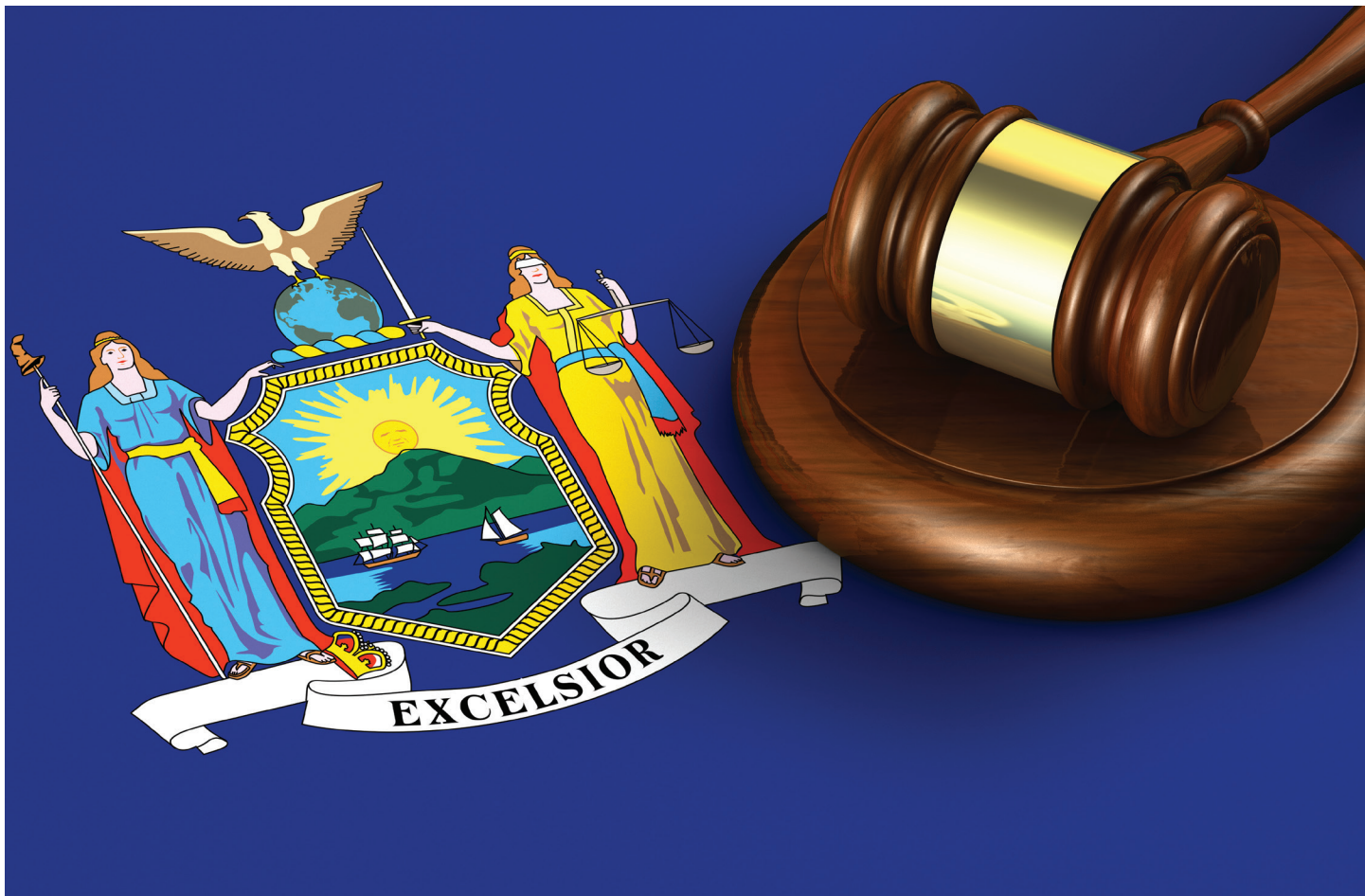


NY Business Law Journal



A publication of the Business Law Section
of the New York State Bar Association



Inside

- Case Study of Fiduciary Abuse in a Closely Held Corporation: How The Palm Got Out of Hand
 - The Attorney-Client Privilege and Its Application to Communications with Former Corporate Employees
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 - Reference Checks for Employees Discharged Due to Misconduct
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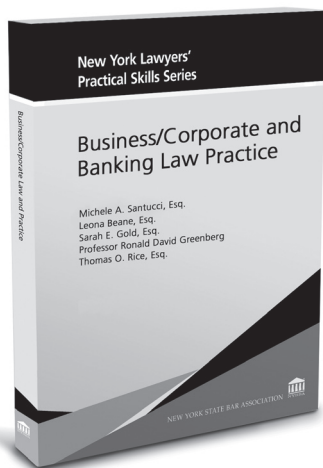
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This practice guide covers corporate and partnership law, buying and selling a small business, the tax implications of forming a corporation and banking law practice. It covers many issues including the best form of business entity for clients and complicated tax implications of various business entities.

Updated case and statutory references and numerous forms following each section, along with the practice guides and table of authorities, make this edition of *Business/Corporate and Banking Law Practice* a must-have introductory reference.

The 2018–2019 release is current through the 2018 New York legislative session and is even more valuable with the inclusion of Downloadable Forms.

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Message from the President

Diversifying the Legal Profession: A Moral Imperative

By Hank Greenberg

No state in the nation is more diverse than New York. From our inception, we have welcomed immigrants from across the world. Hundreds of languages are spoken here, and over 30 percent of New York residents speak a second language.

Our clients reflect the gorgeous mosaic of diversity that is New York. They are women and men, straight and gay, of every race, color, ethnicity, national origin, and religion. Yet, the law is one of the least diverse professions in the nation.

Indeed, a diversity imbalance plagues law firms, the judiciary, and other spheres where lawyers work. As members of NYSBA's Business Law Section, you have surely seen this disparity over the course of your law practices.

