the Supreme Court announced its decision in *Omnicare*, at least one court has engaged in a thorough analysis of the decision's implications on liability for statements of belief. *See In re BioScrip, Inc. Sec. Litig.*, No. 1:13-cv-06922-AJN (S.D.N.Y. Mar. 31, 2015) (stating that *Omnicare* increased the scope of liability for statements of belief beyond current Second Circuit precedent by holding that such a statement may be misleading "if, although sincerely held, it is formed on the basis of an omitted fact…that would likely conflict with a reasonable investor's own understanding of the facts conveyed by that statement."). For a full description of the *BioScrip* decision, please see page 36 of this publication. Other courts have applied *Omnicare*'s Section 11 misstatement and omission analysis to claims brought under Section 10(b) of the Securities Exchange Act. *See In re Merck & Co., Inc. Sec., Derivative & "ERISA" Litig*. Nos. 05-1151 (SRC), 05-2367 (SRC) (D.N.J. May 13, 2015), *In re Genworth Fin. Inc. Sec. Litig.*, No. 3:14-CV-682 (E.D. Va. May 1, 2015). Several other opinions have cited *Omnicare*, though it has not been central to their analysis. *See, e.g., Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc.*, No. 11cv6201 (DLC) (S.D.N.Y. May 11, 2015).

Auditor Liability

Second Circuit Affirms Dismissal of Claims Against Independent Auditors

In re Advanced Battery Techs., Inc., No. 14-1410-cv (2d Cir. Mar. 25, 2015)

The U.S. Court of Appeals for the Second Circuit affirmed the denial of leave to file a second amended complaint alleging that independent auditors violated Section 10(b) of the Securities Exchange Act by falsely representing that their audits of a battery manufacturer conformed with generally accepted auditing standards (GAAS) and accurately reflected the company's financial condition. The plaintiffs alleged that the auditors failed to uncover and disclose numerous red flags in the company's financial statements, including contradictory filings in China and the United States, and the inclusion of a purportedly wholly owned subsidiary that the company did not own. The court held that the plaintiffs failed to adequately allege scienter. The court noted that an independent auditor generally is not required to review a company's foreign regulatory filings and the plaintiffs' allegations that the auditor should have done so in this case were merely conclusory. In addition, the auditors' review took place between 2007 and 2010, well before mid-2011, when regulators began to focus more heavily upon Chinese reverse mergers. Lastly, allegations that the auditors failed to discover that the manufacturer did not own the purported wholly owned subsidiary amounted to at most negligence, which is not sufficient to support a claim under Section 10(b).

SDNY Dismisses Section 10(b) Claims, Finding Allegations Insufficient to Demonstrate Auditor Scienter

Athale v. SinoTech Energy Ltd., No. 11-cv-5831 (AJN) (S.D.N.Y. Jan. 23, 2015)

Judge Alison J. Nathan of the U.S. District Court for the Southern District of New York dismissed claims that an independent auditor violated Section 10(b) of the Securities Exchange Act by allegedly issuing a fraudulent audit opinion that failed to identify nonexistent earnings from certain alleged shell companies. The court held that the plaintiffs merely alleged violations of generally accepted accounting principles (GAAP), which do not state a claim in the absence of corresponding allegations demonstrating fraudulent intent. The court determined that the allegations about material weaknesses in the company's internal controls had an insufficient connection to the alleged fraud involving the shell companies. The plaintiffs also failed to allege that a reasonable auditor under similar circumstances would have expanded its audit in light of an allegedly suspicious increase in the company's expenditures on production equipment, which were paid to the shell companies. Likewise, the court found that the auditor was not reckless in deciding not to confirm accounts receivable from the third-party arrangements, even though the plaintiff alleged that not doing so violated GAAP, because GAAP violations alone are insufficient to demonstrate recklessness. The court determined that the allegations did not give rise to a strong inference of scienter because other equally plausible nonculpable explanations applied to the defendants' conduct, and the plaintiffs' allegations amounted only to fraud by hindsight.

Class Actions

Class Action Fairness Act

CAFA Securities Exception Deprives Ninth Circuit of Jurisdiction

Eminence Investors, L.L.L.P. v. Bank of N.Y. Mellon, No. 15-15237 (9th Cir. Apr. 2, 2015)

In a case of first impression, the U.S. Court of Appeals for the Ninth Circuit held that the securities exception to the Class Action Fairness Act (CAFA) deprived the court of jurisdiction where plaintiff-bondholders' claims stemmed from the defendant's fiduciary duties arising from an indenture trustee agreement.

The plaintiffs asserted causes of action against the defendant bank for breach of fiduciary duty and gross negligence. The bank, the successor to the indenture trustee, removed the putative class action from California state court to federal court pursuant to CAFA. The district court remanded the case based on the defendant's untimely filing but did not consider whether the securities exception to CAFA removal applied. The bank appealed.

Even though the district court did not address the securities exception, the Ninth Circuit noted at the outset that the court lacked jurisdiction if the CAFA securities exception applied, as the bank solely predicated removal on CAFA and the court found no other source of jurisdiction applicable. The CAFA securities exception applies if each claim in a class action is related to certain rights, duties or obligations which must be "related to or created by or pursuant to" a security as defined under the Securities Act Section 2(a)(1) and the regulations issued thereunder.

The Ninth Circuit held that the CAFA securities exception applied. In so holding, the panel concluded that all of the causes of action in the complaint "relate[d] to the rights, duties…and obligations relating to or created by or pursuant to" the bonds at issue, which the parties agreed were "securities" under the Securities Act. The panel reasoned that the causes of action in the complaint were based on alleged duties (*i.e.*, the fiduciary duties of the bank), and thus the alleged duties arose from the bonds and the associated indenture. Acknowledging that the Ninth Circuit had yet to construe the language of the securities exception, the panel looked to the Second Circuit, which has interpreted the CAFA securities exception in three recent cases. The Ninth Circuit summarized the Second Circuit's case law as standing for the proposition that the securities exception applies where the rights or duties at issue are defined by the security instrument itself, even if there are "collateral issues of state law" involved, or there are additional "duties superimposed by state law as a result of the relationship created by or underlying the security." Based on this interpretation, the panel reasoned that even the gross negligence cause of action was based on the "duties superimposed by state law as a result of the relationship created by or underlying" the bonds at issue. Therefore, because the CAFA securities exception "must apply" in such a suit, the Ninth Circuit dismissed the appeal for lack of jurisdiction.

Class Certification

SDNY Finds Two Proposed Class Representatives to Be Inadequate

Gordon v. Sonar Capital Mgmt. LLC, No. 11-cv-9665 (JSR) (S.D.N.Y. Mar. 19, 2015)

Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York denied a motion to certify a class of shareholders in a securities action alleging that a hedge fund violated Section 10(b) of the Securities Exchange Act by engaging in insider trading. The plaintiffs alleged that the hedge fund managers traded a company's stock based on material, nonpublic information that it received from a former employee about an undisclosed contract that was expected to generate substantial revenues. The court held that neither of the two proposed class representatives were appropriate to represent the putative class. First, one proposed representative had significant veracity issues and also failed to disclose his close relationship with his personal attorney—who had a financial incentive in the outcome of the case—and the court determined that the conflict could compromise the representative's ability to protect the interests of the class. The court also reasoned that the proposed representative lacked independent judgment, evidenced by prior testimony indicating that the representative did not know basic facts about the litigation. Second, as to the other proposed representative, the court determined that by netting gains and losses during the class period, the representative had not suffered any economic loss and thus was subject to unique defenses that made him an inadequate class representative. The plaintiffs have filed a petition to appeal the decision.

Settlements

District Court Holds That Nonsettling Defendants Are Entitled to Securities Class Action Judgment Reductions

Rieckborn v. Velti plc, No. 13-cv-03889-WHO (N.D. Cal. Feb. 3, 2015)

Judge William H. Orrick of the U.S. District Court for the Northern District of California held that nonsettling class action defendants are entitled to a judgment reduction measured by the settling defendants' liability on Securities Act claims not explicitly covered under the Private Securities Litigation Reform Act of 1995 (the PSLRA). In so holding, the court clarified the appropriate terms of securities class action bar orders. In addition, the court's order provides class action settlement agreement drafters with guidance by clarifying that bar orders do not preclude "independent claims" and that such orders must be "mutual."

The plaintiffs, investors in Velti plc (Velti), asserted claims under the Securities Exchange Act and the Securities Act against Velti, several of Velti's officers and directors, its accounting firm, and the underwriters of the securities the plaintiffs purchased. Velti and four of the individual defendants subsequently agreed to a settlement with the plaintiffs. However, Velti's accounting firm and the underwriters declined to participate in the settlement. Under the partial settlement, Velti's insurance policies would finance the settlement fund exclusively.

The nonsettling defendants objected to the settlement on several grounds. As an initial matter, they argued that the proposed formula for calculating any judgment reduction they would receive was unacceptably vague. The plaintiffs responded that the calculation was not vague because any future judgment reduction would be "in accordance with applicable law." Agreeing with the nonsettling defendants, the court held that the judgment reduction provision in the settlement agreement had to state more clearly how settled Securities Act claims would reduce any judgment against the nonsettling defendants in the future. The court reasoned that it was not clear which "applicable law" would apply to the judgment reduction because the settlement involved claims under both the Securities Exchange Act and the Securities Act.

The nonsettling defendants further objected to the settlement, arguing that the settlement failed to make clear that they would be entitled to a judgment reduction measured by the proportionate liability attributable to other defendants on all Securities Act claims as opposed to only Securities Act claims that outside directors settled. Again, the court agreed with the nonsettling defendants and held that they were entitled to a judgment reduction measured by the proportionate liability attributable to other defendants under the PSLRA. The court rejected the plaintiffs' contention that nonsettling defendants were only entitled to a dollar-for-dollar judgment reduction on the Securities Act claims that the PSLRA did not explicitly cover. The plaintiffs argued that the plain language of the PSLRA limited judgment reduction measured by the proportionate liability attributable to other defendants to settled Securities Act claims against outside directors and excluded settled Securities Act claims against other defendants. The court reasoned that it was fair to limit nonsettling defendants' future liability based on the liability attributable to other defendants because settling plaintiffs should bear that risk as they have a "financial incentive to make sure that each defendant pays his respective share of damages." The court stated that the court would revise the settlement to make clear that the nonsettling defendants would be entitled to a judgment reduction based on all Securities Act claims against nonsettling defendants, measured by the proportionate liability attributable to other defendants.

As to the proposed bar order—that is, an order that in general bars categories of claims made by or against the settling parties relating to or arising from the settled securities fraud claims — the court concluded that the bar order had to be revised to clarify that it would prohibit claims both by and against released parties. The court held that, under Section 78u-4(f)(7)(A) of the PSLRA, any bar order must be "mutual"—meaning that "any party… protected against claims of contribution and indemnification [would] also be prohibited from asserting such claims." The court reasoned that the proposed securities class action bar order was not mutual because it did not prohibit contribution and indemnification claims *by* the released parties, but merely prohibited such claims *against* them.

Finally, the court dispelled the nonsettling defendants' fear that the bar order precluded their independent claims to recover amounts other than those any released party was required to pay under the settlement. The court made clear that bar orders must be limited to "claims for contribution and indemnity and claims where the injury is the nonsettling defendant's liability to the plaintiff," and cannot preclude independent claims.

Fiduciary Duties

Books and Records

Delaware Court of Chancery Permits Stockholders to Inspect Privileged Documents

In re Lululemon Athletica Inc. 220 Litig., Consol. C.A. No. 9039-VCP (Del. Ch. Apr. 30, 2015)

Vice Chancellor Donald F. Parsons, Jr. of the Delaware Court of Chancery, in the context of a Section 220 proceeding, ordered Lululemon to produce certain privileged communications under the *Garner* exception to the attorney-client privilege but denied stockholder plaintiffs' request for documents from the personal email accounts of its nonemployee directors.

The court previously ordered the company to produce documents relating to a 10b-5 trading plan under which the company's founder and former chairman sold a significant number of shares immediately prior to a 22 percent drop in the company's stock price.

The court subsequently considered whether certain documents fell within the scope of its earlier post-trial order. With respect to two emails that were protected by the attorney-client privilege, the court held that the plaintiffs had established "good cause" to set aside the privilege under *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), because the plaintiffs' claims of wrongdoing were "obviously colorable," the documents sought did not involve legal advice regarding the books and records request, and the two emails at issue were unavailable from another source.

With respect to the plaintiffs' request for documents from the email accounts of its nondirector employees, the court found that its previous order required only the company, and not its directors, to produce documents. The court stated that "it [was] not clear that the Court could require that Plaintiffs receive access to those documents under Section 220," and that the emails were not necessary and essential to the plaintiffs' essential purpose.

Delaware Court of Chancery Permits Stockholder to Investigate Company's Oversight of Subsidiaries

Okla. Firefighters Pension & Ret. Sys. v. Citigroup Inc., C.A. No. 9587-ML (VCN) (Del. Ch. Apr. 24, 2015)

Vice Chancellor John W. Noble of the Delaware Court of Chancery granted a company stockholder's request to inspect books and records, pursuant to 8 Del. C. § 220. The stockholder alleged that the company (the Company) failed to exercise appropriate oversight over two subsidiaries after the Company disclosed that its Mexican Banamex subsidiary had engaged in fraudulent transactions and its Banamex USA subsidiary had received grand jury subpoenas relating to compliance with banking regulations.

The court found that the plaintiff stated a proper purpose for requesting books and records by presenting "some credible basis" from which the court could infer wrongdoing. The court explained that "the 'credible basis' standard sets the lowest possible burden of proof," and emphasized that "[t]he Court…encourages stockholders to pursue a Section 220 demand instead of bringing a premature complaint." While "the record would not likely support fiduciary duty claims capable of surviving a motion to dismiss," the court explained that the standard for entitlement to books and records is lower than that governing a motion to dismiss, and that the plaintiff sufficiently demonstrated "red flags" suggesting the Company may not have exercised sufficient oversight over its subsidiaries. However, the court narrowly tailored the scope of inspection solely to those documents "reasonably required to satisfy the purpose of the demand."

Delaware Court of Chancery Denies Books and Records to Investigate Exculpated Wrongdoing

Se. Pa. Transp. Auth. v. AbbVie, Inc., C.A. No. 10374-VCG (Del. Ch. Apr. 15, 2015)

Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery denied requests brought by stockholders of AbbVie, Inc. to inspect the company's books and records after the AbbVie board of directors changed its recommendation in favor of a transaction with Shire plc, a Jersey entity. The transaction was intended to be structured as a corporate inversion, but subsequent to signing the merger agreement, the U.S. Treasury Department and the IRS announced their intent to issue regulatory guidance eliminating certain tax advantages of inversions. As a result of withdrawing its recommendation in support of the deal, AbbVie was required to pay to Shire a $1.635 billion termination fee.

The court denied the plaintiffs' requests for books and records, holding that "[a] stockholder seeking to use Section 220 to investigate corporate wrongdoing solely to evaluate whether to bring derivative litigation has stated a proper purpose only insofar as the investigation targets non-exculpated corporate wrongdoing." Because the plaintiffs did not allege a basis to establish bad faith or waste based on the board's conduct in evaluating the deal or changing its recommendation, and therefore stated no exculpated claim, the plaintiffs were not entitled to the books and records sought.

Derivative Litigation

Court Enters $171 Million Damages Award for Board's Failure to Evaluate Transaction in Good Faith

In re El Paso Pipeline Partners, L.P. Derivative Litig., C.A. No. 7141-VCL (Del. Ch. Apr. 20, 2015)

Vice Chancellor J. Travis Laster of the Delaware Court of Chancery awarded $171 million in damages against the general partner of El Paso Partners, L.P. (Partnership) for failing to comply with the contractual standards expressed in a partnership agreement governing interested "dropdown" transactions.

In 2010, the Partnership purchased interests in two subsidiaries from El Paso Corporation, which controlled the general partner of the Partnership. In the following months, the Partnership purchased additional ownership of the subsidiaries in transactions whereby El Paso's ownership "dropped down" from El Paso to the Partnership. The partnership agreement required a good faith belief by the general partner's board that such dropdowns were in the best interests of the Partnership.

After trial, the court determined that the general partner's board "failed to form a subjective belief that the [dropdown] was in the best interests of [the Partnership]," explaining that "[t]he evidence at trial ultimately convinced [the court] that when approving the [dropdown], the Committee members went against their better judgment and did what [El Paso] wanted, assisted by a financial advisor that presented each dropdown in the best possible light, regardless of whether the depictions conflicted with the advisor's work on similar transactions or made sense as a matter of valuation theory." The court awarded damages to the plaintiff calculated as the difference between the purchase price and the actual value of assets received in the dropdowns.

District Court Dismisses Data Breach Litigation Framed as Derivative Lawsuit

Palkon v. Holmes, No. 2:14-cv-01234 (SRC) (D.N.J. Oct. 20, 2014)

Judge Stanley R. Chesler of the U.S. District Court for the District of New Jersey dismissed a shareholder derivate lawsuit against directors of Wyndham Worldwide Corporation arising from three data breaches between April 2008 and January 2010 affecting the company's customers' financial and personal data.

During the data breaches, hackers stole over 600,000 customers' credit card information through "memory-scraping malware" after breaching Wyndham's main network and those of its hotels by guessing an administrator's user ID and password information. Palkon, a Wyndham shareholder during these cyberattacks, demanded in mid-2013 that the board pursue litigation over the attacks. The board refused Palkon's demands. Palkon then filed a derivative suit claiming that the board failed to (1) implement an adequate system of internal controls to protect customers' financial and personal information, and (2) timely disclose the data breaches to shareholders after they occurred.

In dismissing the claims with prejudice, the court concluded that the business judgment rule applied, and, under the circumstances, shielded the directors from liability. Under Delaware substantive law, where a board of directors refuses to pursue a shareholder's demand, that decision is subject to the business judgment rule, and a shareholder or order to defeat a motion to dismiss must raise a reasonable doubt that the refusal was a business judgment. A shareholder can do this by pleading with particularity that the decision was either (1) made in bad faith or (2) based on an unreasonable investigation.

First, the court rejected the plaintiff's allegation that the board acted in bad faith. On this point, the plaintiff argued that the board's refusal was influenced by conflicted legal counsel, an argument the court rejected. The court explained that counsel never had multiple, conflicting duties. To the contrary, "counsel was duty-bound at all times to advocate for WWC, and for no one else." Notwithstanding the plaintiff's allegation, there were no well-pleaded facts that counsel to the board faced any prospect of personal liability stemming from the cyberattacks.

Second, the court rejected the allegation that the board's refusal was based on an unreasonable investigation. The court reasoned that the board had "ample" information at its disposal when it rejected the plaintiff's demand. The board originally had become familiar with the subject matter based on a prior Federal Trade Commission (FTC) investigation into cybersecurity and data protection measures. In fact, the court noted, the board discussed cyberattacks and data security generally during 14 different meetings between October 2008 and August 2012. As the court concluded, by the time the plaintiff submitted his letter, the board's review of the letter did not occur in a vacuum. Moreover, the board "specifically consider[ed]" the demand and even met to discuss it. Accordingly, because "WWC's Board had a firm grasp of Plaintiff's demand when it determined that pursuing it was not in the corporation's best interest," the plaintiff failed to raise a reasonable doubt that the refusal was a business judgment.

Section 205

Court Approves Settlement in Contested Action Under Newly Enacted Section 205

In re Cheniere Energy, Inc. Stockholders Litig., C.A. No. 9710-VCL (Del. Ch. Mar. 16, 2015)

Vice Chancellor J. Travis Laster approved a settlement of stockholder litigation and of one of the first contested actions brought under 8 Del. C. § 205, and validated over 25 million shares of Cheniere Energy, Inc. The newly enacted Section 205 provides the Delaware Court of Chancery with a statutory mechanism to validate defective corporate acts.

Stockholder plaintiffs filed derivative and class actions in the Court of Chancery alleging that the Cheniere stockholder vote on Amendment No. 1 to Cheniere's 2011 Incentive Plan was invalid. The plaintiffs alleged that Cheniere improperly failed to count abstentions applying a "votes cast" standard, when abstentions should have been counted as "no" votes using a "present and entitled to vote" standard. Had abstentions been counted as votes against, Amendment No. 1 would not have passed. The plaintiffs therefore claimed that the 17 million shares already issued as compensation to directors, officers and employees pursuant to Amendment No. 1, as well as the additional 7.8 million shares available under the plan, were void. The plaintiffs sought expedition and an injunction of Cheniere's 2014 annual meeting, at which stockholders were to be asked to vote on a new long-term incentive plan for Cheniere officers, directors and employees. Cheniere then filed a petition in the Court of Chancery under newly enacted Section 205 seeking a declaration as a matter of law that the vote on Amendment No. 1 was properly counted and the shares were valid; or, in the alternative, if the court determined that the vote on Amendment No. 1 was not counted properly, to use its authority under Section 205 to validate the shares authorized by Amendment No 1. Ultimately, the parties entered into a settlement of both the stockholder litigation and the Section 205 action. Among other things, the settlement provided that the parties would seek an order from the court under Section 205 validating all shares that had been previously issued under the 2011 Incentive Plan. The settlement also contemplated that the 7.8 million shares available for issuance under Amendment No. 1 would not be used for compensation purposes absent a new shareholder vote.

The court approved the settlement. It remarked that many of the shares being validated were issued to line-item employees, and that "[p]art of what this settlement will do is validate those shares so that there's no question about their validity." The court also noted that the settlement "will remove uncertainty about the validity of these shares in Cheniere's capital structure and also avoid potential problems down the road figuring out who can vote, who can't vote, giving opinions as to due authorization, and all kinds of nasty consequences that would flow if these shares are not validated." Thus, the Court of Chancery approved the settlement, and declared valid under Section 205 approximately 25 million shares of Cheniere stock. The court also rejected the plaintiffs' counsel's request for $43.1 million in attorneys' fees and instead awarded $5.5 million in fees.

Secondary Actor Liability

Second Circuit Denies Petition Seeking Rehearing of Dismissal of Securities Fraud Claims Against Clearing Broker

Fezzani v. Bear, Stearns & Co. Inc., Nos. 14-3983, 09-4414 (2d Cir. Jan. 30, 2015)

The U.S. Court of Appeals for the Second Circuit denied a petition seeking rehearing of an opinion affirming the dismissal of claims that a clearing broker violated Section 10(b) of the Securities Exchange Act by allegedly failing to disclose certain price misrepresentations made by a broker-dealer. The Second Circuit previously determined that the plaintiffs failed to adequately allege facts showing that a clearing broker participated in alleged price manipulation by a broker-dealer. The court denied rehearing because it again determined that the plaintiffs' allegations did not demonstrate that the clearing broker controlled the broker-dealer or directed it to execute the sham transactions at issue. The plaintiffs failed to allege any specific conduct tying the clearing broker to the manipulation of securities prices or communication of those prices to customers, and allegations that the clearing broker merely knew of the fraudulent scheme were insufficient. The court additionally clarified that, counter to the SEC's assertion in an *amicus* brief, the court's previous decision did not limit liability in market manipulation cases only to those defendants that communicated directly with investors. Rather, a person may well be held liable under Section 10(b) for "sending a false pricing signal to the market, upon which victims of the manipulation rely." However, such a theory did not apply in this case because the plaintiffs did not allege that they relied on or even knew about the clearing broker's alleged conduct, and they were not entitled to a presumption of reliance because the securities in question did not trade in a well-developed and efficient market.

