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HeadNotes

As this issue went to press, the markets were being roiled by uncertainty over whether the latest saber-rattling between China and the Trump Administration was, or was not, the precursor to a full-fledged trade war. One area in which the Administration clearly does seem determined to move forward is in imposing export controls on emerging technologies. In November the Commerce Department published an Advance Notice of Proposed Rulemaking (ANPR) pursuant to the Export Control Reform Act of 2018 (ECRA), asking for public comment regarding which technologies should be included. Companies, and their attorneys, that may be affected should be gathering data on the effect they would feel from controls on sectors likely to be targeted, such as biotechnology, artificial intelligence, advanced materials, and computer processing. They should also be mindful of new regulations from the Committee on Foreign Investment in the United States (CFIUS) that require high technology businesses to declare certain foreign investments in these areas before the investment is made.

While controversy continues to surround many actions of the Administration, to date President Trump's appointments to the Federal Reserve Board of Governors and other bank regulatory agencies remain relatively non-controversial. In October the president nominated Nellie Liang to the remaining vacancy on the seven-person Board; if she is confirmed the Board would be fully staffed for the first time in more than 20 years, as both parties have systematically blocked appointments by the other party's president during that time. Ms. Liang is a career Fed staff member who holds a Ph.D in Economics, worked closely with former Fed Chair Ben Bernanke during the global financial crisis, and is considered a leading authority on stress-testing, which has been a major focus of the Fed in enhancing its supervision over the largest banking organizations. She is also a Democrat, and would be the first Asian and only the tenth woman to sit on the Board. The appointment has been widely praised on both sides and appears headed for confirmation.

Meanwhile, a lawsuit filed in the Southern District of New York in August represents a potential threat to the Fed's conduct of monetary policy. In *TNB USA Inc. v. Federal Reserve Bank of New York*, the plaintiff, a newly state-chartered bank based in Connecticut, is challenging the Fed's refusal to open for it a Master Account, without which the bank cannot participate in the payments system. The bank does not propose to take deposits or deal with the public; its business model consists entirely of holding reserves with the Fed on behalf of its customers, large financial institutions, earning interest at the Fed's Interest on Excess Reserves (IOER) rate, while paying its customers a slightly lower rate—in effect, arbitraging the gap between the IOER and the federal funds rate. Apparently fearful that this would compromise the Fed's ability to conduct monetary policy by "targeting" the federal funds rate—the rate charged by large banks for overnight loans to each other, transacted on the books of the Fed—the Fed cited policy reasons in denying it from establishing an account. But under applicable law, it appears, and the bank so argues, that the Fed must grant it such an account, since it holds a valid charter as a bank. We will be following the case closely as it develops.

David L. Glass

Digital currencies continue to be an area in which the law is developing rapidly, as both federal and state regulators grapple with the question of how transactions in such currencies should be regulated. The *Journal* has tracked these developments in recent issues by publishing articles from a number of practitioners and scholars, and this issue is no exception. In "The SEC Goes After Cryptocurrency Issuers for Selling Unregistered Securities: *Howey* Doing?" Professor James Redwood discusses and analyzes two recent Securities & Exchange Commission (SEC) enforcement actions in which the Commission concludes that they are securities, in addition to two recent federal cases addressing this question. In 2017 the SEC fired several "shots across the bow," alerting issuers that it was looking at these currencies to see if they might be "securities" subject to registration and regulation under the Securities Act of 1933, which defines the term "security" to include any "investment contract." Noting that in the seminal case of *SEC v. Howey*, decided in 1946, the Court defined the term "investment contract" to be a "flexible rather than static principle," Professor Redwood expresses the view that the SEC's interpretation is likely to be upheld. His article provides considerable insight into the SEC's thinking, as well as a useful refresher of the underlying law. Professor Redwood, who teaches at Albany Law School, also has long served as the managing editor of the *Journal*.

Another area of recent regulatory controversy is the proposal by the Office of the Comptroller of the Currency (OCC), an office within the Treasury Department responsible for chartering and supervising national banks, to issue a limited national bank charter to financial technology, or so-called "fintech," companies. New York and other states have sued the OCC, contending that its proposal to grant such a charter exceeds its authority under law. Meanwhile, in July the Treasury Department released a comprehensive Report on fintechs, nonbank financial companies more generally, and innovation in financial services, the fourth report issued by the Department in response to President Trump's executive order of February 2016, which set forth certain core principles for the overhaul of the financial system. In "If Only: U.S. Treasury Department Report Creates a Wish Tree of Financial Reform for Fintech," the attorneys of Mayer Brown provide a thorough and comprehensive analysis of the Report, evaluating its recommendations with respect to digital communications, cloud technology, data aggregation and numerous other areas in which the traditional role of the banking system is being challenged by nonbank competitors. It is an invaluable resource for practitioners seeking to understand the changes that may be forthcoming in this fast-moving area.

Commercial contracts routinely contain a so-called *force majeure* clause, which purports to excuse performance for events beyond the control of the parties, such as an earthquake or other "Act of God." In "*Force Majeure*: What Is It Good For?" Stuart Newman and Allison Rosenzweig conclude that the answer is "not much," noting that *force majeure* clauses "are routinely assigned to the scrap-heap of boilerplate at the tail end of an otherwise well-crafted contract." The authors argue that a more carefully drafted clause can also cover a wide variety of less drastic, but potentially just as damaging, circumstances. The problem is, of course, that specifying too many circumstances that constitute *force majeure* runs the risk of creating an inference that those not specifically named are excluded. Their article contains much useful and practical advice for New York attorneys, including drafting tips. As of January 1, 2019, Mr. Newman and Ms. Rosenzweig have joined the multistate law firm Offit Kurman. Mr. Newman is the founder of the *Journal* and serves as Chair Emeritus of its Advisory Board. We are pleased to announce that, in recognition of these and other contributions to the Business Law Section, the Section has awarded him the David Caplan Memorial Award for 2019 for distinguished service to the Section.

"It is a cliché that business decisions should never be driven solely by tax considerations, but in the real world, tax considerations inevitably loom large in how transactions are structured, and whether they are economically viable in the first place."

The attorney-client privilege continues to be a source of ongoing confusion among practitioners. One manifestation of that confusion is the question whether, and when, an attorney may "rat out" (i.e., act as a whistleblower) with respect to an act of his client. For example, if the client is about to offer a potentially harmful product, and dismisses its attorney for arguing against that action, may the attorney report this to a regulatory authority without violating the privilege? In "Lawyers as Rats: An Evolving Paradigm?" Evan Stewart, the *Journal's* ethics guru, reviews this and related questions with his usual unique mixture of wit and erudition. While noting that different states have reached different results, he cautions that the New York courts have not been at all friendly to attorneys "ratting out" their clients—and indeed have expressed the view that it would take an act of the legislature to authorize this.

The "rat out" problem highlighted by Mr. Stewart is, of course, just one in a panoply of problems related to the attorney-client privilege, especially as it applies to in-house counsel. While there is no doubt that communications between a corporation and its in-house counsel are entitled to the privilege, this is only true if the attorney is communicating in her capacity as an attorney, rather than, say, rendering business advice. But the line is not easy to draw in practice. In "The Attorney-Client Privilege and Communications Between Company Employees and Their In-House Counsel," Professor Michael Hutter reexamines this question in light of *SodexoMAGIC, LLC v. Drexel University*, a recently decided case that considered whether certain emails between a company's employee and its in-house counsel were properly withheld from disclosure on grounds of attorney-client privilege. In the course of deciding whether these were business or legal communications, the court laid out a series of "ground rules" that provide guidance for future applicability of the privilege in similar circumstances; although the case was decided under Pennsylvania law, the author notes that New York law is essentially the same on this issue. Professor Hutter teaches at Albany Law School, and has contributed to the *Journal* in the past.

No issue of the *Journal* would be complete without "Inside the Courts," in which the attorneys of Skadden Arps share with our readers their incomparable compendium of substantially all significant litigation currently in the federal courts that affects or could affect the practice of corporate and securities law. For each such case they have provided a thorough, yet concise, description of the issues involved and their significance. Whether or not one is a litigator, "Inside the Courts" is an invaluable heads-up of trends and new developments in these rapidly changing areas of law. We remain indebted to Skadden and its attorneys for sharing their knowledge and insight so generously with our readers.

It is a cliché that business decisions should never be driven solely by tax considerations, but in the real world, tax considerations inevitably loom large in how transactions are structured, and whether they are economically viable in the first place. Our next two articles explore different aspects of the tax law and how they affect business planning. In "Ten Reasons to Prefer Tax Partnerships Over S-Corporations," Professor Bradley Borden reconsiders the relative merits of two types of business organization from a tax standpoint. The S-Corporation is a popular form, as it is relatively easy to create and is taxed on a pass-through basis rather than at the entity level. But especially since the enactment of the Tax Cuts and Jobs Act of 2017, this form has certain pitfalls. The author lays out ten clearly explained, practical reasons why an S-Corporation may not be the optimum choice in all circumstances. Professor Borden is a professor of law at Brooklyn Law School and the author of numerous books and articles on various aspects of taxation.

The second article deals with the federal estate and gift tax, or "death tax" as it is sometimes called. In "The Trump Family's Wealth Transfer," Greg Kiley begins by explaining the origins of the federal tax and its evolution over the years, noting that the tax has always been politically controversial, notwithstanding that at the current cutoff of $11.8 million it actually affects only about 1,800 estates per year. He then lays out in detail, based on the public record, how the parents of Donald Trump used various tax-avoidance strategies to increase their wealth—emphasizing that none of these strategies was illegal at the time it was employed. Thoroughly researched and clearly written, the article offers a fascinating insight into the practical application of tax strategies, as well as a primer on the underlying law. Mr. Kiley is a candidate for the JD degree at Albany Law School.

Historically the London Interbank Offered Rate, or LIBOR, has been a key reference rate for financial transactions of all types. LIBOR refers to the rate at which large financial institutions are willing to lend money to each other, and historically has been unregulated. In recent years, however, a series of scandals broke in which it became clear that certain institutions were manipulating the LIBOR rate they reported for their own advantage. As a result, in 2017 the Financial Conduct Authority (FCA) announced that LIBOR was being phased out, with a target date of 2021. Concluding this issue, in "LIBOR: London's Interbank Bridge Is Falling Down," Danielle Wilner looks at the effects and consequences of the impending phase-out. Her article, which is also thoroughly researched and clearly written, provides invaluable background on the history of LIBOR. She then turns her attention to the proposed replacements—noting that each of them has significant shortcomings that may make the cure worse than the disease. Ms. Wilner is a candidate for the JD degree at Syracuse University School of Law.

The SEC Goes after Cryptocurrency Issuers for Selling Unregistered Securities: *Howey* Doing?

By James D. Redwood

In sending a well-aimed shot across the bow last summer,[1] the SEC made it clearer than ever that it views the issuance of cryptocurrencies, through a blockchain transaction or otherwise, as constituting the offer and sale of a security which must meet the registration requirements of Section 5[2] of the Securities Act or an available exemption.[3] This should have come as no surprise to those who market digital coins, tokens, or other forms of virtual currency,[4] which the Commission had earlier warned would, sooner or later, come under scrutiny by federal regulators. Indeed, on July 25, 2017, the SEC stated the following:

> These [registration] requirements of section 5 apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger [blockchain] technology.[5]

As a result of two recent SEC enforcement actions and two federal court decisions, the later has not merely become sooner. It has become now.

I. Paragon

A. Facts

On November 16, 2018, the Commission issued Cease-and-Desist proceedings against two entities that had offered and sold digital coins through blockchain technology.[6] In the first case, *In re Paragon Coin, Inc.,* the Commission alleged that Paragon, via a "White Paper" used to describe the terms of the ICO,[7] announced the offer of "ParagonCoins" or "PRG" to the general public without filing a registration statement under Section 5 of the '33 Act.[8] In order to arouse investor interest, Paragon offered 10 percent to 25 percent discounts on the offering price of the coins during a one-month "presale" period. The offering was conducted worldwide through websites and social media pages, including Paragon's own website. According to the White Paper, a maximum of 200,000,000 PRG tokens would be sold, and the resulting cap on production would increase the value of the coins over time because of their scarcity. To increase their value further, Paragon stated in its White Paper that it planned to list the tokens on major exchanges in order to facilitate secondary market trading, but in fact the coins were never so listed.

Proceeds from the offering were to be used to develop and implement a "business model" that would include building an "ecosystem" around the tokens to enhance their appeal to investors. This business model would consist of raising capital in the public offering of ParagonCoins and PRG and using the proceeds to add blockchain technology to the cannabis industry. The promoters also promised to work toward the worldwide legalization of cannabis. Importantly, although Paragon told potential purchasers that they would be able to use the tokens to buy goods or services in the future after Paragon created the "ecosystem," no one was ever able to purchase any good or service other than by pre-ordering certain Paragon merchandise. To keep the price of PRG stable, Paragon established a "Controlled Reserve Fund," such that if the price of the tokens dropped significantly, the fund would repurchase them in an effort to stabilize the market price. In the alternative, if the token price shot up too rapidly, the fund would release tokens into the marketplace to bring the price down.

On internet forums, blogs, e-mails, and social media posts, Paragon stated that as its solutions were adopted throughout the cannabis industry, PRG owners who held their tokens as long-term growth assets would see them appreciate in value. The promoters also stated that the Paragon team possessed "a depth of experience across business, technology, blockchain, smart contracts, and the cannabis industry."[9] In this and other ways, the White Paper drew a direct connection between Paragon's ability to create the planned "ecosystem" and the future value of PRG tokens. These assertions as to the attractiveness and value of investing in ParagonCoins and PRG tokens, coupled with those relating to the expertise of Paragon personnel, among other items, led the SEC to conclude that the issuer had offered and sold securities in violation of '33 Act Section 5.

B. Analysis

As digital coins or tokens are not among the specific items listed as securities in Securities Act Section 2(a)(1)[10] and Exchange Act Section 3(a)(10),[11] the Commission turned to the term "investment contract," which appears under the definition of a security in both statutes and which has been described by the Supreme Court in the well-known *Howey* case.[12] Under *Howey,* an investment contract is "an investment of money in a common enterprise with a reasonable expectation of profits to be

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derived from the entrepreneurial or managerial efforts of others."[13] Utilizing this multi-factor test, the Commission had no trouble in finding that the Paragon offering constituted the sale of an investment contract, and thus of an unregistered security.

With respect to the first prong of *Howey,* an investment of "money," the Commission found that the investors in Paragon's general solicitation purchased their tokens in exchange for other digital assets, namely Bitcoin, Ether, Litecoin, Dashcoin, Zcash, Ripple, Monero, Ethereum Classic, and Waves. That the currency used for the exchange of assets was digital rather than fiat appeared to be of no moment.[14] The offering ultimately raised the U.S. dollar equivalent in digital assets of $12,066,000.

The Commission found, with regard to the second prong of *Howey,* namely that the purchasers must have a reasonable expectation of profits from their investment,[15] that the marketing of the ParagonCoins and PRG led the investors reasonably to believe that they would obtain "a future profit from buying PRG tokens if Paragon were successful in its entrepreneurial and managerial efforts to develop its business."[16] Among other things, the SEC noted that investors were told that the proceeds of the offering would be used to build an "ecosystem" that would create demand for the tokens, that Paragon and its agents would pursue the listing of the coins on secondary market trading platforms, that they would utilize the Controlled Reserve Fund to stabilize the price of the tokens, and that they would limit the supply (and in fact over time "burn" excess tokens so as further to restrict the supply), all in order to increase the tokens' value. Because of these representations, the investors could reasonably expect to partake of the anticipated enhancement of value resulting from these measures, and that was sufficient to meet the "expectation of profits" prong of the *Howey* test.[17]

Finally, with respect to the requirement that the efforts essential to the success (or failure) of the enterprise be the work of the promoters or third parties, as opposed to that of the investors, the SEC pointed out that it was Paragon that had the responsibility of creating the "ecosystem" and of taking all the other necessary steps to add value to the tokens (e.g., by increasing demand through the restriction of supply, by attracting investors through the promised application of Paragon's blockchain technology to the highly popular cannabis industry, by stabilizing the price through the Controlled Reserve Fund, and by dangling forth the prospect of secondary market trading). The Commission thus viewed the ParagonCoin and PRG investors as mere passive participants in a scheme engineered by and under the complete control of Paragon and its agents. As a result, it found Paragon liable for having offered and sold investment contracts and thus securities in violation of Section 5.

II. AirFox

A. Facts

On the same day that it decided *Paragon,* the SEC issued a cease-and-desist order against another ICO issuer, AirFox.[18] AirFox stated in its White Paper and elsewhere that it was in the business of selling mobile technology to customers of prepaid mobile telecommunications operators. This technology would purportedly allow those customers to obtain free or discounted airtime or data by interacting with advertisements on their smartphones. To finance its business operations, AirFox offered and sold 1.6 billion "AirTokens" on the Ethereum blockchain. The offering raised the digital equivalent of around $15 million from more than 2,500 investors, who were contacted on websites controlled by AirFox. These funds, according to the White Paper, were to be used to create and capitalize a new international ecosystem. This ecosystem would allow AirFox customers to avail themselves not only of the company's existing technology (obtaining free or discounted airtime or data by interacting with smartphone ads), but would eventually enable them to transfer the AirTokens, engage in peer-to-peer microlending transactions and credit scoring, and use the AirTokens to buy and sell goods and services other than mobile data. With respect to this last inducement to buy the tokens, investors were told that the company would maintain their value by purchasing mobile data and other goods and services that could in turn be purchased by the token holders. There was no evidence that customer funds were ever put to any of these anticipated uses.

The White Paper also stated that the AirTokens would increase in value as a result of AirFox's attempts to provide liquidity by making the coins eligible for secondary market trading. Interestingly, AirFox then demonstrated its apparent awareness of the securities laws by requiring potential purchasers to agree that they were acquiring the tokens as a medium of exchange for mobile airtime and not as an investment or a security, although whether in fact any of the buyers actually agreed to this is not clear from the SEC's opinion. Not surprisingly, none of the promised functionality or new technology ever materialized, and the Commission ultimately concluded that the tokens were a security under *Howey.* Given AirFox's repeated emphasis on enhancing the AirTokens' value, the SEC determined that the motivation of the buyers was "based upon anticipation that the value of the tokens would rise through AirFox's future managerial and entrepreneurial efforts."[19] The purchasers "reasonably believed they could pursue . . . profits by holding or trading AirTokens, whether or not they ever used the AirFox App or otherwise participated in the AirToken ecosystem."[20] AirFox further enticed investors to purchase the tokens by representing that the promoters had worked at "prominent" technology companies and had attended "prestigious" universities. And, in addition to utilizing the White Paper and You Tube videos, AirFox pushed the sale of the tokens on social media sites, blog posts, and message boards that were directed at individuals who were specifically interested in digital assets, thereby increasing the likelihood that they would be sold.

B. Analysis

The Commission began its analysis of the legal issues involved in the AirFox ICO by reference to the DAO Report,[21] reiterating that "tokens, coins or other digital assets issued on a blockchain may be offerings of securities under the federal securities laws, and, if they are, issuers and others who offer or sell these securities in the United States must register the offering and sale with the Commission or qualify for an exemption from registration."[22] The SEC then proceeded to apply *Howey.*

As was the case with *Paragon,* the purchasers in this case exchanged other digital assets for their AirTokens, providing sufficient consideration to meet the "investment of money" prong of the *Howey* test: "Such investment [of digital assets] is the type of contribution of value that can create an investment contract."[23] As for the "reasonable expectation of profits" and "efforts of others" prongs,[24] the Commission pointed out that the purpose of the offering was to raise proceeds to create an "ecosystem" that would foster demand for the AirTokens and increase their value. Additionally, AirFox had informed investors that upon completion of the offering, it would attempt to obtain listing for the tokens on multiple digital token trading platforms in order to provide liquidity. It was AirFox and its agents, not the investors, who would take the steps necessary for the venture to succeed. Thus, all the essential entrepreneurial and managerial efforts would come from AirFox.

Finally, the Commission pointed to the numerous ways in which investment interest was aroused by AirFox through the adoption of marketing techniques designed to facilitate the sale of the tokens. These included the White Paper and other publications, and various social media and other communications sites directed primarily at those who had already demonstrated an interest in the purchase of digital assets, rather than at customers who might actually use the tokens to purchase airtime or data from prepaid wireless carriers, as AirFox had maintained, let alone any tangible goods or services. The SEC was convinced that the offering was structured to encourage speculative purchases by buyers who were primarily interested in obtaining a profit, and that it thus fit within the four corners of *Howey.*

III. Discussion (including the *Zaslavskiy* and *Blockvest* cases)

The shot across the bow mentioned at the beginning of this article, the ingredients of which consisted of the Dao Report, SEC speeches and interview, and various media articles and stories, among perhaps other things, hit below the waterline in the *Paragon* and *AirFox* cases.[25] This is well, given that with both of these entities it would seem that "there was no there there." Having nothing of substance to offer their duped investors,[26] *Howey* was an appropriate vehicle for reining in the offering of assets of such questionable value and utility. The SEC has now served notice on any new start-up ICO issuer that it will probably have to register under the '33 Act and provide the requisite disclosure necessary for the protection of investors. And although an argument can be made that the Commission should extend the reach of the registration provisions to Bitcoin and Ether, these two digital currencies seem to have acquired sufficient (though perhaps debatable) cachet that their risk is minimal, notwithstanding the recent fall in the value of Bitcoin as of the time of this article from $20,000 to under $4,000. It is true that Bitcoin and Ether have both amassed such large computing power that they are probably as secure as virtual currencies ever can be,[27] but it should be remembered that hackers have been quite versatile in relieving digital asset owners of their wealth,[28] whether through defects in the blockchain or otherwise. The disclosure regime of the Securities Act would not necessarily halt the theft of assets, of course, but it could at least alert potential investors to the risk of such theft, as well as other downsides in investing in the exotic ICO marketplace. For the foreseeable future, such disclosure will likely be required of all new players in this marketplace.[29]

There is another problem. The SEC's concern over virtual currencies extends to the prospect, and perhaps prevalence, of fraud in the ICO industry. The antifraud rules of the '33 and '34 Acts, Section 17(a) of the former, and section 10(b) of the latter, buttressed by Rule 10b-5, only apply, of course, to the offer, purchase, or sale of a *security,* and so any attempt to stamp out fraud in the ICO market depends, in the first instance, on a court's willingness to find that the digital asset in question meets the *Howey* test. The results as of this writing are mixed.

As mentioned earlier,[30] two district judges on opposite coasts have recently decided cases involving virtual currencies and come to different conclusions.[31] In the *Zaslavskiy* decision,[32] the judge for the Eastern District of New York agreed with the U.S. Attorney that the two blockchain virtual currencies at issue, "REcoin" and "Diamond" or "DRC," were securities under *Howey.*[33] The facts of the offering and the legal analysis were similar to those in *Paragon* and *AirFox,* but in *Zaslavskiy* the government also alleged violations of the antifraud rules. And the violations were not subtle. In marketing the REcoin and Diamond tokens, the defendant had asserted that they were secured by real estate and diamonds, respectively, although in fact he had never purchased any land or jewels to back them up.[34] Under these circumstances, the district judge did not hesitate in finding criminal violations of the antifraud provisions, a conclusion that would have been impossible had he not first found the coins to be a security.

By contrast, the judge in the *Blockvest* case[35] held that the SEC had not sufficiently demonstrated that the blockchain issuance of BLV digital tokens constituted the offer and sale of a security in violation of Section 5.[36] Critical to the court's decision appeared to be its findings that (1) rather than raising $2.5 million from 32 investors, as the SEC argued, the issuer in fact raised that money from a single investor, and the deal with that investor eventually collapsed anyway;[37] (2) the 32 potential investors were in fact merely "testers" for the "Blockvest Exchange" who committed less than $10,000 to the enterprise;[38] (3) the SEC failed to show that the 32 test investors had reviewed or read materials on the Blockvest website, White Paper, or media postings of the defendants when they clicked the "Buy" button on Blockvest's website;[39] (4) the 32 test investors were "sophisticated" investors known personally to the defendant;[40] (5) there was insufficient evidence to show that the test investors expected profits from the venture;[41] and (6) the mere fact that eight of the investors wrote "Blockvest" or "coins" on their checks in payment for the tokens was "not sufficient to demonstrate what promotional materials or economic inducements these purchasers were presented with prior to their investments."[42] As a result, at the preliminary injunction stage, the court held that the SEC had failed to show that securities were sold pursuant to the *Howey* test.[43]

The *Blockvest* court was also impressed by the fact that defendant Ringgold had acknowledged that "mistakes were made and state[d that] he has ceased all efforts to proceed with the ICO."[44] Aside from the red flag use of the passive voice,[45] Ringgold's pronouncement that he had abandoned the ICO smacks of one of the major exceptions to the mootness doctrine in Constitutional Law: "voluntary cessation of illegal activity," where the defendant is free to return to his old ways absent a definitive judgment that his conduct is unconstitutional, does not make a case or controversy moot.[46] This is particularly disturbing in this case, given that, according to the SEC, among other things, the offering materials for the BLV tokens (1) falsely claimed that they had been "registered" and "approved" by the SEC and used the SEC's seal on the Blockvest website as an imprimatur of approval; (2) falsely asserted that the ICO had been approved or endorsed by the Commodity Futures Trading Commission and the National Futures Association and used the CFTC and NFA logos and seals; and (3) falsely stated that the defendants were "partnered with" and "audited by" Deloitte Touche Tohmatsu Limited. Additionally, in order to convey the impression that they were offering a safe and legitimate investment, the defendants created a fictitious regulatory agency, the "Blockchain Exchange Commission" or "BEC," and gave the BEC its own fake government seal, logo, and mission statement, all of which were nearly identical to those of the SEC. The defendants also gave the BEC the same address as the SEC's headquarters.[47] The district judge shrugged off all these "weaknesses," notwithstanding the fact that some of the misrepresentations continued after the SEC filed its complaint.[48] Apparently, at least for the time being, the judge was happy to allow the defendants to remain free to return to their old ways. Whether this was wise remains to be seen.

IV. Conclusion

The *Howey* test was designed to embody a "'*flexible rather than a static principle,* one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.'"[49] Moreover, "[i]n analyzing whether something is a security, 'form should be disregarded for substance.'"[50] And finally, "Congress intended the application of the ['33 and '34 Acts] to turn on the economic realities underlying a transaction, and not on the name appended thereto."[51] It should take no stretch of the imagination to see that application of the registration and antifraud provisions of the federal securities laws to the ICO industry and to the digital assets that are now flooding the market may well be necessary to protect the overeager investors in these risky instruments, and the courts should be no more hesitant to do so than the SEC. The Commission's recent shots across the bow of *Paragon* and *AirFox*, shored up by the decision in *Zaslavskiy*, are just the opening salvo in what promises to be a long war, and the fact that the shot fell short in *Blockvest* will hopefully represent nothing more than a brief pause in the campaign.

Endnotes

1. *See* "SEC chief says agency won't change securities laws to cater to cryptocurrencies," CNBC interview, Wednesday, June 6, 2018, where Chairman Jay Clayton "made it clear in March that all ICOs constitute securities, and reiterated that Wednesday saying 'if it's a security, we're regulating it.'" (available at https://www.cnbc.com/2018/06/06/sec-chairman-clayton-says-agency-won't-change-definition-of-a-security.html (last visited November 30, 2018)).
2. 15 U.S.C. § 77e.
3. As of the date of the Clayton interview referenced in footnote 1, *supra*, Chairman Clayton apparently viewed only Bitcoin as not being a security, because of its function as a replacement for sovereign fiat currency. *See* "SEC Chairman Jay Clayton Says Bitcoin Not a Security, Most ICOs Likely Are" (available at https://cointelegraph.com/news/sec-chairman-jay-clayton-says-bitcoin-not-a-security-most-icos-likely-are (last visited November 30, 2018)). Today, however, it is apparently the Commission's view that both Bitcoin and Ether are commodities and therefore not subject to the *Howey* test for a security under investment contract analysis. *See SEC's Clayton needs to see key upgrades in cryptocurrency markets before approving a bitcoin ETF* (available at https://www.cnbc.com/2018/11/27/sec-wants-key-upgrades-in-crypto-markets-before-approviing-bitcoin-etf.html (last visited November 30, 2018)).
4. "Virtual currency" is defined as "a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status. . . ." The Financial Action Task Force, *FATF Report, Virtual Currencies, Key Definitions and Potential AML/CFT Risks*, June 2014 (available at http://www.fatf.gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf). Virtual currency

should be contrasted with "fiat currency (a.k.a. 'real currency,' 'real money,' or 'national currency'), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country." *Id.*

5. Securities and Exchange Commission, Securities Exchange Act of 1934, Release No. 81207/July 25, 2017, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, at 18 (hereinafter "The DAO"). The DAO Report also warned that "any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration." *Id.* On November 8, 2018, the SEC issued a Cease and Desist Order against the online trading platform EtherDelta and the individual who created it, for failing to register EtherDelta as an exchange under Section 5 of the Exchange Act. *See* Securities Exchange Act of 1934, Release No. 84553/November 8, 2018, Administrative Proceeding File No. 3-18888, In re Zachary Cohen, Respondent.

6. Blockchain technology allows persons to engage in a theoretically secure transaction online, such as the purchase of digital assets using other digital assets (Bitcoin for ether, for example) or using sovereign or fiat currency (Bitcoin for dollars, for example), through the employment of encrypted computer technology. The initial purchase transaction requires the use of unique cryptographic keys owned by the purchaser and seller (encoded in digital signatures), a timestamp, and relevant information about the transaction (that A, for example, has agreed to purchase Bitcoins from B, using Ether or dollars, and other relevant terms of the deal, usually embodied in a "smart contract" or computerized transaction protocol). This first transaction then takes the form of a digital "block." In order to validate the transaction, numerous other users of the computer platform will solve a complex mathematical equation, presumably devised by the creator of the blockchain protocol, and each correct solution forms a new block in the chain. Once a majority of the users come to that same solution, the transaction is confirmed as genuine. Each correct solution constitutes independent agreement that the A to B transaction is a valid one. The users who form the verification chain are motivated to secure the network by solving the mathematical problem in question through a reward system which gives one of them a prize (a bitcoin, for example). *See generally,* "What Is Blockchain Technology?" (available at https://www.coindesk.com/information/what-is-blockchain-technology) and "How Does Blockchain Technology Work?" (available at https://www.coindesk.com/information/how-does-blockchain-technology-work). The security provided by blockchain is often illusory, however. *See, inter alia,* "The DAO," *supra* note 5, at 1, 9-10 (hackers attacked the system, stealing one-third of the Ether virtual currency used to fund the sale of DAO tokens issued by the digital DAO Entity), and "Hacker lifts $1 million in cryptocurrency using San Francisco man's phone number, prosecutors say," CNBC report, November 21, 2018 (man engaged in "SIM swapping" by taking over the phone number of another man, duping his wireless carrier, and using the information acquired to gain access to and drain cryptocurrency from the victim's accounts at Coinbase and Gemini) (available at https://www.cnbc.com/2018/11/21/hacker-lifts-1-million-in-cryptocurrency-using-mans-phone-number.html (last visited November 30, 2018)).

7. An "ICO" is an "Initial Coin Offering."

8. Securities Act of 1933, Release No. 10574/November 16, 2018, Administrative Proceeding File No. 3-18897, *In the Matter of Paragon Coin, Inc., Respondent,* Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Penalties and a Cease-and-Desist Order (hereinafter "Paragon"). In the interest of conciseness, all future references to the facts and findings of the *Paragon* decision, except in the case of direct quotes, will not be separately footnoted but may be found in the above-referenced document available on the SEC's website at SEC.gov.

9. *Id.* at 7.

10. 15 U.S.C. § 77b.

11. 15 U.S.C. § 78c.

12. *Securities & Exchange Comm'n v. W.J. Howey Co*., 328 U.S. 293 (1946).

13. Paragon, *supra* note 8, at 8. The language of *Howey* is somewhat different, but the elements are essentially the same.

14. *See, e.g., U.S. v. Zaslavskiy, Memorandum & Order,* 17 CR 647 (RJD) 11-12 (E.D.N.Y. September 11, 2018): "'cash is not the only form of contribution or investment that will create an investment contract. . . the "investment" may take the form of "goods and services" . . . or some other "exchange of value"'" (Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 574 (10th Cir. 1991), cert. denied sub nom. *Alcox v. Uselton*, 502 U.S. 893 (1991), quoting *Int'l Bhd. Of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 560 n. 12 (1979). In *Zaslavskiy,* Eastern District Judge Raymond J. Dearie readily concluded that the defendant had offered and sold an investment contract in the form of two types of digital coins, REcoin and Diamond. Judge Dearie's analysis essentially tracked that of the SEC in *Paragon* (and in the *AirFox* case to be discussed next), although the specific issue in *Zaslavskiy* was whether the defendant had violated the antifraud sections of the '33 and '34 Acts and the rules promulgated thereunder (he did). More recently, in a case decided by Judge Gonzalo P. Curiel of the Southern District of California, the judge denied a preliminary injunction to the SEC in a case involving an abandoned public offering of a digital asset, BLV tokens. Judge Curiel held that "[a]t this stage, without full discovery and [with the] disputed issues of material facts [by the plaintiff and defendant], the Court cannot make a determination whether the BLV token offered to the [32 "test"] investors was a 'security.' Thus, Plaintiff has not demonstrated that the BLV tokens purchased by the 32 test investors were 'securities' as defined by the securities laws." *SEC v. Blockvest, LLC* and *Reginald Buddy Ringgold, III a/k/a Rasool Abdul Rahim El*, Case No.: 18CV2287-GPB(BLM), Order Denying Plaintiff's Motion for Preliminary Injunction [Dkt. No. 30] 13-14 (S.D. Cal. November 27, 2018). The *Zaslavskiy* and *Blockvest* cases are discussed further in Part III, *infra.*

15. This is really the third prong of *Howey.* The SEC in *Paragon* elided discussion of the "common enterprise" prong of the investment contract test, perhaps because it was clear to the Commission that the $12,066,000 equivalent of virtual currency raised in the offering was pooled (or at least intended to be pooled, as Paragon never apparently launched its touted "ecosystem") so as to meet the test of "horizontal commonality."

16. Paragon, *supra* note 8, at 8.

17. The "profits" element of *Howey* may be met simply by showing that the purchasers expected to see an "increased value of the[ir] investment." *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

18. *In re Carriereq, Inc*., D/B/A AirFox, Respondent, Securities Act of 1933, Release No. 10575, Administrative Proceeding File No. 3-18898, Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act pf 1933, Making Findings, and Imposing Penalties and a Cease-and-Desist Order (November 16, 2018) (hereinafter "AirFox"). In the interest of conciseness, all future references to the facts and findings of the *AirFox* decision, except in the case of direct quotes, will not be separately footnoted but may be found in the above-referenced document available on the SEC's website at SEC.gov.

19. *Id.* at 3.

20. *Id.* at 5.

21. *See supra* note 5.

22. AirFox, *supra* note 18, at 6.

23. *Id.* at 7.

24. Once again, as in *Paragon*, the SEC omitted discussion of the "common enterprise" prong of *Howey*, probably because the facts were clear that AirFox pooled the $15 million equivalent in virtual currency to fund its unmaterialized projects.

25. Both ICO issuers were forced to cease and desist, register their securities under the '34 Act, and pay substantial penalties to the Commission, among other things.

26. Except for a patch of Blue Sky, perhaps?

27. The Bitcoin blockchain is secured at the hash rate of 3,500,000 TH/s, which is 3.5 million trillion hashes per second. This is the speed at which a computer can complete the mathematical calculation necessary to validate a particular transaction on the blockchain. Ether had been secured at the rate of 12.5 TH/s when it was only two years old. *See* "How Does Blockchain Technology Work?", *supra* note 6, at 2-3.

28. *See id.*

29. SEC Chairman Jay Clayton views Bitcoin (and apparently Ether) as a commodity that is not subject to *Howey. See supra* notes 1, 3. This perhaps reflects his view that virtual currencies can be adequately regulated under existing rules rather than requiring the creation of a new rule or regulation governing them. However, the more decentralized transactions become, the more difficult it may be to meet the definition of a security. Blockchain technology is the paradigm of decentralization and proclaims one of its attractions to be the elimination of trusted intermediaries in the transaction verification chain. *See, e.g.*, "What Is Blockchain Technology?, *supra* note 6, at 3: "Authentication and authorization [of a specific transaction] supplied in this way [through blockchain technology] allow for interaction in the digital world without relying on (expensive) trust." However, the lack of a centralized, trusted intermediary may end up defeating *Howey.* The more decentralization, the less likely it will be that the fourth prong of the *Howey* test, "the efforts of others," will be satisfied.

30. *See supra* note 14.

31. Although it should be kept in mind that the decision in the Blockvest case was on a motion for a preliminary injunction.

32. 17 CR 647 (RJD), September 11, 2018.

33. *Id.* at 17.

34. *Id.* at 2, 17.

35. No. 18CV2287-GPB(BLM), Dkt. No. 30, November 27, 2018.

36. *Id.* at 15.

37. *Id.* at 10. This might defeat horizontal commonality under *Howey*, but not vertical commonality. The court, however, did not specify which test it was applying.

38. *Id.* at 10-11.

39. *Id.* at 12. Presumably the court here was driving at the reliance or transaction causation element of the test for Rule 10b-5 liability, although the district judge failed to clarify this. In any event, the issue at this point was not whether the plaintiff had proven the elements of 10b-5 liability, but simply whether it had offered or sold a security. That determination does not turn on the elements of antifraud liability, but rather on the elements of *Howey.*

40. *Id.* at 12. This goes at best to whether the offers and sales might have qualified for exemption from registration as a private placement, not whether the instrument in question was a security.

41. *Id.* at 13.

42. *Id.* at 14-15. This is true, but irrelevant, as it goes to the separate issue of reliance rather than whether what was offered or sold was a security. *See supra* note 39.

43. *Id.* at 13-15.

44. *Id.* at 15.

45. It is rather dreary to consider the many instances of persons acknowledging that mistakes "were made" as a way of avoiding personal responsibility for having made them.

46. *See, e.g., United States v. W.T. Grant Co.*, 345 U.S. 629, 633 (1953) (quoting *United States v. Aluminum Co. of America*, 148 F.2d 416, 448 (2d Cir. 1945)).

47. *Id.* at 4.

48. *Id.* at 16.