Consider these facts:

- According to a recent survey, only 5 percent of active attorneys self-identified as black or African American and 5 percent identified as Hispanic or Latino, notwithstanding that 13.3 percent of the total U.S. population is black or African American and 17.8 percent Hispanic or Latino.
- Minority attorneys made up just 16 percent of law firms in 2017, with only 9 percent of the partners being people of color.
- Men comprise 47 percent of all law firm associates, yet only 20 percent of partners in law firms are women.
- Women make up only 25 percent of firm governance roles, 22 percent of firm-wide managing partners, 20 percent of office-level managing partners, and 22 percent of practice group leaders.
- Less than one-third of state judges in the country are women and only about 20 percent are people of color.

This state of affairs is unacceptable. It is a moral imperative that our profession better reflects the diversity of our clients and communities, and we can no longer accept empty rhetoric or half-measures to realize that goal. As Stanford Law Professor Deborah Rhode has aptly observed, "Leaders must not simply acknowledge the importance of diversity, but also hold individuals accountable for the results." It's the right thing to do, it's the smart thing to do, and clients are increasingly demanding it.

NYSBA Leads on Diversity

On diversity, the New York State Bar Association is now leading by example.

This year, through the presidential appointment process, all 59 NYSBA standing committees will have a chair, co-chair or vice-chair who is a woman, person of color, or otherwise represents diversity. To illustrate the magnitude of this initiative, we have celebrated it on the cover of the June-July *Journal*. (See <http://www.nysba.org/diversitychairs>)



Hank Greenberg

Among the faces on the cover are the new co-chairs of our Leadership Development Committee: Albany City Court Judge Helena Heath and Richmond County Public Administrator Edwina Frances Martin. They are highly accomplished lawyers and distinguished NYSBA leaders, who also happen to be women of color.

Another face on the cover is Hyun Suk Choi, who co-chaired NYSBA's International Section regional meeting in Seoul, Korea last year, the first time that annual event was held in Asia. He will now serve as co-chair of our Membership Committee, signaling NYSBA's commitment to reaching out to diverse communities around the world.

This coming year as well we will develop and implement an association-wide diversity and inclusion plan.

In short, NYSBA is walking the walk on diversity. For us, it is no mere aspiration, but rather, a living working reality. Let our example be one that the entire legal profession takes pride in and seeks to emulate.

HANK GREENBERG can be reached at hmgreenberg@nysba.org.

HeadNotes

As our Winter 2018 issue went to press, we noted that 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. As this issue goes to press, the chatter on cable news and the press again is heavily focused on the latest retaliation by China for tariffs imposed by the Administration. The more things change . . .

One change, welcome and long overdue, appears to be on the horizon for banking organizations and companies that wish to invest in them. The Bank Holding Company (BHC) Act of 1956, as amended, imposes draconian restrictions on the activities of any company that “controls” a bank, along with stringent capital requirements and a heavy layer of regulation by the Federal Reserve (Fed). For companies such as investment funds that might want to invest in bank shares, but cannot conduct their business under the restrictions that come with being a bank holding company, the question of what constitutes “control” is thus all-important. Among other things, the Fed has great discretion to find legal control, even in cases where the indicia of actual control may appear to be minimal. The Fed has now moved to address the ongoing uncertainty, in a much-anticipated notice of proposed rulemaking (NPR), whereby it would formally adopt a framework based on percentage ownership and other factors. This issue contains an article by the attorneys of Sullivan & Cromwell, discussed below, on the proposed changes.

Meanwhile, closer to home, New York businesses and their lawyers have, as always, numerous challenges of which to be aware. So we are leading off this issue with three short, clearly written articles by New York practitioners aimed at sharing their knowledge and expertise with their colleagues in areas of immediate and practical significance. First up are Stuart Newman, Chair Emeritus of the *Journal's* Advisory Board, and Allison Rosenzweig, with a cautionary tale on one risk of choosing the LLC structure, rather than a business corporation, for a small business. In “Case Study of Fiduciary Abuse in a Close Corporation: How the Palm Got Out of Hand,” they tell the tale of a family-owned business that grew into a national enterprise. Along the way, a handful of insiders were able to enrich themselves at the expense of other family members who were less involved in the business. After some 40 years, the minority owners finally woke up. As the authors explain, the resulting litigation led to several object lessons, of which the most important is the potential risk posed by the lack of corporate governance provisions in the New York Limited Liability Company Law, as compared to the Business Corporations Law. Mr. Newman and Ms. Rosenzweig are business law and transaction attorneys with the firm Offit, Kurman, P.A.

In modern business transactions, it is not uncommon for one party to require that the other provide some form of insurance to protect its position in the event of non-performance, casualty loss or otherwise. But it sometimes turns out that the party that thought it was protected by insurance in fact was not. In “Proof of Insurance: Be Careful What You Ask For—You Don’t Always Get What You Want,” Jay Hack explains the difference between “evidence” of insurance and “proof” of insurance—noting that this apparently fine distinction has led to a surprising amount of litigation. In particular, documents such as certificates of insurance provided on a standard form may fall short of constituting proof that a policy actually was issued. The author provides sound and practical guidance that is relevant to every attorney who structures and advises on business transactions. Mr. Hack, a partner with the New York firm Gallet, Dreyer & Berkey, is a past Chair of the Business Law Section.



David L. Glass

Public companies, and the New York lawyers who represent them, are bound by rules and regulations issued by the Securities & Exchange Commission (SEC). But what happens when an attorney’s obligations under New York law conflict? In such circumstances Evan Stewart, a partner of Cohen & Gresser in New York and the *Journal's* guru on all matters related to attorney ethics, warns, “New York Lawyers: Be Afraid, Be Very Afraid...!” The reason is that following the mandate of the 2002 Sarbanes-Oxley Act (SOX), which addressed corporate abuses in the wake of the Enron scandal, the SEC adopted a “permissive disclosure” standard for lawyers representing public corporations; i.e., the lawyer may (but generally is not required to) disclose material violations by her client. But New York ethics rules allow lawyers to make permissive disclosure only to prevent death or substantial bodily harm, or to prevent a crime, and not with respect to financial fraud. The SEC takes the position that its rule preempts state law, but Mr. Stewart argues that this position is not supported by the legislation, and takes us through several cases reaching conflicting results. As always, his insights are a timely heads-up for New York lawyers regarding the practical pitfalls that may result when they attempt to fulfill their ethical obligations. Don’t be afraid—read Mr. Stewart’s very helpful article instead!