Securities Fraud Pleading Standards

Item 303 Disclosure

District of Minnesota Partially Dismisses Securities Class Action

Beaver Cnty. Emps.' Ret. Fund v. Tile Shop Holdings Inc., No. 14-786 ADM/TNL (D. Minn. Mar. 4, 2015)

Judge Ann D. Montgomery of the U.S. District Court for the District of Minnesota granted in part and denied in part motions to dismiss a securities class action brought on behalf of purchasers of Tile Shop Holdings, Inc. for alleged violations of the Securities Exchange Act and the Securities Act. The plaintiffs alleged that the defendants' failure to disclose Tile Shop's business dealings with companies owned by family members of the CEO violated Sections 10(b) and 20(a) of the Securities Exchange Act and Sections 11, 12(a)(2) and 15 of the Securities Act.

The plaintiffs asserted four theories of liability under Section 10(b) and Rule 10b-5, and the court concluded that three of those theories were sufficiently pleaded under the PSLRA as to the company and its CEO. First, the court held that the defendants' alleged failure to comply with Item 303 of Regulation S-K—requiring the disclosure of trends or uncertainties that would have a material impact on its net sales, revenues or income—could give rise to a violation of Rule 10b-5. Second, the court concluded that because the defendants did not disclose the close relationships between the company and its suppliers, statements regarding the strength of its supplier relationships could be misleading. Third, statements linking the company's high gross margins to its direct sourcing model could be misleading because the defendants did not disclose the nature of the supplier relationships. Although the court upheld the Section 10(b) claims against the company and its CEO, it dismissed the claim against the CFO due to the plaintiffs' failure to adequately allege scienter. The court also dismissed claims under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act, concluding that the plaintiffs failed to allege particular facts that established certain defendants exerted control over the actions of the company.

The court also dismissed the plaintiffs' claims under Sections 11 and 12(a)(2) of the Securities Act relating to the company's June 2013 public offering. The court reasoned that the plaintiffs lacked standing to assert the claims because they did not purchase shares in the June 2013 public offering, nor did they plead facts to establish that their stock purchases were traceable to that offering. The court, however, allowed the Securities Act claims relating to the company's December 2012 public offering to proceed because (1) the plaintiffs pleaded that they purchased shares in that public offering, and (2) the plaintiffs adequately pleaded recoverable damages as required by Section 12(a).

Misrepresentations

SDNY Applies *Omnicare* and Denies, in Part, Motion to Dismiss Claims Against Pharmacy Services Company

In re BioScrip Inc. Sec. Litig., No. 1:13-cv-06922-AJN (S.D.N.Y. Mar. 31, 2015)

Judge Alison J. Nathan of the U.S. District Court for the Southern District of New York refused to dismiss claims that a health care services company violated Section 10(b) of the Securities Exchange Act by misleading investors as to certain allegedly fraudulent Medicare and Medicaid reimbursement practices. The plaintiffs alleged that the company stated that it was in compliance with relevant health care regulations even though it knew, at the time the statements were made, about the government's ongoing investigation into alleged wrongdoing. The court held that the plaintiff adequately alleged that the company's opinions were not honestly held in light of the ongoing investigation. Further, applying the Supreme Court's recent decision in *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund,* 135 S. Ct. 1318 (2015), the court held that the company's failure to disclose the ongoing investigation was actionable because the legal compliance opinions might have led a reasonable investor to believe that there were no pending investigations of wrongdoing. The court dismissed, however, claims that the company exaggerated the success of its pharmacy benefits management segment despite allegedly losing a major client. The plaintiffs failed to adequately allege scienter because although the segment constituted significant business for the company, that fact alone was insufficient to demonstrate that the company knew it had lost the client when the statements were made. Further, although the plaintiffs' confidential witnesses testified that management would receive reports on the business segment, the testimony did not identify the content of particular reports, the date the reports were allegedly made available, or whether the defendants reviewed them.

Omissions

SDNY Dismisses Section 11 Claims Against an Online Video Advertisement Company on Materiality Grounds

Medina v. Tremor Video, Inc., No. 13-cv-8364 (PAC) (S.D.N.Y. Mar. 5, 2015)

Judge Paul A. Crotty of the U.S. District Court for the Southern District of New York dismissed claims that an online video advertisement company violated Section 11 of the Securities Act by allegedly failing to disclose in a registration statement for the company's initial public offering material trends concerning lost revenue resulting from a two-week delay in advertisement purchases from two customers and increasing resistance among customers to performance-based pricing. The court held that the plaintiffs failed to allege that the two-week delay constituted an actionable trend under Item 303 because the timing of customers' purchases commonly varied, and the allegations did not demonstrate that, at the time the registration statement was filed, the delay was likely to negatively affect the company's business. Indeed, because of, and not despite, the "inherently fact-specific" nature of materiality, the court found the plaintiffs' "speculation" about the delay did not support a claim. Likewise, the court determined that the plaintiff failed to allege that the company could have disclosed an alleged trend toward less profitable demographic-based pricing because that trend did not become apparent until four months after the offering. In addition, the court determined that even if the alleged misstatements and omissions were material, each was accompanied by appropriate qualifying.

Reliance

SDNY Declines to Dismiss Investors' Claims That Beauty Company CEO Violated Securities Laws

Le Metier Beauty Inv. Partners LLC v. Metier Tribeca, LLC, No. 1:13-cv-04650 JFK (S.D.N.Y. Feb. 24, 2015)

Judge John F. Keenan of the U.S. District Court for the Southern District of New York denied a motion to dismiss claims that a beauty company's CEO violated Section 10(b) of the Securities Exchange Act. Litigation against the company had been automatically stayed after the company filed for bankruptcy. Investors alleged that the CEO misrepresented how the company would use the proceeds from a sale of equity and used over 80 percent of the funds for prohibited purposes. The court determined that a provision of the purchase agreement providing that the purchaser did not rely upon representations outside of the agreement—disclaiming reliance on materials outside of the transactional documents—did not bar the claims. The "mere existence" of such a provision does not "automatically" mean that reliance was unreasonable, especially in the case of a general disclaimer, and the court noted that in this case the disclaimer did not specifically address any of the plaintiffs' allegations. In addition, the court determined that, at this stage of the proceeding, the plaintiffs' alleged reliance on representations outside of the purchase agreement was not unreasonable as a matter of law, even though the plaintiffs received a detailed business plan and had the ability to request other specific information from management at the time of the sale, because reliance is generally a fact question and the plaintiffs alleged that some of the additionally provided information was false.

Scienter

Fourth Circuit Overturns District Court's Order Dismissing a Securities Class Action for Failure to Plead Scienter

Zak v. Chelsea Therapeutics Int'l, Ltd., No. 13-2370 (4th Cir. Mar. 16, 2015)

A split panel of the U.S. Court of Appeals for the Fourth Circuit reversed and remanded a securities class action against a pharmaceutical company and its executives, holding that the district court erred in dismissing the complaint for failure to plead facts supporting a strong inference of scienter.

The plaintiffs alleged that Chelsea Therapeutics and several of its officers violated Section 10(b) of the Securities Exchange Act by failing to disclose to investors that "the FDA expected Chelsea to produce two successful studies showing evidence of durability of effect" and that the "FDA briefing document included a recommendation against approval" of the new drug. The plaintiffs asserted that omitting this information from company press releases supported a strong inference of wrongful intent. In support of their motion to dismiss, the defendants asked the district court to take judicial notice of certain SEC documents showing a lack of scienter. The district court took judicial notice of the SEC filings and held that the plaintiffs failed to state a Section 10(b) claim.

The court of appeals reversed. First, the court held that it was not appropriate for the district court to take judicial notice of the SEC filings because they were not explicitly referenced in or an integral part of the complaint. Second, while emphasizing that its decision did "not stand for the proposition that a strong inference of scienter can arise merely based on a defendant's failure to disclose information," the court explained that "the scienter inquiry necessarily involves consideration of the facts and of the nature of the alleged omissions or misleading statements within the context of the statements that a defendant affirmatively made." The court considered several positive press releases issued by the defendants that made no mention of the FDA's reservations about the new drug. The court held that the plaintiffs' allegations permitted a strong inference that the defendants acted with wrongful intent "by failing to disclose critical information received from the FDA during the new drug application process, while releasing less damaging information that they knew was incomplete."

In a strongly worded dissent, Judge Stephanie D. Thacker rejected the majority's reasoning, noting that "[s]ince the enactment of the PSLRA, [the Fourth Circuit has] published eight decisions reviewing the dismissal of a securities fraud suit for failure to plead facts supporting a strong inference of scienter; in all of them, [the Fourth Circuit] concluded that the inference was lacking." Notwithstanding her agreement with the majority that the district court improperly relied on the SEC filings, Judge Thacker wrote that the allegations in the complaint did not "strongly imply either fraudulent intent or severe recklessness."

Second Circuit Affirms Dismissal of Section 10(b) Claims Because Company Lacked Motive to Mislead Investors or Disbelieve Its Risk Representations

Westchester Teamsters Pension Fund v. UBS AG, No. 14-165-cv (2d Cir. Feb. 27, 2015)

The U.S. Court of Appeals for the Second Circuit affirmed in a summary order the dismissal of claims that a financial services company violated Section 10(b) of the Securities Exchange Act by allegedly making misrepresentations about the company's risk management systems and internal controls. The plaintiffs failed to adequately allege scienter, either through a showing of "motive and opportunity" or of "conscious misbehavior or recklessness." The court determined that the company had no motive to mislead investors about its risk management systems, and it did not benefit in any way from alleged unauthorized actions of a rogue trader that exposed the company to large financial losses. The court further determined that the plaintiffs failed to allege that the company was reckless because the complaint did not allege with particularity any facts indicating that the company was warned about, or could have known about, the kind of unauthorized trading that occurred. Rather, the company had no reason to disbelieve its representations to investors that its risk controls were effective.

First Circuit Upholds Dismissal of Section 10(b) Claim Against Medical Device Company for Failing to Demonstrate Scienter

Simon v. Abiomed, Inc., No. 14-1502 (1st Cir. Feb. 6, 2015)

The U.S. Court of Appeals for the First Circuit affirmed the dismissal of claims that a medical device company violated Section 10(b) of the Securities Exchange Act by concealing from investors that the company was promoting its heart pump product for off-label purposes. The plaintiffs alleged that the company knew about the alleged misconduct by way of certain nonpublic letters from the FDA concerning the activity, but concealed from investors that a source of its growth was from allegedly off-label sales. The plaintiffs relied on confidential witnesses who asserted that the company ignored the FDA's warnings. The court dismissed the claims because the plaintiffs failed to sufficiently allege scienter. The company had repeatedly disclosed the risk that the FDA might disagree with the company as to the legality of its marketing strategies, and it was not required to disclose any wrongdoing while negotiations with the FDA were pending and had not yet resulted in adverse action. In addition, the confidential witnesses' assertions were insufficient to support an inference of scienter because none of the witnesses had direct contact with senior management, and their assertions lacked specificity as to the time period and extent of the alleged wrongdoing. The court further determined that allegations that certain executives sold stock based on inside information were insufficiently suspicious to give rise to an inference of scienter. One executive actually increased his holdings during the class period, and another's trades corresponded with his first opportunity to sell shares after joining the company.

Tenth Circuit Upholds Dismissal of Section 10(b) Claims Against Biopharmaceutical Company

Wolfe v. Aspenbio Pharma, Inc., No. 12-1406 (10th Cir. Oct. 17, 2014)

The U.S. Court of Appeals for the Tenth Circuit affirmed the dismissal of claims that a biopharmaceutical company violated Section 10(b) of the Securities Exchange Act by allegedly misrepresenting the efficacy of a proprietary screening test for appendicitis. The plaintiffs failed to allege that the current CEO of the company knew that the alleged statements were false at the time they were made. The court rejected the plaintiffs' assertion that the CEO's knowledge could be imputed solely from the CEO's executive position within a company. In addition, allegations that the CEO was informed about problems with the screening test were too "vague" to give rise to an inference of scienter under the PSLRA's heightened pleading standards. Further, the statements allegedly informing the CEO of the problems were made more than a year earlier and, even if true, did not plausibly demonstrate that the CEO knew his statements were false at the time they were made.

Western District of Louisiana Declines to Apply Group Pleading Doctrine to a Company That Is Not 'Extremely Small'

In re CenturyLink, Inc., No. 3:13-CV-02318 (W.D. La. Feb. 3, 2015) (recommendation adopted by the district court at Docket Nos. 70 and 71 on Apr. 21, 2015)

The U.S. District Court for the Western District of Louisiana adopted the recommendation of Magistrate Judge James D. Kirk to grant a motion to dismiss a federal securities class action for failure to plead facts supporting a strong inference of scienter and denied the plaintiffs' request for leave to amend their complaint. The plaintiffs alleged that CenturyLink and its senior executives violated Sections 10(b) and 20(a) of the Securities Exchange Act by falsely representing, in press releases, conference calls, analyst conferences and SEC filings, that the company was financially capable of maintaining its credit rating and dividend payment.

As to the Section 10(b) claim, the magistrate judge held that the plaintiffs had failed to adequately plead scienter. The plaintiffs attempted to rely on the defendants' positions as senior executives to demonstrate a strong inference of scienter. The plaintiffs cited to *Spitzberg v. Houston Am. Energy Corp.*, 758 F.3d 676 (5th Cir. 2014), which allowed plaintiffs to use "group pleading" to establish scienter in a securities fraud action. However, the magistrate judge stated that the holding in *Spitzberg* was "limited to that defendant 'due to the extremely small size of the company at issue.'" The magistrate judge held that because CenturyLink was a large corporation, the plaintiffs were required to "plead facts sufficient to show [an] individual defendant acted with the 'intent to deceive, manipulate or defraud' or that he acted in a manner that was so reckless that it constituted an extreme departure from ordinary care which presented a danger of misleading buyers or sellers." Because the plaintiffs failed to do so, the magistrate judge held that a strong inference of scienter could not be found. The magistrate judge also recommended that because there was no primary violation of the Securities Exchange Act, there could be no control person liability under Section 20(a).

Northern District of California Dismisses Securities Fraud Action for Failure to Plead Scienter

Taormina v. Annie's, Inc., No. 14-02711 (N.D. Cal. April 16, 2015)

Judge Beth Labson Freeman of the U.S. District Court for the Northern District of California dismissed without prejudice a putative class action complaint for securities fraud against organic food manufacturer Annie's, Inc., and certain officers of the company. The plaintiffs asserted claims for securities fraud under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, as well as a claim for control person liability under Section 20(a) of the Securities Exchange Act. The court found that while the consolidated complaint sufficiently alleged a material misrepresentation or omission by the defendants, it failed to adequately plead scienter.

The plaintiffs alleged that, during the class period, the defendants made material misrepresentations regarding (1) the company's accounting practices for customer incentives programs and (2) the adequacy of the company's internal controls over its accounting practices. According to the allegations, the defendants misstated the company's true net income by failing to capture all trade promotion costs. In addition, the company's public filings allegedly misrepresented internal controls over financial reporting because the company's accounting practices for trade promotion costs violated GAAP. During the class period, the company issued a series of press releases regarding its statements on the accounting practices and noted that it would be revising its methodology. However, in making the revision, the company stated that it did not consider the financial impact of the change to be "material," but stated that "material weaknesses" existed in its internal control over financial reporting.

In concluding that the plaintiffs adequately pleaded falsity, the court rejected the defendants' arguments that the statements regarding accounting practices were immaterial simply because the resulting changes in net income were relatively small. On that point, the court stated that it could not "conclude as a matter of law that a reasonable investor would not have viewed the alleged [accounting] discrepancies to be material." With respect to the alleged misstatements regarding the company's internal control over financial reporting, the defendants argued that the statements were couched as opinions and thus must be analyzed in light of the U.S. Supreme Court's recent holding in *Omnicare, Inc. v. Laborers Dist. Council Const. Indust. Pension Fund*, 135 S. Ct. 1318 (2015). In that case, the Supreme Court, reviewing Section 11 of the Securities Act, clarified the circumstances under which a company can be liable for statements of opinion contained in a registration statement. The Supreme Court held that "a statement of opinion is not misleading just because external facts show the opinion to be incorrect," so long as the opinion is honestly believed. The court noted, however, that the discussion of materiality in *Omnicare* "was limited to the second prong of § 11 regarding omissions." Thus, even though the court here agreed with the defendants that some of the statements regarding internal controls were, indeed, couched as opinions, the court "cannot conclude at this stage in the proceedings that the statements were not materially misleading."

Regarding scienter, the court found that statements from confidential witnesses were not themselves indicative of scienter because they were "too vague and general" to demonstrate that defendants made statements with intent or with deliberate recklessness. Indeed, plaintiffs failed to plead "any contemporaneous facts" suggesting that the individual defendants believed at the time that the statements about accounting methods for promotional costs were "inappropriate" and the company's internal controls were "insufficient."

Because Section 20(a) claims are predicated on an underlying violation of the securities laws, the court likewise dismissed that claim.

D. Mass Dismisses Section 10(b) Claims Against a British Columbia Power Company

In Re: Atl. Power Corp. Sec. Litig., No. 1:13-cv-10537-IT (D. Mass. Mar. 13, 2015)

Judge Indira Talwani of the U.S. District Court for the District of Massachusetts dismissed claims that a power company and certain of its officers violated Section 10(b) of the Securities Exchange Act by falsely stating that the company would be able to maintain or increase dividends despite the company's allegedly high debt. The court determined that allegations that the company knew its "crippling" level of debt would negatively affect dividends were too generalized to support a strong inference of scienter, and in any event the company had sufficiently disclosed all pertinent financial information to the market. Further, the court determined that the company's allegedly "labyrinthine" financial disclosures were not alone enough to support an inference of scienter, and the plaintiff failed to allege that the company intended to confuse investors. The court likewise rejected the plaintiffs' argument that the company's bonus structure incentivized officers to delay a reduction in dividends because the plaintiffs failed to plead any "additional or unusual" facts concerning the compensation scheme.

District Court Dismisses Section 10(b) Claim Against Intercloud Systems

Muncy v. Intercloud Sys., Inc., No. 14-111-DBL (E.D. Ky. Mar. 10, 2015)

Judge David L. Bunning of the U.S. District Court for the Eastern District of Kentucky granted in part and denied in part a motion to dismiss claims alleging violations of Section 10(b) of the Securities Exchange Act, Kentucky's Blue Sky Laws and state common law. The plaintiff claimed that the defendant's agents induced him to purchase stock in the company by making false statements and omitting material facts regarding a future initial public offering. In dismissing the Section 10(b) claim, the court held that certain statements concerned "predictions and matters of opinion" and were not actionable because (1) the plaintiff failed to plead facts showing that the defendant made the statement with knowledge of its falsity, and (2) predictions of profit and growth are not actionable unless backed by a guarantee or linked to a misleading statement. The court further concluded that, although a reasonable jury could find that at least one of the statements was misleading, the misstatement was not material because accurate information was publicly available in the defendant's SEC filings.

In addressing the alleged omissions, the court held that the defendant had a duty to disclose that the shares were not registered and the plaintiff would not be able to trade on them because a reasonable investor would consider this information important. The court concluded, however, that there was no liability under Section 10(b) for the alleged omissions because the complaint did not raise a strong inference that the defendant acted with scienter. Accordingly, the plaintiff's claim under Section 10(b) was dismissed. Because Rule 9(b) and the PSLRA do not apply to Kentucky's Blue Sky Laws, and the defendant failed to raise specific arguments as to why those claims should be dismissed, the court denied the defendant's motion to dismiss as to the Blue Sky Law claims.

SDNY Upholds Claims That a Pharmaceutical Company Acted With Scienter in Partially Disclosing Study Results

In Re Intercept Pharm., Inc. Sec. Litig., No. 1:14-cv-01123-NRB (S.D.N.Y. Mar. 4, 2015)

Judge Naomi Reice Buchwald of the U.S. District Court for the Southern District of New York refused to dismiss claims by a putative shareholder class that a pharmaceutical company violated Section 10(b) of the Securities Exchange Act by concealing negative developments in a drug study. The plaintiffs alleged that the company publicly disclosed that it was ending a drug trial after certain positive results, but concealed other allegedly negative findings until the following day. The company's stock price rose on news of the former disclosure and fell on the subsequent disclosure. The court upheld the claims on one of the plaintiffs' two theories of scienter. Although the plaintiffs alleged that the company wanted to increase and maintain its stock price prior to a proposed secondary offering, that offering was four months away, and thus that theory was "too generalized" to support an inference of scienter. However, certain alleged internal emails demonstrated that management knew of the related negative information at the time of the first disclosure and consciously decided not to disclose it. The court further determined that the "selective disclosure" of only the positive information created a "real possibility of misleading investors," and supported a strong inference of knowing misconduct. The court declined to hold at this stage of the proceeding that the information was immaterial because the plaintiffs had sufficiently alleged that it was at least a "significant" part of the company's decision to end the drug trial.

Statutes of Repose/Statutes of Limitations

Tenth Circuit Holds That Tolling Agreement Cannot Toll Time Limit Under Federal Extender Statute, Yet Equitable Estoppel Principles Preclude Use of a Limitations Defense

Nat'l Credit Union Admin. Bd. v. Barclays Capital Inc., No. 13-3183 (10th Cir. Mar. 3, 2015)

The U.S. Court of Appeals for the Tenth Circuit reversed a district court's ruling that the Securities Act's statute of repose barred claims by the National Credit Union Administration (NCUA) against the issuers and underwriters of certain residential mortgage-backed securities. The district court had previously held that the NCUA's federal extender statute pre-empted the Securities Act's statute of repose but that the NCUA's claims were still untimely because the three-year period in the extender statute could not be tolled by agreement. The Tenth Circuit, citing its recent decision in *Nat'l Credit Union Admin. Bd. v. Nomura Home Equity Loan, Inc.*, 764 F.3d 1199 (10th Cir. 2014), reaffirmed its holding that the federal extender statute is a statute of limitations that supplants the Securities Act's three-year statute of repose for suits brought by the NCUA as a conservator or receiver. The court further held that the NCUA's claims were untimely because they were brought outside the federal extender statute's three-year limitation, and the tolling agreement in the case could not toll the limitations period in contravention of the express language of the extender provision that its "limitations period cannot be tolled by agreement." However, the court determined that, although the claims were untimely, the defendant was equitably estopped from asserting the defense because it had expressly agreed not to do so during settlement negotiations, and the NCUA had relied on that promise. The court determined that the extender statute, in this context, operates like a statute of limitation rather than a statute of repose, and thus equitable estoppel may apply where an express promise was made not to assert the limitations period as a defense. In a recent decision by the U.S. District Court for the District of Kansas, the court adopted the Tenth Circuit's reasoning in *Barclays* and reconsidered its prior dismissal of claims against two defendants as time-barred. *Nat'l Credit Union Admin. Bd. v. UBS Securities, LLC*, No. 12-2591-JWL (D. Kan. May 27, 2015). As in *Barclays*, the court determined that the tolling agreements at issue were not enforceable with respect to the extender statute, but that two of the defendants also had agreed not to raise the limitations period as a defense and thus were equitably estopped from doing so. However, as to a third defendant that entered into a tolling agreement without making a "separate express promise" about raising the defense, the court refused to apply equitable estoppel, even though the NCUA argued that such a promise was "implied" in the tolling agreement.