49. The Dao, *supra* note 5, at 11 (quoting Howey, 328 U.S. at 299 (emphasis added)).

50. *Id.* (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

51. *United Housing Found. v. Forman*, 421 U.S. 837, 849 (1975).

If Only: U.S. Treasury Department Report Creates a Wish Tree of Financial Reform for Fintech

By the Attorneys of Mayer Brown, LLP et al.[1]

Introduction

Regardless of whether its recommendations are achievable in whole or in part or merely aspirational, the U.S. Department of Treasury's ("Treasury") report issued on July 30, 2018[2] is an ambitious, well thought-out, comprehensive compendium of proposals to foster innovation in our financial system. Treasury deserves kudos for organizing and analyzing a disparate set of potential reforms to help synchronize old laws with new ways to conduct business. The question is whether this laudable blueprint for reform can serve as the impetus for real change given our current state of affairs.

The Report is the fourth report issued by Treasury in response to President Trump's February 2017 Executive Order No. 13772 ("Executive Order") setting forth certain core principles for the U.S. financial system. The three prior reports generally identified laws, treaties, regulations and other government policies that promote or inhibit federal regulation of the U.S. financial system and included recommended changes consistent with the core principles set forth in the Executive Order.[3] While some of the recommendations require action by federal regulators, others require changes to federal or state laws and most require public funds.

This fourth report explores the regulatory landscape for nonbank financial companies with traditional "brick and mortar" footprints not covered in other reports as well as newer business models employed by technology-based firms ("fintech"). As part of the Report, Treasury explores the implications of digitalization and its impact on access to clients and their data. The Report includes limited treatment of blockchain and distributed ledger technologies as these technologies are being explored separately in an interagency effort led by a working group of the Financial Stability Oversight Council (FSOC). Treasury's preparation of the Report included discussions with entities focused on data aggregation, nonbank credit lending and servicing, payments networks, financial technology, and innovation. It also consulted with trade groups, financial services firms, federal and state regulators, consumer and other advocacy groups, academics, experts, investors, investment strategists and others with relevant knowledge, and it reviewed a wide range of data, research and other published material from both public and private sector sources.

Nobody should expect every one of the Report's recommendations to be implemented efficiently and immediately, if at all. Some recommendations can be implemented through regulatory fiat, others can be implemented by regulators but only through a formal rulemaking process, and still other recommendations will require congressional action. Some of the recommendations are concrete, and others simply outline principles to inform policymakers. Some in theory could be implemented right away, and others are longer-term in nature. Some recommendations surely at some point will be enacted, and others may never see the light of day. To fully implement all of the recommendations in the Report, federal agencies will need to crisply coordinate their initiatives in a strategic way, states will need to realize that a patchwork of inconsistent "solutions" to the same problems is counterproductive, and Congress will need to seize the initiative to legislate in order to promote rather than to prohibit. Nevertheless, the immense barriers to implementation should not diminish the importance and usefulness of the Report.

This Legal Update provides a high-level summary of the Treasury recommendations set forth in the Report, along with a brief analysis of the key areas and some thoughts regarding the prospects for successful implementation of the pertinent recommendations. Some of the key areas covered in this Legal Update include data aggregation, challenges presented by the state and federal regulatory frameworks, marketplace lending, mortgage lending, short-term lending, small-dollar lending, payments, regulatory sandboxes and international approaches and considerations.

Digitalization, Data and Technology

Digital Communications

Telephone Consumer Protection Act (TCPA)

The Report explains that the TCPA has constrained the ability of financial services providers to use digital communication channels despite consumers' increasing reliance on text messaging and email communications through mobile devices. The financial services industry likely will welcome the Report's recommendations with respect to easing such constraints.

The Report recommends that regulators mitigate the risk of liability for calling a reassigned number—a telephone number formerly belonging to a consenting consumer that is subsequently given to another person—by creating a database of reassigned numbers and a broader safe harbor for calls to reassigned numbers so that a caller who had consent from a previous subscriber has a sufficient opportunity to learn that the number has been reassigned. The Report also suggests that updated TCPA regulations should provide clarity on what types of technology constitute an "automatic telephone dialing system" for TCPA purposes given the TCPA's restrictions on the use of autodialers.[4] Finally, the Report notes the importance to the industry of clear guidance on reasonable methods for consumers to revoke consent under the TCPA, including through congressional action if necessary. The Report's TCPA recommendations align with the Federal Communications Commission's (FCC) rulemaking agenda. In March 2018 the FCC sought comment on how to address the reassigned numbers issue.[5]

Fair Debt Collection Practices Act (FDCPA)

Treasury recommends that the Bureau of Consumer Financial Protection ("Bureau") promulgate regulations under the FDCPA to codify that reasonable digital communications, especially when they reflect a consumer's preferred method, are appropriate for use in debt collection. Consumers increasingly prefer to communicate with their financial services providers digitally, such as through text messages and email, but the potential litigation risk from inadvertently disclosing information regarding debts to an unauthorized third party discourages debt collectors from digital communications with consumers. The Federal Trade Commission (FTC) had noted in 2009 that it was unaware of information demonstrating that unauthorized third parties were more likely to have access to debt collection messages conveyed through digital means than through letters and phone calls and that it did not believe in imposing restrictions on debt collectors' use of email and instant messages in the absence of such data.[6] Industry stakeholders have argued in favor of an automatic "opt-in" that is deemed to constitute consent in the event that a consumer provides an email address or other digital communications method in connection with his or her financial services agreement. The industry is likely to favor such an "opt-in" consent method because it could be implemented through consumer contracts.

Data Aggregation Consumer Access Protections

The Report discusses how data aggregators and fintechs should be able to access a consumer's financial information only with informed consumer consent following receipt of adequate disclosures. To achieve that goal, the Report recommends that the Bureau work with the private sector to develop best practices and consumers be given adequate means to revoke prior authorization. If implemented in a thoughtful manner, these principles-based protections should give consumers a meaningful opportunity to control use of and access to their financial information.

Data Sharing Barriers

The Report discusses how data aggregation in general, and APIs[7] in particular, face operational and regulatory barriers. The Report recommends that the private sector develop a solution to allow financial services companies and data aggregators to establish data-sharing agreements that use secure and efficient methods of data access and banking regulators revise their third-party guidance to remove ambiguity related to regulatory authority over fintechs' use of APIs. These recommendations, while generally appearing to be noncontroversial, seem unlikely to be achieved in the near-term because it will be difficult to build consensus among market participants and a variety of resource-constrained regulators.

Data Security and Breach Notice

The Report recommends that Congress enact a federal data security and breach notification law. The current fragmented regulatory regime results in gaps in data security requirements and duplicative costs for institutions that service consumers located in multiple states with inconsistent breach notification laws. While proposals similar to the Report's recommendation have previously failed, in part because of state opposition to federal preemption of the existing state breach notification laws, the frequent occurrence of major, nationwide data breaches may mean that the situation is at a tipping point where such a federal law becomes a reality.

Digital Legal Identity

To combat the difficulties of identity proofing that have increased with the growth of customers' preferences for online or mobile financial transactions and with the disaggregation of financial services, the Report recommends that public and private sector stakeholders work together to develop trustworthy digital legal identity services and products in the financial services sector that are portable across governmental agencies and unrelated financial institutions. In particular, the Report highlights existing initiatives by the Office of Management and Budget and under the REAL ID Act of 2005 as potential foundations for a digital legal identity framework. However, we expect that the viability of a digital legal identity will be driven more by congressional willingness to fund the public portion of the public-private initiatives and an interest on the part of regulators in providing legal certainty to those relying on such initiatives than willingness by the private sector to act independently.

Cloud Technology and Financial Services

The Report recommends that regulators modernize requirements and guidance to better provide for appropriate adoption of new technologies such as cloud computing, including formally recognizing independent U.S. audit and security standards that sufficiently meet regulatory expectations and set clear and appropriately tailored chain outsourcing expectations.

The Report recommends that regulators establish a cloud and financial services working group to develop cloud policies that reflect the interests of key industry stakeholders, including providers, users and others impacted by cloud services. Financial regulators should seek to promote the use of cloud technology within the existing US regulatory framework to help financial services companies reduce the risks of noncompliance and compliance costs associated with meeting multiple and sometimes conflicting regulations. The Report also recommends that regulators be wary of imposing requirements that data must be stored within a particular jurisdiction (e.g., data localization) and should instead seek other supervisory or appropriate technological solutions to potential data security, privacy, availability and access issues.

Big Data, Machine Learning and Artificial Intelligence

As the Report points out, the artificial intelligence (AI) revolution is here. Treasury offers insight into the problems it anticipates from the use of AI in the financial services ecosystem.

The Report notes a laundry list of uses of AI in the financial services industry, including surveillance and risk management, fraud identification, AML monitoring, investment/quant trading opportunities, chat bots and certain loan underwriting tasks. Although absent from the Report, machine learning (ML) and alternative data can be used to reach vast untapped markets of "credit invisibles" (persons without traditional FICO scores), which is a huge opportunity.

AI presents pros and cons for financial services companies and consumers. Competition fosters innovation and may lead to better consumer products and services. The Report mentions that competition may present challenges as well. What if, Treasury worries, the firms with the strongest AI win a monopoly or duopoly? Perhaps a vicious cycle develops: consumers flock to the industry leader, so the leader gets more data, which makes its AI smarter, so it pulls further into the lead; repeat. Smart machines can detect fraud, but can also be used to promote fraud, e.g., through more realistic-looking sham phishing methods. Treasury does not mention it, but you could easily envision an AI arms' race, e.g., ML that spots problematic conduct pitted against ML that conceals such conduct.

There is some debate as to whether AI and ML will elevate biases in the provision of financial services. On one hand, ML underwriting may take biased humans out of the loop. But, ML systems may learn their own biases, for example, by using proxies for protected classes (e.g., determining that purchasers of high-heeled shoes should be denied credit). The Report further notes that ML is notoriously opaque. This is often unhelpful, for example, when the law requires reasons for adverse credit decisions, or where regulators are trying to predict how a portfolio management tool will react in times of stress.

Finally, big data raises privacy issues. Big data drives AI, thus generating a need for more and more data to feed the AI machine, which can lead to data vulnerabilities. On top of that, ML will be using that data in new ways that may reveal more than people anticipate. An example that Treasury does not mention occurred not long ago—smart machines reviewing purchasing patterns alerted marketers that certain women were pregnant before those women publicly disclosed their pregnancies.

The Report makes a number of recommendations that are entirely correct but often not so easy to implement. Treasury offers the following advice: First, regulators should refrain from layering "unnecessary burdens" on the use of AI and ML. The issue is that "unnecessary burdens" is not a clear standard and may be interpreted in different ways by financial services providers and regulators. Second, regulators should be clear in their guidance. This is a laudable goal. Sometimes lack of clarity is a regulatory stratagem, but not always—sometimes it reflects a complex and unclear reality. The latter is harder to solve.

"AI presents pros and cons for financial services companies and consumers. Competition fosters innovation and may lead to better consumer products and services."

Third, regulators should coordinate when it comes to developing AI and ML policy. This is an ambitious goal, especially given what Treasury wants to accomplish (i.e., address when humans should be accountable, address when humans should have primary decision-making authority, ensure that the workforce is ready for digital labor, ensure that AI is transparent for consumers and ensure that AI is robust against manipulation). Finally, the Report notes that the government should invest in AI. This is likely a good idea, so long as government supports, rather than displaces or tramples upon, industry.

Aligning the Regulatory Framework to Promote Innovation

The Report emphasizes the need for a regulatory framework that supports innovation in financial services, including by harmonizing state regulatory and supervisory regimes, allowing special purpose bank charters and encouraging bank partnership models with fintech firms.

Harmonizing State Licensing and Regulatory Efforts

While the Report pays passing homage to the longstanding regulation of consumer financial services by the states, it is overly critical of the manner in which states license financial services companies. Although consumer protection is recognized as being the primary reason for the regulation of nonbank consumer lenders at the state level, the Report notes that state-specific regulatory regimes are expensive and duplicative, chill economic growth of money transmission activities and limit financial products available to consumers because lenders and fintech firms are hampered by various state law requirements. The Report emphasizes the need to allow nonbank firms (including start-ups) to focus on innovation and growth based on a national framework, rather than being bogged down with pesky state requirements. State regulatory agencies may take issue with this position, including (most notably) the New York State Department of Financial Services (NYDFS).

The Report notes that harmonization may streamline examinations of money transmitters and money services businesses through multi-state examinations conducted in accordance with an examination protocol developed by the Conference of State Bank Supervisors (CSBS). Some states are already participating in such multi-state examinations, but it will be interesting to see how willingly states further embrace this suggestion of national examination procedures.

The Report also supports a national regulatory framework applicable to nonbanks and sees great hope in "Vision 2020," a CSBS effort to develop a 50-state licensing and supervisory system by 2020. This effort includes redesigning the existing Nationwide Mortgage Licensing System (NMLS) platform through further automation and enhanced data and analytical tools to create an NMLS 2.0 and harmonizing a multi-state supervision process through adoption of best practices and the development of comprehensive state examination systems. The highlighted feature of Vision 2020 in the Report is the concept of "passporting" and reciprocity of state licenses. While certain limited reciprocity is recognized by state regulators today with respect to certain state licenses, reciprocity is far from common and may be difficult to implement administratively, absent a clear legislative directive.

If the above efforts do not lead to increased harmonization within a three-year period, the Report encourages Congress to take action to encourage greater uniformity in rules governing lending and money transmission. While, in response to the Report, CSBS has stated that it does not support the "creation of new federal rules or unauthorized federal charters that would seek to compromise the ability of state officials to apply and enforce state laws,"[8] it is presently unclear how state regulators will react to this invitation for congressional action on the horizon.

Moving Forward with the OCC's Special Purpose National Bank Charter

The Report characterized the OCC's special purpose national bank (SPNB) charter, which was initially proposed in 2016, as potentially providing fintech firms with a more efficient, and at least a more standardized, regulatory regime than the current state-based regime in which they operate. The Report notes that the OCC has the ability to tailor compliance requirements under a SPNB charter to better suit the safety and soundness risks of SPNBs, which may include: (i) addressing insured deposit-related differences between SPNBs and national banks; (ii) providing safety and soundness rules on capital and liquidity for SPNBs that would be different than those for national banks; and (iii) identifying state laws that would be preempted and those that may apply to SPNBs. The Report suggests that in the case of SPNBs, there should be more limited preemption of state consumer protection laws, including with respect to foreclosures, than is the case for national banks. Additionally, the Report recognizes that clarification is needed as to whether SPNBs should be given access to the Board of Governors of the Federal Reserve System's ("Federal Reserve") payment system and whether new activities incidental to the business of banking would be permissible for SPNBs. The Report also notes that a SPNB charter should not provide an undue advantage to newly chartered SPNBs relative to chartered banks but does not opine as to any unfair advantage over nonbanks, such as industrial loan companies (ILCs), that have operated in the existing state regulatory system for years.

The OCC announced that it would begin accepting SPNB charter applications the same day the Treasury Department released the Report. By taking this step, the OCC was the first federal agency to execute on a recommendation contained in the Report.

In addition to eliminating the barrier of individual state licensing requirements, a SPNB charter enables companies currently operating under a patchwork of state supervisory requirements to standardize their compliance systems and operational functions under one supervisory regime. The National Bank Act (NBA) broadly preempts state law, such that national banks do not need to comply with state laws that conflict, impede, or interfere with national banks' powers and activities.[9] State laws that purport to govern checking and savings accounts, disclosure requirements, funds availability, escrow accounts, credit reports, terms of loans, and state licensing or registration do not apply to national banks and as currently contemplated would not apply to SPNBs.[10] As part of its initiative to encourage fintech companies to apply for a national bank charter, the OCC stated that it would consider the permissibility of any activities for a SPNB charter on a case-by-case basis, indicating potential flexibility in terms of allowing activities to be conducted in conjunction within an existing banking business.[11]

Perhaps (not surprisingly) certain state regulators regarded the OCC's initial proposal for the establishment of the SPNB charter as a competitive threat to their licensing and supervisory authority, and both the CSBS and the NYDFS initiated litigation to block the OCC initiative. Those challenges were dismissed in December 2017 on the basis that the NYDFS claims were not ripe as the OCC had not yet decided whether to accept applications or issue any charters. However, now that the OCC has announced it will be accepting applications, it is likely state regulators and the CSBS will seek to reinstate their litigation.

It should be noted that the concept of a limited purpose national bank is not new or necessarily novel. The OCC has issued limited purpose charters for banks that offer only a small number of products, that are targeted to a limited customer base, that incorporate nontraditional elements, or that have narrowly targeted business plans. To date, special purpose charters have been issued for banks whose operations are limited to credit cards, fiduciary activities, community development, or cash management activities (including bankers' banks).

While a SPNB charter offers benefits in terms of preemption as well as greater regulatory certainty and consistency, potential applicants should be aware of the costs and other requirements that apply to national banks. As a general rule, OCC supervisory assessments are significantly higher than those imposed by states. When it announced that it would begin accepting SPNB charter applications from fintech companies, the OCC did not indicate whether it would implement a more favorable fee structure. In terms of capital requirements, the OCC did indicate, as it has done for other limited purpose banks, that it would consider tailoring capital requirements for fintech SPNBs to the bank's size, complexity and risk profile. In addition to holding capital and paying supervisory fees, a SPNB would have to become a member of the Federal Reserve System, which entails the acquisition and holding of stock in a Federal Reserve Bank.

If the SPNB is a subsidiary of the fintech company and the bank engages in commercial lending and certain deposit-taking activities, the parent company would have to qualify as a bank holding company under the Bank Holding Company Act (BHCA),[12] which, among other things, entails restrictions on the types of activities in which the parent holding company can be engaged as well as on transactions between the subsidiary bank and its nonbank affiliates. Limited purpose banks, including a SPNB, that hold deposits (a concept criticized by Treasury in the Report) must also obtain deposit insurance from the Federal Deposit Insurance Corporation (FDIC) and satisfy the Community Reinvestment Act (CRA)[13] requirements. The OCC has indicated that SPNBs, which are not subject to the CRA, will be expected to commit to meeting an ongoing financial inclusion standard that would be specified as part of their charter approval, although in the Report the Treasury took a dim view of this requirement.

Fintech companies have options to consider in addition to a national bank charter. For example, an ILC charter, while not preempting state consumer protection laws, avoids other requirements and restrictions that apply to owners of banks under the BHCA. Furthermore, an ILC can export interest rates and fees permitted by its home state to borrowers located in others states to the same extent as a national bank and other FDIC-insured state-chartered banks. The ultimate choice a company makes is likely to turn on the range of financial services options the fintech seeks to bundle with other services. Regardless of the licensing option that is ultimately chosen, the greatest challenge for fintechs may be adapting to the highly regulated environment that applies to banks and bank-like entities. The quickly adaptive low-friction philosophy of technology companies tends to stand in stark contrast with the safety and soundness philosophy that predominates at financial services regulators at both the state and federal levels. Achieving a workable balance between these conflicting philosophical approaches may ultimately determine whether fintechs will supplant traditional banks in the provision of consumer and B2B services or remain tethered to them in some form of shared service relationship.

Regulatory Oversight of Third-Party Relationships

The Report emphasizes the need to manage risks associated with third-party providers to SNPBs, such as fintech partners and support services, while recognizing that technological innovations, specialization, costs and the competitive business environment contribute to a financial institution's increased outsourcing to third parties. The Report notes that both banking organizations and others have raised concerns regarding the compliance costs and burdens associated with regulatory oversight of third-party service providers to banking organizations. As financial institutions become more reliant on third-party providers, they must be aware of changing risk factors created by the need to outsource certain functions and manage such risks appropriately. The Report recounts how existing third-party risk management guidance from the prudential bank regulators has created market uncertainty around several key issues, including the scope and categorization of vendors and other third parties subject to the U.S. bank regulators' risk management guidelines, including subcontractors, and the appropriate level of scrutiny. The Report also emphasizes that standards for third-party risk management oversight are not always applied consistently in the examination context, as well as recurring industry concerns regarding the "trickle down" effect of best practices for higher-risk providers to other, less risky third-party relationships. The Report emphasizes that many of these concerns are most acute for community banks and other smaller banking organizations as well as smaller/start-up nonbank fintech firms.

Regulation of Third-Party/Vendor Management

The Report sets out certain recommendations that federal banking regulators should consider, but also states that banking regulators should be prepared to adapt their third-party risk relationship framework to emerging technology developments in financial services. In order to address the regulatory burdens associated with third-party oversight and vendor management of fintech relationships, the Report states that the US bank regulators should, on a coordinated basis, review and amend existing guidance through a formal notice and comment process, with a view to harmonizing and tailoring standards and fostering innovation.

Impact of Bank Activities' Restrictions on Fintech Investments and Partnerships

The Report describes various regulatory impediments to fintech and other "innovation investments" flowing from restrictions on the permissible activities of banks and saving associations and their holding companies. With respect to the types of fintech activities and investments that are permissible for banks and savings associations, the Report is mainly descriptive rather than prescriptive, noting that this is driven primarily by federal statute and, thus, not especially amenable to regulatory action. Nevertheless, the Report notes approvingly the OCC's authority and historic willingness to interpret the "business of banking" over time in a way that fosters innovation and meets consumer needs.

With respect to bank holding companies, the Report reiterates various formal and informal comments and recommendations made over the past year by Federal Reserve officials regarding the need for a reassessment of the BHCA definition of "control." As bank and financial holding company investors and their nonbank fintech partners will appreciate, the question of whether a particular fintech company is "controlled" by a bank or financial holding company investor can often be a difficult question, lacking complete legal certainty absent protracted engagement with Federal Reserve legal staff. Given the complexity of the existing control rules and the significant consequences of a control determination for both parties to a fintech partnership, the Report calls on the Federal Reserve to take another look at the BHCA definition of control in an attempt to create a simpler standard that supports innovation. While the Report does not provide a timeframe for this review, we expect the Federal Reserve to undertake this process through formal notice and comment rulemaking in the coming months.

Updating Activity-Specific Regulations

Marketplace Lending

Treasury makes three recommendations expressly regarding marketplace lenders, each of which appears intended to clarify the regulatory environment and ease conflicting regulatory pressures for marketplace lenders relying on a particular business model—the "bank partnership"—that currently does not fit neatly into a particular federal or state regulatory treatment. Treasury advocates for regulatory certainty across three issues of import for marketplace lenders relying on a bank partnership model.

First, bank partnership models require that each loan be lawful when made, but case law regarding when the bank will be treated as the "true lender" has generated multiple, ambiguous standards, some of which threaten to recharacterize the non-bank platform as the lender whenever the platform has the "predominant economic interest" in the program. Accordingly, the Report recommends that Congress codify true lender standards, including noting that a commercial relationship between a bank and third party would not affect the bank as the true lender.[14] This recommendation reflects the approach already taken in H.R. 4439, the "Modernizing Credit Opportunities Act," which is currently under consideration by the House Financial Services Committee, but which is currently stalled in committee as it is opposed by, among other relevant entities, the CSBS.

Second, bank partnership models involving the sale of loans to the nonbank platform and/or other non-bank third parties require that the non-bank entity be able to enforce the loan pursuant to its terms upon acquisition. The 2015 Second Circuit decision in *Madden v. Midland Funding, LLC*[15] has called into question the longstanding "valid when made" doctrine regarding an acquiring party's ability to charge interest at the contracted for rate if that rate had been permissible only because federal banking laws preempted otherwise applicable usury limits. While subsequent developments have called into question the scope and validity of *Madden*'s holding, states and private plaintiffs have begun to raise *Madden*-based challenges to marketplace lending programs. The Report recommends that the *Madden* issue be stemmed through congressional codification of the "valid when made" doctrine into the federal banking laws.[16]

Finally, bank partnership models require that lending platforms have sufficient authority to engage in the range of ancillary activities they conduct to support the origination of loans by their bank partners. In many cases, this issue comes down to the applicability of state licensing regimes to the activities in question. The Report expresses concern over the role that one set of licenses for this type of activity may have in inhibiting the viability of bank partnerships. It supports revisions to credit services laws that would exclude origination activities on behalf of a federal depository institution in connection with a bank-partner program. This recommendation may gain more support than other recommendations that are more onerous on state regulatory authorities.

With respect to marketplace lending, the Report makes recommendations regarding harmonization of state oversight and licensing regimes and encouragement of the OCC's SPNB charters designed to permit fintechs to operate on a more uniform basis nationwide, each of which we previously discussed in this article.

The marketplace lending industry has flourished over the past several years and is now garnering substantial regulatory attention. Some of that attention—primarily by state regulators—has generated legal issues that threaten the vitality of certain marketplace lending business models, but the Report suggests that marketplace lenders have an ally at the federal level in this political climate. The recommendations promoted by the Report are not guaranteed to be enacted. Were one or more pursued by Congress and/or state regulators, however, the resulting regulatory easing could further accelerate an already growing industry.

Mortgage Lending and Servicers

The Report also discusses the challenges and identifies specific recommendations aimed at improving the regulatory approach to a key financial service area for consumers: mortgage lending and servicing.

Electronic Mortgages

The Report recommends that (i) the Government National Mortgage Association ("Ginnie Mae") pursue acceptance of eNotes and more broadly develop its digital capabilities; (ii) Congress appropriate funding for FHA for technology upgrades to improve digitization of loan files; (iii) the Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA), and U.S. Department of Agriculture (USDA) explore development of shared technology platforms; and (iv) the Federal Home Loan Banks (FHLBs) establish as a goal the acceptance of eNotes on collateral pledged to secure advances. Any such efforts will require funding. While FHA is limited by its congressional budget, it is in need of broader technology overhauls beyond the narrower issue of digital mortgage capabilities and could designate a portion of its 2019 budget (and beyond) to develop those digital mortgage capabilities.

If past is prologue, there might not be great hope for interagency cooperation occurring anytime soon. Perhaps, however, Ginnie Mae and FHA will focus on this point, since that is within their control, at least to a degree. And it would be in their best interests to adopt eMortgage capabilities.

The FHLBs' development of processes for accepting eNotes as pledged collateral to secure advances would help free up mortgage capital. The question is whether the FHLBs have an incentive to do so. The good news is that Ginnie Mae, FHA, VA, USDA and the FHLBs do not need to reinvent the wheel. The federal Electronic Signatures in Global and National Commerce Act (ESIGN) and state adoptions of the Uniform Electronic Transactions Act (UETA) have been in place for as long as two decades in some instances. These laws authorize the use of eNotes and eMortgages. And SPeRS (Standards and Procedures for Electronic Records and Signature) and MISMO (Mortgage Industry Standards Maintenance Organization) have developed and maintain, respectively, a robust data dictionary and SMART Doc® standards which provide formats for electronic formatting of documents and a technology-neutral set of guidelines and strategies for use in designing and implementing systems for electronic transactions. These are readily available to lenders, government-sponsored enterprises (GSEs) and secondary market investors should they decide to heed Treasury's recommendations.

Electronic Closings and Notarizations

The Report calls for states that have not authorized electronic and remote online notarization to authorize the interstate recognition of remotely notarized documents and standardize eNotarization practices. The Report also emphasizes the need for Congress to enact a minimum uniform national standard for remote, online electronic notarizations.

Completing the mortgage process through digital notarization offers borrower convenience. However, it remains one of the key impediments to the digital process. While ESIGN and UETA establish the validity of electronic signatures in consumer credit transactions, notarizations of mortgages are subject to state notary laws, many of which do not authorize digital notarization but instead require a physical signature and notarization. Nonuniform state laws pose a cost barrier for eNotarization system vendors and create uncertainty for investors who would like to purchase digital mortgages.

The same is true of eRecordings of deeds and security instruments. While 33 states and territories have enacted a version of the Uniform Real Property Electronic Recording Act (URPERA), it is up to each county to implement eRecordings. As of May 31, 2018, just over half of the 3,600 recording jurisdictions in the United States offered electronic recording.

There are numerous hurdles to electronic notarization and recordation. First, while UETA (adopted in all but three states) authorizes notaries to use electronic signatures, many state regulatory agencies and legislative bodies insist that state laws expressly authorizing remote, online notarizations must first be put in place. The legislative process takes time, not to mention that there needs to be an appetite for change. Recent attempts in some states have not succeeded (e.g., California). Second, laws for electronic notarization are not standard from state to state. It is difficult, and costly, for vendors to develop solutions without standardization.

Trust is another issue. Many participants in the notary community fear fraud if notarizations are performed without the signer being physically present. And some are concerned that data breaches of consumer personal information will compromise knowledge-based authentications.

Also, the interests of all players in the mortgage industry are not the same. Clearly consumers, lenders and investors would benefit from nationwide, standardized electronic notarization and recording laws. The same is not necessarily true of land records offices, which could see a reduction in staffing and control over the notary process. Lenders and investors might be less likely to require title insurance policies if mortgages are registered electronically (e.g., through MERS or a blockchain technology). Similarly, if enough states authorize nationwide, remote notarization, local notaries may realize there is the potential to lose business and revenue to national notaries. Finally, cost is an issue. Technological solutions must be in place for counties to participate in electronic recordation. This requires new hardware, software and programming—all of which costs money that many localities do not have.

> *"Many participants in the notary community fear fraud if notarizations are performed without the signer being physically present. And some are concerned that data breaches of consumer personal information will compromise knowledge-based authentications."*

Appraisals

The Report acknowledges the exhaustive efforts of federal and state regulators and industry organizations to delineate minimum licensing requirements for appraisers, articulate clear appraisal standards and ethical rules and ensure appraiser independence and freedom from coercion, extortion, intimidation, or other improper influence. However, citing research published by the National Association of Realtors, the Report notes that appraisals are criticized as a frequent source of loan closing delays. To address this concern, the Report recommends that Congress update the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 to allow for the use of automated and hybrid appraisal practices in a defined and limited subset of loan transactions with stringent provisions for monitoring their use. The Report recommends that government loan programs develop enhanced automated appraisal capabilities and explore the possibility of using new industry technologies in the government sector, as well as support standardized appraisal reporting, proprietary electronic portals to submit appraisal forms, limited appraisal waivers, and the easing of appraiser education requirements in favor of on-the-job training or other types of education credits. The recommendations raise a number of industry questions. For example, will automation ultimately eliminate individual appraisal jobs? Do the Uniform Standards of Professional Appraisal Practice (USPAP) apply to automated systems and artificial intelligence? Do automated systems always contain up-to-date information and consider all of the important factors that go into a valuation? Nevertheless, the recommendations in the Report underscore the value of new and impending appraisal technologies and, if adopted, may be successful in reducing costs and increasing turnaround times.

False Claims Act

The Report highlights the rise in the Department of Justice's (DOJ) and U.S. Department of Housing and Urban Development (HUD) Office of Inspector General's use of the False Claims Act (FCA) since the financial crisis and the residual impact of multimillion dollar FCA liability in reducing access to credit. This exposure and financial risk have reduced the number of mortgage participants willing to lend in this space and increased credit overlays. In this context, the Report largely adopts many industry recommendations made previously by mortgage industry participants that are designed to increase predictability in the government-insured mortgage origination marketplace and reduce liability for clerical origination errors. Treasury recommends the following:

- Material Defects: To assist DOJ in evaluating which mortgage origination defects to pursue under the FCA, HUD should establish standards to determine which program requirements and violations are considered "material." Additionally, DOJ should link its materiality standard to agency standards. For qui tam actions regarding nonmaterial errors, DOJ should exercise its statutory authority to dismiss those cases.
- Remedies: HUD should clarify potential remedies and liability for both servicers and lenders, including the use of indemnification or premium adjust-

ments, and ensure that the remedies correlate with the existing FHA Defect Taxonomy.

- Safe Harbor: HUD should establish a safe harbor from claim denials and forfeited premiums for errors that (1) are immaterial to loan approval and (2) have been cured pursuant to FHA requirements (and absent indicia of systemic issues).
- Other Factors: FHA should consider other factors in determining potential liability for errors, including the systemic nature of the problems, role of senior management, overall loan quality and correlation of the errors with default.

These recommendations are welcome perspectives to a mortgage industry that has struggled to grow in the face of unpredictability and substantial liability for seemingly non-material loan origination errors. Although the recommendations are a positive step in the right direction, additional recommendations could further the Treasury's goal of creating certainty to government-insured lending. Most importantly, in addition to clarifications regarding HUD's standards of materiality, additional amendments to both the loan-level and annual certifications are needed to reflect the subjective realities of FHA lending and assure lenders that they will be held accountable only for their knowing and material errors that directly impact the insurability of loans. On remedies, the Defect Taxonomy should provide express guidance regarding the penalties HUD will pursue for each tier within the defect categories, including whether all unmitigated findings in the Tier 1 designation will result in indemnification. HUD should also expand the Defect Taxonomy to include defect categories for FHA servicing and claim requirements to increase lenders' certainty with regard to those areas.

The recent confirmation of the new FHA Commissioner gives HUD and the DOJ an opportunity to incorporate these and the Report's recommendations, many of which could be accomplished without amendment to the National Housing Act or implementing regulations. As noted in the Report, if such efforts prove unsuccessful or fail to stimulate increased lender and servicer participation in federally insured mortgage programs, legislative changes to the FCA would be ripe for pursuit by Congress.

Loss Mitigation Standards and FHA Servicing Regulations

The Report notes that, although most mortgage loan investors share "guiding themes" for loss mitigation, there is no national loss mitigation standard. GSEs, agencies, banks and private-label servicers offer differing loss mitigation programs based on business models, regulatory mandates and borrower segments served. These differences create challenges for servicers, including reduced efficiency, increased costs and lack of scalability, particularly for delinquent and defaulted loans. Additionally, consumers generally cannot choose their investor or servicer (with the exception of choosing government-insured loans at origination) and face uncertainty when facing loss mitigation options that are dictated by investors.

Treasury's recommendations focus on these challenges in the context of federally supported mortgage programs. Treasury recommends standardizing federal loss mitigation programs, including establishing certain parameters regarding application packages, affordability standards, loss mitigation waterfalls and referrals to financial counselors. However, the Report is careful to note that the government should not prescribe particular loan modification products, nor does the Report recommend a national standard that would apply to private investors.

Treasury also recommends that HUD review and reduce burdensome regulatory requirements under FHA servicing standards. Specifically, the Report recommends amending FHA's unique foreclosure timeline regulations to change how penalties are assessed when incremental foreclosure milestones are missed but the overall foreclosure timeline is not negatively impacted and to better align with the Bureau's existing regulations regarding default servicing activities. Treasury also recommends that HUD revisit the property conveyance process to explore changes that would reduce costs, inefficiencies and delays that occur under the current process. As the Report notes, another recommendation to help reduce costs and conveyances to HUD would be to expand the use of alternatives to the conveyance claim process, including Note Sales and the Claims Without Conveyance of Title process.

These are welcome recommendations in light of the industry's continued challenges with conflicting and burdensome servicing requirements for federally insured mortgages. The FHA loss mitigation, foreclosure, property preservation and unique claims processes are governed by detailed regulations, as well as substantial agency guidelines. While progress can be made through policy change for certain issues, many of the recommendations in the Report will require amendments to FHA servicing regulations. The arrival of a new FHA Commissioner and a strong housing market may create the conditions required to pursue an overhaul to these regulations with the goal of aligning federal servicing standards and replacing outdated and unduly burdensome rules presently governing FHA servicing.

Debt Collection

The debt collection industry continues to struggle with conflicting court opinions, "regulation through enforcement," and pervasive consumer complaints despite the Bureau's ability to establish debt collection rules under the FDCPA. Treasury accordingly recommends that the Bureau establish standards for third-party debt collectors, including standards for the type of information that must be transferred to other debt collectors or to debt buyers, and determine whether the content of validation of debt notices required under the FDCPA should be expanded. Notably, the Report does not support applying the FDCPA to first-party debt collectors and suggests that Congress explore this option.

These recommendations are not surprising and come nearly two years after the Bureau released its outline of debt collection proposals,[17] which included proposals for data transfers and expansion of validation of debt notice content (among other practice-related proposals), and nearly five years after the Bureau's original Advance Notice of Proposed Rulemaking on debt collection. However, the Bureau has yet to issue a proposed rule. Hopefully the Bureau will heed the recommendation and bring more certainty to the debt collection and debt buying industries.

State Foreclosure Practices

Since the housing crisis, the average length of the foreclosure process has increased exponentially in both judicial and nonjudicial states. Extended foreclosure time frames have affected the housing market through increased interest rates for borrowers and negative pressures on home pricing. For federally supported housing programs where national pricing is a factor, this can also result in additional costs being passed on to borrowers in states with shorter foreclosure timelines. As a result, the Report recommends that states standardize their foreclosure statutes to align with a model foreclosure law. The Report suggests that pivoting away from a judicial review foreclosure process may reduce the time and resources associated with foreclosures without sacrificing state and federal borrower protections. Additionally, to account for added costs of longer foreclosure timelines, the Report recommends that federally supported housing programs consider a guaranty fee and insurance fee surcharges in states where foreclosure timelines are substantially longer than the national average.

Non-Depository Counterparty Transparency

Since the financial crisis, the secondary mortgage market supported by Fannie Mae, Freddie Mac and Ginnie Mae has provided nondepositories with a willing purchaser or guarantor and enabled nondepositories to expand their market share. Ginnie Mae, in particular, has offered a reliable market for nondepositories, with nondepositories providing approximately 70 percent of the new Ginnie Mae originations. The Report points out certain risks in a housing market propped up by nondepository lenders. Of particular concern is liquidity and the capacity of nondepositories to survive a large-scale market downturn. For instance, if a nondepository faced a financial meltdown and significant borrower delinquencies, the concern is that it may not have access to capital sufficient to meet Ginnie Mae's requirement to make advances.

The Report also suggests ways to mitigate such risks. First, the Report mentions increased transparency and reporting requirements, ideally standardized across Ginnie Mae, Fannie Mae, Freddie Mac, FHA and the CSBS (important as nondepositories are chartered and regulated at the state level), which will provide such investors with information necessary to assess nondepository counterparty risk. Second, the Report recommends that Ginnie Mae be allowed to assess higher guaranty fees in the event of perceived counterparty risk. Finally, the Report recommends a review and evaluation of Ginnie Mae's current staffing and contracting policies to address its changing workforce needs.

Although the foregoing recommendations would be beneficial, some would be difficult to implement. For instance, standardized reporting requirements for Fannie Mae, Freddie Mac and Ginnie Mae would be a substantial undertaking, require compromise to harmonize various investor requirements and likely take years to implement. Similarly, revising the Ginnie Mae charter to allow for increased guaranty fees would require congressional action.[18] The most likely area of change would be revisions to Ginnie Mae's policies to address staffing needs, but note that Ginnie Mae is still dependent on congressional appropriations for funding any such policy changes.