Speaking of ethical rules in New York, an ongoing area of uncertainty relates to the scope of their application to in-house corporate lawyers. In the prior (Winter 2018) issue of the *Journal*, Albany Law School Professor Michael J.

Hutter explored this issue from the standpoint of communications between an in-house attorney and other current employees of the corporation. In this issue he turns our attention to “The Attorney Client Privilege and Its Application to Communications With Former Corporate Employees”—a situation that might arise, for example, in conjunction with an internal investigation of conduct that took place before the employee left the company. Professor Hutter notes that New York courts generally recognize that a corporation may invoke the privilege with respect to communications with its attorneys, whether in-house or outside, in conjunction with an internal investigation, provided the purpose was to render legal advice to the corporation. But is communication with a former employee the equivalent of communication with the corporation, for the purpose of invoking the privilege? And do courts distinguish between communications made with the employee while employed and post-employment? Professor Hutter reviews recent cases addressing these issues and provides practical and clear advice for attorneys who may find themselves conducting an investigation for a corporate client. More generally, his article is a valuable refresher for all corporate attorneys regarding application of the privilege to their work for corporate clients.

As noted above, welcome and significant changes in the Federal Reserve’s approach to determining when a company “controls” a bank are in the offing. In “Federal Reserve Proposes Comprehensive Regulation for Determining ‘Control,’” the attorneys of Sullivan & Cromwell provide a comprehensive explanation of the changes that would be made by the proposed new regulation, noting that its primary purpose is to make the entire “control” determination process more transparent. In addition, however, the new regulation would significantly modify the Fed’s existing approach to controlling influence determinations. The authors explain that these changes should significantly enhance the ability of investors such as private equity funds to invest in shares of banks and bank holding companies without fear of being deemed to control them, but they caution that the Fed is not necessarily liberalizing the indicia of control with respect to non-bank subsidiaries of the bank holding company, due to the underlying policy embedded in the Bank Holding Company Act against allowing banking companies to engage in “commerce.”

Another welcome change is in the offing in the bank regulatory world. In “Financial Stability Oversight Council Seeks to Change How It Determines Systemic Risk,” Kathleen Scott explains how the Council (FSOC) is proposing to take a completely new approach to systemic risk, by focusing on activities that pose risk to the financial system rather than focusing on individual non-bank companies. The FSOC, created as a kind of super-regulator under the Dodd-Frank Act that responded to the global financial crisis, is chaired by the Secretary of the Treasury and includes the heads of all the financial regulatory agencies. Among other things, under Dodd-Frank, it

has the power to designate large non-bank financial companies as “systemically important financial companies (SIFIs)” which would then be regulated as bank holding companies by the Federal Reserve. Ms. Scott shows why this approach has failed to achieve the intended result of reducing systemic risk and describes how the proposed new approach would work. Along the way, she provides a very useful primer on the background and genesis of the FSOC itself. A senior counsel with Norton Rose Fulbright in New York, Ms. Scott is a past Chair of the Business Law Section and of its Banking Law Committee.

An ongoing area of concern for every company and its counsel is the ever-expanding scope of employment law, and the responsibilities it places on business to protect employees in a variety of situations. One such situation is the provision of reference checks to prospective new employers. Many employers follow a policy of simply confirming an employee’s dates of employment, in order to avoid potential defamation actions for furnishing negative information. But, inspired by the #MeToo movement, the question of whether an employer should disclose a prior history of sexual harassment has come to the fore. Taking the lead, California has now enacted legislation providing a qualified privilege to employers who disclose this information. In “Reference Checks For Employees Discharged Due to Misconduct,” Jeffrey Klein and Nicholas Pappas of Weil Gotshal discuss both the new California law and the issue of reference checks more generally, from the standpoint of both the former employer and the prospective hiring employer. They note that in New York, an employer generally may disclose information regarding the character of a former employee, as long as it does so without malicious intent. However, employers generally should remain concerned that references disclosing misconduct can lead to defamation lawsuits. The authors provide useful practice suggestions that should command the attention of every attorney who advises companies on employment practices. This article previously appeared in the *New York Law Journal*; we express our appreciation to Weil Gotshal and ALM Media for permission to reprint it.

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.

One of the great satisfactions for the editors of the *Journal* is the ongoing flow of quality articles submitted

by law students for the Business Law Section's annual Student Writing Competition. Elsewhere in this issue we celebrate the three winners of the 2018 Competition: Ms. Melanie Lupsa (Seton Hall University School of Law), Ms. Monica Lindsay (Pace University Elizabeth Haub School of Law), and Ms. Danielle Wilner (Syracuse University School of Law). In this issue we are pleased to feature three more outstanding and informative contributions from law students. The editors note that, in making these awards, we focus on the timeliness and relevance of the article to our readers, as well as the quality of the writing and research.