SDNY Finds That FDIC Extender Provision Does Not Pre-Empt the Securities Act's Statute of Repose

F.D.I.C. v. Bear Stearns Asset Backed Sec. I LLC, No. 1:12-cv-04000-LTS (S.D.N.Y. Mar. 24, 2015)

Judge Laura Taylor Swain of the U.S. District Court for the Southern District of New York dismissed claims brought under Section 11 of the Securities Act by the Federal Deposit Insurance Corporation (FDIC) as receiver for two banks because the claims were time-barred by the Securities Act's statute of repose. The court rejected the FDIC's argument that the statute of repose was pre-empted by the FDIC Extender Provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which provides a six-year statute of limitations for contract claims brought by the FDIC as a receiver. The court determined that the Supreme Court's recent decision in *CTS Corp. v. Waldburger*, 134 S. Ct. 2175 (2014), which held that a similar extender provision did not pre-empt a state statute of repose, implicitly overturned prior law in the Second Circuit that held that such extender provisions may pre-empt a statute of repose. Applying *Waldburger*, the court determined that the text of the FDIC Extender Provision did not include any "reference to any statute of repose," indicating that Congress intended only to displace otherwise applicable statutes of limitations, and not statutes of repose. The court noted the Tenth Circuit's potentially conflicting decision in *Nat'l Credit Union Admin. Bd. v. Nomura Home Equity Loan, Inc.*, 727 F.3d 1246 (2013), and explicitly disagreed, noting that the "concepts of claim accrual, and measurement from events distinct from the actions of the defendant, are entirely inconsistent with the conceptual and practical framework of statutes of repose." The FDIC has appealed this decision to the U.S. Court of Appeals for the Second Circuit. The FDIC also has appealed a prior decision, issued in the Southern District of New York in September 2014, dismissing the FDIC's claims as time-barred on the same grounds. *FDIC v. Chase Mortg. Fin. Corp.*, No. 12-cv-6166, 2014 WL 4354671 (S.D.N.Y. Sept. 2, 2014). That appeal now is awaiting oral argument.

Northern District of Ohio Dismisses, in Part, Claims Against Brokerage Firms for Distributing Unregistered Securities

In re Biozoom, Inc. Sec. Litig., No. 1:14-CV-01087-JSG (N.D. Ohio Feb. 26, 2015)

Judge James S. Gwin of the U.S. District Court for the Northern District of Ohio dismissed, in part, claims brought against several brokerage firms for allegedly selling unregistered securities in violation of Section 12(a)(1) of the Securities Act. The defendants argued that many of the plaintiffs' claims were time-barred because a Section 12(a)(1) action must be brought within one year of the alleged violation, and the plaintiffs had filed most of their claims more than a year after purchasing the securities at issue. The plaintiffs countered that because Section 12(a)(1) prohibits both selling and offering unregistered securities, the one-year limitations period did not begin to run until the defendants stopped *offering* the stock. Citing Supreme Court precedent interpreting Section 12(a)(1) to require "some nexus with an actual sale" (*Pinter v. Dahl*, 486 U.S. 622, 644 (1988)), the court ruled that a violation occurs when an unregistered security is sold, even if the defendant subsequently continues to promote the security. Accordingly, the court dismissed many of the plaintiffs' claims as untimely.

The defendants argued that the remaining claims should be dismissed because the defendants were not "sellers" within the meaning of Section 12(a)(1), and because the Securities Act's dealer and broker transaction exemptions shielded them from liability. The court disagreed, determining that (1) the plaintiffs had plausibly alleged that the defendants sold the at-issue securities directly to them and (2) the defendants had not met their burden of establishing their entitlement to either exemption from the registration requirement. Consequently, the court declined to dismiss the plaintiffs' remaining claims.

Whistleblower Protections

SDNY Dismisses Whistleblower Claim Under CFPA as Matter of First Impression

Murray v. UBS Sec., LLC, No. 1:14-cv-00927 KPF (S.D.N.Y. Feb. 24, 2015)

Judge Katherine P. Failla of the U.S. District Court for the Southern District of New York dismissed a claim that an employer violated the anti-retaliation provisions of the Consumer Financial Protection Act (CFPA) by allegedly terminating an employee because of his refusal to publish misleadingly optimistic research about commercial mortgage-backed securities (CMBS). The court determined as a "matter of first impression" that the plaintiff's CFPA claim was only viable if the Consumer Financial Protection Bureau had designated CMBS as covered financial products under the statute's catch-all provision. Because the agency had not done so, the court dismissed the claim. The court did not dismiss, however, the plaintiff's claim pursuant to the Sarbanes-Oxley Act, even though the plaintiff had previously filed a claim under the Dodd-Frank Act based on the same facts, because the plaintiff's subsequently filed claim had not yet accrued at the time of his first lawsuit. In addition, the court also declined to stay the Sarbanes-Oxley claim pending resolution of the employee's Dodd-Frank claims, which had been ordered to arbitration. The court reasoned that, in light of the anti-arbitration provision in Sarbanes-Oxley, it would be "curious to stay litigation of such a statutory claim so that arbitration might proceed unimpeded on a different claim."

"Pigs Get Fat, Hogs Get Slaughtered: Keeping Lawyers Out of the Slaughterhouse"

By C. Evan Stewart

Recently, I was on a conference call with a large, distinguished group of lawyers in which various courses of action were debated. One such course, I opined, was particularly troubling because I feared we would be buying a pig in a poke. Eventually (and fortunately), the group veered away from the course I feared. But I was troubled that no one seemed to know what I meant when I referenced the "pig" and the "poke"; later, I asked two colleagues if they understood the phrase, and they candidly fessed up that they did not.[1]

As readers of this learned *Journal* know, from time to time this author has attempted to alert members of the bar to a whole variety of pigs in pokes.[2] This article will identify two more.

Threatening Criminal Action

Suppose the following hypothetical: (1) your client is the respondent in a FINRA arbitration in which the claimants are suing for hundreds of millions of dollars in damages, with an evidentiary hearing imminent; (2) while you are preparing witnesses and getting ready for trial, you learn that the claimants' attorneys have been contacting the U.S. Securities and Exchange Commission, the Attorney General of the United States, the U.S. Attorney for the Southern District of New York (the home of your client), the New York Attorney General, FINRA's Enforcement Division, the U.S. Consumer Financial Protection Bureau, and the U.S. Attorney for the Northern District of California (the home of the claimants); (3) the purpose of the claimants' attorneys' efforts in contacting those governmental (and quasi-governmental) agencies is to have them launch an investigation(s) into your client's "criminal wrongdoing" which harmed the claimants; (4) only the U.S. Attorney for the Northern District of California has taken the bait and launched an investigation; and (5) the claimants' attorneys are from a prominent national law firm, with the lawyers working on the case based out of the firm's New York City and San Francisco offices. What, if anything, is wrong with this picture?

Long ago and far away, in a distant universe (i.e., when the author was in law school), the answer was pretty clear. In 1969, the American Bar Association adopted the Model Code of Professional Responsibility; and thereafter the states generally adopted the ABA's Code. Of particular relevance to our hypothetical were Canon 7 ("A Lawyer Should Represent a Client Zealously Within the Bounds of the Law") and Disciplinary Rule 7-105 ("A lawyer shall not present, participate in presenting, or threaten to present criminal charges solely to obtain an advantage in a civil matter."). The ABA's Ethical Consideration 7-21 fleshed out the rationale for DR 7-105:

> The civil adjudicative process is primarily designed for the settlement of disputes between the parties, while the criminal process is designed for the protection of society as a whole. Threatening to use, or using, the criminal process to coerce adjustment of private civil claims or controversies is a subversion of that process; further, the person against whom the criminal process is so misused may be deterred from asserting his legal rights and thus the usefulness of the civil process in settling private disputes is impaired. As in all cases of abuse of the judicial process, the improper use of criminal process tends to diminish public confidence in our legal system.

Ethical Consideration 7-21 cited as its reference point the 1930 decision of New York's Appellate Division, First Department *In re Gelman*.[3] In that case, a New York lawyer wrote a threatening letter to a taxi driver who had been in an accident with the lawyer's client. Among other things, the lawyer wrote that if he was "put to the trouble of proceeding against [the driver] personally…, [he would] be compelled to initiate criminal proceedings against [the driver] for failing to cover [his] taxicab by proper insurance policy under the law."

While it turned out the driver did have "proper" insurance (and thus the threat of "criminal proceedings" was not in fact a meaningful one), the First Department ruled that the lawyer was to be "severely censored" for violating "the principle which condemns any confusion of threats of criminal prosecution with the enforcement of civil claims." In so ruling, the *Gelman* court applied the ethical standard in effect at that time;[4] and that standard would continue to be the widely accepted one thereafter.[5]

In 1983, the ABA, based upon the work of the Kutak Commission, engaged in a wholesale overhaul of the professional responsibility rules. Not included in the new ABA Model Rules, however, was an analog to DR 7-105; thus, at least as far as these aspirational rules were concerned, threats of criminal prosecution in civil matters appeared to be no longer verboten. To the extent uncertainty about that issue remained, the ABA's Standing Committee on Ethics and Professional Responsibility weighed in, issuing Formal Opinion 92-363 ("Use of Threats of Prosecution in Connection with a Civil Matter"):

> The Model Rules do not prohibit a lawyer from using the possibility of prosecuting criminal charges against the opposing party in a private civil matter to gain relief for a client, provided that the criminal matter is related to the client's civil claim, the lawyer has a well-founded belief that both the civil claim and the criminal charges are warranted by the law and the facts, and the lawyer does not attempt to exert or suggest influence over the criminal process.[6]

Three Groups of States

So how have the states (and the District of Columbia) reacted to this change of affairs? Basically, they have split into three groups. The first, consisting of twenty-seven jurisdictions, has followed the ABA approach and has no explicit prohibition on this conduct.[7] The second, consisting of six jurisdictions, blanketly prohibits this conduct.[8] The third, consisting of eighteen jurisdictions, prohibits this conduct—if it is designed "solely" to gain an advantage in civil litigation.[9]

In the first group of states, a number have seemingly embraced—in a positive sense—making criminal threats to gain a tactical edge. Thus, for example, Delaware takes the view that an "[a]ttorney may use the threat of prosecuting criminal charges against [an opposing party] in order to gain relief for [her client] in her civil claim without violating the applicable ethical standards if the criminal matter is related to [her client's] civil claim."[10] Others have suggested threatening criminal prosecution to gain an advantage in civil litigation *may* be violative of other ethical rules.[11]

With respect to the second group of states, California sets forth the standard in its most explicit and clear terms: "A member shall not threaten to present criminal, administrative, or disciplinary charges to obtain an advantage in a civil dispute."[12] And the California courts and bar authorities have not been reticent in enforcing this provision.[13]

As an example of the third group of states, New York's Rule 3.4 (e) ("Fairness to Opposing Party and Counsel") pretty faithfully tracks the old DR 7-105: a lawyer shall not "present, participate in presenting, or threaten to present criminal charges solely to obtain an advantage in a civil matter."[14]

What Constitutes a "Threat"?

In the two groups of states which recognize there is an ethical issue for lawyers engaging in this conduct, an important issue to understand is what constitutes a "threat." As a 2003 New York State Bar Association Ethics Opinion observed: "there is no universal standard to determine whether a letter 'threaten[s] to present criminal charges.' Such a determination requires the examination of both the content and the context of the letter."[15] A real "threat" is pretty easy to understand, whether it be the threat used in *Gelman* or in a legion of other cases.[16]

But in less obvious situations, different jurisdictions have determined and differentiated between the act of "threatening" versus "notifying" versus "informing" versus "warning" versus "calling attention to." In Colorado, for example (which is one of the states in the third group), that state expressly provides that it is not an ethical violation "for a lawyer to *notify* another person in a civil matter that the lawyer reasonably believes that the other's conduct may violate criminal…statutes."[17]

And in Wisconsin (another state in the third group), it is permissible for a lawyer to *inform* another person that her conduct may violate a criminal statute and that the lawyer or her client has a right and duty to report the violation.[18]

Oregon (also a state in the third group) actually allows threats, "but *only if*…the lawyer reasonably believes the charge to be true and *if* the purpose of the lawyer is to compel or induce the person threatened to take reasonable action to make good the wrong which is the subject of the charge."[19]

And finally, a number of states have statutes requiring lawyers bringing civil actions to give *notice* of potential criminal prosecution.[20] Thus, in those states, complying with a statutory obligation cannot constitute a violation of a lawyer's professional responsibility obligations.

What Is "Solely"?

"Solely" would seem to support a difficult standard—i.e., if there are mixed reasons, the standard would not be met. The same 2003 New York Ethics Opinion cited above,[21] however, suggested a somewhat less unequivocal bar:

> When a lawyer threatens criminal charges unless the recipient takes specified action, the threat is likely to have one clear purpose—the doing of that specific act. Thus, when a lawyer threatens to present criminal charges unless an action is taken which remedies a civil wrong, a presumption is likely to arise that [Rule 3.4(e)] has been violated.

How has this notion been applied in practice? One of the leading (and often cited) cases fleshing out "solely" is *In re Decato*.[22] There, a lawyer sent a letter that said:

> In New Hampshire, it is a crime to obtain services by means of deception in order to avoid the due payment therefore [sic]. Without any proof on your part, you have chosen to stop payment on a check after it was made for the payment of ser-

> vices. Unless you communicate directly with me and give me some proof that the damages sustained to your son's International Harvester were the result of the failure of Decato Motor Sales, Inc., I shall consider filing a criminal complaint with the Lebanon District Court against your son for theft of services.

The issue before the Supreme Court of New Hampshire was whether the lawyer's letter constituted a violation of DR-7-105. The Court concluded that it did not, hanging its hat on the letter's lack of a "demand or request [for] payment"; as such, the Court could not "find by clear and convincing evidence that his *sole* purpose was to 'obtain an advantage in a civil suit.'"[23]

State bar authorities have also weighed in on "solely." The District of Columbia, for example, has said it is permissible for a lawyer sending a demand letter for a debt owed to include citation to criminal statutes and a potential criminal referral, so long as the threat is not made "solely" to gain advantage in the civil collection action.[24] And Michigan is of the view that a lawyer may properly inform opposing counsel of potentially relevant criminal statutes and possible prosecution, so long as her "sole" purpose is not harassment but instead the legitimate enforcement of her client's interests.[25] Other bar authorities have issued opinions of similar ilk.[26]

So where does all this leave us? Notwithstanding the three basic approaches and the jurisdictional traps inherent in the different standards in play across the country, there appears to be a lot of wiggle room in the joints to account for aggressive lawyering, especially if one picks one's language with some care (and with an eye to precedent). Whether this is a good outcome (or a place where the legal profession should feel good about itself), I will leave to others. But, at a minimum, a lawyer needs to proceed with caution if this is a course of conduct being contemplated.

Are Restrictive Settlements Hunky Dory?

At about the same time I was posing my "pig in a poke" concern to my colleagues, another client asked me to opine on the propriety of a settlement agreement that would include a provision whereby the opposing counsel would agree not to represent certain clients or bring certain claims in the future. This struck me as sort of the opposite bookend of the issue just discussed,[27] and I got cracking to provide the answer to a scenario I had never seen in 38 years of practice.

It turns out that there are in fact three answers. The first is that such an arrangement is patently forbidden by the applicable ethical rules. Rule 5.6 (e) (2) states: "A lawyer shall not participate in offering or making…an agreement in which a restriction on a lawyer's right to practice is part of the settlement of a client controversy." And if that were not clear enough, Comment 2 to the Rule states that this provision "prohibits a lawyer from agreeing not to represent other persons in connection with settling a claim on behalf of a client."[28] So, if the first answer is so clear and unequivocal, how can there be two others?

Well, the second answer is that, notwithstanding the ethical restriction, a number of lawyers apparently enter into such agreements with some frequency.[29] Why? Perhaps in the hopes that (1) the ethical prohibition is not (or will not be) known or raised, and/or (2) the restriction, contractually agreed to, will be prophylactically effective in restraining the settling lawyer from bringing new claims.[30] Another reason may be that there has been push-back against Rule 5.6 (e) (2)'s restriction by prominent legal academics as lacking any persuasive rationale.[31]

The third answer is perhaps the most interesting: such agreements, even though they are unethical, have been held to be legally enforceable in certain jurisdictions. Huh? In the words of one Texas state court that reached this result:

> [The restriction] does not void the settlement agreement. The attorneys involved are not parties to this lawsuit. Nor does the agreement affect the outcome of the lawsuit. The ethics of the attorneys' actions, if justifiably questioned, are for a state bar grievance committee to decide and not for this tribunal.[32]

Other states following Texas' lead include New York[33] and Florida.[34] But some other states have not split the baby this way, finding that an ethical violation of this kind also affects the enforceability of a settlement agreement.[35]

By pointing out these three answers, I sincerely hope I am not furthering a race to the bottom by lawyers who believe answers "2" or "3" constitute an appropriate way to practice law.[36] They do not; once one hears answer "1," that should end the analysis.

Conclusion

In keeping with the title of the article, Joseph P. Kennedy once famously remarked: "Only a fool holds out for the top dollar."[37] Hopefully, readers who have made it this far will not be tempted to engage in the foolhardy (or worse) conduct flagged above. For, as Richard Nixon once said when he was discussing the Watergate cover-up with John Dean: "it is wrong[,] that's for sure."[38]

Endnotes

1. Dating back to the Middle Ages, this expression means to buy something without actually knowing its true nature or value (literally, to buy something—perhaps not even a pig—in a sack or bag without first checking out to see what is in the bag). In Finnish, this warning is translated: ostaa sika säkissä; in Irish, it is: ceannaigh mue i mála; in Zulu, it is: ukuthenga ingulube

esesakeni. Some believe this expression also led to another familiar one: "Letting the cat out of the bag." Perhaps more important to cultural historians, in NATIONAL LAMPOON'S EUROPEAN VACATION (Warner Bros. 1985), the Griswold family wins a free trip to Europe after defeating the Froegor family on the game show "Pig in a Poke" ("it pays to be a glutton"). Ellen Griswold (played by Beverly D'Angelo) wins the contest because she makes a sotto voce reference to her husband, Clark Griswold (played by Chevy Chase), at which point the host of "Pig in a Poke," Kent Winkdale (played by John Astin), says: "That's it: Clark…of Lewis and Clark. And the Griswolds are our grand prize winners!"

2. *See, e.g.,* C.E. Stewart, *'Positively 4th Street': Lawyers and the 'Scripting' of Witnesses*, N.Y. St. B. J., vol. 18 no. 1 (Summer 2014); C.E. Stewart, *Mad Dogs and Englishmen*, N.Y. St. B.J., vol. 17, no. 1 (Summer 2013); C.E. Stewart, *Just When Lawyers Thought It Was Safe to Go Back into the Water*, N.Y. St. B. J., vol. 15, no. 2 (Winter 2012); C.E. Stewart, *Thus Spake Zarathustra (And Other Cautionary Tales for Lawyers)*, N.Y. St. B. J., vol. 14, no. 2 (Fall 2011).

3. *In re Gelman*, 230 A.D. 524 (1st Dep't 1930).

4. *See*, *e.g.*, *In re Hart*, 131 A.D. 661 (1st Dep't 1909); *In re Abrahams*, 158 A.D. 595 (1st Dep't 1913); *In re Penn*, 196 A.D. 764 (1st Dep't 1921); *In re Ayman*, 226 A.D. 468 (1st Dep't 1929).

5. *See*, *e.g.*, *In re Glavin*, 107 A.D. 2d 1006 (3d Dep't 1985); *In re Linietsky*, 699 N.Y.S.2d 61 (2d Dep't 1999); *Standing Comm. v. Ross*, 735 F.2d 1168 (9th Cir. 1984); *In re Lewelling*, 678 P.2d 1229 (Or. 1984); *State ex rel. Counsel for Discipline v. Lopez Wilson*, 634 N.W.2d 467 (Neb. 2001); *In re Watson*, 768 N.E.2d 617 (Ohio 2002); *In re Huffman*, 983 P.2d 534 (Or. 1999); *In re Trexler*, 541 S.E.2d 822 (S.C. 2001); *Weiss v. Comm'n for Lawyer Discipline*, 981 S.W.2d 8 (Tex. App. 1998); *In re Boelter*, 985 P.2d 328 (Wash. 1999); *In re Robinson*, 46 So.3d 662 (La. 2010).

6. As demonstrated *infra* in notes 10–11, the ABA's Formal Opinion can be cited for many (and not always in harmony) positions. Related to the second subject matter of this article, *see infra* note 27 and accompanying text, the ABA's Formal Opinion also opined that the Model Rules "do not prohibit a lawyer from agreeing, or having the lawyer's client agree, in return for satisfaction of the client's civil claim, to refrain from presenting criminal charges against the opposing party as part of a settlement agreement." *Id.*

7. States following this approach are: Alaska, Arizona, Arkansas, Delaware, Indiana, Iowa, Kansas, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Utah, Washington, West Virginia, and Wisconsin.

8. States following this approach are: California, Illinois, New Jersey, Oregon, Tennessee, and Vermont. Five states bar such threats if they are made "to obtain an advantage in a civil matter." New Jersey's prohibition is directed against threats made "to obtain an improper advantage."

9. States following this approach are: Alabama, Colorado, Connecticut, the District of Columbia, Florida, Georgia, Hawaii, Idaho, Kentucky, Louisiana, Maine, Massachusetts, New York, Ohio, South Carolina, Texas, Virginia, and Wyoming. *See, e.g.*, *In re Yarborough*, 488 S.E. 2d 811 (S.C. 1997); *People v. Sigley*, 951 P.2d 481 (Colo. 1998).

10. *See* Del. State Bar Ass'n Comm. On Prof'l Ethics, Op. 1995-2 (1995). *Accord* Alaska Bar Ass'n, Ethics Op. 97-2 (1997); State Bar of S. Dak., Ethics Op. 94-3 (1994); State Bar of Mich., Ethics Op. RI - 78 (1991). *See also* Utah State Bar, Ethics Advisory Op. 03-04 (2003). *See also West Virginia State Bar Comm. on Legal Ethics v. Printz*, 416 S.E. 2d 720 (W. Va. 1992) (DR 7-105 (A)'s prohibition is "unworkable"); *Ruberton v. Gabage*, 654 A.2d 1002 (N.J. Super. Ct. 1995) (threat okay because "lawyers must be free to advance the strength of a client's case in candid and objective ways"). And the ABA's Formal Opinion 92-363 also concluded that certain circumstances justify making criminal threats to gain an advantage in civil litigation. *Accord* Alaska Ethics Op. 97-2 (1997); Delaware Ethics Op. 1995-2 (1995); Michigan Informal Ethics Op. RI-78 (1991); North Carolina Ethics Op. 2008-15 (2009); South Dakota Ethics Op. 94-3 (1994); Utah Ethics Op. 03-04 (2003); West Virginia Ethics Op. 2000-01 (2000); Wisconsin Ethics Op. 2001-01 (2000).

11. *See, e.g.*, *State ex rel. Oklahoma Bar Ass'n v. Worsham*, 957 P.2d 549 (Okla. 1998) (lawyer's threat of criminal prosecution without *any basis in fact or law* could/would violate Rules 3.1, 4.1, 4.4, 8.4 (d) & (e)); Maryland Ethics Op. 2003-16 (2004) (former DR 7-105 (A) was "basically sound," but the rule was too broad; other ethical rules should work to counter improper threats by lawyers); Michigan Informal Ethics Op. RI-78 (1991) (Rules 3.1, 3.3, 3.4, 3.8, 4.1, 4.4, 8.3, and 8.4 adequately deal with the same concerns articulated by DR 7-105 (A)). And the ABA's Formal Opinion 92-363 expressed a similar view: Rules 3.1, 4.1, 4.4, and/or 8.4 may address the conduct barred by DR 7-105 (A)). *See* ABA Comm. on Ethics & Prof'l Responsibility Formal Op. 92-363 (1992). *See also* Arizona Ethics Op. 93-11 (1993); Delaware Ethics Op. 1995-2 (1995); Florida Ethics Op. 89-3 (1989); New Mexico Ethics Op. 1987-5 (1987); North Carolina Ethics Op. 98-19 (1999); West Virginia Ethics Op. 2000-01 (2000).