Student Lending and Servicing

As the size and nature of this market continues to grow and shift, student lending and servicing is an emerging area of focus for federal and state regulators.[19] The Report recommends enhancements related to school accountability, servicing standards for federal student loans, borrower communication and data quality. Many of the student lending and servicing issues highlighted in the Report are issues that are well-known in the industry, but some of the Report's recommendations involve the novel use of technology to increase efficiencies, decrease costs and improve consumers' experience in connection with federal student loans.

School Accountability

The Report indicates that Treasury is concerned about the lack of school accountability in student lending, particularly schools that do not offer a good value for their tuition and therefore lead to student loan debt that borrowers struggle to repay. There have been a number of enforcement actions brought by federal and state agencies in recent years against for-profit institutions related to deceptive marketing and other perceived predatory behavior by schools.[20]

As the Report points out, schools have few metrics or requirements related to the performance of federal student loans. To increase school accountability, the Report supports the implementation of a risk-sharing model that would require schools with consistently low loan repayment rates to repay some amount of federal funds. Risk-sharing models have been used by some companies in the private student lending space, but using it in connection with federal student loans would be a novel approach. Because the implementation of a risk-sharing model would require the passage of legislation, it is unlikely that such changes would occur in the near future. The Report also acknowledges that a risk-sharing model would pose some thorny issues, such as how to account for schools with consistently low loan repayment rates, but high percentages of disadvantaged students.

Servicing Standards

The Report acknowledges that servicing federal student loans is a complicated endeavor. First, there are myriad different federal student loan types (including legacy vintages) with different loan features and parameters. In addition, there are eight different repayment plans that may be available to federal student loan borrowers, all of which have different eligibility requirements and plan features. There also are certain features such as delayed repayment and interest capitalization that are unique to the student loan product and which complicate the servicing process. Despite the complex nature of servicing federal student loans, the Report highlights the lack of useful guidance provided to student loan servicers, resulting in inconsistency in servicing practices across servicers. The complexity of servicing federal student loans also hinders the ability of borrowers to understand the terms of their loans and available benefits. As a result, servicing personnel often shoulder the responsibility for explaining nuanced terms and servicing processes to consumers without standardized guidance from the US Department of Education (ED).

To increase consistency and decrease servicing costs, the Report recommends that the ED establish minimum servicing standards for federal student loan servicers. The Report suggests that any minimum servicing standards focus on providing guidance for transactions with significant financial implications for borrowers (e.g., choice of repayment plans, application of lump sum payments across multiple loans), creating minimum contact requirements and implementing timelines for certain activities, such as correcting identified account-specific issues.

The Report's recommendations echo many of the recommendations made in the Joint Principles on Student Loan Servicing published by the Treasury, the ED and the Bureau back in September of 2015.[21] Almost three years later, meaningful progress still has not been made toward developing regulations or other guidance that would formalize these concepts. With the ED recently suggesting that state laws that purport to regulate student lenders are preempted by the federal Higher Education Act,[22] it may be prudent for the ED to act more quickly to consolidate its authority and dissuade states from creating their own regulatory frameworks for student loan servicing.

Borrower Communication

The Report also makes recommendations related to two discrete areas of federal student loan servicing involving borrower communications—the use of email communications with borrowers and the lack of E-SIGN capability. With respect to the use of emails, the Report recommends providing borrowers with earlier email communication (servicers often do not have borrowers' email addresses until a loan enters repayment) and more substantive email messages (rather than simply notifying borrowers that a message is available in the servicer's online portal).

The Report highlights the unnecessary costs and inefficiencies associated with servicers' inability to obtain e-signatures from federal student loan borrowers. The Report recommends that the ED provide secure E-SIGN software and technology to federal student loan servicers in order to increase efficiency and decrease servicing costs associated with obtaining wet signatures from borrowers on all required forms.

Data Quality

A recurring theme of the Report is that the federal student loan market is often driven by private servicers, rather than the ED. At present, servicers maintain the majority of loan-level data about their federal student loan portfolios. Because this data comes from different servicers and is in different formats, it hinders the ED's ability to monitor trends and address potential portfolio-wide issues.

Given the increasing size of the federal student loan portfolio, the Report recommends that the ED include on its Office of Federal Student Aid management team individuals who have expertise in managing large consumer loan portfolios. The Report also recommends that the ED increase transparency by publishing more data regarding performance and costs on its website to provide taxpayers with more insight into how the federal student loan portfolio is performing

The Report's recommendations appear to be designed to enable student loan servicers to leverage technology in order to more efficiently and effectively deliver services to student borrowers. Although many of these recommendations seem unlikely to come to fruition (e.g., risk-sharing model with schools), other recommendations that have the potential to significantly increase efficiencies (such as providing E-SIGN software to student loan servicers) may gain enough traction to result in meaningful changes to the market.

Short-Term, Small-Dollar Lending

Treasury makes two recommendations regarding short-term, small-dollar lending: first, that the Bureau rescind its Payday Rule; and second, that regulators encourage banks to make (prudently) short-term, small-dollar loans.

The Report recommends that the Bureau rescind, rather than amend, its Payday Rule. Treasury's primary argument for rescinding the Payday Rule is that the states already highly regulate short-term, small-dollar lending. The Report suggests that the extensive state action is unnecessary. Treasury also argues that the Payday Rule restricts consumer access to credit and decreases product choices. Rescinding the rule, Treasury says, would lead to additional credit opportunities for under-banked consumers who otherwise may be left with few alternatives, such as turning to unscrupulous or illegal lenders. The Report does not address consumer protection concerns previously expressed by the Bureau about debt traps, though omission of that concern may have resulted from Treasury's treatment of payday lending as the "lesser of two evils" when compared with the possible alternative of loan sharking and its belief that states know best when it comes to their citizens' credit and consumer protection needs.

Since the Bureau already indicated its intent to reconsider the rule in a political environment seemingly aligned with Treasury's positions, its recommendation may succeed—an outcome that the industry would likely welcome. While lenders frequently prefer uniform federal regulatory regimes over a 50-state hodgepodge of requirements (the Report itself notes that state-level differences can in some cases create uncertainty, increase costs and inhibit wider adoption of innovations),[23] Treasury's view is that the Bureau's Payday Rule is too restrictive.

The Report also recommends that federal banking regulators encourage banks to return to small-dollar lending. Specifically, Treasury recommends that the FDIC follow the OCC's lead in rescinding some small loan guidance from 2013, which identified risks associated with offering direct deposit advance products in a way that chilled banks' appetite for offering such products. The Report frames the OCC's change in guidance as a move to ensure that consumers did not run to less-regulated nonbanks.

Treasury's two recommendations indicate that it would prefer that federal and state regulators take steps to encourage sustainable and responsible short-term, small-dollar installment lending by banks. Treasury would like to see barriers to such lending removed. It does not, however, provide any specific framework for supporting the goals of sustainability and/or responsibility. Presumably, those are discussions best had among the federal banking regulators, the Bureau, and state legislatures and regulators, rather than the Treasury itself.

IRS Income Verification

Income verification is an integral part of most credit inquiries. Mortgage lenders must ensure that borrowers have the means to make their monthly mortgage payments. Investors, along with Fannie Mae, Freddie Mac and government insured and guaranteed loan programs such as the FHA and VA, impose rigorous income verification requirements, including a requirement to obtain copies of the borrower's tax returns dating back two years for certain types of financing. However, the Internal Revenue Service (IRS) delivers tax data to lenders using outdated technology that often results in closing delays and increased costs. The Report recognizes that IRS methods are out of sync with real-time information transfers that have become increasingly common throughout the lending industry. To address this challenge, it recommends that Congress fund IRS modernization, including electronic upgrades to support more efficient and timely income verification. Such modernization presumably would, among other things, facilitate lenders' receipt and use of historical income data earlier in the credit process, eliminate paperwork and delays, and lower operational costs. However, as the Report acknowledges, it would require extensive and expensive enhancements to IRS systems, including acquisition of e-signature capability and additional borrower authorization protocols to ensure the IRS delivers only tax data approved by the consumer. Were Congress to fund such improvements, it would be critical for the IRS to ensure its current system remains operational during the interim period and that further delays do not abound.

New Credit Models and Data

Recognizing that new credit models and data sources have the potential to significantly expand underserved consumers' access to credit, Treasury recommends that regulators facilitate testing of and experimentation with new models and data and that regulators enable increased use of new modeling and data by reducing regulatory uncertainty, preferably through interagency coordination. With respect to industry participants, Treasury recommends that they continue efforts to capture telecom, utility, and rental payments, as well as more granular credit card usage information, through regular reporting to consumer credit bureaus.

The Report explains that U.S. financial institutions historically have relied on standardized credit data and models, such as the widely used FICO score, for extending consumer credit. However, fast moving developments in data availability and modeling methods are yielding innovative approaches to credit underwriting. Some of these new techniques involve applying newer data, such as rental and utility payments, to existing modeling approaches, while others use new modeling techniques (e.g., machine learning) combined with unexpected types of data, such as social media usage, internet browsing history, shopping patterns, etc.

The Report emphasizes the importance of balancing the potential benefits of these advances—including expanded credit opportunities for underserved consumers and improved loss rates for creditors—with important policy considerations, such as compliance with consumer protection requirements, regulatory model validation expectations, and data quality and privacy issues.

Although the United States is somewhat behind other countries in formalizing a regulatory framework for incentivizing fintech innovation, significant developments to implement the Report's recommendations are emerging. For example, in July of 2018, the Bureau established a new Office of Innovation,[24] and the OCC announced that it will begin accepting applications for its much anticipated fintech charter.[25] In September, the Bureau announced that it had joined with 11 financial regulators and related organizations to create a Global Financial Innovation Network.[26] Also, as discussed later in this article, Arizona became the first state to establish a fintech regulatory sandbox.[27] On the other hand, establishing an infrastructure for reliably capturing new types of data will require significant effort and collaboration, and applying outdated consumer protection statutes such as the Fair Credit Reporting Act (FCRA) to new data sources raises challenging compliance questions that will likely need to be addressed by new legislation.

Credit Bureaus

Treasury focused on two main issues regarding credit bureaus: data security and the application of the Credit Repair Organizations Act (CROA).

The Report recommends that the FTC, which has significant privacy and data security expertise, retain its Gramm-Leach-Bliley-Act rulemaking and enforcement authority over nonbank financial companies. In addition, the applicable agencies should coordinate efforts to protect consumer data held by credit bureaus, and Congress should evaluate whether further data protection authority is needed.

While the FCRA regulates how credit bureaus collect, use and share consumer credit data, and the FTC's Safeguards Rule requires credit bureaus (among others) to employ data security measures to safeguard consumer information from unauthorized access, currently there is no data security supervisory authority over credit bureaus. In 2017, one of the three largest U.S. credit bureaus experienced a massive security breach involving extremely sensitive data about nearly 150 million consumers, which breach underscored the need for more robust supervision of credit bureaus' information security practices.[28]

The Report also recommends that Congress amend the CROA to exclude the national credit bureaus and credit scorers from coverage. Congress enacted the CROA in 1996 to protect consumers against predatory credit repair organizations that falsely claimed to be able to improve consumers' credit ratings for a fee. In 2014, the Ninth Circuit held[29] that credit bureaus seeking to provide legitimate credit and financial education services to consumers qualified as credit repair organizations under the CROA. The Report observes that this decision, combined with the strong remedies under the CROA, has deterred credit bureaus from providing valuable credit education and counseling services and therefore recommends that Congress amend the CROA to exclude credit bureaus from coverage. Whether Congress will enact legislation to authorize information security supervision over credit bureaus and/or exempt credit bureaus from CROA coverage remains to be seen, but it is unlikely that either measure would face serious opposition.

Payments

The Report makes three recommendations regarding payments. First, the Bureau should provide more flexibility for Electronic Fund Transfers Act (EFTA)/Regulation E disclosures related to remittance transfers and raise the threshold for a *de minimis* exemption (currently 100 transactions per year). Second, the Federal Reserve should move quickly to facilitate faster retail payments, such as through the development of real time settlement services, that would allow for more efficient and universal access to innovative payment capabilities. Finally, the Federal Reserve and Secure Payment Task Force should continue their work regarding payment security, including next steps and actionable deadlines and ensuring that security solutions do not include specific technical mandates.

Remittance Transfer Rule Reform

The Report says that Section 1073 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") created a "particular regulatory inefficiency" for international remittance transfers. Section 1073 of the Dodd-Frank Act amended the EFTA[30] by adding a new Section 919.[31] Section 919 requires remittance transfer service providers (RTSPs) to give various disclosures to consumers at different points in the remittance transfer process and provides a right to cancel a remittance transfer within a 30-minute window (subject to some exceptions).

The Bureau adopted the Remittance Transfer Rule, or the RTR, as directed by Section 919. Both Section 919 and the RTR define "remittance transfer" broadly. The term generally includes any electronic transfer of funds from a US-based consumer to a person in a foreign country, regardless of the method used for the transfer or the type of institution effecting the transfer. According to the Report, compliance with the RTR has been made challenging because the disclosure requirements are inflexible (e.g., the paper disclosures requirement). The Report recommends that the Bureau provide for more flexible disclosures, but does not give any specific recommendations, other than for the Bureau to raise the threshold for a *de minimis* exemption (currently 100 transactions per year).

The Report is correct that compliance with the RTR has been difficult for many companies. The RTR imposes prescriptive and precise rules for the timing, content and format of disclosures. These rules were developed with traditional remittance transfers in mind (e.g., simple fund transfers via casas de cambio or hawala systems). Thus, the requirements are tailored to that type of transaction. However, the definition of "remittance transfer" is broader. It may, for example, include bank transfers initiated from an account to a foreign payee and P2P transfers where the recipient is outside the United States. It may even include some payments to foreign merchants (although most transactions initiated through a card network are excluded). Applying rigid rules designed for a traditional remittance transfer to these other kinds of transfers can be challenging at best. Sometimes, it can be impossible, or result in disclosures that are confusing to consumers.

It is not clear, however, how much the Bureau can do to solve this problem without congressional action. Many of the most problematic aspects of the disclosure regime are dictated by Section 919. The corresponding provisions of the RTR often largely track the language of the statute. Much of the "new" content in the RTR either fills gaps or interprets provisions in the statute. While there are a number of changes to the RTR that the Bureau could make that are consistent with the statute, comprehensive reform of the remittance transfer disclosure regime may require statutory amendments.

Payments Innovation

The Report discusses various innovations in payment systems that the industry has recently adopted or that are in development, including P2P systems and digital wallets (FC, cloud-based, QR code, and so forth) and real-time clearing and payments.

With respect to innovative payment solutions (e.g., P2P systems and digital wallets), the Report says that a wait-and-see approach is the best course. These systems are still in their nascent stages and there is intense competition. For faster payments, the Report recommends that the Federal Reserve act quickly to support these efforts. The Report in particular notes that the Federal Reserve should take steps to ensure that smaller institutions, such as community banks and credit unions, have access to these systems.

The Report correctly notes that too much regulation, too soon, risks distorting fast-evolving and innovative payments technologies. However, the Report misses the fact that these innovations often get caught up by existing regulations because some legacy rules are tailored to archaic systems and technologies. Freeing the payments industry from innovation-stifling regulation requires some action by both legislators and regulators.

Payments Security

The Report recommends that the Federal Reserve continue to push for work product from the members of the Secure Payments Task Force (which disbanded in March 2018) with respect to security priorities applicable to mobile payments. It also recommends that the Federal Reserve stop studying the issue of payment security priorities and releasing reports with recommendations on principles—and to start taking concrete steps to implement those principles-based recommendations.

Rationalizing the Regulatory Framework for Financial Planning

As detailed in the Report, because financial planning is not itself a federally regulated activity, persons engaged in the business of financial planning are subject to a patchwork of regulation that may depend on other business activities of the provider (e.g., as an investment adviser under state or federal law, as a bank, or as a lawyer or accountant) and where the provider is located, based on local state law.

In order to rationalize the fragmented regulatory framework, Treasury recommends that rather than create a new centralized regulator, an appropriate existing regulator of financial planners (federal or state) would be tasked as the primary regulator with oversight responsibilities. For example, to the extent a financial planner was providing investment advice, the Securities and Exchange Commission or a state securities regulator would become the primary regulator. While the various state and federal regulatory agencies could presumably all voluntarily agree to abide by the deference suggested by Treasury, it seems inevitable for some "turf wars" to arise, which may necessitate additional legislation to grant authority to any such primary regulator to adopt regulations targeted to activities of financial planners.

Enabling the Policy Environment

Agile and Effective Regulation for a 21st Century Economy

Regulatory Sandboxes

Innovators frequently cite the number of financial regulators and the complexity of their regulatory and administrative regimes as unreasonably burdensome on innovation. To address these concerns, the Report recommends that federal and state financial regulators establish a "regulatory sandbox"[32] to address innovative products, services, and processes, or in the absence of such collaboration, that Congress take such action. While such a unified solution is ambitious, agencies such as the Bureau and the Commodity Futures Trading Commission and states like Arizona have already announced an openness to creating regulatory sandboxes.[33] Accordingly, we are cautiously optimistic that some form of regulatory sandbox will be created, particularly if Treasury provides diligent attention and coordination resources to the initiative.

Agile Regulation and Procurement

Treasury determined that innovators and financial regulators have difficulty working together because federal appropriation and acquisitions requirements limit the speed and flexibility of agencies wishing to implement new technology. Some nonfinancial agencies, such as the US Department of Defense and NASA, have specialized "other transaction authority" that allows them to develop agreements that do not need to comply with government standards. Treasury believes that if this authority were granted to the financial regulators, they would be able to expeditiously engage with the private sector to better understand and apply new and innovative technologies.

While the likelihood for adoption of this recommendation is low in light of congressional gridlock, we expect that some regulators will seek out creative solutions to achieve the same aims within the constraints of their existing statutory authority.

Regtech

Regtech generally refers to fintechs that focus on providing innovative products and services to assist regulated financial services companies in meeting compliance requirements. Regtech has grown significantly in recent years, but remains constrained by legacy rules that are difficult to translate for automated solutions.

The Report recommends that regulators tailor regulations to address regtech initiatives and partner with market participants in such efforts. While the types of change needed to implement these recommendations will require numerous rulemakings over an extended horizon, we expect that Treasury's recommendations will be welcomed by the regtech industry as a touchstone for urging regulators to write and rewrite regulations with an eye toward providing the clarity and precision required for regtech solutions.

Engagement

Financial services companies and fintechs remain wary of engaging with regulators because of enforcement risks and bureaucratic delays. To reduce this friction in innovation, the Report broadly recommends that regulators assess current regulations, reach out to the industry and establish clear points of contact for industry and consumers. We expect that efforts to break down such barriers will increase under the current administration.

Education

The Report does not make specific recommendations with respect to education, but encourages universities and regulators to explore ways to bridge the knowledge gap between regulators and educational organizations. This initiative seems unlikely in the current deregulatory environment, again with constrained regulatory budgets.

Critical Infrastructure

The Report addresses threats to critical infrastructure by encouraging regulators and the private sector to shift their collective focus from threat identification to vulnerability identification and remediation. Specifically, the Report emphasizes the need to focus on cybersecurity and consider establishing a technology working group to better understand current developments. The Report also encourages regulators to collaborate with the financial services industry to identify, properly protect, and remediate vulnerabilities. This is an area where the private sector is already rapidly advancing, and we expect to see further developments as regulators gain greater experience with cyber risk management.

International Approaches and Considerations

The final section of the Report offers a sneak peek into how non-U.S. nations are thinking about fintech products and how U.S. regulators will work with foreign regulators. The section is a grab bag of non-U.S. and international examples of technological innovation, efforts to foster such innovation, and progressive, forward-looking and cooperative international studies and regulation of such innovation. This discussion is offset with counter-examples of efforts to curb the perceived excesses of emerging technologies, including data privacy efforts in Europe and protectionist national laws and policies.

In addition to the United States, several countries are pursuing policies to foster innovation and growth in financial technologies (e.g., India, China, Hong Kong). Central banks across the globe are considering how to use Distributed Ledger Technology (DLT)—blockchain being the best known form of DLT—to support commodities trading and securities settlement, among a raft of other financial products and services.

Although new and emerging financial technologies have been embraced in many jurisdictions worldwide, they have also raised concerns with respect to privacy of personal and financial data. Some international data protections include requiring that data be stored and processed locally, putting caps on foreign ownership, forcing the formation of JVs, and enforcing discriminatory licensing requirements. Although Treasury politely refrains from naming names, China's booming domestic fintech market is among those that remain relatively closed to U.S. firms. The Report expresses a healthy skepticism about these restrictive measures, characterizing them as potentially damaging to cross-border regulatory cooperation and unnecessary barriers to trade.

The Report details U.S. engagement with international counterparts in a variety of forums focused on financial innovation. The United States participates in myriad international cooperation efforts including the G20, FSB, and IMF, to identify and mitigate the risks of new financial technologies with an eye toward U.S. growth. The Report recommends that Treasury engage with international organizations and the private sector to advance U.S. interests and domestic regulatory priorities.

The Report notes that it is premature to develop international regulatory standards addressing fintech technologies. That said, there may be benefits in the future to the United States having a seat at the table in such discussions.

Conclusion

The succinct presentation and coherent organization of a long list of important public policy recommendations for reform of the financial system probably is the most important benefit of the Report. Like the proverbial "wish tree," the Report is filled with wishes and offerings to help chop away legal and regulatory barriers to facilitate emerging technologies and new ways of conducting a financial business. It will not be easy to convert the recommendations into a comprehensive legal framework. But you have to start somewhere.

Endnotes

1. Including Mayer Brown, LLP (Illinois, USA); Mayer Brown International, LLP (England); Mayer Brown (a Hong Kong partnership); Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices"); and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies").
2. U.S. Dep't of Treasury, A Financial System that Creates Economic Opportunities, Nonbank Financials, Fintech, and Innovation (June 2018), https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi....pdf (hereinafter "Report").
3. U.S. Dep't of Treasury, A Financial System that Creates Economic Opportunities: Banks and Credit Unions (June 2017), https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf; U.S. Dep't of Treasury, A Financial System that Creates Economic Opportunities Capital Markets (October 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf; U.S. Dep't of Treasury, A Financial System that Creates Economic Opportunities Asset Management and Insurance (October 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.
4. Historically, the industry has argued that the definition of "autodialer" under the TCPA was too broad because it includes equipment that merely has the capacity to make an autodialed call, rather than being limited to equipment that actually is used by an autodialer.
5. Fed. Commc'n Comm'n, FCC Fact Sheet: Advanced Methods to Target and Eliminate Robocalls (Mar. 2018), https://transition.fcc.gov/Daily_Releases/Daily_Business/2018/db0301/DOC-349522A1.pdf.
6. William Kovacic et al., Collecting Consumer Debts: The Challenges of Change: A Workshop Report, Fed. Trade Comm'n (Feb. 2009), https://www.ftc.gov/reports/collecting-consumer-debts-challenges-change-federal-trade-commission-workshop-report.
7. "Application Programming Interfaces" mean a program that links the aggregator's or fintech's systems to the financial services provider's systems, and uses pre-defined communication and data exchange protocols to transfer information.
8. *See CSBS Responds to Treasury, OCC Fintech Announcements*, Conference of State Bank Supervisors (Jun. 18, 2018), https://www.csbs.org/csbs-responds-treasury-occ-fintech-announcements.
9. Barnett Bank v. Nelson, 517 U.S. 25, 33–34 (1996).
10. 12 C.F.R. §§ 7.4007(b), 7.4008(d) (2015).
11. The OCC has authority to define what activities are part of the business of banking or incidental to the business of banking. 12 U.S.C. § 24(Seventh) (2008).
12. 12 U.S.C. §§ 1841 *et seq.* (2003).
13. 12 U.S.C. §§ 2901 *et seq.* (1977).
14. This recommendation reflects the approach already taken in H.R. 4439, the "Modernizing Credit Opportunities Act," which is currently under consideration by the House Financial Services Committee, but which is stalled in committee as it is opposed by, among other relevant entities, the CSBS. Modernizing Credit Opportunities Act, H.R. 4439 (115th Cong., 2017-2018), *available at* https://www.congress.gov/bill/115th-congress/house-bill/4439/text; *CSBS Opposes "True Lender" Bill (H.R. 4439)*, Conference of State Bank Supervisors (May 18, 2018), https://www.csbs.org/csbs-opposes-true-lender-bill-hr-4439.
15. 786 F.3d 246 (2d Cir. 2015).
16. As with the "true lender" issue, this recommendation reflects the approach already taken in an existing bill, H.R. 3299. That legislation has made more progress than the "true lender" bill, in that it has passed out of the House and is under consideration by the Senate, though it still faces an uphill battle if it is to be enacted.
17. *A Debt Collection Overhaul is Upon Us: The CFPB's Proposals Offer a Sign of What's to Come*, Mayer Brown (Aug. 5, 2016), https://www.mayerbrown.com/A-Debt-Collection-Overhaul-Is-Upon-Us-CFPBs-Proposals-Offer-a-Sign-of-Whats-to-Come-08-05-2016/.
18. The maximum guaranty fee is set at 6 basis points by 12 U.S.C. § 1721(g)(3)(A).
19. The federal student loan portfolio is composed of almost $1.4 trillion in outstanding student loans. Report, *supra* note 2, at 122.
20. *See e.g.*, Complaint for Permanent Injunction and Other Relief, Consumer Financial Protection Bureau v. Corinthian Colleges, Inc., No. 14-7194 (N.D. Ill. Sept. 16, 2014), *available at* https://files.consumerfinance.gov/f/201409_cfpb_complaint_corinthian.pdf.
21. *Joint Statement of Principles on Student Loan Servicing*, U.S. Dep't of Treasury & Educ. (Sept. 2015), https://files.consumerfinance.gov/f/201509_cfpb_treasury_education-joint-statement-of-principles-on-student-loan-servicing.pdf.
22. Federal Preemption and State Regulation of the Department of Education's Federal Student Loan Programs and Federal Student Loan Servicers, 83 Fed. Reg. 10,619 (Mar. 7, 2018).
23. Report, *supra* note 2, at 97; *See* Kristie D. Kully et al., *CFPB's Final Payday Lending Rule: The Long and Short of It*, Mayer Brown (Oct. 6, 2017), https://www.cfsreview.com/2017/10/cfpbs-final-payday-lending-rule-the-long-and-short-of-it/#more-2433.

24. *Bureau of Consumer Financial Protection Announces Director for the Office of Innovation*, Consumer Fin. Prot. Bureau (Jul 18, 2018), https://www.consumerfinance.gov/about-us/newsroom/bureau-consumer-financial-protection-announces-director-office-innovation/. According to the Bureau, the Office of Innovation will focus on creating policies to facilitate innovation, engaging with entrepreneurs and regulators, and reviewing outdated or unnecessary regulations. The Bureau's Project Catalyst, an initiative under which the Bureau issued its first no-action letter regarding the use of alternative data in credit underwriting, will transition to this new office. *CFPB Announces First No-Action Letter to Upstart Network*, Consumer Fin. Prot. Bureau (Sept. 14, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/.

25. *OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies*, U.S. Dep't of Treasury (Jul 31, 2018), https://www.occ.treas.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html.

26. *BCFP Collaborates With Regulators Around The World To Create Global Financial Innovation Network*, Consumer Fin. Prot. Bureau (Aug. 7, 2018), https://www.consumerfinance.gov/about-us/newsroom/bcfp-collaborates-regulators-around-world-create-global-financial-innovation-network/.

27. H.B. 53-2434, 2nd Sess. (Ariz. 2018).

28. In response to this breach, the NYDFS has imposed additional cybersecurity and registration obligations on certain credit bureaus.

29. Stout v. FreeScore, LLC, 743 F.3d 680 (9th Cir. 2014).

30. 15 U.S.C. §§ 1693 *et seq.* (2010).

31. *Id.* § 1693o-1.

32. A "regulatory sandbox" allows an innovator to test a new idea in a limited setting without having to definitively resolve or comply with all conceivable regulatory requirements.

33. Neil Haggerty, *CFPB Looking to Hop On Fintech Sandbox Bandwagon*, Am. Banker (May 29, 2018), https://www.americanbanker.com/news/cfpb-looking-to-hop-on-fintech-sandbox-bandwagon-mick-mulvaney; *Arizona Becomes First State in U.S. to Offer Fintech Regulatory Sandbox*, Ariz. Attorney Gen. (Mar. 22, 2018), https://www.azag.gov/press-release/arizona-becomes-first-state-us-offer-fintech-regulatory-sandbox.

Force Majeure: What Is It Good For?

By Stuart B. Newman and Allison W. Rosenzweig

Your client has a problem. He manufactures and installs heavy equipment for the power transmission industry. He has a fixed price contract to build, ship and install equipment to a Canadian power plant. The work at his factory was completed on time and on budget, but between the time of contract and delivery—which will require a caravan of ten tractor-trailers—the Department of Transportation issued new federal regulations governing maximum consecutive driving hours and minimum off-duty hours for long-haul drivers. As a result, shipping and delivery costs will be substantially higher, and due to a shortage of drivers, completion of delivery will take longer than specified in the contract. The client needs to re-negotiate shipping and delivery costs.

You review his contract, and although there is a *force majeure* clause, it is of the bare bones variety, just a boilerplate throw-in, that provides little comfort. For this situation, the answer to the question in the title of the article is—the clause is not good for much.

The purpose of this article is to suggest that *force majeure* clauses deserve more respect and attention than they usually get when they are routinely assigned to the scrap heap of boilerplate at the tail end of an otherwise well-crafted contract.

Definition

For a concept so widely used in commercial agreements, it is remarkable that neither the common law nor statutory law provides objective guidance for standardization. *Force majeure* defies standardization -- it is whatever the parties to an agreement mutually decide it should mean for them in the context of the transaction between them.

The underlying concept of *force majeure* is simple enough, and relates generally to an excuse or defense asserted for non-performance under a contract resulting from a frustration of purpose caused by an event occurring after a contract is signed, "preventing" performance by one or more parties. The variables are where the fun begins: what types of events do or do not constitute an occurrence; is the result one that prevents total or only partial non-performance; is the non-performance perpetual or is the problem limited to delivering on-time performance?

The three conditions generally required for application of the concept of *force majeure* are that the qualifying event be: 1) **external**—in no way caused by the act or failure to act of the party seeking to invoke it as a defense; 2) **unpredictable**—totally unforeseen so that the party claiming *force majeure* could not reasonably have foreseen the event happening; and 3) **irresistible**— nothing, within the reasonable ability of the party, could have prevented the event from happening.

Triggering Events

The most common and most widely accepted triggering event category for invoking *force majeure* is Acts of God, exemplified by, e.g., earthquakes, floods, lightning strikes or other natural events. A second widely accepted category is political events such as riots, terrorism, war or civil disturbances. Ambitious contract draftsmen can creatively expand the list: chemical or nuclear contamination; shock waves from aircraft traveling at supersonic speeds, etc. However, an event that results in a mere financial difficulty or economic hardship alone is insufficient to allow a party to avoid their contractual commitments pursuant to a *force majeure* provision.

The obvious problem with a long list of triggering events that is too specific is the risk of excluding the one that actually occurs, but was not listed. A suggestion to help deal with this is offered below under Drafting Tips.

Purpose of *Force Majeure*

The underlying purpose of a *force majeure* clause in a commercial contract is to allocate risks between or among the parties that may result from non-performance because of unforeseen events. Any such allocation of risk involves negotiation: the performing party naturally wants as broad a defense for non-performance as possible, and the party to whom performance is promised wants to narrow the scope of excused non-performance, keeping the risk on the party contracting to deliver. Third parties may also have a stake in this negotiation. For example, if outside funding is part of the project, the lender will oppose any provision that adds to the uncertainty of performance and delivery.

Just as with all other contract provisions, the goal is to achieve a fair result within the leverage each party is bringing to the table.

Remedies

Simply identifying the triggering events that constitute *force majeure* is a job half-done. To achieve the true purpose of the provision, allocation of risk, a well-drafted clause should address the consequences and remedies if a triggering event does occur.

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Is performance excused, or is the performing party allowed more time to perform? Does the party expecting performance have any options to exercise, e.g., right to cancel, or is that party entitled to a price adjustment? Consider the following suggestions.

Drafting Tips

- Both sides should first consider the availability and cost of insuring against the occurrence of triggering events that are insurable. Not all *force majeure* events are insurable, but many of them may be.
- While the *force majeure* clause will certainly include a specific listing of some of the usual Acts of God and political events, the party called upon to perform and deliver might want to add:

  > or other unforeseeable circumstances, whether similar or dissimilar to any of the foregoing, beyond the control of the Parties against which it would have been unreasonable for the affected party to take precautions and which the affected Party cannot avoid even by using its best efforts.

- Remember the client delivering heavy equipment to the power transmission industry? His contract might have contained a related provision akin to *force majeure* allowing for shifting the financial risk in the event of change of law or regulation. Always consider the peculiar nature of the industry and the circumstances of the particular transaction to identify triggering events unique to the instant contract. When the client asks for your help with his contract, ask the client what could go wrong, what are the risks that could affect performance, and what would be a fair remedy if the risk occurs.
- If other countries play a role in the parties' ability to perform their contract obligations, it may be prudent to include the specific locations in the *force majeure* clause. Industries have spread across the globe. Be sure to have this discussion with your client to get a clear understanding of the overseas locations that may affect the supply chain, transportation, workforce or other aspects of their specific business.
- While drafting and negotiating the *force majeure* clause, the parties may consider whether the delay or failure to perform a party's obligations under the contract due to the effects of the *force majeure* event can result in one party terminating the contract, with or without liability to the other party. For example:

  > If the delay or failure of either Party to perform its obligations under this Agreement exceeds thirty (30) days, Buyer may immediately, upon the end of the thirty (30) day period, terminate the Agreement without any liability to Seller.

- On the other hand, the parties may wish to make continued performance of the contract obligations a viable option. In that case, the *force majeure* clause should include an extended period of time for an excusable delay to allow the party additional time to complete performance.
- "Impossibility" and "impracticability" to perform an obligation due to unexpected circumstances are very high standards, but one or both terms are often found in boilerplate *force majeure* clauses. For greater flexibility, consider excusing performance when it would be "inadvisable" or "commercially impracticable" to perform.

> *"The underlying purpose of a* force majeure *clause in a commercial contract is to allocate risks between or among the parties that may result from non-performance because of unforeseen events."*

- For more stringent protection, the affected party should be under an express duty to minimize the disruption caused by the *force majeure* and use reasonable diligent efforts to resume full performance under the agreement.
- If the contract imposes exclusivity between the parties, the parties may consider whether the *force majeure* clause should be drafted to cease the exclusivity obligation during the period of delay, or even require the parties to renegotiate, modify and reform the contract to reflect a new understanding of the parties.

Conclusion

Force majeure clauses deserve more attention than is typically given when they are consigned to the back of the contract under the category of "Miscellaneous." An effective *force majeure* clause requires thought to draft, guarding against supervening events and assigning the risks equitably between the Parties if such events occur. It is important to consider the respective interests of the parties, the industries and the events that may affect performance. A carefully drafted *force majeure* clause is an important tool for allocating risk of loss associated with unexpected events and reducing the need to litigate such issues.

Lawyers as Rats: An Evolving Paradigm?

By C. Evan Stewart

James Cagney never said: "You dirty rat." What he did say was: "Come out and take it, you dirty, yellow-bellied rat, or I'll give it to you through the door."[1] Of course, regardless of whatever adjectives are used, a "rat" is still a "rat." And that applies to lawyers who rat-out their clients; or does it?

In recent years, there has been a fair amount of public commentary about what rights lawyers have to be a rat.[2] So now would seem to be a good time to revisit this subject and take stock of the historical and current landscapes.

The Good, the Bad, and the Ugly (the Early Years)

The starting point is (or should be) *Balla v. Gambro*.[3] In that case, the general counsel (Roger Balla) of Gambro, Inc., an Illinois-based company that was the subsidiary of a Swedish company, Gambro AB, learned that a German affiliate was about to ship dialyzers into the United States that did not comply with Food and Drug Administration (FDA) regulations. Believing that the machines posed possibly life threatening injuries (or worse), Balla went to Gambro's U.S. president and persuaded him to block the shipment. Subsequently, the president changed his mind and green-lighted the dangerous dialyzers. When Balla learned of that latter action he confronted the president, telling him Balla would do whatever was necessary to stop the shipment (as well as any sales) of the dialyzers. The president thereupon fired Balla; the next day, Balla ratted on his former company to the FDA.

A year later, Balla filed a retaliatory discharge claim against Gambro in Illinois state court, seeking $22 million. Both the trial court and the intermediate appellate court ruled that he had no valid cause of action. Before the Illinois Supreme Court, Balla argued that the court should sanction a cause of action because he had faced a "Hobson's Choice"—either report his client's wrongdoing (thereby saving lives, but being fired) or keep quiet (thereby letting people be maimed or killed, but keeping his job).

In 1991, the Illinois Supreme Court not only refused to sanction a cause of action, it rejected the "Hobson's Choice" argument. Rather than facing two unpalatable choices, the court observed that Balla, in fact, had no choice: under Rule l.6(b) of the Illinois Rules of Professional Conduct, attorneys were *required* to reveal confidential client information when a·client is about to commit an act that would result in death or serious bodily injury. The court further opined that Illinois public policy (i.e., keeping the public safe from deadly products) would be protected without creating a retaliatory discharge cause of action for lawyers, reasoning that when lawyers took and passed the Illinois bar exam they had willingly agreed to the requirement of ratting out clients in such circumstances.[4]

Many legal academics criticized the *Balla* decision, and shortly thereafter the California Supreme Court decided to take another approach in *General Dynamics v. Superior Court*.[5] There, the court determined that a whistle-blowing in-house lawyer could assert two different causes of action. The first was a contract action, assuming that a contract could be proven; the court reasoned that demonstrating a breach thereof would not lead to breaching professional obligations of client confidences (or, correspondingly, breaching the attorney-client privilege).