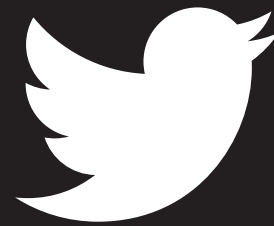
First up is "Critical Audit Matters: Improving Disclosure Through Auditor Insight" by Katherine Cody. Ms. Cody explains how the independent auditor's report, essentially unchanged for some 80 years, is undergoing a significant revision in 2019 with the addition of the disclosure category for Critical Audit Matters (CAM). All public companies are required to disclose all material information to the public annually, on Form 10-K filed with the Securities & Exchange Commission (SEC). The sole communication from the company's independent auditors is a short letter included with the 10-K that historically has followed a "pass/fail" model, i.e., the auditor either states that the company's financial statements present its financial condition "fairly in all material respects" or it does not. But even if it "passes" — referred to as an unqualified opinion—the auditor's letter does not highlight or explain which areas of risk that were examined might be considered of critical importance. The new CAM are part of a broader SEC initiative to provide greater disclosure, especially for individual investors. In a clear and thoroughly researched analysis, Ms. Cody argues that while CAM are a useful addition for individual investors, additional updates to existing disclosures are necessary to close the information gap between institutional and individual investors. Ms. Cody is a candidate for the J.D. at St. John's School of Law. An earlier version of this article appeared in the University of California (Davis) *Law Review*; the version appearing in this issue has been updated by the author to reflect subsequent developments.

Another rapidly changing area of securities law involves "crowdfunding," or the raising of capital directly from individual investors, usually over the internet. While crowdfunding has proven very popular with both entrepreneurs and investors, it has significant problems—in particular, limitations on funding portals and capital availability and the potential for fraud. In "Challenges and Implications for Potential Reforms of Crowdfunding Law," Kei Komuro discusses the history and different types of crowdfunding and the SEC's attempt to regulate this market through its Regulation Crowdfunding. He goes on to propose specific reforms to deal with the problems noted. In the area of fraud, for example, he notes that in a survey conducted by Forbes, 84 percent agree that crowdfunding is a legitimate way for entrepreneurs to finance their business, but only 27 percent trust the

honesty of those using this method to raise capital—suggesting that reforms are needed to encourage investors to provide funds. Mr. Komuro is a candidate for the J.D. at Fordham University School of Law.

The rapid advance of technology such as artificial intelligence poses significant new challenges for the application of patent law. Concluding this issue, Danielle Kassatly addresses "The Patentability of Technology in the Information Age: How the Checks and Balances of the Courts in a Patent Suit Pathway Stimulates Innovation in the Field of Artificial Intelligence." Ms. Kassatly begins with a useful primer and overview of how patent litigation is conducted, explaining how a special appellate level court, the Federal Circuit, was created in 1982 to have jurisdiction over patent law cases—as distinguished from other federal courts, which have jurisdiction based on geography or personal jurisdiction. Noting that the Supreme Court has said that the objective of patent law is "striking the balance between protecting inventors and not granting monopolies over procedures that others would discover by independent, creative application of general principles," she illustrates how the Supreme Court's approach to these issues has diverged from that of the Federal Circuit and other lower courts. She reviews a number of recent cases that have addressed the application of patent law to software in particular, which poses special problems under the law. Her article is an invaluable primer on patent law generally, as well as an insightful comment on its application to modern technology. Ms. Kassatly is a candidate for the J.D. at the University of California Davis School of Law.

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Case Study of Fiduciary Abuse in a Closely Held Corporation: How The Palm Got Out of Hand

By Stuart B. Newman and Allison W. Rosenzweig

The Palm, a family-owned steakhouse, opened in 1926, first became a New York institution and then, as the concept was rolled out from the original Second Avenue location by the grandchildren of the founders, a powerhouse national and worldwide brand.

As so often happens with successful multi-generational family businesses, control and management of The Palm, as well as equity, disproportionately settled into the hands of those family members who stayed in and actively ran the restaurant, while involvement and equity dwindled for other descendants who chose to pursue outside interests. In the case of The Palm's family holding corporation, after almost 90 years in business the corporation was owned 80 percent by descendants who ran the operation (the "Majority Defendants") and 20 percent by their cousins who did not (the "Minority Plaintiffs").¹ Unfortunately, as also happens in such scenarios, the insiders here took the opportunity to palm a few extra dollars for themselves—quite a few actually—at the expense of their cousins on the outside. Therein lies the rub and the juicy facts which led the minority cousins to bring a derivative action in New York Supreme Court, New York County. The result was a decision by Judge Masley, in *Ganzi v. Ganzi* (Index No. 653074/2012), NYSCEF Doc. No. 253, filed November 15, 2018.

Recipe for Litigation

At the heart of The Palm case is the fact that the restaurant's success led to the development of substantial and valuable intellectual property in the holding company: trademarks, service marks, restaurant design elements including menu, food quality choices and methods of preparation, as well as décor which included walls covered with caricatures (remember?), sketches, cartoons and other distinguishing elements. All of this Palm IP was used, beginning in 1972, to open other Palm restaurants, first in Washington, D.C. then nationally. The Court called these restaurants the "New Palms." By the time this action was brought, there were 54 New Palms, with the Majority Defendants—but not the family holding company or the Minority Plaintiffs—holding ownership stakes in all of them. Each New Palm operated under a license agreement from the family holding corporation which provided for a flat fee annual royalty of \$6,000 per restaurant.

Additionally, in 1975 the Majority Defendants set up their own management company that entered into a master license agreement with the family holding com-

pany, giving the management company the exclusive worldwide right to sub-license all Palm IP to third parties. For this extremely valuable right to grant sub-licenses, the management company paid the holding company a flat annual fee of \$12,000. Under authority of the master license agreement, the management company entered into many sub-license agreements worldwide with third parties, creating "an empire of Palm-branded businesses." Significantly, royalties on these sub-licenses were not on a flat rate basis, but at full market rate based on a percentage of sales.

None of these arrangements wherein the Majority Defendants had substantial financial interests was submitted to the board of the family holding corporation for approval by vote of the disinterested directors or shareholders as required under BCL § 713. In fact, shareholder and board meetings for the holding company were sporadic at best and, following a 10-year gap in meetings, such meetings were totally discontinued after 1986.²

Out of the Kitchen and into the Courthouse

The pattern of self-dealing with the company's valuable IP spanned 40 years before the Minority Plaintiffs commenced this action. Why they kept their claim on the back burner for so long was not addressed, but the Court had to deal with affirmative defenses of acquiescence and laches, which it effectively did by finding that here the Majority Defendants were not prejudiced by the delay and that corporate waste, as established in this case, could not be ratified.