12. *See* CAL. RULES OF PROF'L CONDUCT, Rule 5-100(A).

13. *See, e.g.*, *Crane v. State Bar*, 30 Cal. 3d 117 (1981); *Lopez v. Banvelos*, 2013 WL 4815699 (E.D. Cal. Sept. 6, 2013); *In re Elkins*, 2009 WL 3878295 (Cal. Bar Ct. Rev. Dep't 2009); *In re Malek-Yonan*, 2003 WL 23095707 (Cal. Bar Ct. Rev. Dep't 2003).

14. Connecticut, Florida, Georgia, Hawaii, Kentucky, Massachusetts, New Jersey, and Virginia all house this prohibition in Rule 3.4. Texas, Idaho, Tennessee, and Wyoming house it in Rule 4.04. Maine houses it in Rule 3.1; Ohio houses it in Rule 1.2; and the District of Columbia, Illinois, and Louisiana house it in Rule 8.4.

15. NYSBA Comm. on Professional Ethics, Formal Op. 772 (2003). Thus, as Comment 5 to New York's Rule 3.4 states: "[N]ot all threats are improper. For example, if a lawyer represents a client who has been criminally harmed by a third person (for example, a theft of property), the lawyer's threat to report the crime does not constitute extortion when honestly claimed in an effort to obtain restitution or indemnification for the harm done." N.Y. RULES OF PROF'L CONDUCT R. 3.4 cmt. 5. *See also* N. McMillan, *Recent Developments in the Ethical Treatment of Threats of Criminal Referral in Civil Debt Collection Matters*, 21 GEO. J. LEGAL ETHICS 935 (2008).

16. *See supra* note 5. Interestingly, the U.S. Supreme Court recently handed down a decision whereby a not-so implicit notification threat of criminal conduct by a state-approved group of dentists was held to constitute a violation of the Sherman Act. *See North Carolina State Bd. of Dental Exam'rs v. Fed. Trade Comm'n*, No. 13-539 (Feb. 25, 2015).

17. COLO. RULES OF PROF'L CONDUCT R. 4.5(b) (2012) (emphasis added). *See also id.* at cmt. 6.

18. *See* Wisconsin Ethics Op. E-01-01 (2001). *Accord In re McCurdy*, 681 P.2d 131 (Or. 1981) (examining a lawyer's letter to parents of hit-and-run driver specifically which disclaimed "threatening," but did *inform* them of likely criminal exposure).

19. OR. CODE OF PROF'L RESPONSIBILITY DR 7-105 (2003) (emphasis added).

20. *See, e.g.*, Ohio Ethics Op. 87-9 (1987); Florida Ethics Op. 85-3 (1985); South Carolina Ethics Op. 07-06 (2007); Utah Ethics Op. 71 (1979); *see also Knoell v. Petrovich*, 90 Cal. Reptr. 2d 162 (Cal. Ct. Appls. 1999).

21. *See supra* note 15 and accompanying text.

22. 379 A.2d 825 (N.H. 1977) (sometimes this is cited as *Decato's Case*).

23. *Id.* at 888 (emphasis added). *But see In re Hyman*, 226 A.D. 468, 235 N.Y.S. 622 (1st Dep't 1929), which the New Hampshire Supreme Court distinguished on the ground that in *Hyman* (unlike in *Decato*) the lawyer *did* evidence a demand for payment which thus satisfied the "solely" requirement.

24. District of Columbia Ethics Op. 339 (2007).

25. Michigan Informal Ethics Op. RI-78 (1991).

26. *See also* Florida Op. 85-3; Georgia Op. 26 (1980); Utah Op. 71 (1979) (opining that a letter referencing criminal sanctions in the conduct of stopping payment on a check is not violative of the "solely" standard because state laws require such notification before filing a civil action); NYSBA Comm. on Professional Ethics, Formal Op. 772 (2003) (stating a lawyer may threaten an administrative or disciplinary proceeding against a broker so long as *one* purpose of the threat is to obtain information about the broker's history of conduct).

27. *See supra* note 6.

28. *See also* ABA Formal Ethics Op. 93-371 (1993); Colorado Formal Ethics Op. 92 (1993) ("When restrictions on the practice of law become bargaining chip between parties, the integrity of the profession is threatened.").

29. *See In re Mosher*, 25 F.3d 397 (6th Cir. 1994); Joanne Pitulla, *Co-Opting the Competition—Beware of Unethical Restrictions in Settlement*, A.B.A. J. vol. 78, no. 8, at 101 (1992).

30. *See* Philadelphia Ethics Op. 86-121 (1986). In that opinion, the Philadelphia bar authorities took the view that it was permissible to ask opposing counsel to state that she has no "present intention" to file another suit against his client, so long as the settlement agreement itself does not include a binding restriction to that effect. New York is not in accord with this approach. *See* NYSBA Comm. on Professional Ethics, Formal Op. 730 (2000).

31. *See* Gillers & Painter, *Free the Lawyers: A Proposal to Permit No-Sue Promises in Settlement Agreements*, 18 Geo. J. Legal Ethics 281 (2005); Golan, *Restrictive Settlement Agreements: A Critique of Model Rule 5.6(b)*, 33 Sw. U.L. Rev. 1 (2003).

32. *Shebay v. Davis*, 717 S.W.2d 678, 682 (Tex. Ct. App. 1986).

33. *Feldman v. Minars*, 658 N.Y.S.2d 614 (1st Dep't 1997) (finding the agreement was not contrary to New York public policy and thus is not voided; but the promising lawyers are barred from representing clients if solicited in violation of the agreement). *See also Stratton Faxon v. Merck & Co.*, 2007 U.S. Dist. LEXIS 93413 (D. Conn. 2007).

34. *Lee v. Florida Dep't of Ins. & Treasurer*, 586 So.2d 1185 (Fla. Dist. Ct. App. 1991).

35. *See e.g.*, *Jarvis v. Jarvis*, 758 P.2d 244 (Kan. Ct. App. 1988).

36. As I tell my law students, I will hunt down (even to Tierra del Fuego) anyone citing this article as a defense to such conduct and the punishment will be slow and excruciatingly painful.

37. *See Galleries*, Sec. & Exc. Comm'n Hist. Soc'y, http://sechistorical.org/museum/galleries/ (last visited Apr. 28, 2015). President Kennedy's father also said: "More men die of jealousy than of cancer."

38. *See* B. Woodward & C. Bernstein, *Nixon Debated Paying Blackmail, Clemency*, Wash. Post, May 1, 1974, at A01.

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Providing Payment Processing or Other Services to Illegal Businesses? Beware of Financial Services (and Other) Regulators

By Sabra M. Baum

Businesses that provide payment, or even other essential services, to organizations engaged in illegal activities, including activities in violation of consumer protection laws, may need to pay closer attention to the changing regulatory environment. In recent years, both "Operation Choke Point" and the recent Consumer Financial Protection Bureau (CFPB) lawsuit in the debt collection industry (both discussed below) highlight that businesses (other than just banks and financial institutions) may also now be seen by financial services regulators as an essential cog in the wheel of law enforcement to help root out illegal or improper conduct of their customers. Businesses, especially payment processors, that ignore this expectation do so at the risk of regulatory fines and action, especially if they know, or should have known, of the illegal or improper conduct of their customers.

Banks and Financial Institutions

Since the Bank Secrecy Act (BSA) was established in 1970, banks and other financial institutions have had some 45 years to become accustomed to the type of obligations expected of them under the BSA and anti-money laundering (AML) laws and regulations, such as the USA PATRIOT Act. Those laws provide law enforcement and regulatory agencies with some of the most effective tools to help combat money laundering and crimes, such as drug trafficking and terrorism, that impact the global economy.[1] Among other things, financial institutions are required to file Currency Transaction Report (CTR) and Suspicious Activity Reports (SAR) reports, maintain AML policies and procedures and conduct certain due diligence on their customers. In addition, under the USA PATRIOT Act, financial institutions are prohibited from engaging in business with certain types of customers (e.g., foreign shell banks) and are required to conduct enhanced due diligence procedures for other types of customers (e.g., foreign correspondent and private banking account customers).[2]

Arguably, the BSA and AML laws have effectively made banks and other financial institutions quasi-law enforcement agencies or, at least, integral partners with regulatory agencies by placing them on the "front line" to help identify and shut down criminals' use of the banking system which, ultimately, is intended to help shut down their illegal business activities.

Operation Choke Point

In the last few years, a Department of Justice (DOJ) initiative (dubbed "Operation Choke Point") and a recent CFPB lawsuit, discussed further below, may indicate that regulators also are now turning to non-bank businesses, such as payment processors, that provide services to criminals or businesses engaged in illegal activities, in order to help regulators identify and shut down those illegal businesses.

In March 2013, the DOJ announced an initiative to investigate the role of banks in allowing illegal payday lenders to originate Automated Clearing House (ACH) debit entries in order to withdraw funds from a consumer's bank account.[3] The DOJ couched its investigation in light of BSA obligations of such banks. In August 2013, the New York Department of Financial Services (NYDFS) sent a letter to over a hundred financial institutions requesting that they assist the NYDFS to "choke off" ACH system access by illegal payday lenders.[4] U.S. prosecutors have opened numerous criminal and civil probes into banks and payment processors as part of Operation Choke Point. So far, settlements have been reached with Four Oaks Bank in April 2014[5] and CommerceWest Bank in March 2015,[6] in each case, for their respective role in allowing third party payment processors to use the banking system to process unauthorized ACH debit entries (on behalf of their illegal payday lender customers) from consumer bank accounts.

Operation Choke Point largely has targeted banks to stop them from processing ACH and other withdrawals for illegal payday lenders. Numerous banks, including Fifth Third Bank and Capital One Bank, reportedly terminated accounts with payday lenders amidst the increased regulatory scrutiny.[7]

However, the initiative also has encouraged banks to stop doing business with third party payment processors that are initiating unauthorized ACH withdrawals on behalf of their illegal payday lender customers. The indirect effect of Operation Choke Point, then, is that payment processors are finding it more difficult to service customers that might be conducting illegal activities, such as payday lending. Most banks have increased their BSA/AML and other due diligence of payment processors, stepped up monitoring of "return rates" for unauthorized ACH debit entries, and terminated payment processor relationships that are too risky for the bank. In this environment, payment processors, in turn, are having to take a closer look at the type of customers they are servicing, and root out those customers that are engaged in illegal payday lending. Otherwise, the payment processors themselves risk being cut off from the banking system (which, effectively, will shut down their businesses).

CFPB Lawsuit

A very recent lawsuit filed by the CFPB in the debt collection industry goes a step further than Operation Choke Point in indicating that regulators might now be turning to non-bank service providers, such as payment processors and even others, to help banks and regulatory agencies on the "front line" in identifying and shutting out illegal businesses from the banking system (and, therefore, helping to shut down those businesses).

On April 8, 2015, the CFPB announced that it had filed a large lawsuit[8] against more than a dozen debt collectors, payment processors and related service companies that failed to stop illegal debt collection activities.[9] The debt collectors are based in Georgia and New York and allegedly harassed consumers about 'phantom' debts (i.e., a debt that the consumer either doesn't owe, or that a creditor is legally barred from collecting) in violation of the Fair Debt Collections Practices Act. Importantly, the CFPB has joined in its lawsuit a number of service providers to the debt collectors, including the worldwide payment processor, Global Payments Inc., several other servicing companies and a telemarketing firm, on the basis that they knew or "should have known" that the debt collectors were engaged in unlawful activity, thereby aiding the debt collectors' schemes.[10]

The payment processors were not themselves involved in the allegedly illegal conduct of harassing consumers. However, the CFPB's lawsuit claims that the debt collectors would not have been successful without the cooperation of the payment processors and telemarketing firm and that the payment processors failed to monitor the debt collectors' accounts, even after some of the processors had flagged the debt collectors as prohibited merchants. In fact, the CFPB alleges that the payment processors gave the debt collectors an "air of legitimacy" that further helped the debt collectors' schemes. *The American Banker* quoted John Da Grosa Smith, of Smith LCC, which represents one of the payment processors, as criticizing the lawsuit on the basis that: "The CFPB now argues that [internal policies of the payment processors designed to minimize their credit exposure] impose a pseudo regulatory obligation for them to investigate violations of the Consumer Financial Protection Act. The CFPB effectively seeks to 'deputize' small businesses without notice or lawful authority."[11]

Concerns for Businesses

Currently, banks and other financial institutions are burdened with numerous AML and BSA obligations that place them alongside the regulators with helping to identify and shut out criminals from the banking system, and shut down their business activities. However, Operation Choke Point and the above CFPB lawsuit suggest that the financial services regulators may now also be expecting other types of businesses, such as payment processors, to fill a quasi-law enforcement role (by helping to shut out their customers from the banking industry and, thereby, shut down their illegal activity), or face regulatory fines and actions.

One concern with this change to focusing on such non-bank service providers is that it is not always clear whether a business' customers are engaged in illegal activities. Laws often differ among jurisdictions, and businesses do not typically have the means to determine whether their customer is acting illegally in their business practices. Moreover, where the illegal activity is alleged to encompass violations of consumer protection laws such as UDAAP (Unfair, Deceptive and Abusive Acts or Practices), the determination of illegality may be very difficult to make in light of the often unclear, and sometimes expanding, scope of those laws.

Another concern with this change is that it is unclear how far the regulators will go with the type of businesses that will be expected to act in a quasi-law enforcement role. Operation Choke Point and the above CFPB lawsuit both have focused on payment processors (and a telemarketing firm). What about businesses that provide other essential services to a customer engaged in illegal activities, or businesses that provide services that could create an "air of legitimacy" of the illegal business, or businesses whose services might ensure the success of the illegal business? Those factors all were relevant in the above CFPB lawsuit against the payment processors.

A final concern with this change is that the scope of the industries on which the regulators might focus is unclear. In 2011, the Federal Deposit Insurance Corporation (FDIC) published a list that contained numerous merchant categories, including payday lenders, debt consolidation firms, ammunition sales, dating services, pornography businesses, telemarketing firms and others, that it said warranted heightened attention by banks in processing their transactions.[12] When the DOJ announced Operation Choke Point in 2013, many critics drew a connection between the DOJ's initiative and the FDIC's list, and the FDIC faced heavy pressure from the banking industry and those merchant groups to remove or amend its list.[13] The FDIC finally withdrew its list in July 2014 and said "the list had been misinterpreted, resulting in banks' severing ties with legitimate businesses."[14] However, the concern remains that the FDIC (and likely other regulators) will continue to see merchant categories on the FDIC's 2011 list as troubling. While the regulators have focused on payday lending and debt collection in Operation Choke Point and the above-mentioned CFPB lawsuit, it may well be that the regulators will expect non-bank businesses also to help root out illegal activity engaged in by businesses in the other merchant categories on the FDIC's 2011 list.

Conclusion

Operation Choke Point and the recent CFPB lawsuit indicate that the regulatory environment may be changing. Regulators may be turning their attention to businesses that provide services, such as payment processing or even other essential services, to organizations engaged in illegal activities or other activities that the regulators consider to be high-risk. Non-bank service provider businesses are, arguably, now being seen by regulators as one of the cogs in the law enforcement wheel, and may be increasingly expected to provide quasi-law enforcement assistance to help root out those illegal activities. In light of this, businesses (like banks and other financial institutions) may well need to conduct some level of due diligence on their customers to ensure they know who they are doing business with, monitor third party complaints about their customers, and be aware of return rates for any payment processing. Businesses, especially payment processors, that ignore this expectation, may well face regulatory action, especially if there are facts that indicate they knew, or should have known, of the illegal or improper conduct of their customers.

Endnotes

1. http://www.fincen.gov/news_room/aml_history.html.
2. Uniting and Strengthening America by Providing Appropriate Tools to Restrict, Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act).
3. http://www.justice.gov/opa/speech/financial-fraud-enforcement-task-force-executive-director-michael-j-bresnick-exchequer. "Banks, therefore, should consider whether originating debit transactions on behalf of Internet payday lenders—particularly where the loans may violate state laws—is consistent with their BSA obligations."
4. http://www.dfs.ny.gov/about/press2013/pr1308061.htm and http://www.dfs.ny.gov/about/press2013/pr130806-link1.pdf.
5. http://www.justice.gov/usao/nce/press/2014/2014-apr-29.html.
6. http://www.justice.gov/opa/pr/commercewest-bank-admits-bank-secrecy-act-violation-and-reaches-49-million-settlement-justice.
7. http://www.americanbanker.com/issues/179_73/fifth-third-capital-one-cut-off-payday-lenders-1066918-1.html.
8. http://files.consumerfinance.gov/f/201504_cfpb_complaint-universal-debt.pdf.
9. http://www.consumerfinance.gov/newsroom/cfpb-sues-participants-in-robo-call-phantom-debt-collection-operation/. The lawsuit was actually filed on March 26, 2015, under seal.
10. http://www.americanbanker.com/news/law-regulation/cfpb-launches-its-own-choke-point-style-operation-1073659-1.html.
11. http://www.americanbanker.com/news/law-regulation/cfpb-launches-its-own-choke-point-style-operation-1073659-1.html.
12. http://www.americanbanker.com/issues/179_144/fdic-withdraws-alleged-hit-list-of-high-risk-merchants-1069031-1.html.
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Commercial Banks and Compliance with Sustainability Accounting Standards

By Samuel P. Gunther, Sheila A. S. Gunther and Richard H. Murray

Introduction

The authority of the SEC faces a challenge that directly affects commercial banks and their directors and shareholders. The Sustainability Accounting Standards Board (SASB) proposes regulation of commercial banking disclosure rules which far exceeds the current SEC mandates.

What is the SASB and how does the SASB justify its position? The story begins in 2010, following the initiation of a project originated by Prince Charles of England, when the International Integrated Reporting Council (IIRC) was formed. IIRC's stated objective was to create a new reporting framework to enable organizations to disclose, in a single place, how they intend to create value over time in so-called Integrated Reports (IR).[1]

The IIRC describes itself as a "global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs [non-governmental organizations]."[2] IIRC sets standards for producing annual IRs that disclose how organizations intend to create value over short, medium, and long-term periods. These reports, "the next step in the evolution of corporate reporting," are designed to present not only financial results but also "environmental, social and governance information" (ESG information) in a single place.[3] ESG information is also known as sustainability information. In December 2013, the IIRC incorporated ESG information into its International Framework for integrated reporting.[4]

The SASB is a non-profit United States sister organization of the IIRC. Incorporated in 2011 and launched in 2012, SASB develops industry-based sustainability standards for disclosure of material ESG impacts by U.S. publicly traded companies.[5] SASB is supported by individuals and organizations in the United States that believe U.S. businesses should be required to disclose sustainability information in 10-Ks of public companies because that information is essential to the decision making process for U.S. investors. SASB issued a Conceptual Framework (Framework) in October 2013.[6] SASB intends to implement that Framework by issuing non-financial sustainability standards for more than eighty individual industries. SASB's authority is currently self-proclaimed but aspires to recognition by the SEC through SASB's list of influential proponents.

Aware that the IIRC's position, providing for integration of sustainability information with other reports into a single integrated report, "is not fully compatible with the U.S. Federal disclosure regulations and disclosure requirements for publicly listed companies in the U.S. and therefore could present a hindrance for a successful implementation of integrated reporting in the U.S.,"[7] the SASB's Framework states that the disclosure of ESG information should be mandatory in existing 10-Ks.

According to SASB, stakeholders, whose views on disclosure must be considered, are no longer merely financial investors but must include all elements of society affected by sustainability. The SASB claims that current SEC reporting requirements focus on financial data and exclude sustainability considerations. SASB asserts that the use of ESG resources affects a reporting company's long-term value and insists that ESG and financial information are of equal weight. SASB has some high profile supporters but currently lacks the clout to canonize its agenda in legislation. The SASB has issued numerous industry-wide ESG reporting requirements, including one for commercial banks, which the SEC does not currently recognize or mandate. Consequently, SASB attempts to amplify the SEC's current requirements with additional ESG reporting requirements that are non-authoritative. It should be noted that SEC registrants, including banks, presently are required to disclose all information, if material to the reporting company.[8]

Although the SASB's sustainability reporting standards are not presently authoritative, one cannot disregard them. The SASB is well funded by donations from Bloomberg Philanthropies, the Rockefeller Foundation, large accounting firms and other donors. Michael Bloomberg, former Mayor of New York City, is the Board Chairman. The SASB board also includes former SEC Commissioners and a former Chairman of the Financial Accounting Standards Board (FASB). The SASB has met with representatives of the SEC, the FASB and the accounting profession. SASB is on a mission to add new ESG disclosure standards to current requirements.

Commercial banks are under pressure from the SASB to comply with its proposed regulations made without any authority. In 2014, the SASB issued its Commercial Banks Sustainability Accounting Standard (CBSA).[9] The CBSA sets compliance requirements for commercial banks.[10] SASB's Framework presents sustainability reporting standards for inclusion in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) in 10-Ks. Without justification, SASB equates the importance of ESG non-financial information with financial reporting. Significantly, although the SASB has met with the SEC, the Commission has not approved use of the SASB Framework or CBSA as authoritative or as appropriate for use in SEC filings. The CBSA is an attempt to impose regulation on banks without legislation or authority.

CBSA identifies five disclosure issues for commercial banks:

- Financial Inclusion and Capacity Building;
- Customer Privacy and Data Security;
- Management of the Legal and Regulatory Environment;
- Systemic Risk Management;
- Integration of Environmental, Social and Governance Risk Factors in Credit Risk Analysis.

For each issue, CBSA sets forth a "Description" with SASB's rationale and policies and "Accounting Metrics" to implement the objectives in the Description. This article discusses and analyzes each of the five issues identified by SASB in its CBSA.

Financial Inclusion and Capacity Building: Description

SASB believes that "[c]ommercial banks should disclose how they are enhancing shareholder value through efforts to expand inclusion and build capacity."[11]

That description provides SASB's conclusions without giving supporting analysis for why banks *should* disclose in MD&A how they are enhancing shareholder value. Nowhere does CBSA explain how or why banks' efforts will result in "enhancing shareholder value."

Financial Inclusion and Capacity Building: Accounting Metrics

To implement SASB's conclusions, CBSA lists five Accounting Metrics which each bank shall mandatorily disclose in MD&A:

1. Average dollar amount of loans to underserved and unbanked business segments as a percentage of all lending;
2. Number of participants in financial literacy initiatives for unbanked, under-banked or underserved customers;
3. The bank's initiative programs or financial services focused on enhancing the financial literacy of unbanked, under-banked, or underserved customers;
4. Loan-to-deposit ratios;
5. Loan default rates for all lending and separately for lending to underserved and/or under-banked business segments.[12]

These disclosures mandate little, if any, useful information about the profitability, assets and net worth of banks. Investors focus on new information that significantly alters the total mix of information made available. The information proposed by SASB for MD&A disclosure about loan charge-offs is immaterial. The information called for by CBSA is already provided in bank financial statements and/or in MD&A. Thus CBSA's requirements are superfluous.

Financial Inclusion and Capacity Building: Observations on Description and Accounting Metrics

The Financial Inclusion and Capacity Building section of CBSA mandates that banks comply by disclosing financial information[13] about which SASB has no expertise and which is already governed by detailed disclosure requirements prescribed by the FASB and the SEC. CBSA's disclosures intrude upon the expertise of bank management, the FASB, the SEC and independent auditors, recognized authorities on financial reporting and MD&A disclosures. CBSA adds no required information that benefits shareholders.