The court also qualifiedly endorsed a tort claim under two alternative scenarios: (i) where an attorney was fired for refusing to violate a mandatory ethical requirement; or (ii) when a non-attorney could also bring such a claim and the claim could be proven without violating the attorney-client privilege. While initially this seemed like a bold step, it was not. First, because California's ethic rules were diametrically opposed to Illinois's (in California, attorneys were ethically barred from disclosing client confidences). And second, because the attorney in *General Dynamics* could not prove a retaliatory discharge claim without violating the attorney-client privilege.[6]

A number of jurisdictions followed California's somewhat tepid toe-in-the-water approach,[7] but others wanted to go further. Perhaps emboldened by the 2003 changes to ABA Model Rule 1.6,[8] some courts allowed lawyers to bring these claims, while "making every effort practicable to avoid unnecessary disclosure" of client confidences, and imploring the trial courts to be imaginative in utilizing orders to minimize against "unnecessary disclosures."[9]

In *Willy v. Administrative Review Board*,[10] the U.S. Court of Appeals for the Fifth Circuit in 2005 went farther—a lot farther; not only did it recognize the validity of a retaliatory discharge claim, it also ruled that the in-house lawyer could affirmatively use—without limitation—attorney-client privileged materials/communications to prove his claim. The key to the court's ruling was a specific change by the American Bar Association to part of Model Rule 1.6. Previously, Rule 1.6(b)(5) had allowed for the revealing of client confidences only "to establish

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a defense on behalf of the lawyer." The Rule was subsequently changed to add the words "claim or" before "defense"—and that change, reasoned the Fifth Circuit, thereby allowed the lawyer in *Willy* to affirmatively breach the attorney-client privilege.[11]

The Good, the Bad, and the Ugly (the Later Years)

More recent decisions have continued to reflect different policy choices. Thus, for example, the state courts of Kentucky, Utah, New York, and Minnesota have all said "no" to retaliatory discharge claims by lawyers.[12] And it should be noted that these states, while following the outcome of *Balla*, do not have Illinois' idiosyncratic Rule 1.6; rather, they all have professional responsibility codes somewhat more in line with ABA Model Rule 1.6.[13]

On Oct. 25, 2013, the U.S. Court of Appeals for the Second Circuit affirmed the district court's 2011 dismissal of a False Claims Act qui tam action by Mark Bibi, a former general counsel of Unilab. Bibi, together with two other former Unilab executives, sued Unilab's new owner, Quest Diagnostics, on the ground that the company had engaged in a pervasive kickback scheme.[14] At the district court level, legal academic ethics experts proffered dramatically opposing opinions: Professor Andrew Perlman of Suffolk University Law School supported Bibi, testifying that Bibi was entitled to "spill his guts" because he believed Unilab's actions were criminal; Professor Stephen Gillers of New York University Law School opined that Bibi's disclosure violated his professional obligations to his former client. The district court sided with Gillers, and dismissed the case.

On appeal, the Second Circuit upheld the important ethical obligation that lawyers have in protecting client confidences (under New York's Rule 1.6), and the court refused to sanction the breaching of said confidences (especially to profit thereby).[15]

But before folks start thinking there is a recent trend in one direction, we have to factor in a decision rendered in December 2016 by a federal magistrate judge in California: *Wadler v. Bio-Rad Laboratories*. [16] In that case, Sanford Wadler, the former general counsel of Bio-Rad, sued his former employer after he was fired. Wadler claimed that the termination was in retaliation for his informing the board of directors of purported Foreign Corrupt Practices Act violations. On the eve of trial, Bio-Rad filed a motion in limine to exclude virtually all of Wadler's evidence on the ground that it was covered by the company's attorney-client privilege. Magistrate Judge Joseph Spero ruled against the motion, opining not only that Bio-Rad was untimely in seeking the requested relief, but also that (1) federal common law applied to privilege issues and, as such, Wadler was permitted under ABA Model Rule 1.6 to use privileged communications to establish his claim; and (2) the state of California's restrictive confidentiality obligations were preempted by the SEC's Sarbanes-Oxley rules and regulations governing attorney conduct.[17]

As for federal common law and its interaction with ABA Model Rule 1.6., the magistrate judge followed the lead of the Fifth Circuit in *Willy*.[18] And that ruling led to the admission at trial of a vast array of privileged communications before the jury. The result? An $11 million verdict in favor of the fired general counsel. The verdict is now on appeal.[19]

Unfortunately, there are more than a few problems with what the magistrate judge (and the Fifth Circuit in *Willy*) did: (1) the ABA Model Rules are merely aspirational rules and are not in effect *anywhere*—and, more important, they certainly do *not* constitute federal common law; (2) the change to Model Rule 1.6(b)(5) to add "claim or" has not been adopted by a great number of states (e.g., California -- the state which licensed Wadler; New York; etc.)[20]; and (3) both the *Bio-Rad* and *Willy* decisions equate the attorney-client privilege—an evidentiary concept rooted in law and a privilege owned by the client—with a lawyer's ethical obligation to maintain client confidences; the latter has *no* bearing on whether a lawyer can unilaterally breach the attorney-client privilege—and it is *extremely* unlikely that a former employer would waive the privilege to allow a former attorney to prosecute a lawsuit against her company.[21]

Where Do We Go Now?

Obviously, in light of the foregoing, if a lawyer is thinking about whistleblowing (for potential, personal profit), there are a number of possible options and outcomes—depending upon where a lawsuit could be brought *and* the state in which the lawyer is licensed. That said, for readers of this distinguished journal, most if not all of whom are New York–licensed lawyers, those options and outcomes are not viable ones. For not only is the relevant case law for New Yorkers anti-whistleblower,[22] New York (as noted above) has not adopted the "offensive" concept set forth in ABA Model Rule 1.6(b)(5).[23] Furthermore, New York's highest court three decades ago expressly held that a wrongful discharge tort claim did not exist in New York State for a lawyer; the court also ruled that, for one to be created, it would have to come from the state legislature.[24] Since that time (1992), our elected officials have not said "boo" on this subject.

Endnotes

1. *Taxi* (Warner Bros. 1932) (Loretta Young co-starred). Rats, in fact, are not per se dirty animals; they actually attend to their grooming. *See, e.g., Ratatouille* (Walt Disney/Pixar 2007) (Remy, a French rat, fulfills his dreams and becomes a great Parisian chef.). It is the environment in which rats dwell (in New York City, for example, the subways and the sewers) that infects them with dirt, bacteria, diseases, etc. Rats have even played important roles in American political history. Witness that, when confronted by his mentor's (Theodore Roosevelt)'s challenge to his re-election,

President William Howard Taft responded: "Even a rat in a corner will fight." New York Times (May 4, 1912).

2. *See*, *e.g.*, C.E. Stewart, *Whistleblower Law: What Rights do Ratting Lawyers Have?* New York Law Journal (March 14, 2014); E. Cohen, "Wrongful Discharge Claims by Former In-House Attorneys Gain Acceptance," *ABA/BNA Lawyers' Manual on Professional Conduct* 661 (Oct. 9, 2013); B. Temkin, *May Lawyers Collect Whistleblower Bounties Under Dodd-Frank Act?* New York Law Journal (Nov. 6, 2013); M. Roqoff, P. Ramer, D. Liben, *Ethics Rules Put the Brakes on Attorney Whistleblowers*, New York Law Journal (Dec. 17, 2013).
3. 584 N.E. 2d 104 (Ill. 1991).
4. *Accord Emery v. Northeast Illinois Regional Commuter Railroad Corp.*, No. 1-05-3584 (Ill. App. Ct. 1st Dist. Nov. 30, 2007); *Ausman v. Arthur Andersen LLP*, 348 Ill. App. 3d 781, 810 N.E. 2d 566 (1st Dist. 2004). The Illinois Supreme Court further opined in *Balla* that establishing such a cause of action would be contrary to the policies enunciated by the U.S. Supreme Court in *Upjohn v. United States*, 449 U.S. 383 (1981) (which ruled that the corporate attorney-client privilege applied to all employees, in order to ensure employee cooperation with lawyers, thus resulting in greater law compliance). Illinois subsequently changed its Rule 1.6(b) and brought it more into line with the ABA Model Rule. *See infra* note 8. Whether that change (which includes "claim or"—*see infra* note 11 and accompanying text) would now permit Illinois attorneys to bring these types of claims remains (to this author) unknown.
5. 7 Cal. 4th 1164, 32 Cal. Rptr. 2d 1, 876 P.2d 487 (1994).
6. Subsequent California decisions limit in-house lawyers suing former employers to revealing client information *only* to their own lawyers. *See*, *e.g.*, *Fox Searchlight Pictures Inc. v. Paladino*, 89 Cal. App. 4th 294, 106 Cal. Rptr. 906 (Cal. Ct. App. 2001).
7. *See GTE Prods. Corp. v. Stewart*, 653 N.E.2d 161 (Mass. 1995).
8. In 2003, the ABA adopted this version of Model Rule 1.6:

   Rule 1.6 Confidentiality of Information

   (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

   (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

   1. to prevent reasonably certain death or substantial bodily harm;
   2. to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
   3. to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
   4. to secure legal advice about the lawyer's compliance with these Rules;
   5. to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
   6. to comply with other law or a court order.
9. *See*, *e.g.*, *Crews v. Buckman Labs*, 78 S.W.3d 852 (Tenn. 2002); *Spratley v. State Farm*, 78 P.3d 603 (Utah 2003); *Seidle v. Putnam Invest.*, 147 F.3d 7 (1st Cir. 1998); *Kachman v. Sunguard Data Sys.*, 109 F.3d 173 (3d Cir. 1997).
10. 423 F.3d 485 (5th Cir. 2005).
11. *See supra* note 8. Other courts citing the "offensive" language in Model Rule 1.6 as persuasive have included *Heckman v. Zurich Holding Co. of America*, 242 F.R.D. 606 (D. Kan. 2007); *Hoffman v. Baltimore Police Dep't*, 379 F. Supp. 2d 778 (D. Md. 2005); *Alexander v. Tandem Staffing Solutions*, 881 So.2d 607 (Fla. Dist. Ct. App. 2004).
12. *See Greissman v. Rawlings and Associates*, No 2016-CA-000055 (Kty. Ct. Appls. Aug. 18, 2017); *Pang v. Int'l Documents Servs.* 2015 WL 4724812 (Utah Sup. Ct. 2015); *State ex rel. Danon v. Vanguard Corp., Inc.*, 2015 NY Slip Op 32213 (Sup. Ct. N.Y. Co. Nov. 13, 2015); *Kidwell v. Sybaritic Inc.*, 784 N.W.2d 221 (Minn. 2010).
13. *See supra* note 8; but without the "claim or" language of the Model Rule.
14. *United States ex rel. Fair Lab. Practices Assocs. v. Quest Diagnostics*, 734 F.3d 154 (2d Cir. 2013), *aff'm*, 2011 U.S. District LEXIS 27014 (S.D.N.Y. April 15, 2011).
15. The New York state court judge in *Danon* (*see supra* note 12) was clearly influenced by the *Quest Diagnostics* decision. The lawyer (David Danon) subsequently filed a claim in federal court in the Eastern District of Pennsylvania, asserting whistleblower claims under Sarbanes Oxley, Dodd-Frank, and the Pennsylvania Whistleblower Law. Although the claims were dismissed by the district court, the Third Circuit revived them in 2017. As of the date of this article, the outcome of this litigation is not known.
16. 2016 WL 7369246 (Dec. 20, 2016).
17. The correctness of this second ruling has previously been addressed by me in *The Fork in the Road: The SEC and Preemption*, New York Law Journal (May 10, 2017).
18. *See supra* notes 10 & 11.
19. *See Bio-Rad Wants Verdict Reduced in Fired GC Case*, New York Law Journal (March 8, 2018).
20. Thus, in states that have adopted the "offensive" use language in Rule 1.6(b)(5), courts citing (and applying) that state provision are at least on somewhat sounder ground allowing wrongful discharge claims to proceed. *See*, *e.g.*, *Van Asdale v. International Game, The*, 498 F. Supp. 2d 1321 (D. Nev. 2007); *Hoffman v. Baltimore Police Dep't*, 379 F. Supp. 2d 778 (D. Md. 2005). That said, however, that does not cure the third problem enumerated above. *See infra* note 21 and accompanying text. Moreover, in jurisdictions that have *not* added the "offensive" language to Rule 1.6(b)(5), the bar authorities have been clear in *not* permitting breaches of client communications. *See*, *e.g.*, Nebraska State Bar Op. 12-11; D.C. Bar Opinion 363 (October 2012). *Accord* D.C. Ct. App. Bd. on Prof. Resp. No. 14-BD-061 (August 30, 2017).
21. While courts routinely miss the important distinction between an attorney's ethical duty of confidentiality and the attorney-client privilege (the latter of which is grounded in the law of evidence, and is owned by the client), thankfully at least one court has not. *See Nesselrotte v. Allegheny Energy, Inc.*, 2008 U.S. Dist. LEXIS 55730, at **36-39 (W.D. Pa. July 22, 2008) (rules of Professional Conduct "do not constitute substantive law" and do not trump the attorney-client privilege).
22. *See supra* notes 12-15 and accompanying text; *see also infra* note 24.
23. *See supra* notes 20, 11 & 8.
24. *See Weider v. Skala*, 593 N.Y.S. 2d 752 (1992); *accord Joffe v. King & Spalding LLP*, No. 17-cv-3392 (VEC), 2018 BL 204273 (S.D.N.Y. June 8, 2018); *see also Wise v. Consolidated Edison Co. of N.Y., Inc.*, 723 N.Y.S. 2d 462 (1st Dept. 2000) (attorney wrongful discharge claims "do not fall within the exception permitting an attorney to disclose confidences or secrets necessary to defend 'against an accusation of wrongful conduct'").

The Attorney-Client Privilege and Communications Between Company Employees and Their In-House Counsel

By Michael J. Hutter

The venerable attorney-client privilege in New York protects any confidential communication between an attorney and a client that is made for the purpose of obtaining or providing legal advice against disclosure to third-parties, subject to certain exceptions. This is true whether the privilege applicable to the communication is New York's privilege as codified in CPLR 4503(a) and applied in New York state courts; or in New York federal courts in diversity jurisdiction actions as required by Federal Rule of Evidence 501; or the federal common law privilege applicable in New York federal courts in federal question actions.[1] Indisputably, corporations, as other clients, are entitled to the benefits of the privilege.[2]

Equally indisputable is that communications between in-house counsel and the corporate client may fall within the privilege. To be sure, not all such communications are protectible under the privilege. Only those corporate communications which involve counsel primarily acting primarily as a legal advisor, and not acting as a business advisor rendering only business advice with incidental legal advice, fall within the privilege.[3]

Whether a communication between or involving an employee of a corporation, officer or non-corporate officer, and the corporation's in-house counsel is protectible is not always easy to determine.

Whether a communication between or involving an employee of a corporation, officer or non-corporate officer, and the corporation's in-house counsel is protectible is not always easy to determine. The reason is that while in-house counsel has the role of legal advisor for the corporation, in-house counsel may also have other roles within the corporation, non-legal roles such as providing business advice. In this context, the dichotomy between law and business advice can become blurred, resulting in uncertainty as to whether a communication is in fact protectible. This uncertainty creates issues in discovery as to whether such a communication needs to be disclosed or can be withheld on the basis of privilege. The uncertainty can also extend to communications that may occur between in-house counsel and corporate employees as to whether they will be privilege protected.

Helpful guidance for determining whether these corporate communications may be protected by the attorney-client privilege was recently provided in *SodexoMAGIC, LLC v. Drexel University*, 291 F.Supp.3d 681 (ED Pa. 2018). In *SodexoMAGIC*, a discovery dispute arose as to whether 50 emails of the parties, communications between a party's employee and the party's in-house counsel, were properly withheld from disclosure on the basis of the attorney-client privilege. The dispute involved whether the communications related to the providing of legal advice or business advice. In the course of resolving the parties' dispute, District Court Judge Michael M. Baylson set forth four basic rules, essentially "ground rules," that governed the issue, accompanied by 13 hypothetical email examples, essentially "guidelines," as to the applicability/non-applicability of the privilege.

These ground rules and hypotheticals are helpful in determining whether a communication is privileged, and in providing guidance to minimize that a communication that needs to be made and which contains business and legal advice will in the future need to be disclosed. While the *SodexoMAGIC* decision applies Pennsylvania law, the decision is worthwhile reading for New York attorneys. The reason is that analysis of Pennsylvania law governing its attorney-client privilege is comparable to New York's.

Ground Rules

The initial ground rule set forth is that a communication with an attorney or a subordinate of an attorney, such as a paralegal, is protected under the privilege, provided the communication is made with the primary purpose of securing legal and not business advice, *Sodexo MAGIC*, 2011 F. Supp. 3d at 684. New York law is to the same effect.[4]

The second ground rule is that a communication with an attorney or subordinate acting in a "scrivener like" capacity is not privileged. *SodexoMAGIC*, 291 F.3d at 684,

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686. An example is where there is an exchange of draft agreements and an attorney or subordinate merely inserts revisions requested by the client without any accompanying rationale. The New York courts are likely to reach the same conclusion.[5]

The third ground rule is that where the communication is about a specific fact, or the substance of a draft agreement or proposed addition, and legal advice is requested or rendered about that matter, the communication is privileged. *Sodexo MAGIC*, 291 F.Supp.3d at 684-685. New York law would reach the same conclusion.[6]

The fourth ground rule is that the party asserting the privilege has the burden of establishing that the privilege applies to the communication in issue, namely that the communication related primarily to the providing of legal advice. *SodexoMAGIC*, 291 F.Supp.3d at 685. New York follows this burden rule.[7]

Second

4. VP emails to Corporation A's Sales Manager: "President has instructed us to proceed to negotiate a contract for food services with College X. Get to this ASAP."

5. Sales Manager emails to VP: "I've just met with Manager of College X and we have a handshake deal. How much detail do we need in the written contract?"

6. VP emails to President: "Sales Manager reached a great deal for us. Let's keep the written contract simple and direct to close the deal ASAP."

Judge Baylson concluded e-mails 4, 5, and 6 are not privileged as no legal advice was requested or provided. *Sodexo MAGIC*, 291 F.Supp.3d at 685.

> *"The party asserting the privilege has the burden of establishing that the privilege applies to the communication in issue, namely that the communication related primarily to the providing of legal advice."*

Guidelines

Judge Baylson set forth 13 hypothetical e-mail communications that raised the issue as to whether the communications were protected by the privilege. Starting with easy ones and progressing to ones where the answer may not be so clear, he used the hypotheticals and the answers thereto as a basis for resolving not only the specific issue before him but also for use in resolving future disputes. The hypotheticals may be grouped and discussed as follows.

First

1. President of Food Service Corporation A sends email to General Counsel: "What are the requirements of a binding contract for food service contract with College X?"

2. General Counsel emails the President with a list of the requirements for such a contract.

3. President emails to Corporation A's VP, who as part of her job is engaged in negotiations with College X: "Our General Counsel has advised me that in order to form a binding contract with College X, we need to agree on requirements 1, 2, and 3."

Judge Baylson concluded emails 1, 2, and 3 are privileged documents as they were clearly made or related to legal and not business advice. *SodexoMAGIC*, 291 F.Supp.3d at 685.

Third

7. President emails to General Counsel: "Draft this contract as quickly as possible. Draft a contract including 1, 2, 3 and also 4, 5 and 6."

8. General Counsel emails to in-house Paralegal: "The President wants a contract with 1 through 6. Please take language from our prior contract with College Z to get the process started."

9. VP emails to Paralegal: "I heard you are working on our contract with College X. Please write these exact words into provision 6: 'It is hereby agreed that the amount is $400.'"

Judge Baylson concluded that emails 7 and 8 were privileged since both involved legal advice. Specifically, as to email 7, the President is asking for legal services from the General Counsel and in e-mail 8 the General Counsel was communicating with a subordinate to start the drafting of a contract, which is providing the legal services. *Id*. at 686-687. However, email 9 is not privileged as the paralegal is not involved with providing legal services, but working merely as a "scrivener" making changes requested by the VP. *Id*. at 686.

Fourth

10. General Counsel emails to VP: "Here is my proposed contract attached to this e-mail. Show this to College X, but tell them it is non-negotiable."

11. VP emails to College X: "Here is our proposed contract. Our General Counsel says since we are giv-

ing you such a good deal, we must insist on these terms as written. Please send it back with your signature."

12. Emails by non-lawyers within each party, and between Corporation A and College X, following execution of the contract, disputing its interpretation, and at times indicating they rely on their counsel's advice.

13. As a result of a dispute on contract interpretation between the parties, VP discusses this with President and then contracts General Counsel about her interpretation of the contract and General Counsel responds. VP forwards this email to College X.

Judge Baylson concluded emails 10 and 13 are privileged. The former is privileged as it was made in furtherance of legal services, and the latter was privileged for the same reason, until it was disclosed. *Id*. at 686. However, email 11 is not privileged as the communication has lost its confidentiality since the communication was disclosed. *Id*. at 686. Email 12 is also not privileged since "even if the representatives rely on their in-house counsel's prior privileged advice, unless the counsel's interpretation is repeated in essentially verbatim language in the email... only the content of the communication with counsel is privileged and may be redacted. The rest of the document must be produced." *Id*. at 686.

Using the ground rules and conclusions reached under his 13 hypotheticals, Judge Baylson then resolved the parties' privilege disputes. *Sodexo MAGIC*, 291 F. Supp. 3d at 686.

Takeaways

SodexoMAGIC provides helpful guidelines for privilege analysis as to communications involving in-house counsel, counsel's support staff and the corporation's executives. Use of these guidelines can help the attorney to better determine whether a communication is in fact privileged, or will be protected by the privilege. This is especially so since Judge Baylson's conclusions for each of the 13 hypotheticals are consistent with New York law.[8]

Endnotes

1. *See generally* Barker & Alexander, Evidence in New York State and Federal Courts (2d ed) §§ 5:8, 5:11.
2. *Rossi v. Blue Cross & Blue Shield of Greater N.Y.*, 73 N.Y.2d 588, 591-592 (1989).
3. *Id*.
4. *See* Martin, Capra & Rossi, New York Evidence Handbook (2d ed) § 5.22 at pp. 315-366.
5. *Id*. at § 5.2.4.
6. *Id*.
7. *Priest v. Hennessy*, 51 N.Y.2d 62, 69 (1980).
8. *See generally* Barker, *supra* note 1, §§ 5:6 collecting cases); Martin, *supra* note 4, § 5.2.4 (collecting cases).

Inside the Courts

An Update From Skadden Securities Litigators

Extraterritoriality

Northern District of California Denies Cryptocurrency Foundation's Motion to Dismiss, Holding Foundation Is Subject to SEC Jurisdiction

***In re Tezos Sec. Litig.*, No. 17-cv-06779 (N.D. Cal. Aug. 7, 2018)**

Judge Richard Seeborg denied defendant Tezos' motion to dismiss, holding that the company's cryptocurrency—also called Tezos—is a security subject to the jurisdiction of the SEC.

The plaintiff investors argued that cryptocurrency distributed in connection with the defendant's initial coin offering (ICO) was subject to SEC rules and regulations for the sale of unregistered securities because the critical aspects of the sale occurred in the United States. The defendant argued that the ICO occurred outside the United States because it was administered by the Swiss-based Tezos Foundation, the transactions took place in the U.K. where the software was based, and the terms of the sale governing the ICO contained a forum selection clause that designated Switzerland as the exclusive forum for disputes.

The court held that the Tezos ICO fell within the SEC's jurisdiction. The court reasoned that, in determining whether the sale of "an unregistered security, purchased on the internet, and 'recorded on the blockchain'" is a domestic transaction subject to the application of U.S. law and thus the SEC's jurisdiction, the "critical aspects of the sale" must occur in the United States. Here, the court found that because the transaction was hosted on an Arizona-based server, run by a California resident, and ICO investors had likely learned about it from "marketing that almost exclusively targeted [U.S.] residents," the critical aspects of the sale occurred in the United States, and thus the sale was subject to the jurisdiction of the SEC.

Fiduciary Duties

Aiding and Abetting Breaches of Fiduciary Duty

Court of Chancery Dismisses Aiding-and-Abetting Claims Post-Trial

***In re PLX Tech. Inc. Stockholders Litig.*, Consol. C.A. No. 9880-VCL (Del. Ch. Oct. 16, 2018)**

Post-trial, the court entered judgment in favor of a defendant alleged to have aided and abetted breaches of fiduciary duty, holding that although the plaintiffs prevailed on their claims, they failed to prove damages.

The action arose from Avago Technologies' acquisition of PLX Technology following an activist campaign. Prior to the acquisition, Potomac Capital, a 9.4 percent stockholder, replaced three of PLX's directors with its co-managing member, Eric Singer, and two other nominees. Soon thereafter, PLX's financial advisor notified Singer that Avago wanted to acquire PLX at $6.53 per share. Singer did not share that information with the rest of the board. A few months later, a representative of Avago met with Singer and proposed to acquire PLX for $6.25 per share. Nine days later, PLX agreed in principle to a deal at $6.50 per share.

Stockholders filed suit against the members of PLX's board of directors for breaches of fiduciary duty, and against Potomac, Avago and PLX's financial advisor for aiding and abetting breaches of fiduciary duty. Prior to trial, all of the defendants other than Potomac were either dismissed from the case or settled the claims against them.

The Court of Chancery held that the plaintiff prevailed on each element of its aiding-and-abetting claim against Potomac but failed to prove damages. The court noted that enhanced scrutiny would apply to a sale of the company for cash unless, under the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), the merger was approved by a fully informed, uncoerced stockholder tender. After finding that the PLX board committed several disclosure violations, the court concluded the standard of review would be enhanced scrutiny under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). The court noted that although the "narrow, pre-signing canvass with a post-signing market check" suggested that the process fell within a range of reasonableness, it concluded that the sale process was plagued by "divergent interests," and that Potomac "succeeded in influencing the directors to favor a sale when they otherwise would have decided to remain independent." However, with respect to damages, the court determined that the sale price exceeded PLX's fair value on a stand-alone basis, even though the process was "flawed from a fiduciary standpoint."

Controling Stockholder Litigation

Delaware Supreme Court Affirms Court of Chancery's Dismissal Under *MFW*

***Flood v. Synutra Int'l, Inc.*, No. 101, 2018 (Del. Oct. 9, 2018)**

The Delaware Supreme Court affirmed the Court of Chancery's dismissal of breach of fiduciary duty claims and related aiding-and-abetting claims under *Kahn v. M&F Worldwide Corp.* (*MFW*), 88 A.3d 635 (Del. 2014), clarifying the circumstances under which the business judgment rule may apply to controlling stockholder transactions.

The action arose from a squeeze-out merger whereby Synutra International was acquired by its controlling stockholder group. The control group's initial nonbinding proposal did not condition a potential transaction on *MFW*'s dual protections of both approval by a special committee of independent directors and a majority of the company's disinterested stockholders. The control group did, however, send a follow-up letter two weeks after its initial proposal expressly conditioning the transaction on such approval. The plaintiff, a stockholder of Synutra, filed a lawsuit challenging the merger, arguing that it did not comply with the standard set forth in the *MFW* decision, which lessens the standard of review for evaluating mergers involving a controlling stockholder from entire fairness to business judgment review when the merger is conditioned "*ab initio*" on the dual protections.

In the case below, the Court of Chancery held that, despite the two-week delay in conditioning the deal on *MFW*'s dual protections, the control group ultimately complied with *MFW*. Accordingly, the court dismissed the complaint.

The Delaware Supreme Court agreed with the Court of Chancery and clarified *MFW*'s *ab initio* requirement. The court stated that a controller satisfies the requirement when it "condition[s] the buyout on both [procedural protections] at the beginning stages of the process of considering a going private proposal and before any negotiations commence between the Special Committee and the controller over the economic terms of the offer." The court also expressly overruled *dicta* in *MFW* observing that the plaintiff's "allegations about the sufficiency of the price call[ed] into question the adequacy of the Special Committee's negotiations." The court explained that "a plaintiff can plead a duty of care violation only by showing that the Special Committee acted with gross negligence, not by questioning the sufficiency of the price," and that a "price question is not one for a court applying the business judgment rule standard" but rather for the stockholders to vote on themselves.

Mergers and Acquisitions Litigation

Court of Chancery Authorizes Termination of Merger Agreement Due to Material Adverse Effect

***Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018)**

In a 246-page post-trial decision, Vice Chancellor J. Travis Laster denied a seller's request for an order directing a buyer to specifically perform its contractual obligations to close a merger, finding that the buyer validly terminated the merger agreement because, among other things, it appropriately relied on the fact that the buyer had suffered a material adverse effect (MAE), as defined in the merger agreement.

The litigation arose from Fresenius Kabi AG's contemplated acquisition of Akorn, Inc. pursuant to an April 2017 merger agreement. In the second quarter of 2017, Akorn's business performance "fell off a cliff" and continued to deteriorate. Later in 2017, Fresenius conducted an investigation that revealed Akorn had "serious and pervasive data integrity problems," including submitting falsified product data to the Food and Drug Administration (FDA). Fresenius provided Akorn with a notice of termination of the merger agreement on the grounds that Akorn (i) breached regulatory representations and warranties that could reasonably be expected to have an MAE (the Bring-Down Condition); (ii) materially breached a covenant that it complied with or performed in all material respects its obligations (the Covenant Compliance Condition), including to operate in the ordinary course of business (the Ordinary Course Covenant); and (iii) had suffered an MAE. In response, Akorn sued for specific performance, asserting that Fresenius breached the Covenant Compliance Condition by failing to use its reasonable best efforts to consummate the merger (the Reasonable Best Efforts Covenant) and take all actions necessary to obtain antitrust approval (the Hell-or-High-Water Covenant).

First, the court found that Akorn breached the Bring-Down Condition, which required Akorn's representations, including representations regarding regulatory compliance, to have been true at signing and closing. At the time of signing, Akorn had "widespread regulatory violations and pervasive compliance problems" and these problems "got worse, rather than better," during the relevant time period. The court estimated that Akorn's data integrity issues constituted a regulatory MAE because the issues would result in a valuation hit of about $900 million, or a 21 percent decline in Akorn's implied value under the merger agreement.

Second, the court found that Akorn breached its duty to use "commercially reasonable efforts"—which the court treated as synonymous with "reasonable best efforts"—to carry on its business "in all material respects" in the ordinary course of business. The court found that Akorn's conduct—in canceling regularly scheduled audits in favor of verification audits that would not reveal additional deficiencies, failing to devote any resources to data integrity projects, submitting regulatory filings to the FDA based on fabricated data, and failing to investigate regulatory issues upon receiving whistleblower letters—constituted a material departure from reasonable best efforts to conduct the business in the ordinary course.

Third, the court found that Akorn suffered a MAE that "substantially threaten[ed its] overall earnings potential [] in a durationally-signficant manner." From Q2 2017 through Q1 2018, Akorn's year-over-year declines each quarter ranged from 25 percent to 34 percent for revenue, 84 percent to 292 percent for operating income and 96 percent to 300 percent for earnings per share. In contrast, over the five-year span of 2012 to 2016, Akorn grew consistently, year over year, when measured by the same metrics. Akorn's "dramatic downturn in performance is durationally significant" because it "persisted for a full year" and showed "no signs of abating."

By contrast, the court found that Fresenius did not breach the Reasonable Best Efforts Covenant because it "analyzed and remained committed to fulfilling its obligations under the Merger Agreement" even while it evaluated its rights, including termination rights. Fresenius did breach the Hell-or-High-Water Covenant because, for one week, it embarked on a path that would have pushed obtaining regulatory approval beyond the time frame established in the merger agreement. The court, however, found that Fresenius' breach was not material because, within one week of deviating, Fresenius reverted back to the path that would have kept obtaining regulatory approval within the merger agreement time frame.

The court therefore concluded that Fresenius had validly terminated the merger agreement. Akorn has since taken an appeal.

Misrepresentations

SDNY Rules That Companies Must Go to Trial Over Claims Brought by Group of Investment Funds

***Silvercreek Mgmt., Inc. v. Citigroup, Inc.*, No. 02-CV-8881-JPO (S.D.N.Y. Sep. 28, 2018)**

Judge J. Paul Oetken granted, in part, several financial institutions' motions for summary judgment on claims under Section 11 of the Securities Act. The claims originated from plaintiffs' October 2001 investment of approximately $100 million in two types of Enron securities, which became worthless after Enron's bankruptcy. As to the Section 11 claim, the financial institutions argued that the plaintiffs had failed to establish that they were underwriters for purposes of Section 11 liability. The court granted summary judgment as to one company because the offering at issue was a Rule 144A private placement, not a public offering, and the court held that Section 11 did not apply. Although the plaintiffs argued that the private offering was sufficiently related to a subsequent public offering of the same securities, the court held that Section 11 liability arises only where the public and private transactions are so intertwined that they appear as one to the investing public, and that the plaintiffs had failed to demonstrate the company's involvement in any public offering or even that a public offering had occurred.

As to the other company, however, the court found a materially disputed fact with respect to that company's participation in a public offering of the securities and therefore whether the company could be held to be an underwriter. The court noted that the public registration statement indicated that the company was a reseller of the notes and could be deemed to be an underwriter within the meaning of the Securities Act. The company also purportedly participated in preparing the registration statement and conducting due diligence. The court rejected the company's argument that it had only a minor role and purchased only a small amount of the securities at issue, holding that Section 11 permits liability for "*every* underwriter."

Proxy Solicitations

District of Nebraska Dismisses Shareholder Suit Regarding Allegedly Misleading Proxy Statement

***In re Nat'l Research Corp. S'holder Litig.*, No. 4:17-cv-441 (D. Neb. Oct. 9, 2018)**

Judge John M. Gerrard dismissed claims brought by a corporation's minority shareholders under Section 14(a) of the Securities Exchange Act, SEC Rule 14a-9 and Nebraska law against a corporation, its chairman and controlling shareholder, and the other members of its board of directors. The plaintiffs alleged that the board violated federal law by including false or misleading information in a proxy statement soliciting minority shareholder approval for a plan to repurchase and retire the corporation's Class B stock. Specifically, the plaintiffs alleged two theories. First, the proxy statement was misleading because it did not disclose management's cash flow projections. Second, the proxy statement was misleading because reimbursements to the controlling shareholder characterized as legal, advisory and financial modeling fees were in fact the controlling shareholder's personal expenses related to a prior failed iteration of the share repurchase plan.

Applying the heightened pleading requirements of the Private Securities Litigation Reform Act (PSLRA), the court dismissed the federal claim. As to the allegation regarding omission of cash flow projections in the proxy statement, the court noted that there was no strong inference of scienter because the plaintiffs failed to ascribe a motive, purpose or "plan in mind" for the omission. The court further observed that omission of the cash flow projections did not render any statement in the proxy statement untrue or misleading.

As to the allegation regarding the mischaracterization of the controlling shareholder's personal expenses related to the prior failed repurchase plan, the court noted that the amounts reimbursed to the controlling shareholder were in fact for legal, advisory and financial modeling fees. Any disagreement stemmed from the plaintiffs' view that the prior failed repurchase plan was for the personal benefit of the controlling shareholder. Even though the proxy statement did not disclose that the same lawyer advised both the controlling shareholder and the board of directors, the plaintiffs alleged this only to be a "potential conflict of interest" and not an actual conflict of interest that could render misleading the statement regarding reimbursement for legal fees.

SEC Enforcement Actions

Ninth Circuit Holds That General Partnership Interests Are Investment Contracts and Qualify as Securities Under Federal Law

***SEC v. Schooler*, No. 16-55167 (9th Cir. Sept. 26, 2018)**

The Ninth Circuit affirmed the district court's grant of summary judgment to the Securities and Exchange Commission (SEC), finding that unregistered, purported "partnership interests" sold by the defendant qualified as "investment contracts" and therefore constituted securities under federal law.

The defendant formed a general partnership to identify tracts of land to purchase, with the hope that the land would become developed and increase in value. The defendant sold interests in the partnership to investors. The SEC sued, claiming the partnership interests were unregistered securities and that the defendant had defrauded his investors.

In granting summary judgment to the SEC, the Ninth Circuit held that although the defendant marketed these real estate investments as partnership interests, they qualified as investment contracts under federal law because they were "investment[s] in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." Specifically, the Ninth Circuit found that the general partnership interests were "stripped of the hallmarks of a general partnership and marketed as passive investments." For example, unlike a typical real estate investment, general partners had no control over what land to purchase or how much to pay for it. Rather, the defendant "exercised near total control over the investments between receipt of investor payments and execution of the partnership agreements," and the partnership agreements were not effective upon delivery of investor funds, but rather, at an arbitrary date after "nearly all meaningful decisions were made that would determine the success or failure of the investment."

DC Circuit Vacates Decision, Remands Case Adjudicated by Unconstitutionally Appointed Administrative Law Judge

***Harding Advisory LLC v. SEC*, No. 17-1070, SEC-3-15574 (D.C. Cir. Sept. 19, 2018)**

A three-judge panel of the D.C. Circuit set aside an SEC decision and order, and remanded the case for a new hearing. The case involved claims against investment adviser Wing Chau and his company, Harding Advisory LLC (Harding). The administrative law judge (ALJ) assigned to adjudicate the case found that Chau and Harding violated Section 17(a) of the Securities Act and Section 206 of the Investment Advisers Act by committing fraud in connection with the management of certain collateralized debt obligations, and imposed penalties. On review, the commission upheld the ALJ's decision and imposed additional fines and disgorgement. Chau appealed to the D.C. Circuit. The Court of Appeals ordered a stay pending the U.S. Supreme Court's decision in *Lucia v. Securities and Exchange Commission*, 138 S. Ct. 2044 (2018), which challenged the appointment of the ALJ who adjudicated the case as constitutionally invalid.

On June 21, 2018, in its decision in *Lucia*, the Supreme Court held that ALJs are "Officers of the United States" and thus subject to the Appointments Clause of the U.S. Constitution. The Court further held that if a party makes a timely constitutional challenge to the appointment of the ALJ who adjudicates his or her case, the party is entitled to relief. In the case of an adjudication tainted by an Appointments Clause violation, the appropriate relief is a new hearing before a properly appointed official.

Following the decision in *Lucia*, the SEC moved to remand Chau's case to the commission for a new hearing. Chau opposed, arguing that under *Lucia*, the commission's order could not be affirmed or modified but rather must be set aside. Chau reasoned that the Supreme Court's mention in *Lucia* of "remand" as a remedy for an Appointments Clause violation was merely *dicta* that carried no weight.

The D.C. Circuit issued an order setting aside the commission's decision and remanding Chau's case to the SEC for a new hearing before a different ALJ or before the commission, in accordance with *Lucia*. The circuit court rejected Chau's argument that the case could not be remanded. Quoting language from its decision in *Sierra Club v. EPA*, 322 F.3d 718 (D.C. Cir. 2003), the court emphasized that "carefully considered language of the Supreme Court, even if technically dictum, generally must be treated as authoritative."