While the court reviewed several patterns of conduct by the Majority Defendants alleged in the complaint to constitute minority oppression, misappropriation, breach of fiduciary duty and corporate waste, Judge Masley devoted substantial discussion in her opinion to the diversion by the Majority Defendants to themselves of the restaurant's valuable intellectual property, through their direct ownership interest in the New Palms and through the use of the master license agreement they unilaterally gave their own management company. The Court held that, as interested parties to these flat rate royalty

STUART B. NEWMAN is the Chair and Advisor Emeritus of the Editorial Advisory Board of this journal. He and Ms. Rosenzweig are attorneys with Offit Korman, P.A.

agreements, the Majority Defendants did not satisfy their burden of proving, under BCL § 713(b), that the agreements were fair and reasonable to the family company. In fact, expert witnesses for *both* sides testified that “similar licensing fees in the restaurant industry are calculated as a percentage of sales.” Although the experts differed on what the appropriate percentage should be for The Palm, the court found that 5% of gross sales was the reasonable royalty rate that should have applied to all the license agreements. Minority Plaintiffs were awarded substantial money damages, thereby giving the Majority Defendants their just desserts.

The Takeaway

If Michelin gave star ratings for decisions in restaurant litigation, Judge Masley would score well. Her opinion implicitly recognized that it is not uncommon in closely held businesses for uninvolved family members to underappreciate the efforts of those who devote themselves to running and growing it. Undeniably, the Majority Defendants here had a vision for The Palm and did achieve great success. “It is undisputed that the family was proud of [the defendants] and they had much to be proud of.” *Ganzi v. Ganzi*, P. 16. The Majority Defendants were entitled to be well-compensated for their efforts. However, that success did not entitle them to enrich themselves in a way that was unfair to the corporation and the other shareholders.

It is long established under both the common law and the BCL that officers and directors have an obligation to perform their duties in good faith (§§ 715(a) and 717(a) respectively), and that they may be held accountable for misconduct involving violation of their duties, waste of corporate assets, and unlawful transfer of corporate assets (§ 720).

It is also well established that transactions or agreements between a corporation and one or more officers or directors wherein such persons have a financial interest

are not *per se* void or voidable. But, the material facts of such transactions or contracts need to be disclosed to the board in good faith and approved by vote of the disinterested directors, either by unanimous vote of the disinterested directors or by approval of the board without counting the vote of the interested directors (§ 713(a)). If not so approved, the corporation could void them unless the interested parties carry the burden of proving that they were fair and reasonable (§ 713(b)).

As noted, however, the formalities of board and shareholder meetings at The Palm went down the drain decades ago. Although it is difficult to imagine the Majority Defendants succeeding in proving that their self-dealing license transactions were fair and reasonable, it is also difficult not to fault the Minority Plaintiffs for failing to insist on greater transparency and at least annual meetings of the board and the shareholders.

The Palm case sends an important message to business lawyers: corporate governance is still important. The New York Limited Liability Company Law, enacted 25 years ago, is regrettably silent on governance provisions that are explicit in the BCL. As a consequence, practitioners representing LLCs with members whose interests may not necessarily always be aligned tend not to think of meetings, resolutions and minutes. While the current preference for LLCs over corporations as the business entity of choice is more often than not entirely justifiable, that does not excuse abandonment of basic formalities of governance that have stood the test of time.

Endnotes

1. Including the estate of a cousin whose surname, appropriately, was “Cook.”
2. The agreement between the family holding corporation and the management company also provided for management services and compensation to the Majority Defendants. As to this, the court quoted from an independent report that was entered into evidence concluding that the restaurant had been grossly mismanaged, providing a “near perfect textbook example of how not to manage a restaurant.”

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Proof of Insurance: Be Careful What You Ask For—You Don't Always Get What You Want¹

By Jay L. Hack

Many business transactions require that one party maintain insurance for the benefit of another party. In a commercial mortgage loan, the borrower must maintain hazard insurance on the real estate collateral for the benefit of the mortgagee lender. Commercial tenants must provide liability insurance, and often hazard insurance, covering their landlord. Contractors must provide insurance benefitting owners before they commence construction and subcontractors must do likewise for general contractors. Owners of units in condominiums and cooperatives must provide insurance for the condo or coop before embarking upon the renovations of their units. Adjoining real estate owners insist on insurance when their neighbor seeks access to make improvements or repairs.² In matters not involving real estate, transport companies and automobile leasing companies are often on one side or the other of the need to provide insurance.³

Demanding insurance is easy. In a mortgage loan, the lender's commitment letter requires evidence or proof of hazard insurance, and often liability insurance, to protect the lender and the value of the collateral. Similarly, a lease may require liability insurance from even a minor tenant protecting the landlord if a customer or business invitee of the tenant is injured. Likewise, an owner seeking to improve real property will almost always include in the construction contract a requirement for liability insurance from the general contractor and the general contractor normally requires the same in contracts with subcontractors.

However, making certain that the insurance is in effect and that it covers the beneficiary is the difficult part of the process. The mistaken belief that insurance is in effect and covers a particular person when it isn't, or doesn't, has led to a surprising amount of litigation. The litigation often involves beneficiaries who claim to be insured and who present "evidence" of insurance but not quite "proof" of insurance. As stated by the Court of Appeals in *Consol. Edison Co. of New York, Inc. v Allstate Ins. Co.*, "Generally, it is for the insured to establish coverage and for the insurer to prove that an exclusion in the policy applies to defeat coverage."⁴ Therefore, the supposed beneficiary must first establish that a policy exists and that the policy covers the beneficiary and the occurrence. A little bit of evidence of insurance does not go a long way.