The description also says, "[c]ommercial banks should disclose how they are enhancing shareholder value through efforts to expand inclusion and build capacity." If management of a bank must comply with this requirement but does not agree with applying resources to achieve that end, management's hands are tied. The judgment of bank management becomes irrelevant, permitting SASB to dress up its views of desirable social policy in the guise of material information under the securities laws. Clearly, the SASB's compliance regulations do not identify material facts for investors, provide valid bases for mandatory disclosures in 10-Ks, or recognize the expertise of bank management.

Customer Privacy and Data Security: Description

CBSA's description imposes additional compliance requirements, asserting that banks should present enhanced disclosure about the number and nature of breaches in protection of personal financial data and management's strategies to address related risks. CBSA further asserts that these disclosures will allow shareholders to understand how banks are protecting shareholder value.

Customer Privacy and Data Security: Accounting Metrics

The Accounting Metrics require disclosures of the number of data security breaches and the percentage of data security breaches involving customers' unencrypted personally identifiable information, corrective actions taken in response to specific incidents, trends in security breaches, and management's approach to identifying and addressing vulnerabilities and threats to data security.[14]

Customer Privacy and Data Security: Observations on Description and Accounting Metrics

SEC CF Disclosure Guidance: Topic No. 2 "Cybersecurity" establishes compliance requirements for managements of filing companies about data security disclosures.[15] That Guidance states that in MD&A:

> Registrants should address cybersecurity risks and cyber incidents in their MD&A if the costs or other consequences associated with one or more known incidents or the risk of potential incidents represent a material event, trend, or uncertainty that is reasonably likely to have a material effect on the registrant's results of operations, liquidity, or financial condition or would cause reported financial information not to be necessarily indicative of future operating results or financial condition.[16]

The Cybersecurity Risk Release presents the Division of Corporation Finance's expectations that in SEC filings, Risk Factors, Description of Business, Legal Proceedings, MD&A and Financial Statements fairly presented in accordance with GAAP must be considered separately for possible disclosure about cybersecurity risks and incidents.[17] The Release also requires descriptions of the nature of material Risk Factors and annual consideration of possible disclosure in independent auditor reports on examinations of internal controls.[18]

The explicit requirements and the detailed discussion by the Division of Corporation Finance about the implications of Cybersecurity risk, which include requirements imposed on reporting companies and their independent auditors, demonstrate that this matter is a financial subject.[19] Why duplicate currently mandated Division of Corporation Finance compliance requirements?

Management of the Legal and Regulatory Environment: Description

CBSA's Description states:

> Companies must now adhere to a complex and inconsistent set of rules relating to both performance and disclosure on issues including insider trading, anti-trust, price fixing, and market manipulation. In addition, commercial banks are subject to rules against tax evasion, fraud, money laundering, and corrupt practices. Finally, enhanced rewards for whistleblowers established under the Dodd-Frank Act may increase the number of complaints brought to regulators.[20]

SASB demands compliance by managing these concerns but provides no guidance for management action or MD&A disclosure that is presently not required by the SEC. The absence of any discussion in CBSA about existing authoritative sources and disclosure requirements for SEC filings on the management of banks' legal and regulatory environments incorrectly suggests that no other authority currently exists.

Management of the Legal and Regulatory Environment: Accounting Metrics

The first CBSA Accounting Metric requires disclosure in MD&A of the total annual amount and nature of fines and settlements with respect to regulatory and civil actions. A reporting company is required to describe corrective action taken as a result of *each* incident.[21]

The second Accounting Metric requires disclosure of instances in which "legal or regulatory" issues were brought to management's attention through its internal processes and the percentage of those matters that were *substantiated.* In addition, the CBSA demands of a reporting company: "[D]isclosure shall be made of "any corrective actions" taken following the "inquiries" etc. noted above "including but not necessarily limited to those that were *substantiated*."[22]

"Substantiated" might or might not include an alleged compliance violation followed by payments in settlements, regardless of amount, in which no culpability has been proved or admitted or for matters that are discontinued or dismissed without payment following the expiration of statutes of limitation. Moreover, application of the CBSA requires disclosures about the "nature" and number of mere allegations. This is a compliance nightmare.

Management of the Legal and Regulatory Environment: Observations on Description and Accounting Metrics

The SEC requires 10-K disclosure by commercial banks about material legal and regulatory issues. GAAP requires bank management of a registrant that incurs a fine or settles a regulatory matter to record the event as a charge to income. Financial statement note disclosure may have to be made, if material.[23]

Again, the CBSA demands compliance on topics within the specific expertise of the SEC and FASB which have already addressed the legal and regulatory environment in existing pronouncements. Issues concerning legal exposure for regulatory fines and settlements and tax issues have the potential for direct impact on financial statements. These matters are financial. Yet SASB's Conceptual Framework specifies that SASB's objective is to require disclosure of "non-financial" information. Moreover, enforcement actions for alleged insider trading, market manipulation, Foreign Corrupt Practices Act violations, money laundering and whistleblowing, all cited in CBSA for possible additional mandatory disclosure, impinge on the authority of the SEC, which has historically dealt with such matters. CBSA implicitly asserts that unless the SEC adopts the SASB mandates in CBSA's Management of the Legal and Regulatory Environment provisions, the SEC disregards something material to investors.

Systemic Risk Management: Description

The description states that banks must demonstrate how risks to capital are managed to protect shareholder value. Compliance means that banks must enhance disclosure of metrics including the results of annual stress tests, Basel III liquidity ratios, exposure to over-the-counter derivatives, and management of risk limits.[24]

Systemic Risk Management: Accounting Metrics

CBSA requires four Accounting Metrics disclosures:

- Results of stress tests under adverse economic scenarios;
- Basel III liquidity coverage ratios;
- Net exposure to written credit derivatives;
- Value of level 3 assets and the percentages of those assets to total assets.[25]

Under Dodd-Frank, the Federal Reserve conducts supervisory stress tests annually on bank holding companies and their subsidiaries that have at least $10 billion in consolidated balance sheet assets. Dodd-Frank requires each company with $50 billion or more in consolidated assets to perform annual stress tests and publicly disclose a summary of the results of its annual company-run stress tests applying the severely adverse scenarios provided by the Fed. Companies with between $10 billion and $50 billion of consolidated assets must also conduct and publicly report on their annual company stress tests. These reports applying severely adverse scenarios are readily available on the internet.[26]

For the first metric, results of stress tests under adverse economic scenarios, CBSA requires bank holding companies in the $10 billion plus consolidated assets category to report, in MD&A in their 10-Ks, the results of their internally conducted stress tests under the severely adverse economic scenarios. This duplicates public disclosure already required by Dodd-Frank. Smaller banks will be required to report the results of their voluntary stress tests using guidance provided by the Office of the Comptroller of the Currency.

CBSA prescribes reporting hypothetical information underlying stress tests which do not use criteria traditionally used in GAAP financial statements or in MD&A. All this information is already available under public reporting requirements of Dodd-Frank. The information is not required in 10-Qs or in 10-Ks and lies outside the disclosure expertise of the SASB. Moreover, CBSA's required disclosure of "net income before taxes"[27] repeatedly mandates disclosure of information that produces a conflict. GAAP recognizes no such concept. GAAP does recognize "income before taxes" and "net income." Therefore, CBSA's proposed requirement is nonsense.

For Basel III liquidity coverage ratio, CBSA states that a bank "shall" set forth certain information presently disclosed in, or derived directly from, bank financial statement line items or financial statement components.[28] That information is obviously financial in nature, again duplicating present requirements.

CBSA's third metric, net exposure to written credit derivatives, states that a bank "shall calculate its net exposure to written credit derivatives."[29] The FASB discusses disclosure of credit derivatives in its Accounting Standards Codification.[30] CBSA cites as authority paragraph 3 of the Basel III Leverage Ratio Framework and Disclosure Requirements,[31] a publication based on financial accounting standards. Basel III computations are financial, not non-financial, in nature. Again, SASB/CBSA disregards and undermines the authority of the SEC and FASB.

CBSA's metric, value of level 3 assets and the percentages of those assets to total assets, requires a bank to report its Level 3 Assets as a percentage of its total assets.[32] Level 3 assets is a GAAP characterization of balance sheet assets whose fair values are "unobservable" because they have no active market or observable basis for valuation.[33] GAAP presently requires disclosure of Level 3 assets.[34] CBSA's proposal causes redundant disclosure.

Systemic Risk Management: Observations on Description and Accounting Metrics

SASB's Systemic Risk Management disclosures are based on financial statement information and existing regulatory prescribed presentations, not ESG disclosures. Again, SASB's focus is financial. SASB's proposal is an encroachment on the legitimate purview of the SEC and FASB, recognized authoritative experts, and duplicates their requirements.

Integration of Environmental, Social and Governance Risk Factors in Credit Risk Analysis: Description

CBSA's description says, "(ESG) factors are increasingly contributing to…financial performance," and commercial banks that do not address related risks and opportunities "could face diminished returns and reduced value for shareholders." SASB demands that banks "monitor and manage 'financed emissions'" of borrowers and bank investees,[35] another unsubstantiated compliance issue.

Integration of Environmental, Social and Governance Risk Factors in Credit Risk Analysis: Accounting Metrics

CBSA's Accounting Metrics present four areas of mandatory disclosure:

1. How ESG factors are integrated into lending and credit risk, including risk to a bank's reputation;
2. Loan portfolio credit risks presented by climate change, material resource constraints, human rights concerns and other ESG trends;
3. Amounts and percentages of lending and project finance that employ ESG factors and sustainability considerations;
4. Loans to energy, materials, industrials and utilities sectors/industries.

According to CBSA, evaluating credit risk requires assessing the *increased potential for default* (non-performing loans) or payment rescheduling due to ESG factors.[36] CBSA asserts that the valuation of underlying collateralized assets supporting a loan by a bank requires a discussion of how a lending bank assesses the risk of devaluation of collateral and potential for stranded, illiquid assets due to ESG factors. CBSA provides no examples of devalued or stranded, illiquid assets caused by ESG factors.[37]

Topic 2 deals with broad sustainability issues such as emissions.[38] SASB requires disclosures about transactions with energy related companies under the guise that loans to disfavored companies present material increased risks to banks. Implicitly, SASB asserts that investors in energy companies don't sufficiently understand the risks of their investments, and bank managers do not adequately comprehend the risks of lending to those companies.

Banks presently address *all* material risks when evaluating whether to advance credit and when evaluating the collectability of loans outstanding, including ESG concerns.[39] Some banks may conclude that 10-K Risk Factor disclosures should be made, if applicable. GAAP financial statement disclosures required by FASB and MD&A disclosures required by the SEC *presently* provide for disclosures of geographic and industry data and credit-risk exposure to major customers. However, CBSA mandates disclosure of loan portfolio risks by industry and geographic location concerning climate change, natural resource constraints (water, forestry products, fossil fuels, extractives), human rights and offshore outsourcing. Those disclosures directly encroach on the domains of the FASB and the SEC whose well-established authority is currently asserted in banks' MD&A disclosures.

Topic 3, amounts and percentages of lending and project financing that employ ESG factors and sustainability considerations, requires disclosure of how a bank integrates ESG factors "into traditional fundamental analysis," for "sustainability themed lending," or loans "for social enterprises."[40] Topic 4, loans to energy, materials, industrials and utilities sectors/industries, requires disclosure of loans made to energy, basic materials companies, industrials and utilities.[41] SASB asserts, without proof, that these topics add new material disclosures for investors.

Despite the assertion in SASB's Framework that it will consider only non-financial issues, its CBSA deals with subjects for which the SEC and FASB have issued disclosure requirements. Disclosure of categories of loans by theme or by class of customers or risk is financial statement information, not non-financial information, and the FASB and SEC have established requirements. The FASB has issued criteria for reporting about industry segments. Moreover, the SEC requires banks to disclose loans by category. The SEC also requires banks to disclose significant concentrations of loans to multiple borrowers engaged in similar activities in order to highlight potential risks to the bank. Thus, the FASB and SEC have addressed these financial issues and established exacting standards for compliance.

Integration of Environmental, Social and Governance Risk Factors in Credit Risk Analysis: Observations on Description and Accounting Metrics

Curiously, SASB disclosures about the integration of ESG information into the lending process do not focus on developments that may mitigate lending risks. For example, SASB ignores consideration of the effects of hydrofracking when discussing what banks should disclose about loans to energy companies.

CBSA asserts that a bank registrant should disclose whether the lending *could* create or contribute to systemic risk for the economy and whether the *borrower's* activities *could* create negative or social environmental externalities.[42] In other words, even if the projected financial returns of the loan by a bank are positive and satisfy bank management, if the business of the borrower theoretically could produce negative externalities, there should be speculative disclosure by the lending bank, notwithstanding the estimated returns of the individual loan. It seems bizarre to require speculation about externalities when financial returns, about which management and investors who invest capital for profit are concerned, can be estimated by established methods.

Under longstanding compliance with GAAP, a bank must evaluate all applicable credit risks when a loan is made. If the probable and reasonably estimable criteria are present, a loss must be reported.[43] For a future loss, the loss would not be reported until that future event occurred. Similarly, if regulatory changes might occur, it would not be appropriate to give financial statement effect to a regulation or law that has not yet been adopted, although disclosure might be required.

The CBSA provides no evidence that SASB considered important existing guidance about ESG risk to the collectability of receivables. In 2010, in Release 9106, long before the CBSA was issued, the SEC provided important guidelines for registrants to consider for disclosure about financial and non-financial information when drafting Forms 10-K, including in MD&A. Release 9106 states, "climate change related physical changes and hazards to coastal property can pose credit risks for banks whose borrowers are located in at risk areas." When preparing SEC filings, reporting companies, including banks, must consider the risks cited in Release 9106 (regarding climate change), and Securities Act Release 8350 (regarding disclosures required in MD&A generally) along with GAAP.[44] Independent auditors who audit those financial statements also examine and report on applicable internal controls. CBSA does not acknowledge existing requirements or add useful disclosure proposals.

A bank's evaluation of reputational risk issues concerning a prospective loan is inherently subjective. In its Release 9106 guidance, the SEC recognizes and directs companies to consider that climate change may pose a potential indirect risk to a registrant's reputation that is to be considered for risk factor disclosure in filings.

A bank is typically not a significant emitting entity. The language of Release 9106 suggests that disclosure might be required for consideration by a financing bank of an entity that is an emitter, but that is one step further removed from the analysis by the emitter. In evaluating reputational risk to the bank, any analysis is even more indirect. Release 9106 suggests that disclosure by a bank, if any, would be in Risk Factors, not in MD&A. Once again, CBSA makes no reference to this SEC guidance in reaching its conclusions.

Certain activists may assert that any bank loan to a company in a disfavored industry (e.g., energy) automatically impairs the reputation of the lender. Thus, the lender should not proceed with the loan. Does the SASB intend to hamper bank loans to companies in disfavored industries? Banks exist to make loans and to generate profits and market value for shareholders. Energy companies need financing. Are attitudes and actions of non-shareholders who assert such loans should not be made more important to bank management and bank shareholders than the income that will be generated by making the loans?

SASB's Framework describes offshore outsourcing as presenting negative risk to labor and to society.[45] Companies outsource work for a variety of reasons, such as performing tasks less expensively, applying technological benefits that reduce labor costs, and accessing new markets. CBSA ignores benefits to banks and their investors. SASB admits in its Framework that "[n]egative environmental and social externalities [offshore outsourcing] by definition, generally do not currently affect the financial returns of companies that generate them."[46]

CBSA's position on offshore outsourcing is identical to SASB's Framework. Because SASB actively solicits the views of shareholders and all non-investor stakeholders when developing standards, individual industry disclosure requirements are affected by non-investor stakeholder views.[47] SASB and CBSA priorities differ fundamentally from those held by investors who risk capital. Effective offshore outsourcing is favorable to a borrower and to a lending bank and its shareholders. MD&A of a borrower and of a lending bank are written for the benefit of investors "as seen through the eyes of those who manage the business," not for the benefit of non-shareholder stakeholders.[48]

CBSA requires disclosure of bank loan portfolio risks involving human rights concerns. They are enumerated in the UN General Assembly's Declaration of Human Rights[49] and include reputational risks such as negative press coverage and brand damage associated with violations of basic human rights. Who identifies the violators and whether the allegations are true or merely politically motivated positions? Who determines whether a borrower has actually committed violations? CBSA does not address these issues. According to SASB, the answers to these unasked, and politically charged, questions provide the bases for mandatory 10-K disclosures.

The application of CBSA to purported human rights violations introduces subjectivity and uncertainty to SEC filings. U.S. securities law is objective. Why should 10-K disclosures by U.S. commercial banks be affected by a UN declaration? SASB attempts to introduce vague foreign policy issues into the SEC filing process. The CBSA position on the disclosure of alleged human rights issues is fraught with ambiguity, confusion and the potential for bias.

Concluding Commentary

A major league batter's ultimate humiliation occurs in achieving the dreaded golden sombrero, going 0-for-4, striking out four times in one game. In issuing its CBSA, the SASB has earned the platinum sombrero, going 0-for-5, striking out on all five CBSA compliance issues.

In its Framework, SASB differentiates between standards for disclosures of sustainability, ESG non-financial information that it intends to prescribe and financial information which it will not prescribe. To emphasize the difference, SASB states that it views sustainability information as a complement to financial accounting to be evaluated side by side with financial information.[50] SASB, which does not have expertise in GAAP reporting and in MD&A disclosures, requires disclosures that are financial in nature. For each of the five SASB/CBSA issues, the SEC and the FASB have in place prescribed reporting and disclosure requirements. SASB uses its agenda to superimpose its positions on present authoritative, recognized reporting standards.

CBSA does not explain why SASB wants managements to disclose in MD&A how they intend to *enhance shareholder value* or how managements intend to *protect shareholder value*. There is no contextual background to aid a user in reaching reasoned conclusions about the meanings of those undefined terms or the implications of selecting one of the phrases for use rather than using the other phrase. Moreover, the thrust of SASB's proposed disclosures in CBSA about how management *enhances* or *protects* shareholder value is fundamentally different from the SEC's purposes and policies of disclosures in MD&A. The SEC states that MD&A is intended to provide information as seen through the eyes of management, so that investors can ascertain whether past performance is indicative of future performance. MD&A requires analysis of financial statements; MD&A does not require non-financial sustainability information. CBSA's proposed ESG disclosures concern policies and acts SASB believes management should undertake to achieve the goals of enhancing and protecting shareholder values. In MD&A the SEC does not share this agenda and does not require those disclosures.

In its 2013 Framework, SASB announced its policy to formulate only ESG disclosures. Contrary to this statement, in CBSA, SASB continuously prescribes financial disclosures. The SEC and FASB already deal with financial disclosures. SASB should put its issues directly to the SEC, the legitimate regulatory authority. SASB's disregard of the objectives and significance of existing SEC and FASB disclosure requirements renders the CBSA of no value to investors whose sole interest is profiting from their investments.

SASB proposes that commercial banks comply with disclosure and conduct regulations guided by ESG concerns. CBSA says that banks should offer products and services to underserved populations, ensure privacy and data security of customers, monitor and manage financed emissions of borrowers, address external effects of off-shore outsourcing and address human rights concerns. This wish list is more appropriate for a retail consumer protection agency agenda. Our securities laws protect investors in commercial banks, but SASB's beneficiaries are not investors. Without amending any laws, the SASB proposes erasing the securities law distinction between a shareholder (one who puts his money where his mouth is) and a non-investor.

Endnotes

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26. *Dodd-Frank Act Stress Test 2014: Supervisory Stress Test Methodology and Results*, Bd. Governors Fed. Reserve 1–2, 5–7 (Mar. 2014), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140320a1.pdf. *See also* 12 C.F.R § 252.148(a)-(cc).
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Emerging Equities in Paying for Municipal Services—The Problem with the Real Property Tax

By Amanda A. Godkin and Matthew K. Mobilia

The Eroding Real Property Tax Base

The primary source of revenue to finance municipal services,[1] such as police, fire protection, emergency services, park and recreation facilities, etc., is the real property tax (RPT), that lien on real property levied annually by local governments satisfied by paying your RPT each year. Non-payment of the RPT will eventually result in the local government's foreclosure on an individual's residence or business. Not surprisingly, the RPT is the most effective form of local government taxation—easy to collect and easy to increase because real property can never be relocated. The only unpredictable aspect of the RPT comes from state-mandated limits on the RPT levy[2] and figuring out the assessed value.[3]

Some real property is not subject to the RPT, resulting in lost revenue, which local governments crave today. Article XVI, section 1 of the New York State Constitution provides that tax exemptions "may be altered or repealed except those exempting real or personal property used exclusively for religious, educational or charitable purposes…and owned by any corporation or association organized or conducted exclusively for one or more such purposes and not operating for profit."[4] This constitutional rule was then codified in the Real Property Tax Law.[5] Title 1 of the Real Property Tax Law exempts government property from the RPT.[6] Those corporations whose real or personal property is exempt from the RPT include those granted an exemption from the federal income tax under § 501(c) of the Internal Revenue Code of 1986, as amended (the "Code").[7]

The problem facing local governments with rising municipal costs is that the amount of tax-free property is so great; it results in municipal debt because municipalities cannot receive payment for mandated services. At its worst, some municipalities must remain financially fit while only receiving tax income from just half of the property within the municipal boundaries.[8] For example, in the City of Albany, nearly 60% of the City's real property is exempt from the RPTs, with about one-half of that amount being state-owned property.[9] Similarly, in the Village of New Paltz, home of a major SUNY campus, nearly 75% of the Village's real property is exempt from the RPT.[10] In 2012, a report issued by the New York State Comptroller (the "Report") indicated that tax-exempt government property made up $343 billion, or 41%, of the value of total tax-exempt property in the state of New York (the "State" or "New York").[11] Government property includes property owned by the United States (buildings and land), the State (buildings, jails, and courthouses), state agencies (bridges and tunnels, water systems, sewer systems), local governments (police stations, firehouses, and public libraries), school districts, and foreign governments.[12] Additionally, the Report showed that non-for-profit corporations (NFPC) made up $111.8 billion, or 14% of the value of total tax-exempt property in the State.[13] NFPCs include houses of worship, health care facilities and education facilities.[14] The Code currently exempts income tax from NFPCs because these entities provide goods and services that the government cannot afford or will not provide.[15] New York employs the same rationale to exempt real property of NFPCs and government institutions from the RPT.