On November 30, 2017, while this case was pending, the SEC announced that it ratified the appointments of its ALJs in order to settle the question of whether the hiring process for those judges violates the Appointments Clause.

Securities Fraud Pleading Standards

Fifth Circuit Affirms Dismissal of Section 10(b) Claim, Holding That Challenged Statements Did Not Constitute Material Misrepresentations and Plaintiffs Did Not Plead Loss Causation

***Emps.' Ret. Sys. of the State of Haw. v. Whole Foods Mkt., Inc.*, No. 17-50840 (5th Cir. Oct. 3, 2018)**

On October 3, 2018, a three-judge panel dismissed a putative class action lawsuit against Whole Foods Market, Inc. and several of its officers. The suit alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act.

On June 24, 2015, the New York City Department of Consumer Affairs (DCA) released a report detailing violations of national weights-and-measures standards by Whole Foods. On June 29, 2015, Whole Foods CEOs

John Mackey and Walter Robb posted a video to the retailer's website, stating that the company had "made some mistakes" with regard to its pricing. When the company released its third-quarter financial data on July 29, 2015, it failed to meet its sales targets for the quarter, as the company experienced a slowdown in sales growth in the weeks between the DCA's report on June 24, 2015, and the end of the quarter on July 5, 2015.

The plaintiffs, who purchased Whole Foods stock between July 31, 2013, and July 29, 2015, alleged that three categories of statements made by Whole Foods during that period were false in light of the weights-and-measures violations: (i) assertions of competitive pricing; (ii) statements suggesting high standards for transparency, quality and corporate responsibility; and (iii) exaggerated financial results that fraudulently reported revenues earned as a result of the weights-and-measures violations. The plaintiffs alleged that these statements deceived stockholders into purchasing stock at artificially inflated prices.

"The court further held that statements regarding transparency, quality and corporate responsibility were 'the sort of puffery that a reasonable investor would not rely on,' rather than material misrepresentations."

The district court dismissed the case for failure to state a claim, holding that the complaint did not sufficiently identify a material false or misleading statement or adequately plead loss causation, and thus failed to meet the elements of a Section 10(b) cause of action.

The Fifth Circuit affirmed. It held that the plaintiffs failed to allege the competitive pricing statements were misleading because they had not compared the prices at the time in question with prior prices, nor had they alleged that the prices were unattractive to consumers. The court explained that even though the prices actually charged were higher than advertised, this did not yield the inevitable conclusion that the charged prices were uncompetitive. The court further held that statements regarding transparency, quality and corporate responsibility were "the sort of puffery that a reasonable investor would not rely on," rather than material misrepresentations.

With respect to the plaintiffs' allegation of exaggerated financials, the court held that the plaintiffs failed to plead the alleged fraud with particularity, as they did not plead, for each statement alleged to have been misleading, how much of its revenue Whole Foods allegedly overstated. The court further held that the plaintiffs failed to adequately plead loss causation with respect to the allegedly exaggerated financials. The plaintiffs alleged that their loss occurred when Whole Foods' stock price dropped about 10 percent on July 30, 2015, over a month after the weights-and-measures scandal was revealed. The court held that because the plaintiffs did not allege that any new information was revealed in the time period between the DCA findings and the price drop, they failed to identify a decline in stock price that shortly followed a corrective disclosure.

Falsity

Western District of Washington Dismisses Securities Fraud Class Action Arising From Consumer Investigation for Failure to Assert Particularized Facts

***In re Zillow Grp. Inc. Sec. Litig.*, No. C17-1387-JCC (W.D. Wash. Oct. 2, 2018)**

Judge John C. Coughenour dismissed a putative class action against Zillow Group that arose from a Consumer Financial Protection Bureau (CFPB) investigation into Zillow's co-marketing deal for agents and lenders, finding that the plaintiffs failed to allege falsity with particularity.

Zillow, an online real estate marketing site, offered real estate agents and mortgage lenders a co-marketing program that allowed lenders to contribute to a real estate agent's advertising costs in exchange for appearing on the agent's online listing and receiving some of the leads the agent received from visitors to the site. In April 2015, the CFPB began investigating Zillow's co-marketing program, and in February 2017, it notified Zillow that it was considering legal action for violations of the Real Estate Settlement Procedures Act (RESPA). In August 2017, investors sued, alleging that Zillow previously made misrepresentations regarding the investigation and that they purchased Zillow shares at an artificially inflated price.

The plaintiffs alleged that Zillow made false or misleading statements during an investor call that led investors to believe the co-marketing program was in compliance with RESPA, when Zillow knew it was not. The plaintiffs also claimed that Zillow should have disclosed the CFPB's investigation, and that its failure to do so also misled investors.

The court granted Zillow's motion to dismiss. The court determined that investors failed to allege particularized facts demonstrating that Zillow knew the co-marketing program violated RESPA. The court further found that Zillow was not required to disclose the CFPB investigation because its affirmative statements did not give the impression that Zillow was not under regulatory scrutiny. Therefore, Zillow had no duty to disclose it.

Scienter

Sixth Circuit Reverses Dismissal of Shareholder Suit Alleging Pharmaceutical Company Fraudulently Misled Investors

***Dougherty v. Esperion Therapeutics, Inc.*, No. 17-1701 (6th Cir. Sept. 27, 2018)**

The Sixth Circuit reversed a decision dismissing a putative class action brought against a pharmaceutical company by a group of its shareholders. The plaintiffs, who purchased stock in the company during the class period, alleged that the company misled investors by stating in a press release that the FDA would not require it to perform a costly test before approving a drug for market. When the company walked back its statements upon receipt of further information from the FDA, the company's stock price fell 48 percent. The plaintiffs brought suit as a result.

The plaintiffs alleged the company misled investors with false statements, violating Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. The district court held that the plaintiffs failed to adequately plead a strong inference of scienter because the company's statements were not reckless and, further, that the statements fell within the safe harbor provision of the PSLRA as forward-looking statements.

The Sixth Circuit disagreed. In analyzing the company's statements under the factors set forth in *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001), the court determined that the company's two alternative explanations for the discrepancy in its statements were no more plausible than the plaintiffs' position that the statements were knowingly or recklessly false. Furthermore, the court found that the statements were not forward-looking, but rather, were mixed statements of present fact and future prediction and, as such, fell outside the PSLRA's safe harbor. Accordingly, the Sixth Circuit reversed the district court's dismissal and remanded.

SDNY Dismisses Putative Class Claims Brought by Investors in Multinational Gold Mining Company

***In re Barrick Gold Corp. Sec. Litig.*, 17-cv-3507-NRB (S.D.N.Y. Sep. 20, 2018)**

Judge Naomi Reice Buchwald dismissed putative class claims against a multinational gold mining company brought under Section 10(b) of the Securities Exchange Act. The plaintiffs alleged that, following several incidents in 2016 and early 2017 where one of the company's major mines located in Argentina had chemical spills resulting in certain regulatory measures being imposed by local authorities, the company made false and misleading statements that mischaracterized the impact that those incidents would have on the mine's operations. The plaintiffs alleged that the company had misrepresented that it had taken certain remedial steps and that the mine's output and operating costs for 2017 would not be materially affected by the incidents. The plaintiffs alleged that the truth was revealed when the company later announced quarterly operating results showing forecasted reduced output and increased costs for the mine as a result of local regulatory restrictions.

The court determined that the company's statement about remediation was not adequately alleged to be false because the plaintiffs did not plead that the defendants had not undertaken the remedial steps described in their public statements (for example, implementing aerial surveillance of the mine). The court further determined that the plaintiffs failed to adequately plead a strong inference of scienter. Although some of the company's executives had access to information that might have rendered their statements knowingly misleading, the "individually insufficient allegations do not combine to create an inference of scienter sufficient to satisfy the PSLRA." The court also determined that the company's statements were not actionable because they were protected by the PSLRA's safe harbor for forward-looking statements. The statements concerned the mine's expected future economic performance for 2017 and were accompanied by meaningful cautionary language.

SLUSA Preclusion

Ninth Circuit Holds Breach of Fiduciary Duty Claims Precluded by SLUSA

***Northstar Fin. Advisors v. Schwab Invs.*, No. 16-15303 (9th Cir. Sept. 14, 2018)**

The Ninth Circuit dismissed a putative class action asserting a breach of fiduciary duty claim, finding that it was a covered class action precluded by the Securities Litigation Uniform Standards Act (SLUSA).

The plaintiffs alleged that the defendant breached its fiduciary duty to shareholders by mismanaging an index fund. Specifically, the plaintiffs alleged that the fund's 1997 proxy statement representing that the fund would be managed conservatively was a contract that defendant breached by concentrating more than 25 percent of the fund's assets in mortgage-backed securities and collateralized mortgage obligations from 2007 to 2009.

SLUSA bars class actions based on state law claims alleging a misrepresentation or omission in connection with the purchase or sale of covered securities. Here, the Ninth Circuit affirmed dismissal of the plaintiffs' claims, holding that they were barred by SLUSA because the plaintiffs' purported contract claim based on a breach of promises made in the proxy statement was actually a disguised securities fraud claim. The panel reasoned that the plaintiffs expressly pleaded an omission—that investors were not told about the deviation from the conservative investment policy stated in the proxy agreement. Therefore, the plaintiffs "did not simply plead a garden-variety breach of contract claim," but rather, a misrepresentation or omission barred by SLUSA.

Ten Reasons to Prefer Tax Partnerships Over S-Corporations

By Bradley T. Borden

Introduction

With the enactment of the Tax Cuts and Jobs Act of 2017, business owners and their advisors may pause to reconsider the entities they prefer to operate businesses and own property. Often, they will be choosing between tax partnerships (i.e., most LLCs and partnerships) and S-Corporations, so a review of some of the similarities and differences between those two types of tax entities is in order. Tax partnerships are not subject to an entity-level tax. Instead, income and expense items flow through to members of tax partnerships and the members individually report and pay tax on that income. Similarly, subchapter S of the Internal Revenue Code allows income and expense items to flow through to the shareholders of a small business corporation ("S-Corporation"), so many taxpayers and some practitioners believe S-Corporations are a preferred entity for various types of businesses. In truth, the rules affecting stock ownership and the type of stock that S-Corporations may issue often make S-Corporations a cumbersome and difficult form of business entity to use. Also, Subchapter S's failure to adopt an aggregate theory of taxation makes S-Corporations less desirable than tax partnerships in many situations. While in limited situations an S-Corporation may be a desirable form of entity, the reasons against using an S-Corporation often outweigh the reasons for using S-Corporations as a business entity. The ten reasons for preferring tax partnerships over S-Corporations are based on a comparison of federal income tax treatment of S-Corporations and the more favorable federal income tax treatment available to tax partnerships.

S-Corporations appear to be popular for their ease of creation and income pass-through feature. When choosing between a C-Corporation and an S-Corporation, most taxpayers would choose an S-Corporation because with an S-Corporation, income and expense items flow through to the shareholders instead of being subject to double taxation under Subchapter C. The problem, however, is that in enacting Subchapter S to allow for flow-through taxation of income and expense items, Congress did not fully adopt an aggregate theory for S-Corporations. Thus, S-Corporations provide some but not all of the benefits that are available under Subchapter K. Failure to consider the other issues that arise from selecting an S-Corporation over a tax partnership can result in some very significant tax problems for the shareholders of an S-Corporation.

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Reason 1: Shareholders of S-Corporations Must Be Individuals

In some circumstances, parties who are starting a business will know immediately that an S-Corporation is not a formation option because for whatever reason it is required or desired that an entity own equity in the business. Often, however, one or more individuals starting a business opt for an S-Corporation structure without considering that this form significantly limits flexibility with respect to future ownership. *See* Section 1361(b)(1)(B) (there are exceptions for estates and certain types of trusts).

Example. Assume a client has a successful business operating as a limited partnership with multiple owners ("Client"). Client had a competitor in another market that was an S-Corporation owned in equal shares by two individuals ("Target"). One of the two individuals was ready to retire and the parties agreed to terms whereby Client would buy out the retiring individual and Target would be owned in equal shares by Client and the remaining individual. The problem, of course, is that because of the S-Corporation restrictions, Client is not allowed to become a shareholder of Target. A practitioner may address this problem by having Target and Client form a new LLC ("Newco") owned in equal shares by Target and Client. Target may contribute all of its operating assets (valued at $300,000) to Newco, and Client may contribute $150,000 cash to Newco. Newco may then specially allocate to Target cash-flow in the amount of $150,000 to compensate Target for its disproportionate capital contribution. Target may use this cash to redeem the shares of the retiring owner. This example illustrates the unfortunate obstacles that choosing an S-Corporation presents. These obstacles would not have existed if Target had not been formed as an S-Corporation.

Reason 2: Shareholders of S-Corporations Must Be Residents or Citizens of the United States

As with Reason 1, this restriction may not seem like a burden when one forms an S-Corporation for two resident individuals. The problem will arise later when the company has a wonderful opportunity to expand with the investment of a new best friend who happens to be a foreign resident. *See* Section 1361(b)(1)(C).

Reason 3: S-Corporations May Not Have More Than 100 Shareholders

The limitation on the number of shareholders would pose burdensome restructuring issues for a company considering an I.P.O. or other broad-based equity strategies. *See* Section 1361(b)(1)(A).

Reason 4: S-Corporations May Not Have More Than One Class of Stock

This restriction can create a real burden. It often becomes desirable to treat the owners differently from one another with respect to voting rights, economic rights (*e.g.*, providing for a preferred return), or buy/sell rights (*e.g.*, treating owners differently upon retirement, termination, death, disability, etc.). Partnerships and LLCs afford great flexibility in this regard. *See* Section 1361(b)(1)(D).

Example. If an S-Corporation makes a disproportionate distribution, such disproportionate distribution may be deemed a preference, which would violate the restriction that an S-Corporation may not have more than one class of stock.

Reason 5: S-Corporations Must Pay Participating Shareholders Reasonable Compensation

S-Corporations must pay reasonable compensation to their shareholders. *See David E. Watson, P.C. v. United States*, 757 F. Supp. 2d 877 (S.D. Iowa 2010). Reasonable compensation does not come within the definition of qualified business income (QBI), and the 20 percent QBI deduction does not apply to such income. *See* Section 199A(b)(4)(A). Similarly, guaranteed payments and payments to partners acting in a non-partner capacity do not come within the definition of QBI, so the QBI deduction does not apply to such income. *See* Section 199A(b)(4)(C), (D). Payments to partners cannot be compensation, because partners cannot be employees of tax partnerships. *See* Rev. Rul. 69-184, 169-1 C.B. 256. Furthermore, allocations to partners are not excluded from the definition of QBI. Thus, allocations of income and payments of those allocated amounts to partners can come within the definition of QBI, if they are neither guaranteed payments or payments to a partner in a non-partner capacity. The different treatment of compensation and QBI income may make the tax partnership a more attractive entity.

In some situations, business owners may prefer compensation from an S-Corporation over allocations from a tax partnership. The QBI deduction cannot exceed 50 percent of wages the QBI pays or 25 percent of wages plus 2.5 percent of the unadjusted basis of the QBI's assets. *See* Section 199A(b)(2)(B). If a business pays wages to third parties that are sufficient to ensure that the wage limit does not apply to the QBI deduction, then business owners are most likely better served running the business through a tax partnership than through an S-Corporation. If the business does not pay wages to third parties the wage limit may prohibit the business from qualifying for the QBI deduction. Such a business may benefit from forming as an S-Corporation and paying reasonable compensation to the shareholders. Payment of compensation to the shareholders should enable the business owners to take the QBI deduction with respect to the portion of income that is not compensation. The business owners would have to run an analysis to determine whether the S-Corporation or tax partnership will provide the best tax result.

The QBI deduction is only available for a qualified trade or business (QTB). *See* I.R.C. § 199A(a)(1)(A), (b)(1)(A). The definition of QTB includes most businesses, but it excludes specified service trades and businesses (SSTB), which include law, accounting, and financial services businesses, among others, with income that exceeds a threshold amount. *See* I.R.C. § 199A(d).

Reason 6: S-Corporations Cannot Make Special Allocations

Section 704(b) provides that partners may agree to specially allocate items of income, gain, loss, deduction, or credit to particular partners, so long as the allocation has substantial economic effect. Subchapter S does not provide a similar opportunity to specially allocate items of income, gain, loss, deduction, or credit to its shareholders. Thus, all such items of an S-Corporation must be allocated to the various shareholders according to their interests in the corporation. *See* Section 1366(a)(1).

Reason 7: Contributions to S-Corporations May Be Taxable

Section 1371(a) provides that unless a specific exception in the Internal Revenue Code exists, Subchapter C shall apply to S-Corporations. This rule has the potential to create many unfavorable tax consequences that can be avoided in the tax-partnership context. Subchapter S does not provide specific rules for the contribution of property or services to an S-Corporation. Therefore, the rules of Subchapter C must be applied to such transactions. As shown below, this can produce negative tax results to the shareholders of an S-Corporation.

1. Property and Service Contributions

If two individuals intend to form an S-Corporation by one individual contributing property and the other individual contributing services, the formation of that entity may create taxable income to both individuals. Alternatively, if the individuals choose to form an entity taxed as a partnership for federal income tax purposes, it is possible to form such tax partnership without triggering taxable income to either individual on formation of the tax partnership. Consider the following example:

Example. Randi and Jodi, unrelated parties, form Blue Corp., an entity that will be taxed as an S-Corporation. Randi contributes land worth $75,000 that has a basis to Randi of $30,000 in exchange for 75 shares of Blue Corp. stock. Jodi receives 25 shares of Blue Corp. stock in exchange for services provided on behalf of the corporation. Because no provision in Subchapter S addresses the tax treatment of this transaction, Subchapter C controls. Section 351, found in Subchapter C, provides that no gain or loss shall be recognized on the formation of a corporation if property is transferred to the corporation solely in exchange for stock in such corporation, and immediately after incorporation, the person or persons contributing the property control the corporation. *See* Section 351(a). For this purpose, control is defined in Section 368(c) as 80 percent of the total combined voting power of all classes of stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Section 351 will not apply to Jodi because Jodi contributed services, not property, in exchange for her stock in Blue Corp. Section 351 will not apply to Randi, because Randi does not control Blue Corp. immediately following the contribution. Therefore, Randi must recognize $45,000 of gain ($75,000 fair market value less $30,000 basis), and Jodi must recognize $25,000 of ordinary income when she receives the 25 shares of Blue Corp. stock.

This result could be avoided if, instead of forming a corporation, Randi and Jodi had formed a partnership. Under Section 721, Randi would not recognize any gain on the contribution of the land to a tax partnership. If Jodi receives an interest in the capital of a tax partnership, she would recognize income upon the receipt of such capital interest. This result can be avoided by granting Jodi a profits interest in a tax partnership, which most likely would not be taxable to her upon receipt of tax-partnership interest. *See* Rev. Proc. 93-27. Thus, Randi and Jodi can form a tax partnership and obtain the economic results they desire without being taxed on formation. The same result cannot be obtained in the S-Corporation context, even if Jodi agreed to receive only a profits interest. In fact, if Jodi were to receive only a profits interest in an S-Corporation, such an arrangement would likely violate the single-class-of-stock rule.

If the property contributed by Randi was subject to liability, the contribution of the property to a tax partnership could result in income to Randi. *See* Section 752. In such a situation, however, Randi would likely recognize gain on the contribution of the property to an S-Corporation under Section 357(a) and (c). With a tax partnership, agreements among the partners and the tax partnership often may be drafted to ensure that an adjustment by a partner's share of tax-partnership liabilities does not trigger gain recognition.

2. Adding a New Member

In the S-Corporation context, the admission of a new member to a corporation will likely trigger gain recognition to such individual if the individual contributes appreciated property or services in exchange for the interest in the corporation. As stated above, Section 351 applies only if the person contributing property in exchange for stock controls the corporation immediately after the contribution. When a new investor joins an existing corporation, Section 351 rarely applies.

"In the S-Corporation context, the admission of a new member to a corporation will likely trigger gain recognition to such individual if the individual contributes appreciated property or services in exchange for the interest in the corporation."

Example. In the example above, assume that after forming Blue Corp. and operating it for four years, Randi and Jodi agree to admit Bobbi as another member of the corporation. At the time of Bobbi's contribution, assume that Randi's and Jodi's stock is worth $140,000 in the aggregate. Bobbi contributes a truck worth $60,000 having a basis of $20,000. Because Bobbi owns less than 80 percent of Blue Corp. following the contribution, Section 351 does not apply to the contribution. Therefore, Bobbi must recognize $40,000 of gain on the contribution of the truck to Blue Corp. If, in the alternative, Randi and Jodi had formed a tax partnership, Section 721 would apply to the contribution of the truck by Bobbi to the tax partnership. *See* Treas. Reg. § 1.721-1(a). Thus, Bobbi would not recognize any gain on the contribution of the truck to the tax partnership.

3. Profits Interests

As stated above, another benefit of tax partnerships over S-Corporations is that tax partnerships allow partners to grant profits interests upon formation of the tax partnership or to grant profits interests to new members joining an existing tax partnership. Such interests allow the profits partners to participate in the growth of the business but do not trigger gain on the granting of such interests. An S-Corporation may not grant the equivalent of a profits interest to only one shareholder because of the single-class-of-stock rule.

Reason 8: Liquidation of S-Corporations May Trigger Corporate-Level Gain

Subchapter S does not protect the corporation from gain on the distribution of assets from the corporation. Since Subchapter S is silent, Subchapter C applies to such situations. Section 311(b)(1) of Subchapter C provides that a corporation recognizes gain on the distribution of appreciated property.

Example. If Red Corp., an S-Corporation, distributes land worth $100,000 with a $30,000 basis to one of its two equal shareholders, Red Corp. will recognize $70,000 of gain on the distribution. (This also may violate the single-class-of-stock rule). That $70,000 of gain will be allocated equally between the two shareholders. Shareholders avoid this result when the entity making a distribution is a tax partnership instead of an S-Corporation. Section 731(a)(1) provides that no gain or loss will be recognized by a partner on the distribution of appreciated property. Section 731(b) provides that no gain or loss shall be recognized to a tax partnership on the distribution of property to a partner. In the tax-partnership context, the main concern is avoiding the disguised sale rules under Section 707 and avoiding the anti-mixing-bowl rules under Sections 704(c) and 737 on the distribution of property from a tax partnership. Those provisions may require gain recognition if previously contributed property is distributed to a partner other than the contributee partner.

Business owners often realize the weakness and disadvantage of using an S-Corporation when it comes time to dispose of corporate assets and liquidate the corporation. One common example is a situation in which shareholders agree to sell the property of an S-Corporation but have different objectives regarding the sale proceeds. For example, it is not unusual for corporations owning real property to have one shareholder desire to use the proceeds from the sale of such property to reinvest in other like-kind property in an exchange that qualifies for Section 1031 nonrecognition treatment. The other shareholder often desires to receive cash on the disposition. If the corporation simply sells the property, uses one half of the proceeds to reinvest in other like-kind property and receives the other half of the proceeds in the form of cash, the corporation will recognize gain that will flow-through to the shareholders in proportion to their ownership interests in the corporation. Thus, the shareholder desiring to obtain Section 1031 nonrecognition treatment will recognize a portion of the gain resulting from the disposition of the property. In the alternative, shareholders may desire to distribute the property to the shareholders and allow each to dispose of an undivided interest in the property separately, allowing each to reinvest the proceeds according to his or her objectives. If the property has appreciated, Section 311 requires the corporation to recognize gain on the distribution, and the gain will flow through to each of the shareholders. Therefore, a subsequent disposition of the property as part of a Section 1031 exchange will produce no tax benefit to the shareholder desiring nonrecognition treatment.

If the entity is set up as a tax partnership, however, the partners can agree to specially allocate any gain to the partner desiring to receive cash. Assuming the allocation has substantial economic effect, the partner desiring to obtain nonrecognition treatment should recognize no gain on the transaction. Alternatively, the tax partnership may be able to distribute the property to the partners tax free, following which each partner may dispose of his interest in the property pursuant to his personal objectives.

Reason 9: No Internal Step-Up in Corporate Assets Allowed

Section 754 provides a significant benefit to members of a tax partnership. That section provides that in the case of certain distributions and certain dispositions, the tax partnership may file an election to step up the basis of the assets of the tax partnership. The same opportunity is not available to S-Corporations. Consider the consequence of stepping up the basis of tax-partnership assets.

1. Death

Section 743(b) provides that upon the death of a partner, the basis of tax-partnership property may be increased if a Section 754 election is in effect. An example demonstrates the significant benefit of this provision.

Example. Assume Green Partnership is owned equally by Ali and Mohammed. The partnership has a single asset, land, with a fair market value of $100,000 and a basis of $50,000. Ali and Mohammed each have a $25,000 basis in their interests in Green Partnership. Assume Green Partnership has a Section 754 election in effect on the day Ali dies, passing his interest in Green Partnership to Apollo. If Ali's interest in Green Partnership were worth $50,000, Apollo would take that interest with a $50,000 basis under Section 1014. Thus, if Apollo immediately sold that interest, Apollo would recognize no gain on the disposition. Because the Section 754 election is in effect, the partnership also increases the basis of the land it holds with respect to Apollo. Therefore, the basis of the land with respect to Apollo gets a $25,000 step-up in basis. Thus, if the partnership sold the property immediately following the transfer of the interest to Apollo, the partnership would recognize $25,000 of gain, all of which would be allocated to Mohammed, and Apollo would recognize no gain on the transaction.

Unfortunately, this same result would not occur if the entity were an S-Corporation. In such case, upon the death of Ali, the shares of the corporation would pass to Apollo and take a stepped-up basis under Section 1014. Thus, Apollo would have a $50,000 basis in those shares and would recognize no gain if he immediately disposed of them for cash. On the other hand, if the corporation disposed of the land immediately following Ali's death, 50 percent of the gain recognized would be allocated to Apollo. Thus, Apollo would recognize $25,000 of gain on the disposition of the land by the corporation.

2. Disposition of Shares

Section 743 also allows a tax partnership to increase the basis of its assets with respect to a partner who acquires an interest in a tax partnership.

Example. In the example above, if Apollo had acquired Ali's interest for $50,000 in a sale, Ali would take a $50,000 basis in the tax-partnership interest, and the tax partnership would step-up the basis of the property to $75,000. Thus, if the tax partnership disposed of the property immediately following Ali's acquisition, the tax partnership would recognize $25,000 of gain, all of which would be allocated to Mohammed, and Apollo would recognize no gain on the transaction. If, instead, Apollo were to acquire shares in an S-Corporation from Ali, Apollo would take a basis in the S-Corporation stock of $50,000, but the basis of the assets held by the corporation would not be stepped-up. Thus, a subsequent disposition of the assets by the corporation would result in taxable gain being allocated to Apollo.

3. Distributions

Section 734 provides that if a Section 754 election is in effect, the basis of tax-partnership assets may be adjusted if a distribution results in gain to a partner. For example, assume that Arnold has a basis of $10,000 in his one-third interest in Hollywood Partnership. The tax partnership has no liabilities and has assets consisting of $11,000 cash and property with a basis of $19,000 and a value of $22,000. Arnold receives $11,000 in cash in liquidation of his entire interest in the tax partnership. He has a gain of $1,000 under Section 731(a)(1). If the Section 754 election is in effect, the Hollywood Partnership basis for the property becomes $20,000 ($19,000 plus $1,000). Subchapter S does not have a similar provision that would allow an S-Corporation to increase the basis of corporate assets on the distribution of property to a shareholder. Section 734 adjustments are mandatory if a distribution causes a substantial basis reduction (defined as more than $250,000).

Reason 10: S-Corporations May Not Allocate Debt to Their Shareholders

Section 752 provides that the partners of a tax partnership are deemed to make a cash contribution to a tax partnership when the partners' shares of tax-partnership liabilities increases. Under Section 722, any such increase in partners' shares of tax-partnership liabilities will result in an increase in the partners' bases in the tax partnership. This increase in a partner's bases in the tax partnership creates opportunities for partners that are not available to shareholders of S-Corporations.

Example. Alan, Chris, and Tom are equal partners in Orange Partnership. Alan, Chris, and Tom each have a basis of $30,000 in their interests in Orange Partnership. Orange Partnership owns a single building worth $200,000 and having a basis of $90,000. The building is not subject to debt. Alan, Chris, and Tom decide to cause the partnership to borrow $150,000 and use the building as collateral for the loan. The liability of the partnership will be allocated equally among Alan, Chris, and Tom. After borrowing the funds, Alan, Chris, and Tom decide to distribute the $150,000 loan proceeds equally among the partners. Thus, Alan, Chris, and Tom each receive $50,000 cash on the distribution. Because the $150,000 was allocated equally among Alan, Chris, and Tom, the outside basis of each partner is increased from $30,000 to $80,000. Thus, the distribution of the $50,000 cash from the partnership to each partner does not result in gain to any of the partners. If, instead of being a partnership, Orange Partnership were a corporation taxed under Subchapter S, the corporation's borrowing of $150,000 would not increase any of the shareholders' basis in their Orange stock. Thus, a subsequent distribution of the loan proceeds would create taxable gain to each of the shareholders, as the $50,000 distribution would exceed the shareholders' basis in their stock by $20,000. Each shareholder would recognize $20,000 of income on the distribution.

Reasons to Like S-Corporations

Even though the reasons for disliking S-Corporations are real and significant, there are some reasons to like S-Corporations. In fact, the preference can be situational and depend upon the nature of a business, the level of income of a business, the amount of wages the business pays, and other factors. This part provides three reasons why some business owners may prefer S-Corporations.

1. Employment Tax Planning

Under the Internal Revenue Code two types of income are subject to employment tax: (1) wages, as defined in Section 3401(a), and (2) net earnings from self-employment as defined in Section 1402(a). Employees who receive a salary or other compensation from an employer have employment tax withheld from the compensation payment. The employer matches the amount withheld from the employee's compensation. Those who are self-employed are responsible for paying self-employment taxes. The amount of employment tax paid by self-employed individuals equals the amount of employment tax withheld from an employee's compensation plus the amount matched by the employer. The employment tax comprises two components: (1) Social Security; and (2) Medicare. The Social Security and the Medicare components of the employment tax are computed separately based on different formulas.

a. *Social Security*. For wages paid in 2018, the Social Security tax rate is 6.2 percent for both the employer and the employee. Since the amount paid by self-employed persons must equal the amount paid by the employee plus the amount paid by the employer, the Social Security tax rate for a self-employed person is 12.4 percent of self-employed income received in 2018. In 2018, the Social Security tax is applied only to the first $128,400 (the "wage base limit") of wages paid to an employee and to self-employment income received by a person who is self-employed.

b. *Medicare*. The Medicare rate is 1.45 percent each for the employer and the employee on all wages. Thus, the Medicare tax rate for a self-employed individual is 2.9 percent. This tax rate is applied to every dollar of wages paid to an employee and to every dollar of self-employment income received by a person who is self-employed.

Example. Assume Clyde, as a sole proprietor, earns $150,000 from his dry-cleaning business. Because he did not receive these payments from an employer, they do not qualify as wages. Thus, no employment tax would be withheld from the amount paid to Clyde. The $150,000 does, however, come within the definition of self-employment income under Section 1402. Clyde would pay Social Security tax equal to 12.4 percent of $128,400 of the total amount of self-employed income he received in 2018. Thus, he would pay $15,922 in Social Security tax for 2018. The Medicare tax equals 2.9 percent of the total $128,400 of self-employment income that Clyde receives. Thus, Clyde would pay $3,724 of Medicare tax in 2018. Total employment tax would be $19,646.

i. *Corporations*. In either situation, Clyde could reduce the amount of employment tax he pays by establishing a legal entity and paying himself a wage. For example, assume beginning January 1, 2018, Clyde operates the dry-cleaning business as a corporation. Clyde, as president of the corporation, determines that his compensation should be $95,000 for operating the business. The Social Security tax paid on $95,000 would be $11,780, and the Medicare tax paid on the $95,000 would be $2,755, for a total amount of employment tax paid equaling $14,535. This amount is $5,111 less than the total amount Clyde would pay if the $150,000 were self-employment income.

An S-Corporation allows Clyde to reduce the amount of income that will be subject to employment tax by causing the corporation to pay him $95,000 of compensation. The remaining $55,000 of income will flow through to Clyde as a non-taxable distribution from the corporation, assuming the corporation distributes it. This benefit can also be achieved using limited partnerships.

ii. *Limited Partnerships*. The general rule for imposing employment tax on members of a limited partnership is that the general partner (if an individual) is subject to self-employment tax on all income from the limited partnership. *See* Section 1402(a). Limited partners, however, are not subject to self-employment tax unless they participate in the management of the limited partnership for compensation. *See* Section 1402(a)(13). Owners of a limited partnership can be both general and limited partners. To obtain the favorable self-employment tax treatment available to S-Corporations, a limited partnership would allocate some income to the general partners and some to the limited partners. Income allocated to the general partner would be self-employment income (subject to employment tax). Income allocated to the limited partners would not be self-employment income (not subject to employment tax). To avoid liability as a general partner, the owners would create a special purpose LLC or S-Corporation to be the general partner.

iii. *Limited Liability Companies*. Questions exist about how a member of an LLC should be treated for employment tax purposes, if such member participates in the management of an LLC. The Tax Court recently ruled that income allocated to a member of an LLC who has no authority to act on behalf of a manager-managed LLC in his or her member capacity is not self-employment income. *See Hardy v. Commissioner*, T.C. Memo 2017-16 (Jan. 17, 2017). On the other hand, income allocated to a member of an LLC who had authority to act in a member capacity on behalf of the member-managed LLC is self-employment income. *See Castigliola v. Commissioner*, T.C. Memo 2017-62 (Apr. 12, 2017).

Because business owners can manage employment taxes using either an S-Corporation or a tax partnership, other factors will determine which type of entity provides the best tax results. As discussed above, income of a tax partnership that is QBI may qualify for the QBI deduction, whereas compensation paid to shareholders does not. Therefore, the tax partnership may provide more favorable tax results than an S-Corporation.

2. Banks

Federal and state regulatory rules generally require that banks be corporations. If the bank is closely held, it is generally more advantageous to have the bank elect S Corporation status than subject the shareholders to double taxation.

3. Simplicity

One of the most tempting reasons for business owners to adopt S-Corporations is that they can be much simpler than tax partnerships. Because income and distributions must be pro rata to S-Corporation shareholders, accounting and tax reporting for such entities and their shareholders is relatively simple. By contrast, the allocations of income and loss and shares of liability in a tax partnership can become quite complex. Some business owners may therefore prefer the simplicity of S-Corporations over tax partnerships.

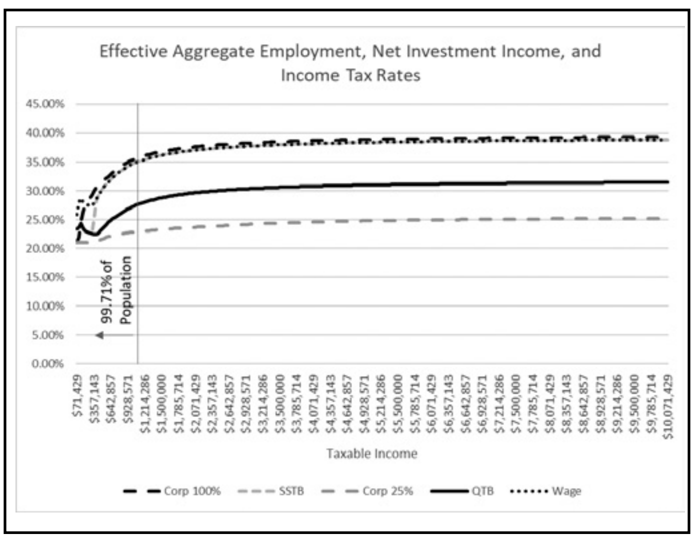
Tax partnerships can avoid some of the complexity by keeping the tax partnership's financial arrangement simple. For instance, the tax partnership could require pro rata contributions, allocations, and distributions. By so doing, the owners could benefit from other aspects of partnership tax, but not be crushed by the complexity of partnership tax.

Entity Combinations May Provide the Best Tax Result

With the tax rates provided under the Tax Cuts and Jobs Act of 2017, identifying the ideal business structure can be complicated because the most advantageous structure may change depending upon the amount of income a business has. The analysis of a business, therefore, should consider the effective tax rates the business might have at various income levels and then consider whether the entity structure may help minimize the effective tax rates.

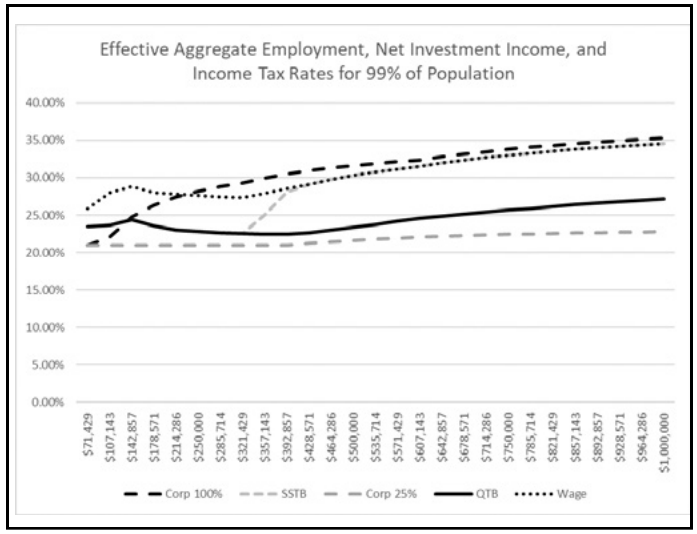
1. Effective Tax Rates

The following graph shows the effective tax rates at various income levels, taking into account the type of business and entity that recognizes the income. The rates account for income tax, employment tax, and net investment income. The computations also assume that the business pays sufficient wages to satisfy the wage limit in Section 199A, so a QTB will qualify for the 20 percent QBI deduction.