Frequently, beneficiaries who request proof that there is insurance benefitting them accept a "Certificate of Insurance" or "Evidence of Insurance" on a form that is not part of the insurance policy. The forms almost universally

used for this purpose are provided by ACORD Corporation.⁵ Two common forms are the ACORD 25 Certificate of Liability Insurance and the ACORD 28 Evidence of Commercial Property Insurance.⁶ ACORD is an insurance industry trade group that has created forms designed to standardize the insurance business for brokers, agents and carriers. However, the ACORD forms are standards that the insurance industry wants, not standards that insurance consumers want. As explained in an opinion of the general counsel to New York State Department of Financial Services (DFS), "[a]n ACORD certificate of insurance is a commercially created document that is often used by the insurance industry to summarize information about a person or entity's insurance coverage. It is not a contract..."⁷

We must first examine the text of the ACORD forms themselves. The forms include limiting language that disclaims that they create legal rights. The ACORD 28 Form, Evidence of Commercial Property Insurance, states:

This evidence of commercial property insurance is issued as a matter of information only and *confers no rights upon the additional interest named below*. This evidence does not affirmatively or negatively amend, extend or alter the coverage afforded by the policies below. This evidence of insurance does not constitute a contract between the issuing insurer(s), authorized representative or producer, and the additional interest. (emphasis added).

Similarly, the ACORD 25 Form, Certificate of Liability Insurance, states:

This certificate is issued as a matter of information only and confers no rights upon the certificate holder. This certificate does not affirmatively or negatively amend, extend or alter the coverage afforded by the policies below. The certificate of insurance does not constitute a contract between the issuing insurer(s),

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authorized representative or producer, and the certificate holder. (*emphasis added*)

Although ACORD certificates are in common use every day, they are a far cry from actual insurance. They are not even binders. In no way do they prove that insurance is in effect, let alone that a beneficiary is covered by that insurance. The language of the ACORD forms, as confirmed repeatedly by the courts in New York, establishes only one universal fact—if there is no insurance policy, or if the language of the insurance policy does not cover either the beneficiary making the claim or the claim itself—then an ACORD COI provides nothing except perhaps a fraud claim against the person preparing the certificate. Some courts have even held that a fraud or estoppel claim gets no traction because of limiting language on the face of the certificate. The legal irrelevancy of a COI was subsequently confirmed by statute in New York when the legislature created a new Article 5 of the Insurance Law in 2014,⁸ at the behest of the insurance industry, which expressly provides that a certificate is not a policy and cannot vary the terms of the policy.

The courts in New York have time and again analyzed claims of coverage when there is no insurance policy covering the underlying claim but there is a COI evidencing coverage, but containing the ACORD limiting language. Not surprisingly, the courts in New York have consistently read the ACORD COIs as meaning exactly what they say. The Appellate Division, Fourth Department, made this clear as recently as 2017 in *Landsman Dev. Corp. v RLI Ins. Co.*,⁹ a case in which a worker for a contractor doing work on the landowner's property was injured and sued the landowner. The landowner had a COI naming him as an additional insured, but due to an oft-repeated technicality, the landowner was not covered by the additional insured language in the insurance policy.¹⁰ When the insurance carrier moved for summary judgment, the court noted:

We also agree with [the insurance company] that the certificates of insurance in [the landowner's] possession in February 2010 did not confer additional insured status. It is well established that a certificate of insurance, by itself, does not confer insurance coverage, particularly [where, as here,] the certificate expressly provides that it 'is issued as a matter of information only and confers no rights upon the certificate holder [and] does not extend or alter the coverage afforded by the policies' (quoting from *Sevenson Envtl. Servs., Inc. v Sirius Am. Ins. Co.*, 74 A.D.3d 1751, 1743, 902 N.Y.S.2d 279).¹¹

A COI may constitute evidence of an intent by the carrier to issue an insurance policy, but it does not mean that there is a policy. In another injured workman case, the Ap-

pellate Division, First Department, commented in *Tribeca Broadway Assoc., LLC v. Mount Vernon Fire Ins. Co.*¹² that "[a] certificate of insurance is only evidence of a carrier's intent to provide coverage but is not a contract to insure the designated party nor is it conclusive proof, standing alone, that such a contract exists."¹³ The First Department expanded on this analysis and pointed out that the broker for the contractor was just that, a broker, without the authority to bind the insurance carrier as its agent.¹⁴ The Fourth Department likewise confirmed that when the carrier established that neither it nor its duly authorized agent had issued the certificate, summary judgment for the carrier was appropriate.¹⁵

The Second Department in *Vikram Const., Inc. v. Everest Nat. Ins. Co.*¹⁶ has held likewise, also in a construction case in which an employee of a subcontractor sued the general contractor for injuries on the job. There was no policy, so there was no insurance. "[The carrier] established its prima facie entitlement to judgment . . . by submitting evidence demonstrating that it did not issue a policy of insurance to [the worker's employer]."¹⁷ The existence of a COI was irrelevant.

Although a certificate issued by a carrier or an agent does not itself establish that a policy exists, it may work as an estoppel against the carrier's denial of coverage. In *Sevenson Envtl. Services, Inc. v. Sirius Am. Ins. Co.*,¹⁸ the Fourth Department reiterated the basic principle that a COI is not a policy, but then focused on the dichotomy between a certificate issued by a broker and a certificate issued by the carrier or its agent. Faced with a statement by an employee of the insured's broker that the broker was authorized by the carrier's agent to issue a COI, and a claim by the carrier that the alleged agent was not an agent, the court found an issue of fact and denied summary judgment. The court stated:

Nevertheless, an insurance company that issues a certificate of insurance naming a particular party as an additional insured may be estopped from denying coverage to that party where the party reasonably relies on the certificate of insurance to its detriment. For estoppel based upon the issuance of a certificate of insurance to apply, however, the certificate must have been issued by the insurer itself or by an agent of the insurer . . .¹⁹