There is no provision in law that permits local governments to recover the cost of providing municipal services from NFPCs and government institutions.[16] The law requires all properties, regardless of taxable status, to receive the same quantity and quality of municipal services.[17] Providing such services to NFPCs and government institutions places an extraordinary burden on residential property owners and businesses that pay the RPT. As the Report indicates, nearly 30% of all real property in New York is exempt from the real property tax base.[18] On average, the cost of municipal services to residential and commercial real property is nearly 45% more than if all real property were subject to the RPT.[19] We refer to this tax anomaly in RPT policy as the "RPT Premium." As a result, it comes as no surprise that New York is considered the state with the highest local government real property taxes in the nation.[20] The State's high RPT levels are in direct relationship to the migration of New Yorkers to states with lower RPT burdens.[21]

Attempts to relieve the unfriendly effect of New York's high RPT on businesses have inflamed the RPT Premium on residents and businesses by taking more real property from the tax rolls. Like many states, New York offers generous tax incentives (e.g., exemption from RPT; sales tax exemption on construction costs; mortgage recording tax exemption) to private businesses looking to open or expand in the State.[22] Regardless of whether these incentives provide employment opportunities or increase surrounding home values, they immediately remove taxable parcels from the tax rolls, thus increasing the RPT Premium.[23] For example, the current program called START-UP NY, a partnership between academic institutions and start-up companies, grants a 10-year RPT exemption for businesses that build on or near an academic institution in the program.[24] These economic development programs, intended to spur private sector employment, do not take into account the increased cost of municipal services on account of (i) increased demand on infrastructure resulting from increased employment, and (ii) reduced RPT to local governments by taking real property off the tax rolls.[25]

This is not to say that current law and policy is indifferent to the windfall tax-exempt properties receive from free municipal services. The RPT, based on 19th and 20th century tax policy, was effective until the 1970s when various industries and people began leaving New York for better economic opportunities.[26] In order to revitalize the weak upstate New York economy, the legislature has enacted several economic development statutes that stimulate building hospitals, shopping centers and educational facilities.[27] But once these parcels start to generate economic activity requiring municipal services, how long should the State allow tax abatements to continue? The question becomes: how is the public well-served if municipal services are financed by only two-thirds of the real property subject to the RPT? Without a tax or fee for municipal services imposed on all developed parcels, the value of economic development primarily benefits private sector investors but does nothing for local governments without a replacement for lost RPT.[28]

While New York local governments are required to provide and incur the expense of municipal services to persons, businesses and institutions in any new development without any offsetting revenue, in Massachusetts[29] and New Jersey,[30] for example, the cost of municipal services may be exacted from developers. These "impact fees" or "linkage fees" are outlawed in the Empire State.[31] Instead, New York relies on payment-in-lieu of-taxes (PILOT) agreements, which attempt to offset a portion of the lost RPT resulting from policies granting exemption from the RPT.[32] In theory, PILOTs lessen the burden of local government by requiring the benefited party to pay a portion of the RPT that would be levied on the real property, were it subject to RPT. However, as discussed below, the statutory regime to impose, collect and enforce payment of PILOTs is weak compared with the *in rem* remedies available to levy, collect and enforce the RPT. Further, PILOTs are subject to diversion from the municipal treasury, and their calculation is entirely arbitrary as a percentage of the RPT.[33] And, importantly, PILOT calculations bear no rational relationship to the actual cost of municipal services provided or benefits received by tax-exempt NFPCs and government institutions.

Addressing Inequities in Payment for Municipal Services

The State is failing local governments by not enacting a legal obligation requiring NFPCs and government institutions to contribute to the cost of municipal services. These services include, without limitation, services that we take for granted: police services and public safety facilities; fire prevention and protection services and firehouses; emergency medical services (EMS), including specialized equipment and vehicles for all services. They also include (i) water supply, distribution and treatment facilities; (ii) sewer disposal and treatment facilities; (iii) streets, sidewalks, rainwater storm drains, street lights, traffic signals and signage; and (iv) parks and public recreation facilities. Public libraries are often part of municipal services.[34] Some would argue that local governments are not particularly burdened by providing municipal services to tax-exempt institutions. For example, there may be a little more police work required for pulling rowdy college students out of village bars at 2 a.m.;[35] there may be a little more litter in the parks on a nice summer's day when the hospital staff takes lunch outside.[36] These are nothing more than the unintended consequences of the presence of a college campus and health care facility within a municipality. But could the same be argued when catastrophic events occur on these tax-exempt parcels? For example, should an oil train derail and explode on the Capital Region's transportation artery[37] and damage a college campus,[38] or an aspiring jihadist trained in ISIS Internet propaganda open fire in a health care facility,[39] or protesters displeased with a grand jury verdict stage a "die-in" on a state or federal highway disrupting traffic and commerce for hours[40]—the cost to the NFPCs and government institutions who benefit from the police, fire and emergency services who come to the rescue is zero.

In today's world, we live in a less secure and potentially more violent society, compared to a century ago when statutory provisions were enacted to provide tax-exempt status to NFPCs and government institutions. Many would argue that these provisions are outdated and provide no rational relationship between those who benefit from municipal services and those who pay for them.[41] Despite this argument, there is a strong bias in law that permits the RPT exemption to continue for NFPCs and government institutions.[42]

In *Colleges of Seneca v. City of Geneva*[43] the Court of Appeals held a college dormitory built by a private sector organization on land owned by the college is part of the realty of the college for real property taxation and thus deemed owned by the college and exempt from RPT absent clear evidence of private ownership. In *Deromedi v. Town of Thermopolis*[44] the Wyoming Supreme Court held that a building purchased by the town of Thermopolis with a federal community development block grant in order to house the "Wax Museum of Old Wyoming," as well as other cultural and recreational activities, was exempt from real property taxation as a building being used for a governmental purpose, despite the fact that the museum was operated by a for-profit business that was charging an admission fee and was paying rent to the town of Thermopolis. These cases also reaffirm that if the source of payment is the RPT, tax-exempt properties are under no obligation to pay for municipal services even if these properties directly benefit from such services. Currently, the law makes no distinction between real property taxpayers and non-taxpayers for the purposes of availability or deployment of municipal services.[45] Thus, police, fire and EMS responders are legally required to shut down a binge-drinking party on a small-town college campus (tax-exempt) with the same allocation of resources as they would to a hostage/murder and suicide incident in a shopping center (taxable unless a PILOT is in place) or a private home (taxable). What legal bases may be developed to require financial contributions by NFPCs and government institutions to the cost of municipal services?

Aside from the growing RPT Premium stemming from the cost burden disproportionality of tax exemption, many have suggested schemes to better align the costs and benefits of municipal services among all members of the public. Such schemes are problematic because (i) consumption of basic municipal services (police, fire, EMS, etc.) by particular persons and properties is inconsistent over time, making the measurement of cost and benefit difficult; (ii) measurement of the cost of a unit of police, fire, EMS, etc. service needs to relate not only to annual budget expenses, but also to the future costs of emergency or catastrophic events; and (iii) significant municipal services are frequently deployed in poor neighborhoods where the real property tax generates little or no RPT. One could argue that the economic impact on local governments from the Great Recession is cause enough to reform constitutional and statutory RPT exemptions for government institutions and NFPCs. However, although the growth of the RPT Premium coupled with the effects of the Great Recession manifest the imbalance between the cost and benefit of municipal services, remedying fiscal stress is not a legal basis on which to compel NFPCs and government institutions to pay for the cost of municipal services.[46]

Recognizing the lack of payment toward municipal services, the cost-burden on local governments and the growing RPT Premium on individuals and small business, some governments have entered into cost-sharing agreements, such as PILOT agreements, with NFPCs and government institutions.[47] These PILOT agreements attempt to offset the burden of the RPT Premium by requesting that tax-exempt NFPCs and government institutions contract with their local municipality to pay some portion of what their RPT would be.[48] What seems like a good idea in theory does not, however, translate well into legally sustainable cost-sharing arrangements. Beyond regulating PILOTs in the context of economic development, there is no statutory authority that recognizes PILOTs as legally binding, valid and enforceable cost-sharing agreements with NFPCs and government institutions. State law fails to address how PILOTs are authorized by the parties involved, on what basis payments to the local government are measured, how the payments are calculated, and when, how and from what specific source, if any, payments are made, or how payments are enforced. These matters are left to the discretion of the taxing jurisdiction and tax-exempt party to include in the four corners of their PILOT contract, therefore failing to create a uniform way to institute cost-sharing agreements. PILOTs to pay for the costs of municipal services are entirely voluntary gestures by tax-exempt institutions. Why would an NFPC pay the equivalent of an RPT when it can receive municipal services for free?

A PILOT is a poor scheme to alleviate the RPT Premium for local taxpayers. A PILOT assumes an NFPC or government institution would pay the RPT, but for the RPT exemption. As a matter of law, this assumption is wrong. The design of a PILOT agreement is to simply return a portion of lost RPT to the local municipality without regard to any other factor, including the correlation between the cost and benefit of the municipal service. The city of Syracuse has a PILOT program with Syracuse University, as does Cornell University and Ithaca College with its local municipalities.[49]

Table 1[50]

Voluntary Payment Arrangements Between Municipalities and Nonprofits in New York State			
Nonprofit	**Municipalities**	**Amount**	**Note**
Cornell University	Tompkins County, City of Ithaca, and Ithaca School District	$1.9 million (2008); $1.6 million (2009).	Part of ten-year PILOT agreement entered into in 2007. PILOT is based on what the University thinks it can afford.
Ithaca College	Tompkins County, Town of Ithaca, and Ithaca School District	$355,295 (2011); between 2003 and 2011, Ithaca School District has received $1.6 million and the Town and County have received $1.3 million.	PILOT is based on the College voluntarily keeping apartments on the tax rolls since 2003.
Syracuse University	City of Syracuse	$500,000 per year; costs above $150,000 incurred by City for traffic control for Carrier Dome events; CPI-adjusted payments to university-area neighborhood groups (adjusted annually; $368,000 as of 2011 survey).	The approximately $1 million/year the City is receiving from SU represents only a small part of the roughly $24 million in taxes the City has estimated that the University would generate if it were not tax-exempt.
Source: Lincoln Land Institute (PILOT Agreements as of 2011)			

Does the PILOT agreement with Syracuse University sufficiently cover its costs associated with the necessary police, fire and EMS responses to sorority and fraternity parties? Because PILOTS are only voluntary arrangements enforceable in a civil action for monetary damages (unlike the RPT, which is enforceable through a lien on real property), PILOT agreements fail to provide the security of pledged revenues to local governments. Further, their duration is often not more than one fiscal year. Additionally, NFPCs and government institutions are not above withholding PILOT payments when they are displeased with local municipalities.[51] Akron General Medical Center, for instance, is holding its PILOT payment hostage from the Ohio State Tax Department because the state and the hospital disagree as to whether the hospital's "fitness center" is subject to the RPT.[52] This uncertainty surrounding PILOTs frustrates local governments in their attempt to budget accurately and plan for the long-term. How would any government survive if paying taxes becomes nothing more than a voluntary gesture?

In addition, it is also doubtful whether municipalities could ever receive the equivalent of RPT through a PILOT program. A recent Florida Appellate Court decision has prohibited PILOT programs where the PILOT agreement requires a party to make payments that are the equivalent of ad valorem taxes that would otherwise be due but for a statutory tax exemption.[53] The Florida Appellate Court has certified this question to its Supreme Court to determine whether such agreements violate state statutes that provide organizations tax-exempt status.[54] An affirmative decision by the Florida Supreme Court would create a precedent for other states to invalidate PILOT agreements should their terms require the equivalent of ad valorem taxes. As a result, municipalities would never be able to receive the equivalent of the RPT through PILOT programs.

To develop a model correlating costs and benefits of municipal services upon which to construct a statutory regime obligating NFPCs and government institutions to pay for municipal services, we should look to those municipal services that are measurable based on consumption, special benefit and use, and for a statutory regime that already exists to measure costs and benefits. A cost/benefit model already exists for several forms of services, such as: (i) utility services (e.g., water, sewer and electric), whereby ordinances authorize rates by using a metering device and allocate capital costs to a "basic fee" to the consumer; (ii) optional services (i.e., toll roads) charging the consumer only if said consumer exercises the right to consume the service; and (iii) special benefit charges or user fees. Courts have upheld these models reasoning that assessments and user fees do not constitute a tax, and, as a result, may be imposed on all benefited properties, tax-exempt or not.[55] It makes no difference that assessments or user charges for these services had been previously collected via the RPT and collected along with the RPT.[56] The courts do not dispute the validity of the assessment or user charge because either no service was in fact performed (so long as it was made available) or because the benefit was only a personnel service rather than a physical improvement to real property.[57] This cost/benefit model is a product of the post-World War II trend in the United States to assess the cost of government based on the consumption of municipal services and the receipt of special benefits, rather than relying solely on the revenues of the RPT.[58] Since special assessments and user charges have become a legally recognized method of raising local government revenues, without being considered an illegal tax, the cost/benefit model should be implemented in order to charge NFPCs and government institutions for the benefits of essential services (police, fire, EMS, etc.) that they receive.

A Model Law for NFPC/Government Institutions to Pay for Municipal Services

The new model to determine the financial contribution of NFPCs and government institutions toward municipal services is derived from a cost/benefit theory and principles of pay-as-you-go for consumption of municipal services. The model is unlikely to be considered a tax, the most likely challenge to a state law imposing assessments and user fees on the tax-exempt for municipal services.[59] The parameters of a cost/benefit assessment/user fee legal regime for NFPCs and government institutions are not difficult to understand and formulate. Initially, we discard those parameters that have questionable constitutional footing or fiscal sustainability.

First, we must discard the parameters that take into account the NFPCs' and government institutions' wealth or income. Governmental charges based on wealth or income are in the nature of taxes, from which NFPCs and governmental institutions are exempt. While charging a user fee only to entities such as the Ford Foundation, Rockefeller Foundation or SUNY campuses, which possess great wealth and may generate income from quasi-for-profit activities, is tempting, there is no sound legal foundation for this position. Equal Protection claims could be raised by these NFPCs and government institutions for discrimination in assessing costs based on their wealth or income because of the absence of any rational relationship between wealth/income and the value of the municipal services provided. The only way for the local government to charge for municipal services based on the tax-exempts' income or wealth is through voluntary agreements with said institutions (see *supra* Table 1).

Second, PILOTS fail as a parameter because there is no rational relationship between a percentage of the RPT and an allocable share of the cost of municipal services received.[60] These voluntary agreements lack a substantial nexus to measure financial contributions to the cost of municipal services.[61]

A statute requiring NFPCs and government institutions to pay special assessments or user fees for the applicable costs of the municipal service provided is likely to withstand legal challenge if the statute provides that: (i) the assessment pays for a specific benefit, not a general service, and is therefore not a tax (even though it may be collected and enforced like the RPT); and (ii) principles of equity require that the beneficiary pay its fair share of the cost where the charges bear a reasonable relationship or substantial nexus to the benefit received under the same Due Process (and 5th Amendment "takings") and Equal Protection (14th Amendment) principles.[62]

New York law must be revised, although not much, in order to require NFPCs and government institutions to pay special assessments and user fees for municipal services. Legal procedures to impose special assessments and user fees for "improvements" to real property within designated assessment districts or areas presently exist for counties, towns and villages.[63] These procedures do not exist for cities, forcing cities to rely, by statute, on the Home Rule Law and state legislators to replicate local laws that are provided for other municipalities. These statutes define 'improvements' in terms of fixed physical assets attached to the benefitted real property subject to the applicable special assessments and user charges.[64] The definition of "improvements" needs to be expanded to include services, as well as fixed physical assets. Essential services would then be within the scope of the definition, including police, fire protection and EMS.

Determining a measurement for police, fire, EMS, etc. services is the most challenging task when amending municipal statutes. Current law speaks of measuring assessments for improvements in terms of front footage, an area of the parcel and *ad valorem* assessed value. These archaic measuring methods would fail to measure police, fire, and EMS protection from which to calculate the cost that should be assessed. For example, a large college campus of several acres in area may never require more than the college's own "campus police." Why would the college pay for local government policing it does not need based on the size of the campus? Similarly, a medical clinic having only 30 or 40 feet of street frontage, but full of disabled persons, may be the scene of a three-alarm fire requiring numerous police, fire and EMS personnel for several hours to save lives and property. A fee for municipal services based on front footage would be inequitable.

Certain municipal services, however, can be easily measured based on consumption in order to determine an assessment or user fee. The cost of driving on the Thruway depends on the length of the trip and what bridge is crossed. Water and sewer services are measured by the amount of water/effluent flowing through a meter. It is also worth noting that 75 years ago water services were assessed on an *ad valorem* basis (i.e., a percentage of the assessed value of the property, without regard to consumption of water). As technology improved, water and sewer could be measured by metering and priced to the consumer through assessments and user charges on a pay-for-what-you-use basis. Such assessments and user fees are also not subject to the New York "tax cap."[65]

How could a local government "meter" police, fire, and EMS services? You do not need to reinvent the wheel in order to determine the cost of services provided to these NFPCs and governmental institutions. It would simply require a "pay-as-you-use" meter similar to that used by utilities and the EZ-Pass system. Such a system could be based on the "billable hours" of dispatching various staff to the NFPC or government institution for each emergency situation. First, the system would require a determination of the hourly rate of the various police, fire and EMS employee-titles. Where the employees are salaried, simply calculate the hourly rate by dividing the salary over 365 days. Next, take this daily rate and multiply it by the number of hours per shift. Each employee title (e.g., chief of police/fire, detective, "rookie" officer) would then have its own billable hours that could be metered per dispatch. Each police, fire and EMS department would be required to keep logs of each dispatch that outline the number and title of each officer that responds to a call and the length of time they remain on the scene. This information would be possible to track because each police, fire and EMS vehicle would be equipped with a GPS system. Currently, many small towns in Massachusetts are using GPS systems to improve the dispatch system.[66] The city of Boston is now considering their use.[67] This system could easily expand to include tracking time spent at locations for calls to NFPCs or government institutions. Additionally, the use of drones is currently being explored by police departments (City of Baltimore) and federal enforcement agencies (Department of Homeland Security) for high-risk responses.[68] As mentioned earlier, government institutions are often the location of mass shootings and the targets of terrorist organizations.[69] These drones could be used to monitor high-risk responses at these government institutions. The total cost of those on the scene would then be billed to the NFPC or government institution. Responses to a homicide or major fire, for instance, would be more expensive as these events would require a large dispatch of multiple officers, detectives, firefighters and the chiefs of police and fire departments. Yet, these expenses would be in an equitable relationship to the services received.

In addition to the charge for municipal services actually consumed, NFPCs and government institutions could be charged an "administrative fee" and "reserve fund fee," i.e., fees that reflect: (i) the cost of administrative charges associated with metering and billing municipal services, and (ii) the reservation of funds for use in responding to catastrophic incidents. Administrative fees are routinely charged by utility companies in addition to the charge for the product consumed (e.g., water, electricity). In the current age, exploding oil tankers, campus protests and open fires inside buildings are recurring catastrophes. The reserve fund fee can be calculated as a fractional share of the future value of the cost of such catastrophic costs associated with an emergency based on the probability of its occurrence or a flat rate fee that is divided between all NFPCs and government institutions within the municipality. Reserve fees could be charged monthly and placed into a reserve fund established by the local government or a consortium of local governments. Like the State Retirement Fund, once the accumulated accrued future costs are fully funded in the reserve, the reserve fee can be reduced or eliminated. Here, the benefit to local governments is fiscal and in the best tradition of "pay-as-you-go" public finance law. The cost of responding to future emergencies should not cause significant annual budget disruptions as it can be paid from reserves.

Finally, NFPCs and government institutions could also be charged for the cost of equipment associated with police/fire/EMS services, the same way doctors and hospitals charge patients per vaccination, bandage, tongue depressor, etc. Here, along with the metering charges, the NFPC or government institution would receive a charge for the equipment used while police/fire/EMS are dispatched to an NFPC or government institution. These charges could include costs for ammunition and bulletproof vests, if the dispatch involves a shootout, or replacement fire suits, where the suit is damaged while responding to a fire. Billing for these charges could eventually lead to a new line of insurance to cover the costs, thereby alleviating some of the burden on these NFPCs and government institutions that supporters claim is so desperately needed.

This method would be codified and enforced via the court. Parties that fail to pay their assessments or user fees open themselves up to civil actions. Where NFPCs and government institutions receive state financial aid, the statute could provide a state intercept remedy so that assessments and user fees are first paid to the local government from the state aid. A strong enforcement statute would make assessment and user charges enforceable *in rem*, similar to water and sewer assessments.

Shifting Power and Responsibility to Determine Tax Exemption

With the amount of fiscal stress that is placed on local governments to pay for municipal services, local governments should have the legal option to determine the extent to which NFPCs and government institutions are tax-exempt. As previously noted, the State Constitution exempts NFPCs, and the RPTL exempts government institutions, from the RPT, but neither law provides relief from lost RPT tax revenue. In Connecticut and Rhode Island, both states have similar laws that exempt NFPCs and government institutions from the RPT, but unlike New York, both states provide a local remedy to alleviate lost RPT.[70] Connecticut subsidizes 77% of lost real property tax revenue to each local government, while Rhode Island subsidizes 27%. Here, state policy recognizes that local governments require an offset from tax exemption to provide mandated municipal services in a fiscally sound manner.[71]

State authority to grant RPT exemptions could be transferred to local governments, empowering them to determine if additional revenues need to be generated from the tax-exempt institution to fund basic municipal services. In 2002, voters in Virginia approved a referendum amending the state constitution to require that RPT exemptions be granted by local governments rather than by state law.[72] Using this new power, the Board of Supervisors in Fairfax County adopted a law requiring all future real property acquired by NFPCs to be subject to the RPT.[73] It is argued here that local governments under state law should be empowered to determine the extent of exemption from the RPT.[74]

Focusing on a user fee concept, the mayor of Pittsburgh proposed a "Post-Secondary Education Privilege Tax," a 1% tuition tax levied on local university and college students.[75] Such a user fee seems quite equitable: Pittsburgh is home to 85,000 students at 10 universities and colleges; 40% of the City's real property is exempt from the RPT.[76] The city argued that the 1% tuition tax was required because students used municipal services, roads, police and fire protection, and should contribute toward their cost.[77] But the NFPC and government institution lobby is strong and powerful; it opposes shifting costs of municipal services for the usual reasons any institution would oppose new fixed costs.[78] A compromise may be crafted on the basis of best practices in corporate citizenship: can major economic institutions (e.g., medical and educational institutions) that have become the core economy of 21st century urban centers continue to receive municipal services for free without compromising the availability and quality of those services? Consider the state of municipal services in Detroit before the city's bankruptcy filing.[79]

Protecting First Amendment Rights—Je Suis Charlie!

The terrorist attack on the offices of Charlie Hebdo in January 2015, which left a number of people wounded or dead, was an attack on the freedom of speech and freedom of expression.[80] The founding fathers intended that our First Amendment Rights be treated as fundamental individual rights. The people's exercise of these rights on college campuses, in health care facilities, in museums and in government facilities is critical to the development of civilization in an open society. Curtailment of these rights on these properties for fear of injury or death is detrimental to the principles our founding fathers envisioned when writing the First Amendment, yet NFPCs and government institutions are the known targets of organized global terror. Can there be any basis in equitable cost analysis, especially after the attack in Paris, to conclude that NFPCs and government institutions should continue to contribute nothing toward the cost of municipal services, particularly police, fire and EMS? How long will voters and taxpayers tolerate the increasing RPT premium for defending these freedoms on land that bears none of the cost? Is there a lawmaker brave enough to draft the model law we have presented?

Municipal Services as a Consumed Commodity Used and Paid for by All

The model law described above acknowledges that in a diverse and transparent urban society, clinging to the 19th century concept that municipal services are paid exclusively or primarily through the RPT, with no consequence to tax-exempt entities and properties, is grossly unfair and economically disabling to property subject to the RPT. New York is no longer mostly made up of large private businesses that could fund the revenues required for all municipal services for the small population that existed 150 years ago. A continuation of this status quo will only increase the RPT Premium, contribute to making New York uncompetitive both nationally and globally, and foster abuse in claiming tax-exempt status to avoid the RPT.

Local government is the provider of essential services everyone uses and needs. It must be viewed like any other entity that sells goods and services: if you use it, you pay for it.[81] The ability to measure and price all municipal services is a somewhat new fiscal concept. Yet focusing on refinement and implementation of "you use it, you pay for it" should stimulate policy makers and legislators to move to enact the model. Finally, we should wean ourselves from the time-honored but now empirically proven false notion that NFPCs and government institutions save local governments money by providing services governments cannot or will not provide. SUNY produces skilled workers, but many of them move out of state. PILOTs for economic development fatten corporate profits, not local government revenues. Little of the generosity to tax-exempt institutions benefits local governments. Failure to defend First Amendment freedoms in the threat of organized global terror is unacceptable. If we want vibrant communities throughout New York, it is time the tax-exempt pay their fair share.