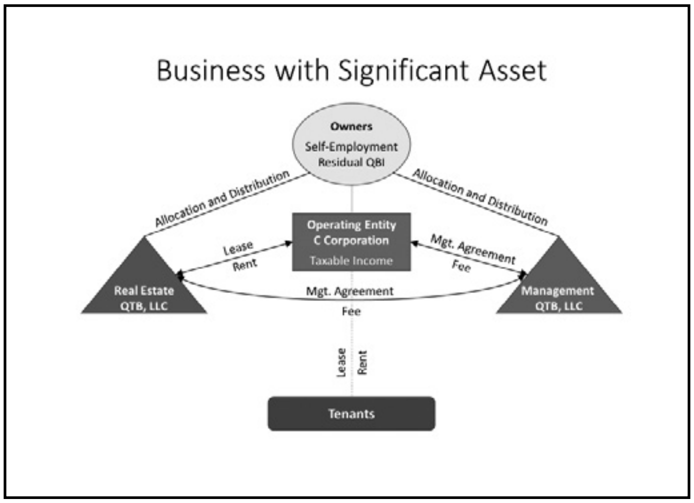
Notice that tax rates only approach their maximum amounts when taxable income becomes very large, but taxable income for most of the population is less than $1,000,000. The tax on corporate income depends upon the percent of after-tax income the corporation distributes. The tax is higher if the corporation distributes 100 percent than if it distributes only 25 percent of its after-tax income.

The following graph presents the effective tax rates of business income at various levels below $1,000,000. Notice that the rates vary considerably depending upon the amount of income the business has. The effective tax rate on wage income is higher than any other effective tax rate until taxable income passes about $200,000, at which point, the effective tax rate of corporate income becomes the highest rate, if the corporation distributes 100 percent of its after-tax income. The effective tax rates on wages and SSTB income eventually merge as the deduction for SSTB income phases out.



2. Entity Structures That May Minimize the Effective Tax Rate

For many businesses, entity choice is not binary—the choice is not simply between tax partnership and S-Corporation. Instead, business owners may choose from among various business structures. In some situations, the most tax-efficient structure may be a C-Corporation, the income of which is taxed at 21 percent, with a limited partnership as the manager, with the assets owned by another entity. The preferred type of structure will depend upon multiple variables, including the amount of income that the business owners want to withdraw from the business and the amount of income the business generates. If the owners do not wish to withdraw all of the income from the entity, they may prefer to form a C-Corporation to take advantage of the 21 percent rate with another entity contracting to provide management services to the corporation. The fee paid to the management entity could be wages, if the members of the entity formerly were employed by the C-Corporation, so this structure may be more useful on formation. That other entity will receive income, which could be QBI and qualify for the QBI deduction. The business owners would cause the C-Corporation to pay the income they wish to withdraw from the entity to the management entity. Most business owners prefer not to allow corporations to hold assets, so business owners may form an entity to hold the corporate assets and lease or license them to the corporation. The following figure represents a structure that some business owners may consider.



Regulations proposed by the IRS in August 2018 would appear to allow, but not require, the owners to aggregate the income, W-2 wages, and unadjusted basis of property of both the real estate and the management entities to determine their section 199A deduction. This type of structure presents some complexity, but the tax savings will prompt some business owners to adopt arrangements that increase the amount of section 199A deduction and may direct income to a C-Corporation. The trouble with a C-Corporation is getting assets out tax free, so business owners and their advisors may be reluctant to allow a C-Corporation to own anything other than the income that flows into it.

Conclusion

This article illustrates that business owners and their advisors should not think of S-Corporations and tax partnerships as interchangeable passthrough entities. Even though neither type of business entity is subject to an entity-level tax, other aspects of the two tax regimes set the two types of entities apart. As a general rule, moving property into and out of an S-Corporation can trigger taxable gain, while such property movement into and out of a tax partnership typically does not trigger taxable gain. The flexibility with allocations in tax partnerships and increasing partners' outside bases by their shares of tax-partnership liability give tax partnerships flexibility that is not available in S-Corporations. Tax partnerships also allow for stepping up the basis of tax-partnership property in certain instances, providing another advantage of partnership taxation. The advantages of tax partnerships generally make them the choice of entity for owning property. Businesses, or parts of businesses, that provide services may prefer the S-Corporation structure to reduce employment taxes. Every situation most likely requires close analysis as rules of thumb do not always hold up across the board.

The Trump Family's Wealth Transfer

By Greg Kiley

Summary

On October 2, 2018 the *New York Times* (NYT) published a special investigation article entitled, "Trump Engaged in Suspect Tax Schemes as He Reaped Riches From His Father." This article attempts to explain many of the tax transactions referenced in the *Times* piece as well as raise additional issues related to the transfer of wealth between Donald Trump's parents, Fred and Mary Anne Trump, and their children. The article is organized as follows:

(I) Brief History of the Estate and Gift Tax for Federal and New York Purposes.

(II) Transactions that, at the time the Trumps engaged in them, were legal or had substantial legal authority. Only after the transactions were engaged in were provisions put into the Internal Revenue Code (I.R.C.) to minimize the effect of these transactions. Provisions discussed in this section are: (1) The Kiddie Tax; (2) Partnership Allocations; (3) Real Estate Tax Shelters; (4) Below-Market Loans; and (5) Swaps of Partnership Debt for Equity.

(III) Analysis of the GRAT executed on Nov. 22, 1995 by Fred and Mary Anne Trump.

(IV) Analysis of valuations done regarding the GRAT, including the 45% discount for lack of control and lack of marketability.

(V) Fred Trump's 1991 Sale of his Interest in Trump Palace for $10,000.

(VI) Analysis of All County Building Supply & Maintenance Transactions.

(VII) Actions that could be taken by the IRS or New York State.

Brief History of the Estate and Gift Tax for Federal and New York Purposes

The modern federal estate tax began to take shape in 1916, when The Revenue Act of 1916 (39 Stat. 756) created a federal tax on the transfer of wealth from an estate to its beneficiaries.[1] The tax was levied on the estate, as opposed to an inheritance tax that is levied directly on beneficiaries.[2] The value of the gross estate includes all property to the extent the decedent had an interest in the property at the time of death.[3] The gift tax, first enacted in 1924, and then reintroduced in 1932, served as a backstop to the estate tax.[4] Whenever property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.[5] The gift tax was necessary in order to prevent individuals from using lifetime transfers to avoid a tax on their estate. In 1976, there was a unification of the estate and gift tax system.[6] This meant that lifetime taxable gifts were taken into account when calculating the estate tax.[7] This unification took away many of the tax advantages inherent in making lifetime gifts, but as we will see in this article, there are still tax advantages to gifting.

The estate and gift tax system has always been highly politicized. As a result, there have been significant changes in both the amount exempted from the estate and gift tax and the rate of tax. In 1977, a year after unification of the two taxes, the estate and gift tax exemption was $120,000, with a top rate of 70 percent.[8] In 2000, the year Mary Anne Trump passed away, the estate and gift tax exemption was $675,000, with a top rate of 55 percent.[9] Currently, as a result of the recent 2017 Tax Cuts and Jobs Act, the federal gift and gift tax exemption is at a historically high level. For tax year 2018, the exemption is currently at $11,180,000, with a top rate of 40 percent.[10] A Joint Committee on Taxation report has estimated that in tax year 2018, only 1,800 estates will be subject to the federal estate tax nationwide.[11]

From a state tax perspective, prior to 2001 states could impose an estate tax of up to 16 percent with no extra burden on its residents as a result of the state death credit, which was codified under section 2011 of the I.R.C.[12] Starting in 2002, the state death credit was phased out, and by the beginning of 2005 it was completely repealed.[13] Starting in 2005, the state death tax credit was replaced with a state death tax deduction, which is less valuable than a credit since it does not reduce taxes dollar for dollar.[14] New York, until February of 2000, put its high net worth families at a significant estate planning disadvantage compared to other states in two ways.[15] First, New York imposed a gift tax on gifts made before January 1, 2000.[16] This was particularly disadvantageous because there is no federal credit available for state gift taxes.[17] Second, it was not until February 2000 that New York State limited its estate tax payable to the maximum amount allowed on the federal estate tax return as a credit for state death taxes.[18] Prior to this date, the top New York State estate tax rate was 21 percent, exceeding the state death tax credit by 5 percent.[19]

It should be noted that currently over 30 states impose a state estate tax equal to the credit that it is currently allowable under law.[20] With the repeal of the state death tax credit under I.R.C. 2011, no state estate tax is now imposed by these states.[21] Currently, New York is one of 12 states (plus the District of Columbia) to still impose a state estate tax.[22] For tax year 2018, New York State imposes an estate tax on New York taxable estates above

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$5.25 million, with a top rate of 16 percent on estates over $10.10 million.[23] As referenced above, this New York estate tax can now only be deducted under I.R.C. 2058, putting New York State residents yet again at an estate planning disadvantage. The date of Mary Anne Trump's death, August 2000, was during the brief window of time in which New York State residents were not at a disadvantage compared to other states regarding state transfer taxes.

Fred Trump died in June of 1999, a little over a year before Mary Anne Trump. The reason why the time of Mary Anne Trump's death has been referenced when discussing estate tax exemptions and rates is because the majority of federal and New York State estate taxes relating to the Trump family's assets were paid upon the death of Mary Anne Trump. Per Form 706, United States Estate (and Generation Skipping Tax Return), filed for Fred Trump, only $736,048 of federal estate taxes were assessed upon his death. A major reason for this is that since 1982, there has been an unlimited marital deduction, for federal and New York state estate tax purposes, for qualified property passing to a decedent's surviving spouse.[24] Despite Fred's estate receiving this marital deduction, he was still able to control the ultimate disposition of the property in his estate by giving Mary Anne a life estate in his property, with the remainder of the property going to the beneficiaries of his choice upon the death of Mary Anne. This is often referred to as a qualified terminable interest property (or QTIP) disposition.[25] This QTIP property is included in the gross estate of the surviving spouse to make up for the fact that a marital deduction was allowed upon the death of first spouse to die.[26]

Kiddie Tax

The *Times* articled reported that by age 3, Donald Trump was earning $200,000 a year in today's dollars from his father's empire. This begs the question of why Fred Trump structured his business to have all this unearned income funneled to his children.

The answer to the above question lies in the progressive tax rates of the federal income tax system. For tax year 1949, the year in which Donald Trump was age 3, the top marginal tax rate for income was 91 percent.[27] Conversely, the lowest marginal tax rate for income in tax year 1949 was 20 percent.[28] Even at an inflation adjusted level of $200,000, the marginal rate on income in 1949 was 56 percent.[29] It was not until the Tax Reform Act of 1986 that this shifting of income was discouraged by the enactment of the "kiddie tax."[30] As originally enacted, the kiddie tax causes a child's unearned income (above a specific threshold) to be taxed at the parent's marginal rate.[31] This eliminated much of the benefit from shifting income to children. The Tax Cuts and Jobs Act of 2017 has modified the kiddie tax so that unearned income above a specified threshold (for tax year 2018, this threshold is $2,100) is taxed as if it were in an estate or trust.[32] For tax year 2018, estates and trusts pay a top marginal tax rate of 37 percent once their taxable income is above $12,500; thus, the kiddie tax still prevents wealthy families from taking advantage of a child's lower marginal tax rates.[33]

Partnership Allocations

Since it has been determined that there was a significant tax incentive to allocate income to children in a lower tax bracket, the question arises of how the Trumps were able to allocate income to children without incurring a significant gift tax liability.

Due to the high marginal tax rates discussed in the previous section, family limited partnerships became increasingly popular. A family limited partnership is an arrangement in which family members pool together capital to run a business project.[34] Although there must be a legitimate nontax purpose for the creation of the partnership, the desire to have property held and managed as a family asset has been considered a legitimate nontax purpose for the creation of a partnership.[35] Income that the family partnership generates can then be allocated to the individual partners, where it is taxed at their individual rates.

By 1948, there were approximately 930,000 family partnerships in the United States.[36] Prior to 1951, the general rule was that only the validity or nonvalidity of a family partnership was open to question.[37] The income-allocation provisions established by the family partnership were seen to be binding upon the Commissioner.[38] This means that even if a partner, such as one of Fred's Trump children, did not contribute a substantial capital interest or provide services to the partnership, he could still be allocated a significant amount of income from the partnership. The reason why the Trumps would not want their children to have substantial capital interests in family partnerships is that the gifting of a capital interest would be considered a gift of property and potentially be

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subject to the gift tax. From 1942-1976, the lifetime gift tax exemption was only $30,000, with an annual gift-tax exclusion of $3,000.[39] It would be more advantageous from a tax standpoint to disproportionally allocate income to children as opposed to gifting a substantial capital interest and then allocating income in proportion to the capital interests.

Starting in 1954 (the year in which Donald Trump was age 8 and already a millionaire), the principle that partnership allocations must meet the substantial economic effect requirement became a part of partnership tax law.[40] While the current test for determining whether partnership allocations satisfy the requirement for substantial economic effect is exceedingly complex, the basic test between 1954 and 1976 was whether the allocation's purpose was the "avoidance or evasion of income tax."[41] An allocation would not have substantial economic effect if it was made to avoid or evade taxes. If it was held that a partnership allocation did not have substantial economic effect, then the partner's distributive share of income, gain, loss, deduction or credit would be determined in accordance with the partner's interest in the partnership.[42] One of the primary factors in determining a partner's interest in the partnership is the partner's relative contributions to the partnership.[43] A child who did not have a substantial capital interest in the partnership, due to gift tax concerns, would not have a substantial interest in the partnership for allocation purposes. Thus, an allocation of income which was significantly disproportionate to a child's capital interest in a partnership would likely not be respected by the Internal Revenue Service (IRS).

Real Estate Tax Shelters

The *Times* article discussed how in the early 1970s Fred Trump invested in the sprawling Starrett City development in Brooklyn and how this investment generated huge tax writeoffs. The article also mentioned that the writeoffs from these low-income housing investments helped Donald Trump avoid paying any federal income taxes in 1978 and 1979. How did these real estate investments generate such huge tax writeoffs for the Trumps?

Generally, a partner's share of partnership loss shall only be allowed to the extent of the adjusted basis of such partner's interest.[44] However, an increase in a partner's share of liabilities shall be considered a contribution of money to the partnership and will increase the adjusted basis of the partner in the partnership.[45] This means that when a mortgage is taken out by a real estate partnership, this mortgage debt increases the adjusted basis to the partners. This increased adjusted basis allows the partner to recognize losses not only to the extent of his personal contribution, but also to the extent of the amount of partnership debt allocated to the partner. It was important to achieve this increase in basis since the deprecation allowed to these partnerships could generate substantial losses. Not only could partnerships take deprecation related to the buildings and structural components they invested in, under section 167(a) of the I.R.C., but section 167(k) of the I.R.C., which was enacted in the Tax Reform Act of 1969, created an accelerated depreciation provision for low-income rental housing expenditures.[46] When Fred Trump invested in the Starrett City development in the early 1970s, there were no statutory limits on the losses that could be taken from these real estate investments.

Since taxpayers were using losses from these partnership activities to offset their ordinary income, Congress responded by putting in statutory limitations to curb these tax shelter activities. Beginning in 1976, Congress enacted the "at-risk" rules of section 465 of the I.R.C.[47] Under section 465, the amount of loss allowed as a deduction is only that which represents the extent to which the taxpayer is at risk with respect to the activity.[48] To be considered at risk under section 465, the taxpayer must either invest or otherwise commit personal funds or property to the investment or incur personal liability for borrowed funds.[49] On the surface this would seem to disallow partners' losses generated using borrowed funds that they themselves were not personally liable for. However, the at-risk rules provide that taxpayers engaged in the activity of holding real property, other than mineral properties, are at-risk for their share of "qualified nonrecourse financing" secured by the real property used in the activity.[50] Real estate investments, such as Brooklyn's Starrett City, promise their investors huge tax writeoffs, so making sure that the debt securing their property qualified as "qualified nonrecourse financing" would be a top priority for them.

It was not until 1986 that Congress added section 469 to the I.R.C., commonly known as the "passive activity rules," to try to curb the proliferation of tax shelters.[51] These rules stated that passive activity losses are only allowed to the extent of a taxpayer's passive income.[52] The passive activity rules applied to individuals, estates, trusts, closely held corporations, and personal service corporations.[53] For determining a gain or loss from passive activities, gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of business (commonly referred to as portfolio income) would not be deemed passive income.[54] The passive activity rules made it much harder for tax shelters to generate currently deductible losses to taxpayers.

Below Market Loans Made from Fred Trump to Donald Trump

The *Times* article reported that in 1979 alone, Fred Trump and his companies extended large loans and lines of credit to Donald Trump in the amount of $4,695,000. The records show that many of these loans were interest-free, or if interest was charged, the payments were often skipped. Before the Tax Reform Act of 1984, which enacted I.R.C. 7872 to provide rules regarding below-market loans, the tax treatment of interest-free and below-market loans was uncertain from both a gift and income tax perspective.[55] On the income tax side, cases such as the 1961 U.S. Tax Court decision in *Dean v. Comm'r* held that interest-free loans resulted in no interest deduction for the borrower nor any interest income to the lender.[56] In addition, the borrower recognized no income despite having access to a significant amount of capital interest-free.[57] This lack of any income tax consequences would have been an ideal situation for the Trumps in 1979 since Fred would not have had to recognize any interest income and Donald, who was struggling at the time and thus in need of additional capital, would most likely not have needed a current interest deduction.

On the gift tax side, the court cases at the time showed the uncertainty regarding below-market loans. The 1977 U.S. Tax Court case of *Crown v. Comm'r* held that the making of a non-interest-bearing loan should not be a taxable event for gift tax purposes.[58] The court's reasoning centered on the fact that an interest-free loan did not deplete the value of the estate and that attempting to apply a gift tax to interest-free loans would be administratively unmanageable.[59] This decision was upheld by the U.S. Court of Appeals the next year.[60] However, in 1984 the Supreme Court of the United States, in *Dickman v. Comm'r,* held that interest-free demand loans resulted in taxable gifts of the reasonable value of the use of the money lent.[61] It is important to note that even before the 1984 enactment of I.R.C. 7872, the forgiveness of a debt was considered a taxable gift made by the party forgiving the debt.[62]

In 1984, I.R.C. 7872 provided much needed clarity on below-market loans for income and gift tax purposes. For below-market loans that exceed $10,000, the lender must recognize interest income on the forgone interest at the applicable federal rate (AFR).[63] The AFR is determined by the Secretary each month and is based on the average market yield of U.S. market obligations as well as the term of the below-market loan.[64] This income recognition is commonly referred to as the concept of imputed interest income, since the lender will have interest income despite not receiving any interest payment. The borrower is entitled to a potential interest deduction equal to the amount of interest the lender recognizes as income.[65] On the gift tax side, the issuance of a below-market loan results in a taxable gift that is equal to the amount loaned over the present value of all payments which are required to be made under the term of the loan.[66] This taxable gift is calculated on the date the loan was made, and the present value calculation is made based on the AFR rate when the loan was made.[67] If the below-market loan is a term loan, meaning it has a fixed tenure rather than being payable in full at any time on the demand of the lender, the taxable gift can be a significant amount since the gift (the difference between the amount loaned and the present value of payments on the below-market loan) increases as the term of the loan lengthens.[68]

Swaps of Partnership Debt for Equity

By 1987, Donald Trump had incurred loan debt to his father of at least $11 million. Disregarding the exclusions from income when debt is discharged due to bankruptcy or insolvency, the discharge of this debt by Fred Trump would have caused Donald to recognize income to the extent of the indebtedness discharged.[69] Instead, this debt owed to Fred Trump was exchanged for Fred having a 7.5 percent equity ownership interest in Trump Palace, a partnership controlled by Donald Trump. This exchange worked out for both Donald and Fred. Donald was able to avoid recognition of discharge of indebtedness income while still having Trump Palace backed by Fred. Fred would be a contributing partner to a partnership and would recognize no gain or loss on his contribution under section 721 of the I.R.C.[70] Fred's tax basis in his newly created partnership interest would be the amount of debt discharged (at least $11 million) plus any additional property he contributed to the partnership.[71]

The American Jobs Creation Act of 2004 amended I.R.C. 108(e)(8) of the I.R.C. to address partnership debt-for-equity transfers.[72] Starting in 2004, if a debtor partnership transfers a capital or profits interest to a creditor in satisfaction of its recourse or nonrecourse indebtedness, the partnership shall be treated as having satisfied the debt with an amount equal to the fair market value of the partnership interest.[73] The regulations provide that the general rule for valuing the fair market value of a partnership interest is its liquidation value.[74] This means that if the partnership indebtedness is greater than the fair market value of the partnership interest created, there will be discharge of indebtedness income realized by the partnership. This income will then be allocated to the partners in the partnership immediately before the satisfaction of the debt, thus preventing the creditor from recognizing any income.[75]

GRAT Executed on Nov. 22, 1995

On Nov. 22, 1995, both Fred and Mary Anne Trump transferred much of their real estate holdings into two separate GRATs. Exactly two years later, this real estate was owned by the Trump children and would not be subject to any estate taxes upon the death of either Fred or Mary Anne Trump. How exactly was this transfer able to happen, and what was the strategy behind the details on the GRAT?

As will be explained below, a GRAT, short for "grantor retained annuity trust," is a perfectly legal estate planning strategy used by many high net worth families to transfer assets out of their estate. A GRAT involves a grantor transferring assets to an irrevocable trust with the grantor retaining the right to an annuity from the irrevocable trust. The value of the gift made by the grantor (in this case the grantors were Fred and Mary Anne Trump), if any, is determined by subtracting the value of the annuity from the value of the transferred property.[76] One of the keys to executing a tax-efficient GRAT when the beneficiaries of the irrevocable trust are family members is to ensure that the interest (or the annuity) the grantor retains is a qualified interest. If the interest retained by the grantor is not a qualified interest, the retained interest is generally valued at zero, and the gift would be the entire value of the property transferred.[77] The I.R.S. has ruled that a retained interest will be a qualified retained interest if the grantor receives the right to payments for at least two years.[78] This is partially why the terms of both Fred and Mary Anne Trumps' GRATs were exactly two years. Especially when the grantors of the GRAT are elderly, there is a significant incentive for the term of the GRAT to be as short as possible. The value of a decedent's gross estate includes all property that the decedent had the right to derive income from.[79] If the grantor dies during the lifetime of the GRAT, the I.R.S. considers the annuity the grantor is receiving to be the retention of the right to income.[80] This means that if either Fred or Mary Anne Trump had died before the GRAT term ended in November of 1997, the assets the deceased transferred to the irrevocable trust would have been includable in their gross estate.

As stated in the above paragraph, if the interest retained by the grantor is a qualified interest, the value of the annuity will be subtracted from the value of the transferred property to calculate the taxable gift made by the grantor. As a result, it is possible to effectively "zero-out" a GRAT by structuring the value of the annuity to equal the value of the transferred property, thus resulting in no taxable gift upon transfer.[81] Interestingly enough, the Trumps did not do this with their GRATs, and instead paid $20.5 million in gift taxes in 1995 upon the creation of the GRATs. One reason this may have been done is that the base of the estate tax is "tax inclusive" where the base of the gift tax is "tax exclusive."[82] When gift tax must be paid, as a result of the tax computed on taxable gifts exceeding the applicable credit amount, the tax shall be paid by the donor.[83] The property used to pay the gift tax is not itself subject to the gift tax.[84] On the contrary, the value of the gross estate includes all property the decedent had an interest in at the time of death, including the property that is used to pay estate taxes.[85] To deter taxpayers from making taxable gifts shortly before death in order to exclude from their estate the property used to pay the gift tax, the amount of the gross estate shall be increased by the amount of any gift tax paid by the decedent on any gift made by the decedent or his spouse during the three-year period ending on the decedent's death.[86] This is commonly referred to as "grossing up" the estate.[87] Fred Trump died on June 25, 1999, about three and a half years after he funded his 1995 GRAT. If his death had been within three years of the funding of the 1995 GRAT, the federal portion of the $20.5 million of gift taxes paid by him and Mary Anne would have been includable in his taxable estate.[88]

Valuations of Property Transferred to GRAT

The valuations of property are where there starts to be significant controversy in the Trumps' wealth transfer. Upon creation of Fred and Mary Anne's GRATs, it was necessary to obtain qualified appraisals of the assets being transferred into the irrevocable trust in order for the gifts to be considered adequately disclosed.[89] The statute of limitations will not start running on a gift tax return if a transfer of property subject to the special valuation rules of section 2702 (GRATs are subject to the section 2702 valuation rules) is not adequately disclosed.[90] The Trumps used an appraiser, Robert Von Ancken, who concluded that the 25 apartment complexes and other properties in the Trumps' GRATs had a total value of $93.9 million. To understand how Mr. Von Ancken arrived at this figure, the valuation process must be examined more closely.

When a gift is made in property, its value at the date of the gift shall be considered the amount of the gift.[91] This value is determined by the price at which such property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.[92] The value of tangible property must reflect its highest and best use as of the valuation date.[93] Although there are gift tax regulations of the I.R.C. detailing the valuation of assets such as stocks, bonds, and annuities, there are no such gift tax regulations for real estate.[94] In general, there are three main approaches to the valuation of real estate: (1) comparable sales; (2) capitalization of income; (3) replacement cost.[95] Each valuation approach has its own set of issues. Replacement cost, alone, usually does not result in a determination of fair market value, but rather serves as an upper limit of value due to the fact that the cost to replace real estate is often more than its present value.[96] Finding comparable sales can pose a challenge for appraisals due to the uniqueness of real property. The only definition in the I.R.C. of comparable real property states that the comparable property must be situated in the same locality as the property being valued, with the determination of properties which are comparable being one of facts and circumstances.[97]

Partially because of the issues with the comparable sales and replacement cost valuation methods, when valuing income-producing property, such as much of the real estate the Trumps contributed to their GRATs, the income capitalization method is preferred.[98] This approach to valuation determines the fair market value of property by analyzing the present value of the income that the property will produce.[99] There are various methods within this approach, but the starting point to the calculation is usually the calculation of gross or net income.[100] Net income is figured by taking gross income less expenses. When determining income and expenses, it is important to examine operating statements for several years to eliminate unusual or non-recurring expenses.[101] Robert Van Ancken's appraisal of two buildings at Trump Village, a complex in Coney Island, claimed that these two buildings were worth negative $5.9 million. This figure was calculated based on years where loss of the property tax exemption, due to the buildings' no longer being in the affordable housing program, temporarily put the buildings at a loss since they could not offset the expense incurred through the loss of the exemption with raised rents. This was clearly a non-recurring issue that would need to be adjusted for, since once rents were raised, the increases would at least partially make up for the loss of the property tax exemption. However, no significant adjustment appears to have been made, and this negative $5.9 million valuation was used to offset other properties' valuations in order to arrive at the $93.9 million appraisal.

The *Times* article then mentioned that after the Trumps received their $93.9 million appraisal, this value was further reduced by $18.3 million in expenses relating to the transfer, as well as a 45 percent discount for gift tax purposes, to arrive at a final value of $41.4 million. This 45 percent discount was most likely the sum of two separately calculated discounts: (1) a discount for lack of marketability; and (2) a discount for lack of control.

interest ownership.[104] The IRS recognizes that the amount of control of a business should be a factor when a block of stock is valued, and it applies this logic to interests in partnerships as well as LLCs.[105] Until 1993, it was the position of the IRS that generally no discount will be allowed where, at the time of the transfer, control of the company rests with the family.[106] The IRS's rationale is that family members could aggregate their voting power to establish control.[107] This would have prevented the interests in the LLCs from benefiting from a lack of control discount, since the Trump children as a family controlled the LLCs. However, in 1993, the I.R.S. reversed its position and agreed with several judicial opinions that there should not be an assumption that all voting power held by family members should be aggregated for purposes of determining whether the family members have control of the company.[108] This reversal of position may have given the qualified appraiser as well as the tax practitioners advising the Trumps more confidence when claiming a discount for lack of control two years later.

While discussing the discount for lack of control, the *New York Times* reported that Fred and Mary Anne's status

"Much like the methodology for the initial valuation of real estate, definitions for the discount for lack of control and the lack of marketability are not codified in either the I.R.C. or its regulations."

Much like the methodology for the initial valuation of real estate, definitions for the discount for lack of control and the lack of marketability are not codified in either the I.R.C. or its regulations. The IRS, in a job aid for IRS valuation professionals, does define marketability as "the ability to quickly convert property to cash at minimal cost."[102] What the four living Trump children ultimately received from their parents in November of 1997 were fractional interests in limited liability companies (LLCs) that held real estate. These LLCs were not publicly traded on an exchange, and as discussed in the previous paragraphs, the valuation of these companies is not widely known and could only be calculated after using complex valuation methods. The lack of marketability discount reflects the fact that the owners of these interests will have more difficulty than an owner of a publicly traded entity in finding a willing buyer, and, in order to sell the interest, those owners may incur expenses such as legal, accounting and syndication fees.[103]

Because there were four Trump siblings and each sibling received only a minority interest in the limited liability companies, none of the siblings could solely control decisions such as when distributions of earnings would be made, when the entity would be liquidated, and other issues that would affect the financial benefits of

as minority owners in their real estate LLCs allowed them to take a discount for lack of control, which is often referred to as a discount for minority ownership. However, for gift tax purposes, it is not necessary for the donors of the LLC interests to be minority owners; rather, the discount for lack of control is based on the interest that the recipients receive.[109] Since Fred and Mary Anne were presumably making gifts to all their four children, the children would be receiving interests with minority ownership, even if what was initially being transferred into the GRAT was a 100 percent interest in an LLC. Changing the ownership structure so that Fred and Mary Anne each owned 49.8 percent of the shares in the LLC's would be a strategy to create minority ownership for estate tax purposes, but it would not have been necessary to ensure minority ownership assuming they were gifting equal shares to each of their children.[110]

When the IRS audited Fred and Mary Anne's 1995 gift tax return, the fair market value of the assets transferred to the GRATs was increased from $41.4 million to $57.1 million. By looking at the portion of the IRS audit report that the *Times* provided, this increase in value was mainly attributed to the increase in the pre-discount value of the real estate transferred from $93.9 million to $120 million. According to its audit, the IRS appeared to agree with the 45 percent discount for lack of control and lack of marketability.

Fred Trump's 1991 Sale of His Interest in Trump Palace for $10,000

Arguably one of the more controversial transactions that the Trump family engaged in was the sale by Fred Trump of his entire stake in Trump Palace for only $10,000 in 1991, after making a $15.5 million investment just four years earlier. As stated previously in this article, a major reason Fred Trump had acquired this interest from Donald was to prevent him from realizing discharge of indebtedness income. Whenever property is transferred for less than adequate and full consideration in money or an equivalent, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.[111] Here, the consideration received by Fred Trump appears to be only $10,000. We are not given details on how much Fred's shares were actually worth at the time of transfer in 1991, but the excess of the fair market value over $10,000 should most likely have been considered a taxable gift.

If the transfer was indeed a gift, then a capital loss should not have been taken as a result of the transfer. The I.R.C. limits the deduction for losses of individuals to (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit; or (3) losses from the involuntary conversion of property.[112] Even if the exchange could have qualified as a loss under the previous test, no deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between related parties.[113] For the purposes of the disallowance of losses, a related party includes a person's siblings, spouse, ancestors, and linear descendants, as well as a corporation or partnership that is at least 50% owned by the person or the person's family.[114] In the Trumps' case, regardless of whether the exchange was made between Fred and Donald, or between business entities that Fred and Donald had controlling interests in, the exchange would be considered between related parties and the loss should have been disallowed.

Analysis of All County Building Supply & Maintenance Transactions

In August of 1992, the Trumps incorporated a corporation named All County Building Supply & Maintenance ("All County"). Fred Trump's four living children as well as his nephew, John Walter, each owned a 20 percent stake in All County. According to the *New York Times*, All County would purchase all the services and supplies needed for Fred Trump's properties and then it would sell these same services and supplies back to Fred Trump at a marked-up price. As a result of this markup, All County would make significant profits that would go to the four Trump children and the nephew.

Under section 482 of the I.R.C., in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary of the Treasury may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[115] Section 482 has been a part of the I.R.C. since 1954.[116] Unlike the related party provisions of I.R.C. sections 267 and 318, "controlled entities" is not explicitly defined for purposes of section 482.[117] A business owned by a parent and a business owned by the parent's children would not statutorily be a controlled group as they would be for sections 267 and 318. Rather, a controlled group means taxpayers owned or controlled directly or indirectly by the same interests.[118] In the Trump family fact pattern, the common interest between All County and Fred Trump's business was for All County to be able to generate income based on the spread between what it paid for supplies and materials and what it charged Fred Trump. Even absent family relationships, this arrangement would be seen as a controlled group.

Once it is established that there is a controlled group of taxpayers, it must be determined if the transactions between the parties meet the arm's length standard.[119] While determining whether a transaction meets the arm's length standards can get very complicated (especially when dealing with multinational corporations), the basic premise is whether the taxpayer would make the same transaction with an uncontrolled taxpayer as he would with a controlled taxpayer.[120] Here, it is clear, based on the evidence presented by the *Times*, that Fred Trump negotiated entirely different rates with his uncontrolled vendors and with his controlled vendor, All County. The Secretary would have a reasonable basis to allocate more taxable income to Fred Trump and less taxable income to All County. When a reallocation is made by the Secretary, it can be particularly disadvantageous if done after the expiration of the statute of limitations for claiming a refund. The regulations state that no untimely or amended return will be permitted to decrease taxable income based on allocation or other adjustments with respect to controlled transactions.[121] In other words, if the Secretary were to adjust the taxable income between Fred Trump and All County, All County would not be able to amend its tax return to claim a tax benefit.

Actions that could be taken by IRS or New York State

When looking at what actions the IRS or New York State can potentially take against the Trump family, it is important to distinguish between civil and criminal actions.

For criminal actions, the I.R.C. states that no person shall be prosecuted for various offenses unless the indictment is found within three years after the commission of the offense.[122] This statute of limitations is extended to six years for offenses such as attempting to defraud the United States; willfully attempting in any matter to defeat any tax; willfully failing to pay any tax or to make any return at the time or times required by law or regulations.[123] For New York State, tax crimes, if severe enough, are classified as felonies, and the prosecution would have to commence within five years of the commission of the act.[124] Since both the IRS and New York closed Mary Anne Trump's estate in 2004, any criminal action would not be able to be brought.

Regarding civil actions, both the IRS and New York State provide that tax must be assessed within three years after the return was filed, with the statute of limitations being extended to six years if the taxpayer omits an amount in excess of 25 percent of gross income stated on the return.[125] However, both IRS and New York State provide that tax may be assessed at any time if there is (1) a false or fraudulent return; (2) a willing attempt to evade tax; or (3) no return is filed.[126] Based on the facts that the *Times* article provided, both the failure of Fred Trump to report a gift when he transferred the Trump Palace partnership interest for $10,000, as well as the shifting of income to All County, could possibly be reason enough to assess a tax regardless of the statute of limitations.

The same day that the *Times* article was written, October 2, 2018, the New York State Tax Department issued a statement that it was "reviewing the allegations in the NYT and vigorously pursuing all appropriate avenues of investigation."[127]As of the writing of this article, there has been no word from the IRS regarding an investigation.

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LIBOR: London's Interbank Bridge Is Falling Down

A Look at the Effects and Consequences of the Impending Phaseout

By Danielle P. Wilner

Introduction

Oh, how the mighty have fallen. In recent years, the London Interbank Offered Rate, more commonly known as LIBOR, or sometimes as the LIBO Rate, has been at the center of scandal, and as a result is now being replaced. What was once considered to be one of the most important benchmarks in the world is now beginning its descent into the history books.[1] An announcement to phaseout LIBOR was made on July 27, 2017 by Andrew Bailey, the chief executive of the Financial Conduct Authority (FCA).[2] Unsurprising to those following the life of LIBOR, the inability to regulate the rate as well as insufficient activity in the underlying market are reasons cited for the phaseout.[3] This announcement came with a phaseout date of 2021, with hopes that a "deadline will give people something to work towards."[4] With the 2021 deadline quickly approaching, it is now being left up to the countries of the five LIBOR currencies to find replacements.[5]

Part One of this article gives a brief background on LIBOR. It examines the evolution of the rate and how it has changed to reflect market concerns. LIBOR is a benchmark interest rate underpinning trillions of dollars in the global markets.[6] It is determined daily by a panel of reference banks submitting their cost of funds on 35 combinations of five currencies and seven interest periods.[7] Since its inception, LIBOR has gone through reforms in order for it to reflect current behavior in the market.[8] The turning point in its reform was in 2014, once numerous instances of manipulation came to light.[9] Oversight of LIBOR was transferred from the British Bankers' Association (BBA) to the Intercontinental Exchange Benchmark Administration (IBA). This shift did not change the way the daily reference rates were submitted, but did improve technologies, methodologies and oversight.[10] Additionally, this Part explains how LIBOR affects the price of loans, both in the institutional and consumer contexts.[11] By using the concept of match-funding, LIBOR determines the interest rate of various financial products from institutional syndicated loans to student loans and mortgages.[12]

Part Two of this article discusses the reasons underlying the announcement to phase-out LIBOR. The motivations for the phaseout are two-fold. The first is the inactivity in the market underlying LIBOR,[13] and the second is the susceptibility of the rate to manipulation.[14] The underlying market is made up of unsecured loans, transactions not frequently entered into by large banking institutions after the 2008 financial crash.[15] The lack of daily trading transactions has caused LIBOR to become more of an "estimated" rate rather than an "offered" rate.[16] The effect of this is a lack of certainty and accuracy in the published rates. Additionally, the scandal surrounding LIBOR has caused people to lose faith in the integrity of the market.[17] "Lenders [publicly] acknowledged that they had falsified their estimates [of LIBOR] in order to shift rates to boost their trading profits and to make their institutions seem healthier than they were during the financial crisis [of 2008]."[18] Although the abuses uncovered through years of global investigation were not officially cited as a reason for the phaseout, they nonetheless play a significant role in the decision to replace, as opposed to reform, LIBOR.