The Supreme Court, Niagara County, went one step further in *Allied World Natl. ASSI Co. v Peerless Ins. Co.*²⁰ when recently faced with this argument, which was upheld on appeal. The court first acknowledged that the COI did not create coverage, but then went on to comment, "Significantly, an insurance company that issues a certificate of insurance naming a particular party as an additional insured may be estopped from denying coverage to that party where the party reasonably relies on the certificate of insurance to its detriment, whereas here,

the certificate was issued by an agent of the insurer.” The insurance carrier argued that the reliance on the certificate was unreasonable because the certificate included the magic words, “confers no rights upon the certificate holder.” However, the court held that there were issues of fact on this and other issues in this case, precluding summary judgment and thereby holding that the “confers no rights” language did not automatically trump an estoppel argument.²¹

However, the First Department, in *Greater New York Mut. Ins. Co. v. White Knight Restoration, Ltd.*,²² held that the limiting language in the certificate, at least when issued by a broker, was sufficient to defeat a cause of action against the broker for fraud or negligent misrepresentation. “Regardless of whether the broker acted recklessly, the causes of action for fraud and negligent misrepresentation, based on the inaccurate certificates, were properly dismissed because it was unreasonable to rely on them for coverage in the face of their disclaimer language and, with respect to the negligent misrepresentation claim, because of the absence of a relationship approximating privity.”²³

Although claims based upon certificates of insurance seem to be predominantly those involving construction contracts and construction injuries, the principles set forth in these cases extend to other types of relationships as well. In *Cendant Car Rental Group v. Liberty Mut. Ins. Co.*,²⁴ the Second Department was faced with a dispute as to whether the insurance carrier was required to defend an auto accident claim involving a truck rented from Budget Rent-a-Car. The COI with the standard limiting language was the final nail in the coffin of the weak proof that was otherwise offered in support of coverage, when the court noted, “Moreover, the certificate of insurance proffered in support of their motion, which expressly stated that ‘it is issued as a matter of information only and confers no rights upon the certificate holder,’ was insufficient to support their contention that they were additional insureds under the Liberty Mutual policy.”²⁵

In another truck leasing case, the Second Department repeated this analysis, holding in *Penske Truck Leasing Co., L.P. v. Home Ins. Co.*,²⁶ that “[t]he certificate of insurance also contained the disclaimer that it was ‘issued as a matter of information only and confer[red] no rights upon the certificate holder’ and that it did ‘not amend, extend or alter the coverage’ afforded by the policies named therein.”²⁷

Likewise, the Southern District addressed similar issues in *Chartis Seguros Mexico, S.A. de C. V. v. HLI Rail & Rigging, LLC*,²⁸ when property was damaged in a train derailment. “Moreover, an insurer may be equitably estopped from denying coverage where the party for whose benefit the insurance was procured reasonably relied upon the provisions of an insurance certificate to that party’s detriment.”²⁹

The New York Insurance Law has been in accord with the ACORD forms since the legislature adopted Article 5 of the Insurance Law in 2014, appearing to bury forever any claim that the ACORD forms created any contractual rights.³⁰ Article 5 starts by allowing an “insurance producer” (an agent, broker or carrier) to create a COI as “evidence” of property or casualty insurance coverage.³¹ Since certificates of insurance had been issued for decades and the Department of Financial Services had approved the process, this grant of permission to issue certificates was unimportant. However, the statute went on to make it clear that such a certificate does not constitute a policy of insurance, even when issued by an agent or by the carrier itself.

Two provisions of the Insurance Law combine to reach this result. First, the definition of an insurance certificate expressly excludes an insurance policy or a binder.³² If an insurance policy or binder cannot be a subset of the universe of insurance certificates, then an insurance certificate cannot constitute a policy or binder. The Insurance Law also, by implication, confirms the effect of the “confers no rights” language when it provides, in Section 502(c), that “A certificate of insurance shall further not confer to any person any rights beyond those expressly provided by the policy of insurance referenced therein.”³³ If the policy actually exists and confers rights by its own terms, then the effect of a COI is irrelevant, but if the policy does not exist or does not name a particular party as covered by it, then the COI cannot create it. *Nemo dat quod non habet*.³⁴

The insurance certificate may not, both by its customary terms and by statute, vary the coverage provided by the policy, when issued. The standard form ACORD 25 and ACORD 28 forms, as quoted above, expressly provide that they do not “amend, extend or alter” the policy. Likewise, Insurance Law Section 502 prohibits any person from willfully requiring that a certificate of insurance provide particular coverage or set forth the terms and conditions of the insurance unless the policy itself expressly includes such terms, conditions or language.³⁵

Article 5 of the Insurance Law was adopted specifically with this result of completely neutering anything

“Although ACORD certificates are in common use every day, they are a far cry from actual insurance.”

inserted into a standard form COI. According to the legislative history of an amendment to Article 5 in 2015, it was not uncommon for the party that was required to provide insurance to request that the producer modify the COI to expand coverage beyond that provided, or expected to be provided, in the final policy.³⁶ Article 5 was added to give insurance brokers and agents a statute that they could point to as justification for their refusal to alter COIs to show non-existent coverage. DFS had already opined many times that such expansion was prohibited,³⁷ but pressuring insurance brokers was apparently still common.

This is further complicated by frequent confusion between an insurance binder and an insurance certificate. An insurance binder is a temporary or interim policy of insurance.³⁸ It is as effective as an insurance policy until the policy itself is issued. Once the insurance policy is issued, the binder disappears, and creates no rights other than for the period from the day the binder is issued until the day the policy is issued.³⁹

To be effective, a binder must be issued by a duly authorized agent of the insurance company, or by the insurance company itself. An insurance broker, who acts as an agent of the insured to obtain a policy, is not authorized to issue a binder. The binder creates legal rights and responsibilities, albeit temporary ones, until the policy is issued. As stated by Judge Hellerstein of the Southern District in *In re September 11th Liab. Ins. Coverage Cases*,⁴⁰

Under New York law, the law that governs, an insurance binder is a separate contract that provides interim insurance until the final policy is issued or refused. *Springer v. Allstate*, 94 N.Y.2d 645, 710 N.Y.S.2d 298, 731 N.E.2d 1106, 1108 (2000). When a loss occurs prior to finalization of an insurance policy, the binder in effect at the time of the loss governs. *World Trade Ctr. Props.*, 345 F.3d 154, 183 (2d Cir.2003). In the case at bar, the binder is the governing contract (footnote omitted).⁴¹

The party being asked to provide insurance often deals with an insurance broker rather than a duly authorized agent or with the carrier itself. In matters not involving buildings as significant as the World Trade Center, the beneficiary who demands a binder or other “proof” of insurance often instead receives only an ACORD COI from a broker.⁴² The COI is far less than a binder, and should never be confused with it.