Endnotes

1. Basic and essential services provided by local governments (cities, counties, towns, villages, fire districts, school districts, special taxing districts for libraries) available to the public, not generally provided by the state or federal government, and required for daily work and domestic activities.
2. Taxable real property is assessed at "full value" as determined by the municipal assessor. A tax rate is applied to the assessed value to determine the tax. There may be different rates for different classes of real property.
3. 2011 N.Y. Laws ch. 97 limited the RPT levy increase for the next fiscal year to 2% of the current fiscal year levy, subject to increase over 2% by super-majority vote of the municipality's governing body or the voters of a school district.
4. N.Y. Const. art. XVI, § 1 (emphasis added).
5. N.Y. Real Prop. Tax Law § 420-A & 420-B (McKinney).
6. N.Y. Real Property Tax Law Ch-50a art. 4, T. 1.
7. I.R.C. § 501(c).
8. In the Village of New Paltz, home of a SUNY campus, nearly 75% of the real property in the village is exempt from RPT. *See* Rachel John & Gerald Benjamin, *Equity and the Property Tax Burden for Citizens of Ulster County*, Ctr for Research, Reg'l Educ. & Outreach, SUNY at New Paltz, *available at* www.newpaltz.edu/crreo/discussionbrief1.pdf.
9. Thomas P. DiNapoli, Off. of the State Comptroller, Research Brief: Property Tax Exemptions in New York State 7 (Oct. 2013), *available at* http://www.osc.state.ny.us/localgov/pubs/research/propertytax_exemptions.pdf.
10. John & Benjamin, *supra* note 8, at 4.
11. DiNapoli, *supra* note 9, at 2.
12. *Id.* at 2–11.
13. *Id.* at 2.
14. *Id.* at 3.
15. I.R.C. § 501(c).
16. However, the Legislature has considered restricting the exemption from RPT to only certain purposes, irrespective of ownership of the real property by a NFPC, excluding those purposes that in the private sector would be engaged in for profit. *See* S.881, 2013 N.Y. Leg. Sess.
17. Clayton P. Gillette, *Equality and Variety in the Delivery of Municipal Services*, 100 Harv. L. Rev. 946, 950 (1987) (providing a book review of Charles M. Haar & Daniel W. Fessler, Equality and Variety in the Delivery of Municipal Services (1986)).
18. DiNapoli, *supra* note 9, at 2.
19. 100% of the RPT paid for by 70% of real property (100/70 = 1.429, almost 45% more than if no real property were exempt).
20. Alexander E.M. Hess et al., *States with the Highest (and Lowest Taxes)*, 24/7 Wall Street (Apr. 2, 2014, 9:02 AM), http://247wallst.com/special-report/2014/04/02/states-with-the-highest-and-lowest-taxes/.
21. E.J. McMahon, *Outflow of New Yorkers Rose in 2013-2014*, Empire Ctr (Dec. 23, 2014), www.empirecenter.org/publications/outflow-of-new-yorkers-rose-in-2014/; *see also* Jeff Platsky, *Baby Boomer Retirees Flee New York*, Press & Sun-Bulletin (Dec. 10, 2014, 3:33 PM), www.pressconnects.com/story/news/local/2014/11/28/baby-boomers-abandon-state/19610089/.
22. N.Y. Gen. Mun. Law art.18-A–C; art. 19-A.
23. *Avoiding Past Mistakes: Principles for Governing Regional Economic Development Councils*, Citizens Budget Comm'n (Sept. 13, 2011), http://www.cbcny.org/content/avoiding-past-mistakes-principles-governing-regional-economic-development-councils.
24. Claudia Tenney, *The START-UP Scam: Telling Delay on Governor's Program*, N.Y. Post (Jan. 12, 2015), http://nypost.com/2015/01/12/the-start-up-scam-telling-delay-on-governors-program/.
25. Louise Story, *As Companies Seek Tax Deals, Governments Pay High Price*, N.Y. Times (Dec. 1, 2012), http://www.nytimes.com/2012/12/02/us/how-local-taxpayers-bankroll-corporations.

html?pagewanted=all&_r=0. (relaying how General Motors walked away from factories throughout the United States through its bankruptcy proceedings, having previously received generous real property tax exemptions to stimulate local employment). GM did not repay taxes to the communities or terminate tax exemptions long after the factories were shuttered. *Id.*

26. Edward L. Glaeser, *Can Buffalo Ever Come Back?* N.Y. SUN (Oct. 19, 2007), http://www.nysun.com/opinion/can-buffalo-ever-come-back/64879/.

27. N.Y. GEN. MUN. LAW art. 18-A–C, art. 19-A.

28. Rachel Weber, *Why Local Economic Development Incentives Don't Create Jobs: The Role of Corporate Governance*, 32 URB. LAWYER 97 (2000), *see also* STATE AND LOCAL GOVERNMENT IN A FEDERAL SYSTEM 37–78 (Mandelker, Wegner, Griffith, Bond & Tyson, eds., 8th ed. 2014).

29. BOSTON, MASS., ZONING CODE art. 26A (1986).

30. N.J. PERM. STAT., § 27:1C-1 et seq.; § 40:55D-42.

31. *Albany Area Bldrs. Assn. v. Town of Guilderland*, 74 N.Y.2d 372, 375–76 (1989). "Impact fees" or "linkage fees," where the developer pays for the public infrastructure supporting the development, are viewed as "taxes," which may only be enacted by the Legislature, not by a local law under home rule powers. New York does not have an impact fee statute.

32. DINAPOLI, *supra* note 9, at 7.

33. *See* Daphne A. Kenyon & Adam H. Langley, *Payment in Lieu of Taxes: Balancing Municipal and Non-Profit Interests*, LINCOLN INSTITUTE OF LAND POLICY (2010).

34. N.Y. State Educ. Dep't., *What Is a Public Library District?*, N.Y. STATE LIBRARY, http://www.nysl.nysed.gov/libdev/libs/pldtools/guide/1what.htm (last visited Apr. 29, 2015).

35. Steve Barnes, *City Urges Bar Owners to Have Last Call Earlier*, TIMES UNION (Jan. 4, 2011), http://www.timesunion.com/local/article/City-urges-bar-owners-to-have-last-call-earlier-935186.php.

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42. Chris Vest, *Bill Aims to Help NonProfits Keep Tax-Exempt Status*, ASSOCIATIONS NOW (Feb. 17, 2015), http://associationsnow.com/2015/02/proposed-bill-aims-help-nonprofits/.

43. 94 N.Y.2d 713, 718 (2000).

44. *In re Town of Thermopolis*, 45 P.3d 1155, 1160 (W.Y. 2002).

45. *Colleges of the Seneca*, 94 N.Y.2d at 716–17.

46. *See Flushing Nat'l Bank v. Mun. Assistance Corp.*, 40 N.Y.2d 731, 740 (1976) (holding that emergencies, including financial emergencies and the police power, do not suspend constitutional principles).

47. DINAPOLI, *supra* note 9, at 7.

48. *Id.*

49. *Id.* at 8.

50. *Id.*

51. In January 2015, Maine Governor Paul LePage proposed authorizing large communities to make up for the elimination of state revenue sharing in future budgets by taxing large nonprofit organizations (50% of the tax which would be levied if properties valued over $500,000 were subject to RPT) such as hospitals, colleges and private schools. NFPCs claim this scheme would place an "undue economic burden" on students, force changes to financial aid for Mainers and impair longstanding relationships with host communities. The change also likely would leave towns and cities scrambling to assess those properties for the first time. *See* Beth Brogan, *Maine College Officials Questions LePage Plan to Allow Communities to Tax Large Non Profits*, BANGOR DAILY NEWS (Jan. 12, 2015, 6:01 PM), www.bangordailynews.com/2015/01/12/politics/state-house/maine-college-officials-question-lepage-plan-to-allow-communities-to-tax-large-nonprofits/.

52. *See* Cheryl Powell, *Akron General Fights for Tax Exemption for Stow Fitness Center*, OHIO.COM (Jan. 6, 2015, 7:56 PM), www.ohio.com/news/local/akron-general-fights-for-tax-exemption-for-stow-fitness-center-1.555809 (stating that Akron General Medical Center is fighting an Ohio state tax department ruling that its "fitness center" is subject to RPT).

53. *AHF-Bay Fund, LLC v. City of Largo*, No. 2D14-408, 2015 LEXIS 5826, at *1 (Fla. 2d DCA).

54. *Id.* at *10.

55. User fees are recognized as a method of payment for improvements to real property (Opt. St. Compt. 88-2, 1099); *see YMCA v. Rochester Pure Waters District*, 354 N.Y.S.2d 201 (1974) (stating that YMCA was required to pay a fee for sewer service). The "sanitary sewer charge," based on consumption of services, was a valid user charge even though it contained a charge for capital improvements. User fees must be equal among all users and not discriminate. Tax-exempt status is not a factor justifying reasonable differentiation in utility services or user fees.

56. *See People v. Townsend*, 18 N.Y.S2d 865 (1940) (stating that Tax Law Sec 4, subd. 6, which exempts charitable institutions from taxation, was intended to exempt NFPCs from sharing in the cost of government but not intended to exempt NFPCs from assessments made for expense of improvement specifically benefiting property or to impose the whole of such expense on other property or the public generally). An NFPC is not exempt from the cost of water and garbage, fire and sewer districts, notwithstanding the absence of statutory authority that property should be assessed in proportion to the benefit received. Assessments were special assessments, not taxes from which NFPCs were exempt.

57. *City of River Falls v. St. Bridget's Catholic Church of River Falls*, 513 N.W.2d 673, 675–76 (Wis. Ct. App. 1994). The Wisconsin Court of Appeals rejected the assertion that a fee is appropriate only where a service actually is used to fight a fire—or that to be a fee, a charge must be assessed for commodities actually consumed. *See also* Opt. St. Compt. 85-24 (stating that a local improvement need not be a physical betterment, but can be a service that enhances the value of benefited property).

58. E. Kurnow, *On the Elasticity of the Real Property Tax*, 18 J. FIN. 56–58 (Mar. 1963). *See also* L. Dadayan, *The Impact of the Great Recession on Local Property Taxes*, NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT (2012) (stating that elasticity declined after 2008 when rising RPT met with declining real property values during the Great Recession).

59. *See Sarasota County v. Sarasota County Church of Christ, Inc.*, 667 So. 2d 180 (Fla. 1995) (holding that (i) benefited parcels must pay the assessment without regard to their tax-exempt status, and (ii) the assessment pays for a specific benefit (even though the beneficiaries may be the general public) such that it is not a tax).

60. Brogan, *supra* note 51.

61. The requirement of a direct relationship between cost and benefit in imposing economic exactions has been addressed by the Supreme Court. *See Koontz v. St. Johns Rover Water Management District*, 133 S. Ct. 2586 (2013). In this case, a developer sought a permit but was told he would need to finance offsite environmental mitigation projects on public lands unrelated to his project. *Id.* The Supreme Court held that (i) the "unconstitutional conditions doctrine" (i.e., pay for unrelated environmental mitigation) prevents "government coercion" of enumerated rights, i.e., getting a building permit, and (ii) government may not leverage a legitimate state interest (land use regulation) that lacks a nexus and rough proportionality to that interest. *Id.*

62. PILOTs remain in the nature of a "tax"—to which state constitutions and statutory exemptions apply. Thus, PILOTs, while interesting as an economic development concept, are legally unenforceable against NFPCs and government institutions. Since special assessments and user fees are not viewed as taxes, they are enforceable, but their application must satisfy the allocation of cost/benefit tests of *Nollan v. California Coastal Comm'n*, 483 U.S. 825 (1987) ("essential nexus") and *Dolan v. City of Tigard*, 512 U.S. 374 (1994) ("rough proportionality"). *Nollan/Dolan* establishes the standard by which special assessments and user fees are subject to heightened scrutiny in due process and equal protection analysis.

63. *See* N.Y. County Law art. 5.; *see also* N.Y. Town Law arts. 12, 12-A, 12-C; N.Y. Village Law art. 22.

64. *Id.*

65. 2011 N.Y. Laws ch. 97 (Tax Levy Limit Law) does not apply to assessments and user fees.

66. Maria Cramer, *Boston Police Officers Wary of GPS for Cruisers*, Boston Globe (Nov. 18, 2013), http://www.bostonglobe.com/metro/2013/11/18/gps-now-monitor-bpd/Vc6qOHTlvehT2YzYWIQkiP/story.html.

67. *Id.*

68. Mark Hellgren, *Many Consider Police Drone Use An Invasion of Privacy*, CBS Baltimore (Aug. 25, 2014, 6:18 PM), http://baltimore.cbslocal.com/2014/08/25/many-consider-police-drone-use-an-invasion-of-privacy/.

69. Gordon Thomas, *Terrorists Using EBay and Reddit to Send Coded Messages: Mossad*, N.Y. Post (Mar. 1, 2015, 8:55 AM), http://nypost.com/2015/03/01/terrorists-using-ebay-and-reddit-to-send-coded-messages-mossad/.

70. Daphne A. Kenyon & Adam H. Langley, *The Property Tax Exemption For Non-Profits and Revenue Implications for Cities*, The Lincoln Institution of Land Policy (Nov. 2011), http://www.urban.org/uploadedpdf/412460-property-tax-exemption-nonprofits.pdf.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. Rich Lord & Tom Barnes, *Pittsburgh Mayor Drops Tuition Tax*, Pittsburgh Post-Gazette (Dec. 22, 2009, 5:00 AM), http://www.post-gazette.com/local/city/2009/12/22/Pittsburgh-s-mayor-drops-tuition-tax/stories/200912220181.

76. *Id.*

77. *Id.*

78. Scott Kraus, *Nonprofits' Property Tax Breaks Under Scrutiny*, The Morning Call (Dec. 25, 2014, 8:53 PM), http://www.mcall.com/news/local/mc-non-profit-tax-breaks-20141225-story.html#page=1.

79. *See generally* Christine Chung, *Zombieland/The Detroit Bankruptcy: Why Debts Associated with Pensions, Benefits and Municipal Securities Never Die…and How They are Killing Cities Like Detroit*, 41 Fordham Urb. L.J. 771 (2014).

80. Anne Nazzaro, *Charlie Hebdo Journalist Defends Satire, Free Speech at Univ. Event*, Chicago Maroon (Feb. 27, 2015), http://chicagomaroon.com/2015/02/27/charlie-hebdo-journalist-defends-satire-free-speech-at-univ-event/.

81. David Folz & Jacqueline Giles, *Municipal Experience with "Pay as You Throw" Policies: Findings From a National Survey*, 43 State & Local Gov. Rev. (2002); Lester M. Salamon, Stephanie L. Geller, & S. Wojciech Sokolowski, *Taxing the Tax-Exempt Sector—A Growing Danger for Nonprofit Organizations*, Johns Hopkins Univ. Ctr. Civil Soc'y Studies (2011), *available at* http://ccss.jhu.edu/publications-findings/?did=244; *"The Nonprofit Margin: Addressing the Costs of the Nonprofit Exemption in New Orleans,"* New Orleans Bureau Gov't Research (2011).

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Certificates of Insurance: Worth the Paper Upon Which They're Written?

By Elio M. Di Berardino

Are you counsel for an owner or general contractor involved in a multimillion dollar commercial construction project which is about to commence? Is your client about to accept bids from several subcontractors, whose budgets you reviewed, to perform foundation, plumbing, electrical or framing work for the construction of this multimillion dollar project? Did you obtain proof of insurance in the form of a certificate of insurance from the general contractor and each of the subcontractors, disclosing that each of the subcontractors is covered to perform the particular work each was hired to perform and that your client is covered as an additional insured under each contractor and subcontractor's policy for any damage or injury that might arise from each contractor or subcontractor's work? If you are, and if you did, then you could sleep peacefully, right? Wrong. The following is an article that highlights the strengths and weaknesses of a certificate of insurance as well as the pitfalls that occur when owners and general contractors accept such certificates of insurance alone as proof that they are also covered in the event of a casualty or injury occurring at the construction site. This article will also provide practical tips directed towards both ensuring that the owner or general contractor is insured and avoiding the pitfalls embodied by the issuance of such certificates of insurance by the contractor or subcontractor's insurance agent.

I. The Purpose of a Certificate of Insurance

A certificate of insurance serves to apprise persons reviewing it of the type of insurance policy or policies issued by an insurance company or companies to a named insured. It will also disclose the identity of an insured or insureds and provide the effective dates of each issued policy referred to in the certificate. In addition, certificates of insurance will inform a reader of the basic limits of liability provided by the policy or policies, along with any applicable exclusions precluding coverage to insureds under certain situations. Generally, a typical Comprehensive General Liability policy provides liability limits of $1MM/$2MM. This combined limit signifies that a policy will provide coverage of up to $1MM dollars per accident or occurrence and $2MM in the aggregate for any one claim.[1]

A certificate of insurance also provides one with the identity of the broker and/or agent who procured the policy, usually called the producer, and the agent who issued the policy to the particular insured. This agent may be either authorized or unauthorized. The issue of whether an agent is authorized by the carrier who underwrote the policy will be discussed later in this article. Finally, a certificate of insurance discloses the identity of the Certificate Holder, the person or entity who requested proof of insurance from the named insured or insureds (contractor or subcontractor). This person or entity is usually the owner of the realty or construction site and the person or entity who hired the general contractor to supervise the construction project. The Certificate Holder may or may not be named as an additional insured to the contractor or subcontractor's insurance policy. The mere fact that the property owner or general contractor's name appears within the box designated as the Certificate Holder is not tantamount to designating the property owner or other person as an additional insured or named additional insured under another contractor or subcontractor's policy.[2]

As a result, the purpose of a certificate of insurance is merely to apprise the person or entity that the particular general contractor or subcontractor has obtained certain types of insurance coverage hopefully applicable to the work that one or the other intends to perform pursuant to the construction contract. Such certificates are routinely requested by owners of real property or general contractors to ensure that the subcontractors they hire possess the requisite insurance to perform the work they are under contract to render.

II. Certificates of Insurance Do Not Amend or Modify the Policy

All too often, however, owners of real property and general contractors attempt to use certificates of insurance to prove that they and others are covered by the same particular policy or policies. They erroneously attempt to establish this point by stating that they are named as the Certificate Holder generally situated in the lower left-hand corner of the certificate of insurance.[3] However, a Certificate Holder is nothing more than an industry designation given to the person or entity that has requested proof that the particular contractor is insured or possesses insurance. Certificate holders are not by virtue of their designation automatically considered additional insureds under a particular contractor's insurance policy.

Some other owners and general contractors attempt to prove that they are covered under the subcontractor's policy by asserting that in the description of operations/special provisions section of the certificate, the Certificate Holder is named as an additional insured. However, under New York law and the laws of many other states, a person or entity does not become an additional insured unless and until he or it is named in the declarations section of the policy and added specifically by endorsement.[4]

The mere fact that a certificate of insurance discloses that another party is a purported additional insured does not actually mean, as many owners and general contractors have come to learn, that they are actually additional insureds under a subcontractor's policy of insurance. In fact, most certificates of insurance embody a disclaimer situated at the top, right-hand corner of the document which states that such certificates are issued as a matter of information only and that they "*confer no rights upon the certificate holder.*"[5] The certificate further informs the reader that it does not "*amend, extend or alter the coverage afforded by the policies below.*" Accordingly, a certificate of insurance issued by a subcontractor's broker, by its terms, does not confer any rights upon the so-called Certificate Holder.[6] Therefore, if a document, itself, apprises one that one should not rely upon it for the accuracy of coverage, then one's reliance upon such a document should be held to be unjustified.[7] Indeed, many jurisdictions do hold that reliance upon a certificate of insurance, alone, regarding the issue of whether another party is an additional insured is unjustified.[8] Remember, in New York the party seeking to establish coverage has the burden of establishing that coverage has been procured and is due and owing.[9]

The law in many jurisdictions, especially New York, holds that in order for a party or entity to become an additional insured, that party or entity must be specifically listed as an additional insured in the declaration pages of the policy or by endorsement to the subject policy.[10] As a result, unless the particular owner or general contractor's name appears within the policy, that party or entity would not be considered an additional insured to the subcontractor's policy. A certificate of insurance is only evidence of a carrier's intent to provide coverage to a particular party or person, but it is not a contract to provide insurance to the party or person seeking such coverage. Additionally, such evidence, standing alone, fails to prove or establish coverage in favor of such party or person.[11] Indeed, courts in New York have held that a certificate of insurance offered in opposition to an insurer's motion for summary judgment is not even sufficient to raise a triable issue of fact regarding the issue of whether the party is a purported additional insured.[12]

III. Exceptions to the Rule: Subsequent Errors; The Split of Authority and Blanket Additional Insured Endorsements

One exception to this rule is when a party was previously named as an additional insured, but upon renewal the party was mistakenly omitted, but its name was placed upon a certificate of insurance as an additional insured.[13] Nevertheless, additional proof would be required to establish that the party was an additional insured.

Another exception to the rule in the Third and Fourth Departments is if the purported certificate of insurance were issued by an authorized agent of the insurer.[14] However, one must bear in mind that there continues to exist a split of authority upon this precise issue. For example, the courts in the First and Second Departments have staunchly held that such certificates, alone, constitute insufficient proof to establish coverage in favor of the purported additional insured.[15] Regardless of the numerous decisions rendered by the courts in the First and Second Departments denying the existence of coverage in favor of the purported additional insured claimants who have erroneously relied to their detriment upon their receipt of a certificate of insurance, the courts in the Third and Fourth Departments have uniformly held that certificates issued by authorized agents of the insurers do estop the carriers from disclaiming coverage to such purported additional insured claimants.[16] While the split of authority rages on by virtue of the withdrawal of the certified question to the New York Court of Appeals in the case cited below,[17] some decisions rendered in the Third Department appear to be harmonizing with the decisions being rendered in the First and Second Departments.[18]

Now, I'm certain that there are some experienced attorneys who are at this moment thinking that an owner or general contractor could also become an additional insured via a blanket endorsement to a particular policy as well. This is true; however, there must also be a separate, distinct and specific contract executed between the parties embodying the language obligating the subcontractor to name the owner or other contractor as an additional insured and further obligating the subcontractor to defend, hold harmless and indemnify the owner and/or general contractor as an additional insured to the subcontractor's policy of insurance.[19] In addition, the subcontractor must also usually pay an additional insured premium to obtain such blanket additional insured coverage.

Absent either a blanket or specific endorsement and the payment of an additional premium, additional insured coverage would not be ordinarily obtained by merely having a certificate of insurance issued purportedly disclosing that another party or entity is an additional insured to the contractor or subcontractor's policy. The only way in which the latter situation could result in a finding of coverage in favor of the purported additional insured is if the certificate of insurance were issued by an authorized agent of the insurer who underwrote and issued the policy from whom the added coverage is being sought.[20] Nevertheless, as mentioned above, you must be wary of which judicial department a future case could be commenced in and recall the continuing and present split of authority that exists regarding whether certificates of insurance, alone, trigger coverage for your client.

IV. Only Authorized Agents Can Bind the Insurer to Additional Insured Requests

This point regarding authorized agents warrants repeating. Although a certificate of insurance could be and is generally issued by any insurance agent who has the generic blank forms, only authorized agents of the underwriting insurance company possess the authority to issue such certificates.[21] Additionally, only such authorized agents have the apparent authority to bind their respective principals or insurance carriers. In fact, ordinarily, such authorized agents would typically execute some sort of agency agreement with a particular insurance company authorizing them to solicit prospective insureds and then offering those prospective insureds binding quotes for particular policies of insurance. If you represent a property owner or general contractor who is awarding a job or bidding upon a job and one's client receives a certificate of insurance or insurance quote from the subcontractor's insurance agent and not the actual issuer's agent, your client does not have the right to rely upon such information because the subcontractor's agent or other agent is not authorized to bind the issuer to such additional coverage terms.[22] As a result, if your client does not receive an authorized quote or certificate of insurance regarding additional insured coverage from the carrier or its agent, your client will not be covered for any incident, injury or casualty that might arise from the ongoing construction project, unless your client possesses an independent policy covering it for the risks associated with the particular construction project.