Part Three of this article analyzes the possible LIBOR replacements proposed by the United Kingdom, the United States, and Japan. These three countries have LIBOR rates tied to their currencies and wasted no time in looking into alternatives to the rate.[19] The United Kingdom has proposed the Sterling Overnight Index Average (SONIA) as its front-runner for the replacement; this is a current rate that tracks the actual cost of funds in overnight transactions between banks.[20] SONIA "is the existing unsecured reference rate for the sterling Overnight Indexed Swap (OIS) market."[21] The United States, on the other hand, has proposed an interest rate that has yet to come into existence.[22] The Secured Overnight Funding Rate (SOFR) "will reflect the cost of borrowing cash secured against US government debt."[23] The rate came into effect in early April 2018[24] and will run parallel with LIBOR for a few years in order to ensure a smooth transition.[25] Japan has chosen the Tokyo Overnight Average Rate (TONAR) as its successor.[26] This proposed "risk-free" rate is already being used as a benchmark for numerous transactions similar to those which reference LIBOR, and it is predicted that its familiarity in the market will help minimize any risks in the transition.[27] Switzerland will likely be using the Swiss Average Rate Overnight (SARON) as the alternative to LIBOR.[28] This risk-free rate reflects both actual transactions and quotes for the underlying repo market.[29] Finally, the Euro LIBOR will be replaced by the Euro Overnight Index Average (EONIA).[30] An overnight interbank interest rate, EONIA expresses an average of unsecured interbank lending in the European Union.[31] One drawback all of these proposed rates have in common,

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however, is that they are rates for very short-term loans.[32] Critics are concerned about what will happen when rates intended for overnight transactions are applied to the longer durations currently supported by LIBOR.[33] What makes LIBOR unique, and therefore a replacement difficult to find, is its application to numerous currencies and tenor periods.[34] The trend in proposed replacements seems to be a more disparate approach with less unification than is provided by LIBOR.[35]

Part Four looks at the other side of the coin and explores different LIBOR reform proposals. The most notable reform proposal came from Martin Wheatley in the form of the Wheatley Review of LIBOR in 2012.[36] In the wake of allegations of global abuse and manipulation, Wheatley published an extensive analysis of the current regulations surrounding LIBOR as well as recommendations for the future. Many of these recommendations, such as lessening the number of currencies and tenor periods, were implemented and allowed LIBOR to continue for many years.[37] In addition to the Wheatley Review, the Financial Stability Board and the ICE Benchmark Administration both published separate recommendations for what they think the future of LIBOR should look like.[38] Their recommendations included a complete review of the benchmark as well as a shift towards using Risk Free Rates (RFRs).[39]

Part Five examines other global interbank markets, specifically the markets in Europe and Hong Kong, to understand why the scandal surrounding LIBOR is absent in other interbank markets. Though structured almost identically to LIBOR in its calculation, the Euro Interbank Market diversifies the reference banks to ensure that there is never a large enough number of reference banks with the same interests. This results in a lack of incentive to manipulate the submissions, thereby keeping the associated rate, EURIBOR, a truthful one. Similarly, while the London Interbank Market is structured to require the actual offered rates by banks on their interbank loans, the Hong Kong Interbank Market, and its associated rate, HIBOR, seeks to measure what the reference banks estimate the funding costs of prime banks in Hong Kong to be.[40] This takes away the temptation to manipulate the rate being submitted in order to maintain reputational expectations.

Part Six considers Brexit from a social and financial perspective. In 2016, the UK voted to leave the EU, making it the first country to attempt this feat. Unfortunately, as a result of the vote and the impending uncertainty surrounding how Brexit will play out, many companies have been making and implementing plans to move their offices and their employees to mainland Europe.[41] Additionally, after the announcement of the outcome of the vote, the British Pound Sterling dropped to its lowest point in decades. The combination of companies demonstrating a lack of interest in London as a place for their offices and the decrease in strength of the currency is making it difficult for people to trust that London is the best place for a prosperous future.[42] This concern will only be exacerbated by the disappearance of LIBOR, as the global financial community will have little reason to keep London on the map.

Finally, this article ultimately concludes that the replacement of LIBOR is not the most advantageous course to take. With the impending effective date of Brexit looming over London, as well as the rest of the world, it seems foolish to push for the replacement of something that allows London to not only stay relevant in the financial community, but the leader that the financial world looks to for guidance. After analyzing the proposed replacements by the countries whose currencies are currently tied to LIBOR, the process of each country choosing its own rate for only its own currency seems to eliminate the progress made by LIBOR of bringing the financial markets together in order to create a global marketplace. Furthermore, looking to other interbank markets for guidance demonstrates that it is possible for LIBOR to remain an influential benchmark so long as steps are taken to reform it and eliminate the temptation for manipulation.

"LIBOR underpins trillions of dollars in financial products globally and is used to calculate the interest rate on transactions involving commercial paper, certificates of deposit, and unsecured deposits."

I. Background on LIBOR

LIBOR underpins trillions of dollars in financial products globally[43] and is used to calculate the interest rate on transactions involving commercial paper,[44] certificates of deposit,[45] and unsecured deposits.[46] "[LIBOR] is the primary benchmark for short term interest rates globally . . . and is also used as a barometer to measure the health of the banking system" as well as serving as a gauge for future interest rates.[47]

LIBOR "refers to the London-based unsecured wholesale market rates for jumbo deposits between major banks that are of varying durations and are denominated in certain designated currencies."[48] In essence, it is a rate of interest earned on deposits. These deposits are often referred to as Eurodollar deposits.[49] LIBOR encompasses five currencies, which all have their own unique LIBO Rate: the U.S. Dollar, the Euro, the British Pound, the Japanese Yen, and the Swiss Franc.[50] Furthermore, the LIBO Rate for each currency is tied to a distinct interest period for which the deposit will earn interest. There are seven different interest periods, ranging from overnight to 12 months.[51]

When a foreign currency deposit is made, the local bank typically won't have a use for it. Take, for example, Melissa, who is an American on vacation in London, and who, while there, goes to a local bank and deposits $100,000,000 U.S. The London local bank has no use for that much U.S. currency, but other U.S. banks do. The local London bank can lend the funds to a U.S. bank for a determinative amount of time, and the interest rate *offered* to the U.S. bank is the LIBOR.[52] "The LIBOR . . . became the basis for calculating the interest rate for a particular loan, since it was the *offered* rate," which would be higher than any lower bids by the borrowing banks.[53]

Evolution of LIBOR

Over time, the method for calculating LIBOR has evolved. "Daily LIBOR interest rate fixings have been published since January 1, 1986."[54] Technology has advanced at a rapid rate, and the financial market is no longer the same as it was in 1986. Although LIBOR has adapted to the change in technology and market customs over the years, we are now at a point at which a pivotal question needs to be asked: should LIBOR continue to be reformed, or simply replaced?

Pre-2014

Historically, LIBOR was administered by the British Bankers' Association (BBA), and was calculated through the use of reference banks.[55] "LIBOR was calculated every London business day by averaging the rates at which designated banks [known as reference banks] estimated they could borrow unsecured funds from other banks [in the various LIBOR currencies]."[56] If LIBOR operated as intended, the banks would "submit the actual interest rates they are paying, or an estimate of rates they would expect to pay, to borrow [funds] from other banks."[57] BBA rules required that each reference bank submit honest and unbiased estimates.[58] Reference banks submit rates for the various LIBOR currencies as well as the multiple interest periods. The submitted interest rates are then averaged, with the highest and lowest rates excluded, and the result is a unique daily rate for each currency and tenor period.[59]

Once the rates were submitted by the reference banks, Thomson Reuters engaged in a number of steps prior to worldwide publication of the final daily LIBO rate.[60] This published rate was then "used to settle trades in various financial instruments, including Eurodollar futures contracts."[61]

In the aftermath of the financial crash of 2008, the method for calculating LIBOR was the center of reform recommendations. The most notable was the recommendation by the former CEO of the FCA, Martin Wheatley, to remove the BBA as LIBOR's administrator.[62] Along with that recommendation also came "basing rate submissions on 'transaction data' [as opposed to estimates] and imposing statutory regulations for administration and submission methods."[63]

The recommendations of Wheatley started to become a reality when, on April 2, 2013, an amendment to the Financial Services and Markets Act 2000 made the "'administering of, and providing information to, specified benchmarks' a regulated activity."[64]

Post 2014

With the discovery of numerous abuses in the LIBOR market, "in 2014, the British Bankers' Association ceased to be the authority in charge of administering and maintaining LIBOR. Those responsibilities were transferred to ICE Benchmark Administration Limited (IBA), an independent subsidiary of the private exchange operator, Intercontinental Exchange."[65] The "IBA maintains a reference panel of between 11 and 18 banks for each currency calculated; each bank submits the rates at which it could obtain unsecured funding in each maturity for the relevant currency."[66] The IBA then excludes the highest and lowest 25 percent of rates and takes the average to use as the daily rate.[67] Although the method of calculation has not changed significantly, the "IBA has made significant investment in new technology, methodologies and oversight."[68] Additionally,

- IBA has developed purpose-built surveillance tools and systems, as well as a dedicated team of analysts who examine a bank's trading activity and related evidence every day, running millions of pre- and post-publication statistical calculations and analysis on LIBOR submissions
- The submission process, which has been unchanged for many years, is now run on modern technology with a redesigned and automated process, providing real time validation checks on the submissions to prevent errors before the rate is calculated
- All redistributors receive LIBOR data at the same time from the same place, and
- The LIBOR Oversight Committee includes representatives of users, submitters and infrastructure providers. The committee also has observers from the Board of Governors of the Federal Reserve System, the Swiss National Bank and the Bank of England. In addition, two independent directors of IBA serve on the committee.[69]

Given powers by Her Majesty's Treasury, the FCA regulates various benchmarks, including LIBOR and

SONIA.[70] Their powers with respect to LIBOR came into effect in April 2013, and since then the administrators and submitters to LIBOR are "subject to the FCA's standards of governance, controls, accountability, management of conflicts of interest and record keeping."[71] The FCA also plays "a leading role in domestic and international initiatives to raise regulatory standards for financial benchmarks."[72] Although independently capitalized, IBA is regulated and authorized by the FCA.[73] "IBA is required to comply with the FCA's rules for benchmark administrators."[74] As a division of Intercontinental Exchange, IBA leads the world in benchmark reform, as demonstrated by their being the one that was looked to in order to reform LIBOR.[75]

How Does LIBOR Affect the Price of Loans?

LIBOR finds itself influential in not just calculating the amount of interest on foreign currency deposits, but also in determining the cost of funds to borrowers. Financial products such as mortgages, student loans, "futures, options, swaps and other derivative financial instruments traded in the over-the-counter market and on exchanges worldwide" rely on LIBOR as a reference rate.[76] Through the use of match funding, LIBOR is now an essential component of various borrowings from institutional credit agreements to consumer loans.

Match funding is "the assumption that underlies the pricing provisions for LIBOR loans."[77] "[It is the principle] that each lender will fund its loan by accepting a Eurodollar time deposit on which it will have to pay interest at a given rate, and that it re-lends the funds to the borrower at the same rate (plus a margin that represents profit)."[78] Match funding is best understood by the following illustration. Tom, an American, is on vacation in London and while there goes into Barclays and deposits $100,000,000 U.S. This is now a Eurodollar deposit. Tom picks an interest period of 12 months and receives a LIBO Rate unique to his currency and the duration of the deposit, say 3 percent. Barclays in London now has $100,000,000 U.S. that it can't do much with, but it will have to pay Tom interest of $3,000,000. In order to cover their interest payment to Tom, Barclays can lend the money to a third party, Widgets, Inc ("Widgets"). Widgets is looking for a 12-month loan of $100,000,000 and goes to Barclays to complete the transaction. Barclays will match Tom's deposit with Widgets' requested loan and charge Widgets 3 percent plus an applicable margin of 2 percent, which represents profit. The $100,000,000 U.S. loan will now cost Widgets, Inc. $105,000,000, and Barclays will pay Tom $103,000,000 and retain a profit of $2,000,000.[79]

LIBOR not only affects institutional lending, but consumer lending as well. "Many credit cards, adjustable rate mortgages and student loans are tied to [LIBOR]."[80] For instance, "private student loans that aren't backed by the federal government and are tied to LIBOR also are beholden to it."[81] As LIBOR fluctuates, so does the interest rate of student loans, leading to either an increased or decreased amount being passed on to the borrower. Acting as an alternative to the prime rate, LIBOR is also the basis for some adjustable rate mortgages.[82] As with student loans, as LIBOR increases or decreases those changes are passed onto consumers through variances in the offered interest rates.[83]

II. Reasons for the Phaseout of LIBOR

On July 21, 2017, Andrew Bailey, the chief executive of the FCA, gave a speech at Bloomberg's London office that would change the face of modern lending: LIBOR is to be phased out by 2021.[84] The announcement to phaseout LIBOR represents a change in direction by the regulatory agencies and the financial markets as a whole, a direction which is away from reformation and toward replacement.[85] There is a tension between the FCA, which believes that the reforms LIBOR has undergone are not sufficient, and the ICE Benchmark Administration, which "favours 'evolving' LIBOR rather than abolishing it entirely."[86]

To be clear, the horse-drawn carriage that is LIBOR is not turning into a pumpkin when the clock strikes the year 2022.[87] The intention behind the long transition period ending in 2021 is that it will "no longer be necessary for the FCA to persuade, or compel,[88] banks to submit to LIBOR."[89]

There was an important question left open after the announcement to phaseout the integral interest rate. What happens to legacy contracts?[90] One year after this announcement, the answer is unclear.[91] This form for U.S. institutional lending agreements already accounts for this problem through the inclusion of a market disruption clause. The inclusion of this clause stemmed from lenders fears of the "possibility that some 'disaster' could occur in the LIBOR market that would result in lenders being unable to obtain LIBOR quotes at the beginning of an interest period, or [the fear] that the quotes obtained would not adequately reflect the cost to the lenders of making a loan."[92] Market disruption clauses have two main components. "The first component is the trigger event that entitles lender to suspend making loans bearing the interest at rates calculated by reference to LIBOR[93] . . . The second component of the [clause] is the consequence of lenders invoking their rights."[94] The form sample language provides that loans with interest calculated by reference to LIBOR are converted to base rate loans.[95]

The market disruption clause is also present in non-U.S. syndicated loan agreements; however, for those agreements, reliance on the base rate may not be practical.[96] For loans syndicated primarily outside the U.S., one approach may be to simply charge the borrower interest equal to the lender's cost of funds, plus the applicable margin.[97] Another option, although more complex, "is to set out a procedure whereby the borrower and the lenders agree to negotiate a 'substitute basis' upon which to price the loans."[98] The borrower also always has the ability to "refinance the loans if it does not like the alternative rates specified by the lenders, though if [LIBOR is no longer available], this option may not be particularly economic."[99]

For those following the evolution of the scandal-ridden interest rate, a replacement of LIBOR seemed inevitable, while for others it came as quite a shock. The reason cited for this drastic decision by Andrew Bailey in his announcement was the inactivity in the market underlying LIBOR.[100] LIBOR cannot command authority as a benchmark without the underlying liquidity to yield its data from.[101] The shift from LIBOR being an offered rate to effectively an estimated rate has "provided the market with a single reference point across a variety of currencies even if trading dried up."[102] Although not cited in the announcement, the numerous instances of abuse cannot be left out of the conversation when considering the reasons for the phaseout. However, despite the immense potential for abuse, the market has been reluctant to make a change because "LIBOR loans [have] almost invariably been lower" than any other option.[103] Additionally, a shift away from LIBOR has been slow to occur because of the willingness of the market to pursue the avenue of reform over replacement.[104]

Insufficient Activity in the Market Underlying LIBOR

The general consensus made explicit by the FCA is that "the underlying market that LIBOR seeks to measure—the market for unsecured wholesale term lending to banks—is no longer sufficiently active."[105] LIBOR is currently being "sustained by the use of 'expert judgement' by the [reference] banks to form many of their submissions."[106] After the financial crash of 2008, "firms have gravitated toward secured funding, which is backed by collateral, over unsecured funding," which is not backed by collateral and is the basis for LIBOR.[107] Additionally, regulators have supported a move away from short-term funding due to its volatile nature.[108] With the trend in institutional borrowing moving away from the use of unsecured funds, it is no surprise that the markets underlying LIBOR are not as active as they once were and are "not expected to become liquid in the future."[109]

One theory that can help explain why some combinations of currencies and interest rates see less action than others has to do with the banks' determination of its rollover risk.[110] "During times of heightened rollover risk, banks 'hoard' liquidity by lending less and more expensively at longer term maturities."[111] The preference of banks towards longer term maturities is leading to an insufficient number of short-term transactions, resulting in an inability to accurately report on the cost of funds. This point was illustrated in the phase-out announcement in which "Mr. Bailey cited what he called an 'extreme example': there was a [unique currency and interest period combination] for which about a dozen banks submitted a rate every day, when only fifteen such transactions of potentially qualifying size were executed in 2016."[112] "The replacement of LIBOR by alternative reference interest rates based on active markets would accomplish the regulatory goals of using reference rates that are more robust and less prone to manipulation."[113]

> *"One theory that can help explain why some combinations of currencies and interest rates see less action than others has to do with the banks' determination of its rollover risk."*

Numerous Instances of Manipulation Globally

The self-regulatory nature of LIBOR has exposed it to various abuses stemming from numerous motivations, the most notable of which is reputation protection.[114] Although "not explicitly linked to the decision to do away with LIBOR,"[115] systemic misreporting is suspected to be a main consideration in the decision to begin the phase-out. LIBOR has been at the center of "billions of dollars in fines and [has shaken] the reputations of some of the world's biggest banks, including Barclays, Deutsche Bank, Royal Bank of Scotland and UBS."[116] Investigation into LIBOR manipulation began in 2012, and U.S. prosecutors are not giving up on ensuring that those manipulating the market are held accountable for their actions.[117] Since the beginning of the global investigation, "regulators in the United States, the UK and the European Union have fined banks more than $9 billion for rigging LIBOR."[118] "Since 2015, authorities in both the UK and the United States have brought criminal charges against individual traders and brokers for their role in manipulating [LIBOR]."[119] Any manipulation of LIBOR means that millions of borrowers are paying either "too little or too much interest on their debt."[120]

The first bank "to provide extensive and meaningful cooperation to the [U.S. Department of Justice]" in the investigation into abuses in the LIBOR market was Barclays.[121] In 2012, it came to light that Barclays manipulated key interest rates, including LIBOR, and would "pay $453 million to U.S. and British authorities to settle [those] allegations."[122] The alleged manipulation was over the course of four years, from 2005 through 2009, meaning that it had an effect on millions of borrowers and even more money.[123] After speculation that Barclays' U.S. Dollar LIBOR was reflective of liquidity problems, management at the bank directed that the LIBOR submissions be lowered.[124] "This management instruction often [resulted] in Barclays' submission of false rates that did not reflect its perceived cost of obtaining interbank funds."[125] This first settlement opened the floodgates to further investigation and charges against both banks and individuals involved in benchmark rate manipulation.

As the second major bank to be fined in connection with LIBOR manipulation, UBS agreed to pay $1.5 billion in fines to regulators in the United States, UK and Switzerland.[126] The plea agreement also called for disgorgement by UBS AG and UBS Japan and required "the adoption of stringent internal controls and compliance measures to prevent and detect any possible misconduct in the future."[127] The bank "admitted to fraud and bribery in connection with efforts to rig [LIBOR]"[128] and also "admitted to manipulating Euribor and Tibor," the rates associated with the Europe and Tokyo interbank markets respectively.[129] "The complaint, led by the U.S. Commodity Futures Trading Commission (CFTC), cited over two thousand instances of wrongdoing committed by dozens of UBS employees."[130] In addition to the UBS parent company, its Japanese subsidiary became the first big bank in over a decade to agree to criminal charges.[131] UBS "agreed to admit to committing wire fraud through its Tokyo office in the case of manipulating LIBOR for loans denominated in Japanese yen, among others."[132]

The first individuals ever criminally charged in relation to the LIBOR scandal were Tom Hayes and Roger Darin.[133] The two former UBS traders were alleged to be involved in a "multi-year scheme to manipulate LIBOR."[134] In the Southern District of New York, Mr. Darin was charged with conspiracy to commit wire fraud while Mr. Hayes was charged with conspiracy to commit wire fraud, wire fraud and antitrust violations.[135] Additionally, in 2013, the U.K. Serious Fraud Office "also charged Mr. Hayes with eight counts of conspiracy to defraud."[136] The London trial of Mr. Hayes led to a guilty verdict on all eight counts and resulted in a sentence of 14 years in prison.[137]

Recently, in August 2017, two Société Générale managers, Danielle Sindzingre and Muriel Bescond, "were charged in New York with rigging the London interbank offered rate and allegedly causing $170 million in harm to the global financial markets.[138] The managers have been charged with conspiracy and transmitting false reports covering a period between May 2010 and October 2011."[139] The U.S. prosecution alleges that Sindzingre and Bescond ordered "subordinates to submit fake U.S. Dollar LIBOR rates so it [seemed] the bank was able to borrow at a lower interest rate. The submissions 'artificially reduced' the U.S. Dollar LIBOR . . . affecting millions of financial transactions tied to the U.S. currency."[140] "The purpose of the scheme was to avoid anticipated reputational harm to Société Générale had the bank submitted honest estimates of its borrowing rates, which were publicized through the LIBOR rate setting process."[141] In addition to the managers, the French bank itself was caught in its own LIBOR scandal. In June 2018, the bank reached an $860 million settlement with U.S. and French authorities in response to their attempted LIBOR manipulation as well as a separate and additional "$475 million settlement with U.S. derivatives regulators to settle the LIBOR manipulation claims."[142]

III. Proposed Replacement Options

Even before the announcement of the phaseout, countries with LIBOR currencies began speculating what rate, or most likely rates, will replace LIBOR. As of now, it seems as though each country having a LIBOR currency is independently trying to determine what its alternative will be. The lack of cohesion among all of the LIBOR currencies is cause for concern as there will no longer be a single benchmark to predict the strength of the market.[143] Furthermore, a single critique spans all of the proposed replacements: what happens when an overnight rate is applied to long-term lending periods? One solution may be to estimate the rates for interest periods longer than overnight. However, this solution lands us back in the same place we are currently in with LIBOR. If estimation of LIBOR is currently proving to be a gateway to manipulation, what is to stop the same manipulation of overnight rates? Another solution may be to have different rates for different interest periods. However, this complex and burdensome alternative is unlikely to be practical in such a fast-paced and global industry.

The United Kingdom

By more than a two-thirds majority, the UK has determined that their replacement of LIBOR will be SONIA, the Sterling Overnight Index Average.[144] "The SONIA index tracks the rates of actual overnight funding deals on the wholesale money markets, rather than relying on submitters like the LIBOR benchmark does."[145] SONIA is a much more active market than the one underlying LIBOR, which was a key reason for replacing LIBOR in the first place.[146] Additionally, SONIA is "administered by the Bank of England and is itself currently undergoing reform."[147]

Based on the skepticism of the long-term success of LIBOR, "the transition to SONIA [is seen as] necessary and not optional."[148] It is, however, being met with some hesitation. "SONIA is an overnight rate, while LIBOR covers [interest periods] going out decades into the future" due to the presence of legacy contracts.[149] There are a number of issues expected to arise when an overnight rate intended for extremely short-term loans is extended to much longer maturities.[150] It is unclear if the rate will be applied to long-term transactions or if multiple rates will be used to replace LIBOR within a single currency to accommodate the different borrowing periods. Additionally, SONIA only reflects the rate of one currency, as opposed to the five major currencies currently reported on by LIBOR.[151]

The United States

The United States is not looking at the end of LIBOR as a roadblock but, in true American fashion, as an opportunity. The U.S. is planning to use a collateralized reference approach, a departure from the underlying unsecured transactions of LIBOR. "The Federal Reserve has tasked the Alternative Reference Rate Committee (ARRC) to be responsible for the transition from the U.S. Dollar LIBOR to a new benchmark replacement."[152] The chosen benchmark replacement "is a newly created index called the Broad Treasury Financing Rate (BTFR)."[153] Subsequently renamed as the Secured Overnight Funding Rate (SOFR), due to the pronounceability issues with BTFR, the new rate will be a secured overnight Treasuries repo rate.[154] SOFR "will reflect the cost of borrowing cash secured against U.S. government debt"[155] and will include all trades used in the Broad General Collateral Rate "plus data on transactions cleared through the Fixed Income Clearing Corporation's Delivery-versus-Payment (DVP) repo service."[156] "DVP repo transactions with rates below the 25th volume-weighted percentile rate are removed from the distribution of DVP repo data each day. This has the effect of removing some (but not all) transactions in which the specific securities are said to be trading 'special.'"[157]

No proposal comes without its critics, and SOFR is no exception. This rate is the proposed solution for only the U.S. Dollar LIBOR, and it will not have extended effects on any other LIBOR currency.[158] Furthermore, SOFR will "include trades between banks and buyside firms [and therefore] will no longer be a reflection of interbank lending, or bank credit strength."[159] Another major criticism of the U.S. choice for replacement is that at the time of the proposal, the rate didn't actually exist yet.[160] SOFR was planned to begin being published about one year after the announcement, and would "have to run in parallel with LIBOR for several years in order to help determine a fair compensating credit spread between LIBOR and [SOFR] for those financial assets that will need to change their reference interest rate to the new index."[161] Just weeks after SOFR debuted, it turned out that those critiques were not without merit. The Federal Reserve Bank of New York had mistakenly included certain repo transactions in the settings for a 10-day period just weeks after the launch of the new benchmark.[162] Furthermore, "the New York Fed [initially] said it [wouldn't] revise the incorrect data," leading to scrutiny of the new rate by market participants.[163] Another critique of SOFR is that the New York Fed is given the ability to *exercise expert judgment* in determining which transactions, if any, "should be excluded from the rate calculations for a given day."[164] This *expert judgement* is exactly what led to manipulation and false reporting of LIBOR in the first place. SOFR's allowance for the intervention of expert judgment has the potential for this rate to be exposed to the same temptations of manipulation and opportunities for inaccurate reporting, thereby leaving the U.S. financial community back at square one in its search for a LIBOR replacement.

Japan

The Japanese have already begun the process of ensuring that the transition away from LIBOR is a smooth one. In 2016, even before the official announcement of the phaseout, Japan had "selected [the Tokyo Overnight Average Rate] TONAR as an alternative to yen LIBOR."[165] TONAR is "a transaction-based benchmark for the uncollateralized overnight call rate using information provided by money market brokers" and is considered to be a risk-free alternative to yen LIBOR.[166] The risk of introducing TONAR as the benchmark rate is low.[167] TONAR is already used for many of the transactions associated with the market underlying LIBOR.[168] Furthermore, TONAR already influences the "interest which banks charge on commercial products such as loans and mortgages."[169]

Although the Bank of Japan is emphasizing the low risks associated with TONAR, those critical of the rate raise the same issues as with SONIA. TONAR is the interest rate charged between banks for loans of short maturity, usually a maturity of one day.[170] The same problems will arise when attempting to use an overnight rate for interest periods of longer duration. Furthermore, TONAR is used for uncollateralized loans.[171] The fact that uncollateralized loans have fallen out of favor by institutional banks after the 2008 financial crash is the same problem faced by LIBOR, illustrated by the current inactivity in the market.

Switzerland

The Swiss National Bank is working on a proposal for an alternative to the Swiss franc LIBOR, which underpins about $6.2 trillion U.S. worth of contracts.[172] The current front runner and most likely candidate is the Swiss Average Rate Overnight (SARON).[173] Recently, in December 2017, SARON, "an overnight reference rate based on data from the Swiss franc repo market,"[174] was chosen to replace the Tomorrow-Next Overnight Indexed Swap (TOIS) rate, a popular Swiss unsecured lending rate.[175] TOIS was "an effective overnight reference rate for the Swiss Franc and [was] indicative of the interest rate banks charge each other on overnight loans made between them."[176] "The volatility of the TOIS fixing was six times higher on average, especially during the most turbulent phase of the [2008 financial] crisis, following the collapse of Lehman Brothers."[177] SARON was chosen as the replacement for TOIS because it was seen as a nearly risk-free alternative and can instinctively be used as a repo-rate.[178] "SARON is a reference rate reflecting both actual transactions and binding quotes of the underlying Swiss repo market whose its methodology ensures robustness and reliability."[179] With its success replacing TOIS and its familiarity in the market, it seems natural that SARON be the chosen replacement for LIBOR.[180]

The Swiss choice carries many of the same critiques as the other proposed LIBOR replacements. There is skepticism as to how an overnight rate will react when applied to longer-term loans. Unique to SARON, however, is the concern that the market for SARON swaps does not exist yet.[181] Furthermore, SARON has yet to be applied to the issue of posting collateral in situations where valuation methods have been updated.[182]

Europe

Following the announcement of the phase-out, "the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA), the European Central Bank (ECB) and the European Commission announced the launch of a new working group tasked with the identification and adoption of a risk-free overnight rate which can serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the eurozone."[183] Although there has been no official preferred replacement option announced for the Euro LIBOR,[184] the current front-runner is [the Euro Overnight Index Average].[185] More commonly referred to as EONIA, it is the overnight interbank interest rate for the Euro zone.[186]

This choice, calculated by the European Central Bank (ECB), "is a daily reference rate that expresses the weighted average of unsecured overnight interbank lending in the European Union [EU] and the European Free Trade Association [EFTA]."[187] EONIA is calculated by the European Money Markets Institute, which also calculates other interbank rates such as the European Interbank Offered Rate (EURIBOR).[188] As opposed to bank submissions, EONIA is based on actual transactions, which helps to eliminate the reporting abuse that is currently in the LIBOR market.[189] EONIA seems to be the natural choice to replace LIBOR as it is very similar to EURIBOR, both in its contributors and in its calculation. Daily contributions are made "from a panel of banks, whose members are credit institutions in the EU and EFTA countries."[190] Each panel bank reports to the ECB "the total volume of unsecured lending transactions [each] day and the weighted average lending rate for [those] transactions."[191] Approximately 30 banks participate in the daily contribution to EONIA, basing their reporting on their actual transactions.[192]

EONIA was recently declared to be a critical benchmark by the European Commission.[193] Additionally, since the end of 2015, EONIA has been under review, and continuing into 2018 its governance and methodology were being enhanced in order to align them with the EU Benchmark Regulation requirements.[194] Even with the reform underway, there is still concern as the market underlying EONIA is that of unsecured funds.[195] This poses the same issues currently faced by LIBOR: low levels of activity in the unsecured lending market lead to unreliable reporting. Additionally, this proposed rate comes with the same concern as all the others. EONIA is an overnight rate and has not yet been applied to the longer interest periods of up to one year that LIBOR currently deals with.

IV. Regulatory Reform Proposals

The evolution and reform of LIBOR have been constant yet everchanging. Since global manipulation of the benchmark has come to light, proposals for reform have become more aggressive, and responses have become more comprehensive. The proposals and swift responses from regulators and participating banks demonstrate that reform is in fact possible, and that it is just a matter of finding the right reform to ensure the long-term stability and performance of LIBOR. However, when it comes to reforming LIBOR, the saying "fool me once, shame on you, fool me twice, shame on me" comes to mind. There is hesitation to continue moving forward with more reform and increased regulation of LIBOR as a lot of resources were put into reforming a rate that is still riddled with problems, which is to say that further reform will not leave us in the exact same place.

The Wheatley Review of LIBOR

The most notable regulatory reform proposal came from Martin Wheatley in September of 2012.[196] Wheatley was the first Chief Executive of the Financial Conduct Authority (FCA), and he took on an extensive review of LIBOR in the wake of the global investigations of claims of manipulation and abuse. The Wheatley Review came to "three fundamental conclusions that underpin its recommendations."[197] First, that reform as opposed to the replacement of LIBOR is the most advantageous route to take; second, "that transaction data should be explicitly used to support LIBOR submissions;" and third, "that market participants should continue to play a significant role in the production and oversight of LIBOR."[198] The report then used these three conclusions as the basis for a 10-point comprehensive plan for the reform of LIBOR.[199] In addition to its 10-point plan, the Wheatley Review also made recommendations with regard to the regulation of LIBOR. Generally urging for increased oversight and enforcement, the report specifically recommended that administering and submitting to LIBOR become regulated activities under the Financial Services and Markets Act 2000, that the UK support the EU in its efforts to develop and implement a new civil abuse regime as well as open and transparent access to benchmarks, and that section 397 of the Financial Services and Markets Act 2000[200] be amended to enable the FSA to prosecute manipulation and attempted manipulation of LIBOR.[201] The Review emphasizes the power of sanctions in ensuring compliance by the contributing banks.[202]

In its review of governance, the Wheatley Review focused on three areas which were identified as failings with the current administration of LIBOR, and for which proposals were made.[203] The first failing was the "insufficient independence of the governance structures, which relied too heavily on the participating banks and their own industry organization."[204] To this, the review recommends that "LIBOR should be a market-led benchmark, administered by a private organization rather than by a public body."[205] This recommendation also helps to curb the second and third failings, which were the inadequate oversight structures and lack of transparency and accountability of the governance structures.[206]

The Review further looked at the submission of the rate and suggested a hierarchy of transactions that should be used in determining LIBOR.[207] Actual transactions in the unsecured interbank deposit market came at the top, followed by observations of third party transactions, quotes by third parties, and finally, in the absence of transaction data, expert judgment.[208] One of the most noticeable recommendations from the Review, which was put into effect shortly after its publication, was the reduction in the number of currencies and interest periods that LIBOR would report on.[209] Despite the extensive recommendations for reforming LIBOR, the Wheatley Review is adamant that reform is a better option than replacement. Finally, the Review emphasizes the need for collaboration among UK, European, and international communities to ensure the successful future of LIBOR.[210]

After the Wheatley Review: Further Reform

The Wheatley Review was influential in shaping the current state of LIBOR. Years after the proposal, the regulation of LIBOR was passed on to the ICE Benchmark Association (IBA), and the number of currencies and interest periods were reduced. The proposals for reforming LIBOR, however, did not stop with the Wheatley Review. Both the IBA and the Financial Stability Board (FSB) put out separate recommendations for what the future of LIBOR should look like.

In July 2014 the FSB published a report in which it addressed the reformation of major interest rate benchmarks, inclusive of LIBOR.[211] The FSB's review and subsequent recommendations stemmed from a request by the G20 following the Wheatley Review of LIBOR and reviews of other benchmark rates as a whole.[212] This report discusses the importance of an active underlying market, and the need for a benchmark to evolve with the market they intend to measure.[213] It also recognizes the monumental impact to financial stability that could occur in the case of a dislocation, or disappearance of LIBOR due to the high number of contracts that rely on that single rate.[214] The FSB report recommends that each country with a LIBOR currency "should implement new designs and methodologies for [LIBOR]."[215] However, the report ultimately concludes that, alongside the various reforms recommended for LIBOR, work toward a (nearly) Risk-Free-Rate (RFR) for each currency would be advantageous.[216] RFRs offer an "interest rate position without bank credit risk; and for collateralized swaps, lower basis risks between the valuation curves . . . and the swap reference rate."[217]

Just one year after the FSB proposal, in 2015, the IBA published a position paper in which it reinforced its plan to reform LIBOR.[218] The paper emphasized the need to "base LIBOR on transactions where there is adequate activity" and to ensure "a waterfall of methodologies for submissions so that LIBOR rates can be published in all market circumstances."[219] Additionally, the IBA proposed to "expand the range of eligible transactions, to standardize the parameters for transactions and the techniques for interpolation and extrapolation, and to frame Expert Judgement appropriately for market conditions when it remains necessary."[220] Finally, the IBA looked to bring clarity and understanding to LIBOR by addressing the ambiguity left by having no definition for the rate and by removing the over-complexity that has come in previous discussions of LIBOR.[221] The subsequent roadmap released by the IBA in 2016 broadened "the set of transactions eligible to support a LIBOR submission and [defined] a uniform submission methodology for panel banks based on parameters detailed by IBA and the LIBOR Oversight Committee."[222]

V. Other Interbank Markets

The London Interbank Market is just one of many around the world, and each Interbank Market has an associated Interbank Offered Rate.[223] This Part will focus on two Interbank markets, and their associated offered rates, the European Interbank Market and the Hong Kong Interbank Market. Although similar in the underlying theory, each interbank market is unique. At their core, interbank rates are "the rate of interest charged on short-term loans made between banks."[224] However, both the Euro Interbank Offered Rate (EURIBOR) and the Hong Kong Interbank Offered Rate (HIBOR) possess characteristics, which, if applied to LIBOR, have the potential to save the rate from impending replacement.

Europe

EURIBOR can be thought of as the LIBOR of Europe. The rate replaced various domestic rates in 1999, at the time the Euro was adopted, in order to bring unification and cohesion among the EU states.[225] EURIBOR "is the rate at which euro interbank term deposits are offered by one prime bank to another within the EMU zone."[226] It is calculated just as LIBOR is, by using a panel of reference banks and averaging their submissions after the highest and lowest submissions are excluded.[227] The panel of reference banks submit what they believe "one prime bank is quoting another prime bank for interbank term deposits within the euro zone."[228] This means that the banks are not submitting their actual rates, removing the temptation to manipulate their submission in order to protect their reputation. EURIBOR reports on one sole currency, the Euro, and eight different tenor periods ranging from one week to 12 months.[229]

Just as LIBOR is for the U.S. and UK, EURIBOR is an "important benchmark for a range of euro-denominated financial products, including mortgages, savings accounts and derivatives."[230] In order for EURIBOR to remain as an accurate and impartial benchmark, the panel of reference banks "range[s] from savings banks to cooperative banks, and from regional to international institutions, and so forth."[231] This diversity makes "finding a common interest between enough members to influence the index . . . extremely difficult if not impossible."[232] The protections in place to ensure that the EURIBOR submissions are truthful is an example LIBOR should strive to emulate.