V. Practice Tips and Insurance Coverage Checklist

Therefore, in order to avoid the risk of your client not being covered for injuries and accidents which often occur during large construction projects, you must ensure that your client receives a copy of the policy or the declarations pages to the policy, along with the additional insured endorsement, particularly naming your client as an additional insured or providing blanket additional insured coverage to persons or entities similarly situated as your client, *i.e.* additional insured coverage for owners and occupiers of land or for lessors. You must also review the list of existing exclusions to the policy to ensure that an exclusion does not exist that would prevent coverage from being triggered in favor of your client.

One such common exclusion is the so-called Employee Exclusion which precludes coverage to insureds and additional insureds for injuries arising to individuals who are employees of a contractor or subcontractor and who are injured while they are working within the scope of their employment.[23] In contrast, if you are an attorney representing an insurer and such exclusion exists and is contained within the subject policy, then you should raise its existence as an affirmative defense in your client's answer and move for dismissal upon this basis as well.[24] Further, you should ensure that the contract executed between your client and the contractor or subcontractor contains provisions establishing the contractor or subcontractor's duty to defend and to indemnify your client and to procure additional insured coverage in favor of your client. Finally, you should ensure that the declarations pages of the particular policy confirm that the additional insured premium was paid by the contractor or subcontractor. If the declarations pages fail to confirm that such an additional premium was paid, then you should obtain a copy of the request to obtain additional insured coverage in favor of your client, along with confirmation that the premium was paid.

Only by obtaining the following documents, including: 1) a certified copy of the insurance policy and/or its declarations pages; 2) additional insured endorsement(s); 3) executed construction contract(s) containing the language that the contractor or subcontractor is obligated to defend and to indemnify your client in the event of an accident or injury; and also 4) acknowledgment obligating the contractor or subcontractor to procure insurance in favor of your client could you be reasonably certain that you have protected your client from the foreseeable risks posed by the construction project. Moreover, as mentioned above, you must still review the existing policy exclusions to ensure that they will not become applicable to preclude coverage to your client. Once having reviewed all of these documents and confirmed coverage for one's client, you may sleep peacefully. Nevertheless, while sleeping, remain ever vigilant.

Endnotes

1. *See* sample certificate of insurance reprinted at the end of this article.
2. *Natural Stone Indus., Inc. v. Utica Nat'l. Assur. Co.*, 29 A.D.3d 758, 816 N.Y.S.2d 133 (2d Dep't 2006).
3. *See* sample of a certificate of insurance following this article.
4. *See Moleon v. Kreisler Borg Florman Gen. Constr. Co.*, 304 A.D.2d 337, 758 N.Y.S.2d 621 (1st Dep't 2003).
5. *See* sample standard certificate of insurance used in New York reprinted at the end of article.
6. *See Illinois Nat'l Ins. Co. v. Am. Alt. Ins. Corp.*, 58 A.D.3d 537, 872 N.Y.S.2d 26 (1st Dep't 2009); *Moleon*, 304 A.D.2d at 337.
7. *School Constr. Consultants, Inc. v. ARA Plumbing & Heating Corp.*, 63 A.D.3d 1029, 882 N.Y.S.2d 227 (2d Dep't 2009).
8. *Home Depot U.S.A., Inc. v. Nat'l Fire & Marine Ins. Co.*, 55 A.D.3d 671, 866 N.Y.S.2d 255 (2d Dep't 2008).
9. *Consol. Edison Co. v. Allstate Ins. Co.*, 98 N.Y.2d 208 (2002); *see also Tribeca Broadway Assocs. v. Mount Vernon Fire Ins. Co., 5* A.D.3d 198, 774 N.Y.S.2d 11 (1st Dep't 2004).
10. *Moleon*, 304 A.D.2d at 337.
11. *Buccini v. 1568 Broadway Assocs.*, 250 A.D.2d 466, 673 N.Y.S.2d 398 (1st Dep't 1998).
12. *Glynn v. United House of Prayer*, 292 A.D.2d 319, 741 N.Y.S.2d 499 (1st Dep't 2002); *Am. Motorist Ins. Co. v. Superior Acoustics Inc.*, 277 A.D.2d 97, 716 N.Y.S.2d 389 (1st Dep't 2000).
13. *Niagara Mohawak Power Corp. v. Skibeck Pipeline Co.*, 270 A.D.2d 867, 705 N.Y.S.2d 459 (4th Dep't 2000).
14. *10 Ellicott Square Court Corp. v. Mountain Valley Indem. Co.*, 634 F.3d 232 (2d Cir. 2011) (certified question regarding validity of certificate of insurance to confer coverage dismissed upon settlement of case); 634 F.3d 112 (2d Cir. 2010) (question of whether certificate issued by authorized agent was sufficient to confer

coverage was certified for appeal to the U.S. Court of Appeals for the Second Circuit).

15. *Home Depot U.S.A., Inc. v. Nat'l Fire & Marine Ins. Co.*, 55 A.D.3d 671, 866 N.Y.S.2d 255 (2d Dep't 2008); *Nicotra Grp. v. Am. Safety Indem. Co.*, 48 A.D.3d 253, 254, 850 N.Y.S.2d 455, 457 (1st Dep't 2008); *Rodless Props. v. Westchester Fire Ins. Co.*, 40 A.D.3d 253, 254–55, 835 N.Y.S.2d 154, 155 (1st Dep't 2007); *Am. Ref-Fuel Co. v. Res. Recycling, Inc.*, 248 A.D.2d 420, 423–24, 671 N.Y.S.2d 93, 96 (2d Dep't 1998).
16. *See Niagara Mohawak Power Corp. v. Skibeck Pipeline Co.*, 270 A.D.2d 867, 868–69, 705 N.Y.S.2d 459, 460–61 (4th Dep't 2000); *see also Bucon, Inc. v. Pa. Mfg. Ass'n. Ins. Co.*, 151 A.D.2d 207, 210–211, 547 N.Y.S.2d 925, 927–28 (3d Dep't 1989).
17. *See 10 Ellicot Square Court Corp.*, 634 F.3d at 112 (dismissing a case upon settlement after reviewing the certified question); *appeal dismissed*, 634 F.3d 232 (2d Cir. 2011); *see also Penguin Grp. v. Am Buddha*, 609 F.3d 30, 41–42 (2d Cir. 2010) (highlighting the unresolved split of authority upon the issue of whether a certificate of insurance issued by an authorized agent alone suffices to establish coverage in favor of the purported additional insured).
18. *See Chmura v. T & J Painting Co.*, 64 A.D.3d 987, 881 N.Y.S.2d 724 (3d Dep't 2009), *remanded upon other grounds*, 83 A.D.3d 1193 (3d Dep't 2011).
19. *BP Air Conditioning Corp. v. One Beacon Ins. Grp.*, 8 N.Y.3d 708 (2007); *W. Bldg. Restoration Co. v. Lovell Safety Mgt. Co.*, 61 A.D.3d 1095, 876 N.Y.S.2d 733 (3d Dep't 2009).
20. *Tomala v. Peerless Ins. Co.*, 14 N.Y.2d 862 (1964).
21. *See Standard Funding Corp. v. Lewitt*, 89 N.Y.2d 546 (1997).
22. *See Sevenson Envtl. Servs., Inc. v. Sirius Am. Ins. Co.*, 74 A.D.3d 1751, 902 N.Y.S.2d 279 (4th Dep't 2010); *Tribeca Broadway Assocs., v. Mount Vernon Fire Ins. Co.*, 5 A.D.3d 198, 200, 774 N.Y.S.2d 11, 12 (1st Dep't 2004); *Lenox Realty v. Excelsior Ins. Co.*, 255 A.D.2d 644, 645–46, 679 N.Y.S.2d 749 (3d Dep't 1998), *lv. denied*, 93 N.Y.2d 807 (1999).
23. *See Essex Ins. Co. v. Mondone*, 106 A.D.3d 1045, 965 N.Y.S.2d 616 (2d Dep't 2013); *Campoverde v. Fabian Bldrs., LLC.*, 83 A.D.3d 986, 922 N.Y.S.2d 435 (2d Dep't 2011).
24. *See U.S. Underwriters Ins. Co. v. 101-19 37th Ave., LLC*, 2014 U.S. Dist. LEXIS 41432, at *1 (E.D.N.Y. Mar. 27, 2014); *Temperino v. DRA, Inc.*, 75 A.D.3d 543, 904 N.Y.S.2d 767 (2d Dep't 2010) (affirming the lower court's granting third-party defendant Rutgers Casualty Insurance Company's summary judgment predicated upon the existence and applicability of the employee exclusion); *Carpio Sanchez v. Nakamura*, 34 Misc.3d 1210(a), 943 N.Y.S.2d 790 (Sup. Ct., Queens Co. 2011).

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ACORD®

CERTIFICATE OF LIABILITY INSURANCE

DATE (MM/DD/YYYY)

THIS CERTIFICATE IS ISSUED AS A MATTER OF INFORMATION ONLY AND CONFERS NO RIGHTS UPON THE CERTIFICATE HOLDER. THIS CERTIFICATE DOES NOT AFFIRMATIVELY OR NEGATIVELY AMEND, EXTEND OR ALTER THE COVERAGE AFFORDED BY THE POLICIES BELOW. THIS CERTIFICATE OF INSURANCE DOES NOT CONSTITUTE A CONTRACT BETWEEN THE ISSUING INSURER(S), AUTHORIZED REPRESENTATIVE OR PRODUCER, AND THE CERTIFICATE HOLDER.

IMPORTANT: If the certificate holder is an ADDITIONAL INSURED, the policy(ies) must be endorsed. If SUBROGATION IS WAIVED, subject to the terms and conditions of the policy, certain policies may require an endorsement. A statement on this certificate does not confer rights to the certificate holder in lieu of such endorsement(s).

PRODUCER	CONTACT NAME:	
	PHONE (A/C, No, Ext):	FAX (A/C, No):
	E-MAIL ADDRESS:	
	PRODUCER CUSTOMER ID #:	
	INSURER(S) AFFORDING COVERAGE	NAIC #
INSURED	INSURER A :	
	INSURER B :	
	INSURER C :	
	INSURER D :	
	INSURER E :	
	INSURER F :	

COVERAGES **CERTIFICATE NUMBER:** **REVISION NUMBER:**

THIS IS TO CERTIFY THAT THE POLICIES OF INSURANCE LISTED BELOW HAVE BEEN ISSUED TO THE INSURED NAMED ABOVE FOR THE POLICY PERIOD INDICATED. NOTWITHSTANDING ANY REQUIREMENT, TERM OR CONDITION OF ANY CONTRACT OR OTHER DOCUMENT WITH RESPECT TO WHICH THIS CERTIFICATE MAY BE ISSUED OR MAY PERTAIN, THE INSURANCE AFFORDED BY THE POLICIES DESCRIBED HEREIN IS SUBJECT TO ALL THE TERMS, EXCLUSIONS AND CONDITIONS OF SUCH POLICIES. LIMITS SHOWN MAY HAVE BEEN REDUCED BY PAID CLAIMS.

INSR LTR	TYPE OF INSURANCE	ADDL INSR	SUBR WVD	POLICY NUMBER	POLICY EFF (MM/DD/YYYY)	POLICY EXP (MM/DD/YYYY)	LIMITS	
	GENERAL LIABILITY						EACH OCCURRENCE	$
	COMMERCIAL GENERAL LIABILITY						DAMAGE TO RENTED PREMISES (Ea occurrence)	$
	CLAIMS-MADE OCCUR						MED EXP (Any one person)	$
							PERSONAL & ADV INJURY	$
							GENERAL AGGREGATE	$
	GEN'L AGGREGATE LIMIT APPLIES PER:						PRODUCTS - COMP/OP AGG	$
	POLICY PRO-JECT LOC							$
	AUTOMOBILE LIABILITY						COMBINED SINGLE LIMIT (Ea accident)	$
	ANY AUTO						BODILY INJURY (Per person)	$
	ALL OWNED AUTOS						BODILY INJURY (Per accident)	$
	SCHEDULED AUTOS						PROPERTY DAMAGE (Per accident)	$
	HIRED AUTOS							$
	NON-OWNED AUTOS							$
	UMBRELLA LIAB OCCUR						EACH OCCURRENCE	$
	EXCESS LIAB CLAIMS-MADE						AGGREGATE	$
	DEDUCTIBLE							$
	RETENTION $							$
	WORKERS COMPENSATION AND EMPLOYERS' LIABILITY Y / N						WC STATU-TORY LIMITS	OTH-ER
	ANY PROPRIETOR/PARTNER/EXECUTIVE OFFICER/MEMBER EXCLUDED?	N / A					E.L. EACH ACCIDENT	$
	(Mandatory in NH)						E.L. DISEASE - EA EMPLOYEE	$
	If yes, describe under DESCRIPTION OF OPERATIONS below						E.L. DISEASE - POLICY LIMIT	$

DESCRIPTION OF OPERATIONS / LOCATIONS / VEHICLES (Attach ACORD 101, Additional Remarks Schedule, if more space is required)

CERTIFICATE HOLDER	**CANCELLATION**
	SHOULD ANY OF THE ABOVE DESCRIBED POLICIES BE CANCELLED BEFORE THE EXPIRATION DATE THEREOF, NOTICE WILL BE DELIVERED IN ACCORDANCE WITH THE POLICY PROVISIONS.
	AUTHORIZED REPRESENTATIVE

ACORD 25 (2009/09)

Committee Reports

Banking Law Committee

A meeting of the Banking Law Committee was held during NYSBA's Annual Meeting week on January 28, 2015. The theme for the meeting was cybersecurity, with a panel consisting of Jay Hack, partner at Gallet, Dreyer & Berkey LLP; Sabra Baum, Vice President and Senior Counsel at M&T Bank; Mark Clancy, Managing Director for Technology Risk Management at The Depository Trust & Clearing Corporation; Sean Reilly, Senior Vice President and Associate General Counsel at The Clearing House Payments LLC; and myself. Topics covered included federal bank regulations and guidance relating to data security; NY State data breach laws applicable to all New York businesses; current schemes on cyberattacks and what banks can do to protect their systems; federal resources available to banks regarding cybersecurity, and how one bank is handling the almost-constant attacks on its computer systems. There was a lively discussion among the panelists and the audience and the speakers were kind enough to stay around afterwards to speak with members who had additional questions.

The spring meeting of the Banking Law Committee was held on May 15, 2015, in New York City. The theme was legislative and regulatory updates and a panel moderated by Kathleen Scott, Banking Law Committee chair, and consisting of Ashby Hilsman, Regional Counsel for the FDIC, James Porreca (Assistant District Counsel, OCC—Northeastern District), and Roberta Kotkin, General Counsel and COO, New York Bankers Association, provided updates on various legislative and regulatory initiatives. As always, there was a lively discussion among the panel and the committee members.

The next committee meeting will take place during the Business Law Section's Fall Meeting in October.

Kathleen A. Scott, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee held a CLE Class at the Spring Meeting titled "Hot Topics in, and Alternatives to, Section 363 Asset Sales." The speakers at this CLE were Jeffrey Bernstein of McElroy, Deutsch, Mulvaney & Carpenter, LLP; Janice B. Grubin of LeClairRyan, A Professional Corporation; Jeremy Johnson of Norton Rose Fulbright; Nicole Leonard of McElroy, Deutsch, Mulvaney & Carpenter, LLP, and Michael J. Riela of Vedder Price LLP. The Bankruptcy Law Committee and the Bankruptcy Committee of the New York City Bar Association also co-sponsored a CLE class titled "E-Discovery in Bankruptcy: Tricks and Tips to Lower Risk, Costs and Save Your Sanity" on June 25, 2015 from 6:00 to 9:00 p.m. For additional information or to suggest topics and ideas for meetings, please contact Scott Bernstein at sbernstein@mccarter.com or by phone at (973) 639-2007.

Scott Bernstein, Chair

Corporations Law Committee and Securities Regulation Committee

At the NYSBA Annual Meeting in New York City on January 28, 2015, the Corporations Law Committee and the Securities Regulation Committee held a joint meeting, which attracted approximately 30 participants from the two committees. The program centered on the life cycle of an early stage company. Adele Hogan and Jeffrey Bagner of the Corporation Law Committee presented on "Choosing the Right Organizational Structure" and "Exit Strategies in the Life Cycle of a High-Tech Company: IPOs and Private Sales," respectively. Peter W. LaVigne, Chair of the Securities Regulation Committee, and Guy Lander presented on "What Startups Need to Know About Finders and other Intermediaries" and "Private Placements for Startup and Early Stages Companies," respectively. Richard De Rose, Chair of the Corporation Law Committee, described recent New York cases that rejected disclosure-only settlements in shareholder litigation.

Richard De Rose, Chair (Corporations Law);
Peter LaVigne, Chair (Securities Regulation)

Derivatives and Structured Products Law Committee

No report submitted.

Ilene Froom, Chair

Franchise, Distribution and Licensing Law Committee

On January 28, 2015, the Franchise, Distribution and Licensing Law Committee held a meeting in conjunction with the Annual Meeting of the Business Law Section, which was held at the New York Midtown Hilton Hotel. At the meeting Craig Tractenberg, of Nixon Peabody LLP, presented a fascinating overview of the various aspects of how the filing of a Chapter 11 Bankruptcy proceeding may affect, and be affected by, the franchisor/franchisee relationship. Mr. Tractenberg, an experienced practitioner in the bankruptcy field generally and a well-respected expert in bankruptcy in the franchise context, covered a wide range of topics and issues, including how specific provisions in franchise agreements are treated in bankruptcy, its effect on pending litigation, the right to reject agreements (including leases), as well as many other topics. The session, which was well attended, was offered for full CLE credit.

Your Chairman, together with Tom Pitegoff and David Oppenheimer, former Chairs of the Committee, and Kevin

Kerwin, an attorney representing the New York State Bar Association, attended two meetings with the New York State Attorney General's Office to discuss the proposed modifications to the New York Franchise Sales Act that had been previously drafted by a subcommittee of the Franchise, Distribution and Licensing Law Committee. It has been the hope of the Committee that we would reach a consensus with the Attorney General's Office with the goal of presenting a "united front" to the New York State Legislature in seeking to formulate a bill amending the present statute. The discussions are ongoing.

On May 15th, several members of the Committee participated in a meeting of the Executive Committee of the Business Law Section. A variety of topics, including planning for the Business Law Section fall meeting, the restructuring of the *NY Business Law Journal* and an update on the status of legislative matters (including the status of the above-discussed modifications to the Franchise Sales Act) were discussed.

For further information regarding the Committee and its activities or with respect to the next Committee meeting, please contact Committee Chair Richard L. Rosen (rlr@rosenlawpllc.com or at 212-644-6644).

Richard L. Rosen, Chair

Insurance Law Committee

The Insurance Committee met on May 15, 2015 and discussed the following topics: investment management regulatory issues for insurance companies, trends in real estate joint ventures, private equity investments, insurance company M&A, catastrophe bonds, developments with life settlements, annuities, cybersecurity and the SEC's disclosure policies related to breaches (particularly as they relate to material weaknesses in financial reporting), IT technology issues, IT contract provisions and IT consulting arrangements that are problematic for insurance and other companies, risk management, and directors and officers insurance policy litigation issues. The Committee members particularly focused on IT consulting-related problems around SAP implementations and big data issues, as well as the types of IT agreement provisions that are added to allow for providers' workers to be replaced and other contract specific issues.

N. Adele Hogan, Chair

Legislative Affairs Committee

The Legislative Affairs Committee is working on three projects. The most recent is a response to a state legislative proposal to expand the reach of Section 630 of the Business Corporation Law. Assembly Bill 737 and Senate Bill 4476 would extend personal liability beyond shareholders of closely held corporations formed in New York to shareholders of closely held corporations formed in other states for unpaid services performed in New York. At its meeting May 15, 2015, the Executive Committee of the Business Law Section decided to oppose this legislation, which would discourage the establishment of new businesses in New York. The Executive Committee decided to go one step further by proposing the repeal of BCL Section 630 in its entirety because it discourages new businesses from incorporating in New York and violates the bedrock principle of shareholder limited liability that applies throughout the United States.

The Executive Committee also proposed repealing new subdivisions (c) and (d) of Section 609 of the New York Limited Liability Company Law, which were added to the law in December 2014 without the prior knowledge of the Executive Committee. That change makes the ten limited liability company members with the largest percentage ownership interest personally liable for wages and salaries of employees. Here, too, the Executive Committee proposes maintaining the principle of limited liability.

The second project is a broad revision of the New York Franchise Act. Members of the Business Law Section's Franchise, Distribution and Licensing Law Committee and NYSBA's Department of Governmental Relations are in continuing discussions with representatives of the New York Attorney General's Office.

Third, members of the Business Law Section's Not-For--Profit Corporations Law Committee are working with the Law Revision Commission, the Lawyers Alliance for New York, the New York City Bar Association and the Nonprofit Coordinating Committee of New York to amend the Not-for-Profit Corporation Law to correct practical problems, oversights and inconsistencies in the Nonprofit Revitalization Act of 2013.

Thomas M. Pitegoff, Chair

Not-For-Profit Corporations Law Committee

The Not-for-Profit Corporations Law Committee has continued to assess the Non-Profit Revitalization Act ("Act"), including practical problems for corporations as well as legal issues for practitioners. While the Act provided long-overdue reforms, there has been difficulty in complying with certain of its provisions and unintended consequences of other provisions. The Committee has been working with many groups including The Lawyers' Alliance for New York, the Law Revision Commission, the New York City Bar Association and the Nonprofit Coordinating Committee of New York to assess the impact of the Non-Profit Revitalization Act and to provide suggestions for statutory amendments to eliminate some of the problems and to clarify ambiguities. These efforts have recently culminated in suggestions for amendments to the Not-for-Profit Corporation Law that have been presented to the appropriate legislative committee chairpersons.

Frederick Attea, Chair

Public Utility Law Committee

No report submitted.

Mary Krayeske, Chair

Securities Regulation Committee

[See Corporations Law Committee, above]

Peter LaVigne, Chair

Technology and Venture Law Committee

No report submitted.

Shalom Leaf, Chair

Publication Policy and Manuscript Guidelines for Authors

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

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

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

Manuscripts are to be submitted to:

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NEW YORK STATE BAR ASSOCIATION

Business Law Section

ANNUAL STUDENT WRITING COMPETITION

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the J.D. or LL.M. degree at an accredited law school during the year in which the article is submitted. The student articles submitted in a given year that are judged first and second best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $1,500 and $1,000, respectively. At the discretion of the editors, they also will be published in the NYSBA *NY Business Law Journal*, which is sponsored by the Section in cooperation with New York Law School. Additional cash prizes may be awarded in the discretion of the Section. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria:

- Relevance to the *Journal*'s audience (New York business lawyers)
- Timeliness of the topic
- Originality
- Quality of research and writing
- Clarity and conciseness

The manuscript should follow Bluebook cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). All submissions become the property of the NYSBA and the *NY Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded.

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, Editor-in-Chief, NYSBA *NY Business Law Journal* (david.glass@macquarie.com). The student should include a brief biography, including law school attended, degree for which the student is a candidate, and expected year of graduation.

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