Hong Kong

HIBOR, otherwise known as the Hong Kong Interbank Offer Rate, is the benchmark interest rate used for lending between banks in the Hong Kong market for interest periods ranging from one to 12 months, with the most popular being one-month and three-month.[233] The rate is calculated similarly to LIBOR; a panel of 20 banks submit its quotes by 11:00 am local time, the highest and lowest three values are discarded and the remaining 14 are averaged to come up with a single daily value.[234] The 20 banks are determined by the Hong Kong Association of Banks (HKAB), which acts as the central bank for Hong Kong.[235] The HKAB was created pursuant to an ordinance in 1981 in order to provide "a framework for the Government to exchange views with the banking sector for the further development of the industry."[236] Although the HKAB does not grant banking licenses, "no fully licensed bank can operate in the [Hong Kong Region] without being a member of HKAB and is thus subject to HKAB's rules."[237] "Having been in place for over 20 years, HIBOR has been used as a set of benchmark interest rates for determining the settlement of a broad range of financial loan contracts."[238]

As is the case with LIBOR, HIBOR also affects the price of institutional and consumer loans, such as mortgages. Mortgages in Hong Kong are priced either based on HIBOR plus a percentage representing profit margin for the banks, or based on the prime rate minus a percentage.[239] For those linked to HIBOR, as the rate goes up, so do the mortgage payments.[240] "However, most borrowers' HIBOR-linked mortgages include a clause which says that if their repayments are greater than they would be on a prime mortgage, they automatically switch to a prime-based payment scheme."[241] "However, as HIBOR rises, the pressure is building on banks to raise their [prime] rates."[242]

"Unlike in the case of LIBOR fixing where the contributing banks are asked to estimate their own funding costs, reference banks for HIBOR are asked to estimate the funding costs of prime banks in Hong Kong [as opposed to their own]."[243] This results in less of a concern regarding the stigma associated with high rates and less of an incentive for underreporting of rates.[244] This also results in a significantly lower "standard deviation of HIBOR submissions by individual reference banks . . . than that for U.S. Dollar LIBOR."[245] Furthermore, the likelihood that the conflicts of interest that arose in the LIBOR scandal might arise in Hong Kong is low, because "generally speaking, banks in Hong Kong do not maintain significant [Hong Kong Dollar] interest rate trading positions."[246]

VI. Effect of Brexit

One of the most publicized divorces in recent history is not that of Brad and Angelina but the United Kingdom and the European Union. On June 23, 2016, the UK voted to leave the EU by only a marginal percentage, making it the first country to break away from the EU.[247] Although this was not the UK's first attempt, this shocking vote resulted in a change in political leadership shortly after the triggering of the exit process by the accession of Prime Minister Theresa May.[248] With Parliament's approval, Article 50 of the Lisbon treaty was invoked, and the two-year notice period for exit was officially triggered.[249] Article 50 has three components: a trigger, notice and negotiations, and the result.[250] The notice and negotiation section of Article 50 is the most complex as no other EU state has gone through this process. The future of Brexit can best be described on a spectrum; at one end a "hard Brexit" and at the other a "soft Brexit."[251] "A hard Brexit means a complete, or mostly complete, break between the European Union and United Kingdom, [whereas] a 'Soft Brexit' allows significantly more flexibility by taking an almost infinite number of forms."[252]

Brexit has resulted in several EU companies moving their business outside the UK.[253] For instance, Unilever is shifting its headquarters to the Netherlands,[254] JP Morgan is moving hundreds of jobs to mainland Europe,[255] and the most iconic British brand, Rolls Royce, is considering moving its operations to Germany.[256] For those companies not contemplating a move, there is much to do behind the scenes to ensure things stay "business as usual" and that the uncertainty is not passed along to clients and consumers. In addition to the geographical shift away from London, Brexit also resulted in a negative economic effect for the UK. "Economically, the United Kingdom is the second largest economy in the European Union; however, since the Brexit vote British Pound Sterling has dropped and remained at its lowest point in decades."[257] To say that the "London (financial) Bridge is falling down" is not a far-off statement considering the unstable future of the City. With businesses leaving and the currency demonstrating a loss of strength, it is difficult to justify placing the fate of the future of business in the hands of London.

Conclusion

On the one hand, there are those who think replacement of LIBOR is the answer, and on the other there is a strong push for further reform in the regulation.[258] The proven inactivity in the market underlying LIBOR alone gives merit to Mr. Bailey's argument that it is no longer a sustainable option.[259] Additionally, the market inactivity coupled with the various instances of manipulation of LIBOR from financial institutions such as Barclays, UBS and Société Générale make the argument for replacement even stronger. However, LIBOR is an invaluable global benchmark that underpins trillions of dollars in financial products, ranging from institutional loans to student loans and mortgages.[260] The benefits of replacing LIBOR, namely the increased assurance of accurate reporting, may not outweigh the burdens.

Though "risk-free," the proposed replacements still have numerous shortcomings. First, they present a lack of cohesion among the currencies, something that should be avoided in today's global marketplace. Second, the current proposed replacements are all overnight rates, and there is no consensus about what will happen when those rates are applied to longer interest periods. Finally, the proposed rates fall short of being used as a predictor of market strength, which is an integral attribute of LIBOR. Furthermore, if other interbank markets were used as guidance and LIBOR were to be reformed by taking the best of all the other interbank rates, this could reduce the temptation for inaccurate reporting and give clients a renewed faith in the market.

In this context, it is perhaps most important to consider the logistical reasons for favoring further reform of LIBOR. The negative social perceptions related to the replacement option will be great and will trickle down to the general public, which has a large role in determining which brands will be successful long-term. Between Brexit and the phaseout of LIBOR, the narrative in the newspapers will likely be that London is no longer a strong financial city. The world currently still looks to London every day to produce a benchmark from which global business can be transacted, and to general consumers London is also seen as a place of strength where businesses should be present. As this changes and businesses leave, as they have already started to do, London's title of Famous Financial Center will be threatened. If this benchmark were to disappear, as the July 27, 2017 announcement has so stated, what will keep London relevant as the financial capital of the world?

Endnotes

1. Chad Bray, *LIBOR Brought Scandal, Cost Billions—and may be Going Away*, N.Y. Times (July 27, 2017), https://www.nytimes.com/2017/07/27/business/dealbook/libor-fca-banks-andrew-bailey.html.
2. Andrew Bailey, Chief Executive, Financial Conduct Authority, The Future of LIBOR at Bloomberg, London (July 27, 2017).
3. *Id.*
4. Bray, *supra* note 1.
5. *See infra* Part I.A.i.
6. Tortoise Investments, *Replacing LIBOR: The Countdown Begins*, Forbes (Aug. 16, 2017), https://www.forbes.com/sites/tortoiseinvest/2017/08/16/replacing-libor-the-countdown-begins/#61a7c7da4e2b.
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8. *See infra* Part I.A.
9. *See id.*
10. ICE Benchmark Administration, Roadmap for ICE LIBOR (2016), https://www.theice.com/publicdocs/ICE_LIBOR_Roadmap0316.pdf.
11. *See infra* Part I.B.
12. *See id.*
13. *See infra* Part II.A.
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15. *See infra* Part II.A.
16. *See id.*
17. *Regulation Alone Will Not Restore Faith in Markets*, Fin. Times (May 26, 2015), https://www.ft.com/content/8a41dd82-0399-11e5-a70f-00144feabdc0.
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19. *See infra* Part III.
20. *See infra* Part III.A.
21. *Transition to Sterling Risk-Free Rates From Libor*, Bank England, https://www.bankofengland.co.uk/markets/benchmarks (last visited April 29, 2018).
22. *See infra* Part III.B.
23. Joe Rennison, *New Treasuries 'Repo' Rate to Replace LIBOR*, Fin. Times (June 22, 2017), https://www.ft.com/content/fe1fbf76-5793-11e7-80b6-9bfa4c1f83d2.
24. Karen Brettell, *What is SOFR? The new U.S. Libor Alternative*, Reuters (April 3, 2018) https://www.reuters.com/article/us-usa-bonds-sofr-explainer/what-is-sofr-the-new-u-s-libor-alternative-idUSKCN1HA0H1.
25. *See infra* Part III.B.
26. *See infra* Part III.C.
27. *See infra* Part III.C.
28. *See infra* Part III.D.
29. *See id.*
30. *See infra* Part III.E.
31. *See id.*
32. *See infra* Part III.
33. *See id.*
34. Additionally, due to the volume of contracts tied to LIBOR, it is now necessary to find a delicate balance between causing the "least amount of market disruption … and more reliable and transparent substitutes." John Glover, *Why It's So Hard to Replace Libor*, Bloomberg (March 15, 2018) https://www.bloomberg.com/news/articles/2018-03-15/why-it-s-so-hard-to-replace-libor-quicktake.
35. *See infra* Part III.
36. *See infra* Part IV.A.
37. *See id.*
38. *See infra* Part IV.B.
39. *See id.*
40. *See infra* Part V.B.
41. *See infra* Part VI.
42. *See id.*
43. Bray, *supra* note 1.

44. Commercial Paper is an "unsecured promissory note with a fixed maturity, usually sold at a discount rate from face value." ICE Benchmark Administration, *supra* note 10.

45. A Certificate of Deposit (CD) is a promissory note issued by a bank entitling the bearer to receive interest. A CD bears a maturity date, a specified fixed interest rate and can be issued in any denomination. *Id.*

46. An unsecured deposit is a deposit that is not protected by a guarantor or collateralized by a specific asset. *Id.*

47. *Id.*

48. Michael Bellucci & Jerome McClusky, The LSTA's Complete Credit Agreement Guide 71 (2d ed. 2017). An interbank market is a global network used by financial institutions to trade currencies amongst themselves. Most of the trading in interbank markets takes place on behalf of the banks' own accounts, as opposed to the accounts of their customers. The minimum size for an interbank transaction is $5 million. For a more in-depth explanation of interbank markets, *see Interbank Market*, Investopedia, https://www.investopedia.com/terms/i/interbankmarket.asp (last visited April 29, 2018).

49. The term Eurodollar and LIBOR are often used interchangeably. A Eurodollar deposit is a U.S. dollar deposit in a foreign bank and therefore not subject to regulation by the U.S. Federal Reserve Board. The term eurodollar comes from the fact that traditionally, these deposits were held almost exclusively in Europe. *Eurodollar*, Investopedia, https://www.investopedia.com/terms/e/eurodollar.asp (last visited April 29, 2018).

50. Bellucci & McClusky, *supra* note 48, at 71. Prior to reform, LIBOR reported on 10 currencies and 15 interest periods. The Wheatley Review of LIBOR: final report, Wheatley Review 35 (Sept. 2012).

51. Bellucci & McClusky, *supra* note 48, at 71. The seven LIBOR maturities are currently: overnight, one week, one month, two months, three months, six months, 12 months. ICE Benchmark Administration, *supra* note 10.

52. This example is simplified for purposes of illustrating how Eurodollar deposits are made and how they affect LIBOR.

53. Bellucci & McClusky, *supra* note 48, at 72.

54. Tortoise Investments, *supra* note 6.

55. ICE Benchmark Administration, *supra* note 10.

56. Indictment at ¶ 9, United States v. Sindzingre, No. 2:17-cr-00464 (E.D.N.Y. issued Aug. 24, 2017). Reference banks are also referred to as the "contributor panel." Both terms are used interchangeably.

57. Alexandra Youngblood, *Developments in Banking & Financial Law*, 35 Rev. Banking & Fin. L. 1, 57 (2015).

58. Indictment at ¶ 9, United States v. Sindzingre, No. 2:17-cr-00464 (E.D.N.Y. issued Aug. 24, 2017).

59. *What is LIBOR and why does it Matter?*, BBC (Aug. 3, 2015), http://www.bbc.com/news/business-19199683.

60. Indictment at ¶ 9, *United States v. Sindzingre*, No. 2:17-cr-00464 (E.D.N.Y. issued Aug. 24, 2017). Prior to publication, "Reuters: (a) ranked the submission from highest to lowest; (b) excluded the four highest and four lowest submissions; and (c) averaged the remaining middle eight submissions to determine the official USD LIBOR rate." *Id.* ¶ 11.

61. Indictment at ¶ 9, *United States v. Sindzingre*, No. 2:17-cr-00464 (E.D.N.Y. issued Aug. 24, 2017).

62. Youngblood, *supra* note 57, at 63. *See infra* Part V.A for a more in-depth discussion on the recommendations made by Martin Wheatley.

63. Youngblood, *supra* note 57, at 63 n.53.

64. *LIBOR Becomes a Regulated Activity*, British Bankers' Assoc. (April 2, 2013), https://perma.cc/6QJE-N5CU.

65. Bellucci & McClusky, *supra* note 48, at 80.

66. ICE Benchmark Administration, *supra* note 10.

67. ICE, *supra* note 7.

68. ICE Benchmark Administration, *supra* note 10.

69. *Id*.

70. *FCA Announces End to LIBOR in 2021: What Next for Loan Contracts?*, Dentons (July 28, 2017), https://www.dentons.com/en/insights/alerts/2017/july/28/fca-announces-end-to-libor-in-2021-what-next-for-loan-contracts. The Sterling Overnight Index Average (SONIA) is the UK's proposed replacement for LIBOR. *See also* Part III.1.

71. *Benchmark Supervision*, Fin. Conduct Auth. (last updated October 10, 2017), https://www.fca.org.uk/markets/benchmarks/supervision.

72. *Benchmark Powers*, Fin. Conduct Auth. (last updated October 10, 2017), https://www.fca.org.uk/markets/benchmarks/powers.

73. *Bringing Integrity to Global Benchmarks*, ICE, https://www.theice.com/iba (last visited April 29, 2018).

74. *Id.*

75. *Id.*

76. *Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty*, U.S. Dep't Justice (June 27, 2012), https://www.justice.gov/opa/pr/barclays-bank-plc-admits-misconduct-related-submissions-london-interbank-offered-rate-and.

77. Bellucci & McClusky, *supra* note 48, at 73.

78. *Id.*

79. The figures in this example have been simplified for illustrative purposes. The interest and fees associated with LIBOR are calculated on a 360-day year and therefore the actual numbers will differ slightly from those stated in this example. *See also* Bellucci & McClusky, *supra* note 48, at 96–98 (providing a more detailed description of how LIBOR is calculated).

80. Tortoise Investments, *supra* note 6.

81. Taylor Tepper, *LIBOR: What It Means for US Consumer Loans*, Bankrate (April 12, 2018), https://www.bankrate.com/finance/banking/libor-what-it-means-for-us-consumer-loans.aspx.

82. *Id.*

83. *Id.*

84. Andrew Bailey, *supra* note 2.

85. Dentons, *supra* note 70.

86. *Id.*

87. Cinderella (Walt Disney 1950).

88. UK and European legislation gives the FCA the power to compel banks to contribute to LIBOR. However, the European Benchmark Regulation, it does not allow the FCA to compel banks indefinitely. In order to avoid the use of invoking its powers under the legislation, the FCA has already conferred with the reference banks and have gained their voluntary agreement to sustain LIBOR for a four to five-year period, bringing us to 2021. Andrew Bailey, *supra* note 2.

89. *Id.*

90. *Id.* Legacy contracts are "existing contracts that reference LIBOR and will survive the deadline." Karen Stretch et al., *LIBOR – Where Are We Now?*, Lexology (April 5, 2018), https://www.lexology.com/library/detail.aspx?g=e2b7f45a-abca-4021-822a-9591cb44142e. One concern with legacy contracts is the ability of parties to the agreements to claim that their duties and obligations under the contract "should be discharged based on the doctrine of 'contract frustration.'" Darren Duffie & Jeremy C. Stein, *Reforming LIBOR and Other Financial Market Benchmarks*, 29 J. Econ. Perspectives 191, 209–10 (2015). In the modern context, the doctrine of contract frustration "is applicable only where impossibility has come about without the fault of either party,"

as is the case with the replacement of LIBOR. L.S. Sealy, *Contract—Frustration—Language*, 19 Cambridge L.J. 152, 153 (1961).

91. Andrew Bailey, *supra* note 2.

92. Bellucci & McClusky, *supra* note 48, at 110.

93. Bellucci & McClusky, *supra* note 48, at 112. The U.S. form institutional syndicated loan agreement does not mandate the invocation of triggers as it would lead to significant portions of loans suffering funding losses. On the other hand, "British-style syndicated credit agreements often require a lower percentage… the purpose of a minimum percentage is to strike a balance between providing real protection to the lenders without subjecting the borrower to idiosyncratic conditions affecting only one or very few of the lenders." *Id.*

94. *Id.*

95. *Id.* Converting to base rate loans is not in the best interest of the borrower as they are typically higher than the LIBO Rate. For a further discussion of base rate loans, see *infra* note 101.

96. Bellucci & McClusky, *supra* note 48, at 112.

97. *Id.*

98. *Id.*

99. *Id.* at 112–13. This is likely not in the borrower's best economic interest as LIBOR is generally a lower rate than other's that might be available in institutional lending contracts. Exercising the option to refinance loans will likely result in a higher cost of funds to the borrower.

100. Andrew Bailey, *supra* note 2.

101. *LIBOR: Missin' You Already*, Fin. Times (July 27, 2017), https://www.ft.com/content/d1a772e8-72d9-11e7-93ff-99f383b09ff9?sectionid=stream/f0c5b30b-96e9-39ec-bee0-be165f9a805c.

102. *Id.*

103. Bellucci & McClusky, *supra* note 48, at 80. With a very few number of exceptions, one being during the financial crisis of 2008, LIBOR is consistently lower than other options, for example the U.S. prime rate. This is because LIBOR is a daily rate and therefore allows for a greater ability to immediately react to the market. The U.S. Prime rate, taken as an illustration, is not as flexible. Banks expend a lot of resources to set, announce and advertise the prime rate, therefore, "changes are relatively infrequent which, in turn means that the rate may not accurately reflect on a daily basis their true cost of making loans." *Id.* at 69.

104. This is demonstrated through the various reforms LIBOR has gone through both before and after 2008. *See supra* Part I.A.

105. Dentons, *supra* note 70.

106. Andrew Bailey, *supra* note 2.

107. Liz McCormick, *Pimco Warns that a Misstep on Replacing LIBOR Couple be Costly*, Bloomberg (Aug. 16, 2017), https://www.bloomberg.com/news/articles/2017-08-16/pimco-warns-that-misstep-on-libor-alternative-could-be-costly-j6f5fv9y.

108. *See generally Liquidity Risk: Thinking Beyond Compliance*, An Oracle White Paper (Oct. 2012), https://www.oracle.com/assets/liquid-risk-compliance-wp-1872381.pdf; *Capital Markets 2020 Will it Change for Good?*, PWC (2015), https://www.pwc.se/sv/pdf-reports/capital-markets-2020-will-it-change-for-good.pdf.

109. *LIBOR: The End of The World as We Know It (And I Feel Fine?)*, Lexology (Nov. 15, 2017), https://www.lexology.com/library/detail.aspx?g=2a7d0fbe-f074-4d9c-8840-6d7d1b34c5d8.

110. Rollover risk "is the risk that [a bank] will be unable to roll over its debt that matures before the term of the loan." Viral V. Acharya & David Skeie, A Model of Liquidity Hoarding Term Premia in Inter-Bank Markets 1 (2011).

111. *Id.* at 2–3, 3 n.4; *see generally id.* (provides a more in-depth discussion of rollover risk and its effects).

112. Bray, *supra* note 1.

113. Michael Foundethakis, *LIBOR: Where Things Stand Now*, Baker McKenzie (Nov. 27, 2017), https://www.bakermckenzie.com/en/insight/publications/2017/11/libor-where-things-now-stand/.

114. Andrew G. Haldane, *Constraining Discretion in Banking Regulation*, in Central Banking at a Crossroads 15 (Charles Goodhart et al. 2014).

115. Bray, *supra* note 1.

116. James McBride, *Understanding the LIBOR Scandal*, Council on Foreign Relations, https://www.cfr.org/backgrounder/understanding-libor-scandal (last updated Oct. 12, 2016).

117. U.S. prosecutors are continuing forward with their seven-year international investigation into the manipulation of LIBOR. *See* Patricia Hurtado, *Societe Generale Bankers Charged with U.S. LIBOR Rigging*, Bloomberg (Aug. 24, 2017), https://www.bloomberg.com/news/articles/2017-08-24/u-s-charges-two-societe-generale-employees-for-libor-rigging.

118. McBride, *supra* note 116.

119. *Id*.

120. Hurtado, *supra* note 117.

121. Alexandra Alper & Kristin Ridley, *Barclays Paying $453 Million to Settle Libor Probe*, Reuters (June 27, 2012), https://www.reuters.com/article/us-barclays-libor/barclays-paying-453-million-to-settle-libor-probe-idUSBRE85Q0J720120627.

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125. *Id.*

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128. Katharina Bart et al., *UBS Traders Charged, Bank Fined $1.5 Billion in Libor Scandal*, Reuters (Dec. 18, 2012), https://www.reuters.com/article/us-ubs-libor/ubs-traders-charged-bank-fined-1-5-billion-in-libor-scandal-idUSBRE8BI00020121219?feedType=RSS&feedName=wtMostRead&utm_source=twitterfeed&utm_medium=twitter&utm_campaign=Feed%3A+reuters%2FMostRead+%28News+%2F+US+%2F+Most+Read+Articles%29.

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130. *Id*.

131. *Tracking the LIBOR Scandal*, N.Y. Times (last updated Mar. 23, 2016), https://www.nytimes.com/interactive/2015/04/23/business/dealbook/db-libor-timeline.html.

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133. Bart et al., *supra* note 128.

134. *Id*.

135. Complaint, *United States v. Hayes*, No. 12 MAG 3229 (S.D.N.Y. Dec. 12, 2012). Mr. Hayes' antitrust charges, which were brought under Section 1 of the Sherman Act for conspiracy in the unreasonable restraint of interstate and foreign trade and commerce, will not be discussed as they are outside the scope of this article. For more information about these charges. *See id*. at 3.

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137. Kirstin Ridley, *Ex-Trader Hayes Jailed for 14 Years by London Court for LIBOR Rigging*, Reuters (Aug. 3, 2015), https://www.reuters.com/article/us-libor-hayes-verdict/ex-trader-

hayes-jailed-for-14-years-by-london-court-for-libor-rigging-idUSKCN0Q81IZ20150803.

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139. *U.S. Accuses Societe Generale Bankers in LIBOR Scheme*, N.Y. Times (Aug. 24, 2017), https://www.nytimes.com/reuters/2017/08/24/business/25libor.html.

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141. Indictment at ¶ 14, *United States v. Sindzingre*, No. 2:17-cr-00464 (E.D.N.Y. issued Aug. 24, 2017).

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182. *Id.*; *See supra* note 152 (further discussion of repo rates).

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194. European Money Markets Institute, *supra* note 190, at 7.

195. *Id.* at 9.

196. *See generally* Wheatley Review, *supra* note 50.

197. *Id.* at 7.

198. *Id.*

199. *Id.* at 8 (2012). The ten-point plan consisted of: (1) the introduction of statutory regulation of administration of, and submission to LIBOR; (2) the transfer of responsibility for LIBOR to a new administrator; (3) specific obligations of governance and oversight being given to the new administrator; (4) compliance of the submitting banks with the guidelines presented in the Wheatley Review; (5) the introduction of a code of conduct for the submitting banks; (6) no longer publishing LIBOR for currencies and interest periods for which there is insufficient trade data to corroborate submissions; (7) the publication of individual LIBOR submissions after three months; (8) the encouragement of banks to widely participate in the LIBOR complication process, even those banks who do not submit to LIBOR; (9) the encouragement of market participants to consider and evaluate their use of LIBOR; and (10) the collaboration and contribution of the UK, European and international communities to the debate on the future of LIBOR. These ten points fall into five broad categories including the regulation of LIBOR, institutional reform, the rules governing LIBOR, immediate improvements to LIBOR and international co-ordination. *Id.* at 8–9.

200. At the time of the Wheatley Review, section 397 of the Financial Services and Markets Act 2000 dealt with misleading statements and practices. In 2013, section 397 was repealed by c.21 of the Financial Services Act of 2012. *Financial Services and Markets Act 2000*, The National Archives, http://www.legislation.gov.uk/ukpga/2000/8/section/397/2001-02-25?timeline=true (last visited June 28, 2018).

201. Wheatley Review, *supra* note 50, at 11.

202. *Id.* at 12.

203. *Id.* at 21.

204. *Id.*

205. *Id.* at 22.

206. *Id.* at 21.

207. *Id.* at 28.

208. *Id.*

209. *See id.* at 35 (2012); *see also supra* Part I.

210. Wheatley Review, *supra* note 50, at 43.

211. Fin. Stability Bd., Reforming Major Interest Rate Benchmarks (2014), http://www.fsb.org/wp-content/uploads/r_140722.pdf (This report looks at interbank offered rates generally, although this article will be referring specifically to the application of its recommendations to LIBOR).

212. *Id.* at 3.

213. *Id.* at 13.

214. *Id.*

215. *Id.* at 58.

216. *Id.* at 3. The RFRs identified for each currency are discussed *supra* in Part III.

217. Fin. Stability Bd., *supra* note 211, at 8.

218. ICE Benchmark Administration, Second Position Paper on the Evolution of ICE LIBOR (2015) https://www.theice.com/publicdocs/ICE_LIBOR_Second_Position_Paper.pdf.

219. *Id.* at 3.

220. *Id.*

221. *Id.*

222. Financial Stability Board, Reforming Major Interest Rate Benchmarks 9 (2016), http://www.fsb.org/wp-content/uploads/Progress-in-Reforming-Major-Interest-Rate-Benchmarks.pdf.

223. For example, there are interbank markets, and associated offered rates in Norway (NIBOR), Bangkok (BIBOR), and Tokyo (TIBOR).

224. *Interbank Rate*, Investopedia, https://www.investopedia.com/terms/i/interbankrate.asp (last visited June 1, 2018).

225. European Banking Federation, Frequently Asked Questions About Euribor 2, https://www.emmi-benchmarks.eu/assets/files/Euribor%20FAQs%20Final.pdf.

226. *Id.* at 1.

227. European Banking Federation, Euribor Technical Features 1, https://www.emmi-benchmarks.eu/assets/files/Euribor_tech_features.pdf.

228. *Id.*

229. *Euribor*, Investopedia, https://www.investopedia.com/terms/e/euribor.asp (last visited June 1, 2018).

230. *Id.*

231. European Banking Federation, *supra* note 225, at 1.

232. *Id.*

233. *Three Month HIBOR Futures*, Hong Kong Exchanges and Clearing Limited (Nov. 21, 2017), https://www.hkex.com.hk/Products/Listed-Derivatives/Interest-Rate/Three-Months-HIBOR-Futures?sc_lang=en#&product=HB3.

234. *Hibor*, Investopedia, https://www.investopedia.com/terms/h/hibor.asp (last visited May 29, 2018).

235. *Id.*

236. *About HKAB*, Hong Kong Association of Banks, https://www.hkab.org.hk/DisplayArticleAction.do?sid=2&ss=0 (last visited July 6, 2018). The ordinance that created the HKAB was the Hong Kong Association of Banks Ordinance, *Id.* at 364. It was created to replace the Exchange Banks' Association. *Id.*

237. Hong Kong Association of Banks, *supra* note 236.

238. Treasury Mkts. Ass'n, Report on the Review of Hong Kong Interbank Offered Rate 3, https://www.tma.org.hk/PubFile/HIBOR%20Review%20Report%20-%20English.pdf.

239. Alun John & Josh Ye, *Explainer: What Hong Kong's interest rate increase means for Hibor, prime and mortgages*, South China Morning Post (Jan. 26, 2018), http://www.scmp.com/business/banking-finance/article/2124349/explainer-what-hong-kongs-interest-rate-increase-means.

240. *Id.*

241. *Id.*

242. *Id.*

243. Treasury Mkts. Ass'n, *supra* note 238, at 1.

244. *Id.* at 14.

245. *Id.* at 18.

246. *Id.* at 14.

247. Thomas Colson, *Brexit, one year to go: Time is running out for Theresa May to get a deal*, Business Insider (March 29, 2018) http://www.businessinsider.com/brexit-timeline-when-will-britain-leave-the-eu-2018-3.

248. *Visual timeline of key events related to Britain's decision to leave the European Union*, LA Times (March 29, 2017), http://www.latimes.com/world/europe/la-fg-visual-brexit-timeline-20170329-htmlstory.html.

249. *Id.*

250. Treaty of Lisbon art. 50, Dec. 13, 2007, E.T.S. No. 165.

251. Benjamin J.W. Eddington, *A Poorly Decided Divorce: Brexit's Effect on The European Union and United Kingdom*, 41 Suffolk Transnat'l L. Rev. 101, 127 (2018).

252. *Id.*

253. Suzi Ring, *Brexit Deal Too Late to Stop Some EU Firms from Moving Business*, Bloomberg (March 19, 2018), https://www.bloomberg.com/news/articles/2018-03-20/brexit-deal-too-late-to-stop-some-eu-firms-from-moving-business.

254. Scheherazade Daneshkhu et al., *Setback for Theresa May after Unilever moves base from UK*, Financial Times (March 15, 2018), https://www.ft.com/content/2d5acab0-283b-11e8-b27e-cc62a39d57a0.

255. *JP Morgan May Move Hundreds of Jobs in Pre-Brexit Move*, BBC (May 3, 2017), https://www.bbc.com/news/business-39789915.

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257. Eddington, *supra* note 251.

258. Martin Arnold & Emma Dunkley, *Libor's Long and Wild Ride Is Coming to an End*, Fin. Times (July 27, 2017), https://www.ft.com/content/88d0dfee-72e0-11e7-aca6-c6bd07df1a3c.

259. Bailey, *supra* note 2.

260. U.S. Dep't of Justice, *supra* note 76.

Committee Reports

The Business Law Section conducts most of its activities through individual Committees that specialize in various areas of business law. Membership in any Committee is open to any member of the Section. While active participation is encouraged, there is no required time commitment. To join a committee, email businesslaw@nysba.org. For more information, visit www.nysba.org/BLSCommittees.

Report from the Section Chair

The Business Law Section is a home for business lawyers in New York State and lawyers outside the state who practice New York business law. This is the place where lawyers, experienced and just starting out, can learn from each other, teach each other and get to know each other outside of our workplaces. There are subject matter committees for business lawyers in almost every area of interest: banking, bankruptcy, business organizations, commodities and derivatives, and securities, to name a few. Committees meet on a regular basis, both in connection with section-wide meetings and at other times during the year. At our Fall Meeting this year, we had presentations on cybersecurity not just as a single topic but as it applies across the subject matter areas of several of our committees. At our Annual meeting on January 16 at the New York Hilton, we will have two kinds of presentations. One will be an update on federal and New York State legal developments, with presenters from most of our committees. The second will be a panel discussion on proposed recommendations for changes to the New York Limited Liability Law, presented by the Business Law Section's study group.

The substantial work of the study group making recommendations on the Limited Liability Law is a good example of one of the most important opportunities provided by membership in the Business Law Section: the opportunity to get involved in projects to improve the business law of New York State. If you are already involved in those projects, we thank you. If you are not involved yet, we need you.

Peter W. LaVigne, Chair

Banking Law Committee

The members of the Banking Law Committee include banking, regulatory, and corporate attorneys. We meet in connection with the Spring, Fall and Annual Meetings of the Business Law Section. At the Fall Meeting on October 18th, held at the Executive Conference Center in Manhattan, we had presentations on Cybersecurity regulation with a panel discussion from attorneys and accounting firms and covered:

- New York State Cybersecurity Regulations (23 NYCRR 500)
- New York State Banking Transaction Monitoring Regulations (3 NYCRR 504)
- European Union General Data Protection Regulations (GDPR)

The presenters, Lena Licata and Louis Bruno, Eisner Amper Director and Principal respectively, and Cullen & Dykman Associate Elizabeth Murphy conducted a detailed discussion on updates with respect to these specific regulations as well as practical implementation issues that arise. There was significant audience participation and gauged interest. Our next meeting is planned for January in conjunction with the Section's Annual meeting.

Tanweer Ansari, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee did not meet at the Fall meeting, but will meet on January 16, 2019, as part of the Section's Annual Meeting. At the meeting, Adam Wofse of Lamonica Herbst Maniscalco LLP and Matt Spero of Rivkin Radler LLP will present a seminar entitled "2018: The Bankruptcy Year in Review."

Matthew Spero, Chair

Business Organizations Law Committee

I am honored to have had the opportunity to serve as Chair of the Business Organizations Law Committee since its formation last year. As a new committee, we are continuously eager to expand and enhance this group. Formerly the Corporations Law Committee, the Business Organizations Law Committee focuses on discussing and investigating the range of issues and new laws affecting business organizations. As always, we hope to grow the committee membership in the coming months, and provide meaningful content and connections.

Over the year, we have had some great presentations and speakers. We kicked off the year at the Spring Meeting with a discussion of the effects of new tax laws featuring a panel of respected professors and tax advisors who shed a variety of perspectives on this hot topic issue. At the Fall Section meeting we had an excellent presentation on cybersecurity and the newly implemented laws surrounding privacy issues, featuring Peter Day, a former Privacy Officer with the Federal Reserve Bank of New York.

I will continue to seek contemporary content and diversified speakers to enhance our group, and provide programs that seek to answer the most important questions on how businesses are affected by new laws and practices. Looking forward to upcoming events in 2019!

Matthew Moisan, Chair

Insurance Law Committee

The Insurance Law Committee recently organized a panel for the Business Law Fall meeting addressing the unique challenges of Cybersecurity Risk Management. The panel touched on the various types of cyber threats as well as the steps available to manage and mitigate them.

At present the Insurance Law Committee is organizing and planning to host an event that will help highlight the opportunities in Insurance Law and related areas for newly admitted attorneys and law students. If you have particular interest in this area and would like to be involved, please contact the Chair at giancarlo@swyfft.com.

Giancarlo Stanton, Chair

Legislative Affairs Committee

The Legislative Affairs Committee monitored a variety of bills in the 2018 legislative session and circulated information for comment within the section. The Committee participated in Section discussions on topics of interest for possible further development, including limited liability companies. The Committee continued to work closely with NYSBA's governmental relations staff and to maintain contact with counterpart committees in other Sections. Anticipated issues that may arise in the 2019 legislative season include limited liability company law and professional practice by not-for-profit corporations.

Mike de Freitas, Chair

Mergers and Acquisitions Committee

The Mergers and Acquisitions Committee of the Business Law Section of the New York State Bar Association met at the Harvard Club on May 24, in conjunction with the Business Law Section's Spring Meeting. The Committee Chair, James Rieger of Tannenbaum Helpern Syracuse & Hirschtritt LLP, along with Anchin Tax Principal Jeffrey Bowden and Anchin Tax Partner E. George Teixeira, gave a presentation on the Impacts of the New Tax Bill on Mergers & Acquisitions. A lively question and answer session was interspersed throughout the presentation. The Committee was gratified by the turnout and the continuing positive trend in attendance at this recently established committee.

James Rieger, Chair

Membership Committee

The Membership Committee has as its goal to seek to increase Section membership by identifying ways to make membership more attractive, especially to younger lawyers, women and minority attorneys. During the year our primary efforts have been directed to:

- On-going review of monthly membership reports
- Liaise with staff and committee leaders to identify "draws" to the section
- Liaise with staff to:
  - develop marketing based on what brings in members, including direct mail, CLE offers, non-CLE presentations, etc.
  - draft targeted follow-ups for up-coming renewals and non-renewing members
- Maintain physical presence at Pathways to the Profession and Diversity presentations
- Engage with non-resident committee to build outreach

We have also established several important new initiatives:

- Combining development efforts:
  - work with other sections to hold joint CLEs or other presentations
  - offer Business Law Section members access to other sections' CLEs or presentations

- maintain a physical presence at those CLEs or presentations

- Law school meet-and-greets:

    - liaise with staff to identify targeted law schools, for physical presence of the section at meet-and-greets

    - outreach to non-resident members, to provide the physical presence and build connections

- Identify individuals within the section interested in outreach and membership development

Carol Spawn Desmond, Chair

Not-For-Profit Corporations Law Committee

At our committee's meeting as part of the Association's 2018 annual meeting, the two Co-Section Chiefs of the Charities Bureau Enforcement Section presented an incredibly well-received CLE program entitled "A View From the Attorney General's Charities Bureau Enforcement Section."

At the 2019 annual meeting, we are thrilled to once again present a CLE program in collaboration with the Attorney General's Charities Bureau. Our program will be held on Wednesday, January 16, from 1:45-3:30 p.m. James Sheehan, Charities Bureau Chief, will be our featured speaker. In addition to Charities Bureau Chief Sheehan's presentation, a portion of the program will focus specifically on the work of the Charities Bureau Transactions Section.

David Goldstein, Chair

Public Utility Law Committee

The Committee on Public Utility Law has moved its annual Utility Law Forum from just before Thanksgiving to Thursday, May 7, 2019, at the Bar Association's offices at 1 Elk Street in Albany, New York.

Our Program Committee is developing a list of topics to be covered at this event, which will likely include issues related to achieving Governor Cuomo's ambitious goal of obtaining 50 percent of New York's electric power needs from clean, renewable sources like solar and wind power by 2030.

I will also be providing a report on developments in the energy industry at the Business Law Section Annual Meeting in New York City on January 16, 2019. I look forward to seeing you all there.

George Pond, Chair

Securities Regulation Committee

The Securities Regulation Committee maintains an active schedule of regular meetings.

- July: Marc Gerber, Skadden Corporate Governance partner, discussed 2018 SEC Staff Guidance on shareholder proposals and other recent SEC developments. Mary Beth Maloney and Amy Mayer, from Gibson Dunn's SEC Enforcement Group, discussed recent SEC enforcement cases.

- September: Keith Higgins, Former Director of Corporation Finance at the SEC and current chair of Ropes & Gray's Securities & Corporate Governance Practice, and Rachel Phillips, from Ropes & Gray's Securities and Public Companies practice, discussed recent regulatory and legislative interest in stock buyback programs. Matt Moisan of Moisan Legal and Bruce Rich of Carter Ledyard & Milburn, LLP, discussed the NY LLC Report and Recommendations by the Ad Hoc Committee of the Business Section of the NYSBA.

- October: At the 2018 Business Law Section Fall Meeting, a panel of speakers discussed the regulatory response to recent cybersecurity developments. Speakers included Keith E. Cassidy, Esq., Associate Director, Technology Controls Program, U.S. Securities and Exchange Commission (SEC) Office of Compliance Inspections and Examinations, Brad Carpenter, Supervisory Special Agent, FBI Cyber Division, and Mekalia Reid, Associate Director, SDDCO Regulatory Services LLC.

- November: J.B. Heaton, of J.B. Heaton, P.C., presented an introduction to legal issues concerning short sales of common stock in the US and an examination of securities regulation—both current and proposed—that arise in hedge fund activism directed at U.S.-listed companies.

- December: Byron Rooney of Davis Polk & Wardwell will present on the results of DPW's recent IPO survey. Second speaker and topic: TBD.

Anastasia Rockas, Chair (by Kelley Basham)

Technology and Venture Law Committee

At the 2018 Business Law Section Fall Meeting, Everett Carbajal of The Carbajal Law Firm PC and Christopher Edwards and Bob Clarida of Reitler Kailas & Rosenblatt LLC spoke on best practices for cybersecurity, including updates on data privacy law, cyber insurance and other guidance for financing transactions for clients in the information technology industry.

Christopher Edwards, Chair

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___ Banking Law (BUS 1100)
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___ Business Organizations Law (BUS 2500)
___ Derivatives and Structured Products Law (BUS 1300)
___ Diversity Subcommittee (BUS 1004)
___ Franchise, Distribution and Licensing Law (BUS 1800)
___ Insurance Law (BUS 1900)
___ Legislative Affairs (BUS 2000)
___ Membership (BUS 2100)
___ Mergers and Acquisitions (BUS 2400)
___ Not-for-Profit Corporations Law (BUS 2300)
___ Public Utility Law (BUS 2200)
___ Securities Regulation (BUS 1700)
___ Private Investment Funds Subcommittee (BUS 1703)
___ Technology and Venture Law (BUS 1400)

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