Since a binder is not itself a “permanent” policy of insurance, the DFS General Counsel issued an informal opinion to the effect that it is up to the beneficiary requiring the insurance whether it will accept a binder as proof.⁴³ However, an amendment of the New York Banking Law in 1990⁴⁴ requires that many lenders making

mortgage loans on 1-4 family residential real properties accept a binder. At the instigation of independent insurance agents, the legislature remedied the difficulty they had in obtaining final policies by adding Banking Law Section 6-j⁴⁵ requiring lenders to accept binders, without saying anything about COIs.

Banking Law Section 6-j served the needs of independent, non-captive agents, who were authorized to issue binders, but did nothing for brokers. Brokers could not satisfy the Banking Law requirements for a binder, even for residential mortgage loans. The law provides that, for a bank to be required to accept a proffered binder, (a) it must temporarily obligate the insurer to provide the specified insurance coverage pending issuance of the insurance policy and (b) the binder must be issued either by an insurer or a duly authorized representative of the insurer.⁴⁶

An insurance broker is the agent of the insured, not an agent for the insurance company except in limited circumstances.⁴⁷ Although insurance agents and insurance brokers are both occasionally referred to as “producers” of an insurance policy, their status, and their right to bind a carrier, are completely different. The broker cannot bind the insurance company to issue an insurance policy. In the rush to close a loan, to commence construction or to consummate some other transaction that no one believes, at the outset, is going to result in an insurance claim, getting an actual insurance policy, or a legally enforceable insurance binder issued by an agent, is often waived. Instead, the party requiring insurance accepts a meaningless COI.

“Wait a minute,” your client says after accepting a COI against your advice, “don’t I have a fraud claim against the broker?” The First Department hinted at this possibility in *St. George v. W.J. Barney Corp.*, when it commented, “. . . while [the insurance broker] may have arguably breached its duty to its client. . . .”⁴⁸ Is the broker liable for knowingly providing an inaccurate certificate?⁴⁹ Is the alleged insured just out of luck because of a failure to read the document that said it conferred no rights? Or, although there is no case law on the subject, should the carrier be liable because the insurance industry knows this is going on and gladly turns a blind eye to the practice?⁵⁰

Conclusion—Marching Orders

So what should a business do when it requires that a counterparty provide the insurance? The only way to be certain, based upon the statute and case law, is to insist upon a copy of a policy of insurance containing a declarations page or an endorsement expressly providing the required coverage to the party that is seeking it. A binder issued by a duly authorized agent of the carrier, or by the carrier itself, is only temporary insurance until the actual policy is issued, but temporary insurance from a binder is better than the empty pseudo-promise of a COI. A binder still presents the risk that once the insurance policy is issued, a variation between the binder and the policy is

decided in favor of the policy on events occurring after the policy is issued. The policy may not provide the same protection that the beneficiary required be stated in the binder, so even with a binder, a careful review of the full text of the policy is necessary.

The initial version of Article 5 of the Insurance Law prohibited persons and government entities from requiring an “opinion letter, warranty, statement, supplemental certificate or any other document or correspondence” in addition to the COI.⁵¹ The legislative history indicates that this provision had been included to protect brokers against being forced to certify, separate from the COI, that there was a policy in effect. Some government entities had imposed such a requirement as a condition of accepting a COI from a broker. Government entities objected to a prohibition on such separate certifications, notably including the New York State Department of Transportation,⁵² which received hundreds of COIs every year as part of its capital improvement program. Ultimately, the prohibition was removed from the statute.⁵³

The New York City Buildings Department, thus free to require an additional certification, created a new form PGLI⁵⁴ with the express purpose of making sure that “all major construction activity is properly insured.”⁵⁵ The PGLI form, which is required to be submitted along with the ACORD certificate before a building permit may be issued, summarizes the general liability insurance coverage for a specific project. The insurance broker or agent must certify that the ACORD certificate to which it is attached “is accurate in all material respects.” In addition, the broker or agent must set forth the per occurrence and per project limits of the insurance and must certify that the City of New York is an additional insured.

The PGLI certifications do not alter the statute and the case law regarding whether insurance is in effect. However, at a minimum, they create a claim against the broker or agent if the certification is false and may, depending on the facts, create criminal liability for making a false certification to a government agency. If the broker or agent has deep pockets or has satisfactory professional liability or errors and omissions insurance, the PGLI certification may provide redress for economic loss when there is no underlying policy directly protecting the Building Department.

Can an independent lender, property owner, developer, coop managing agent or other person seeking insurance protection create a certification form like the PGLI and use it in nongovernment business? Yes. But it still doesn’t get the beneficiary any insurance. It only gets a claim against the broker signing the form. Better is to insist on a binder from a duly authorized agent, including confirmation of the payment of a year’s premium and, whenever possible, a policy number. If the insurance policy is already in place (for example, a property owner who is refinancing a mortgage loan and already owns the property or a contractor who has an umbrella

policy covering all jobs), insist on getting the policy with a binder covering the endorsement in favor of the party demanding the insurance. In my experience, even a broker can get what you want from an agent or the carrier once the broker understands that the deal won’t go forward without it.

It Isn’t Over ‘til It’s Over⁵⁶

There is an additional trap for the unwary. Additional insured coverage is ineffective, even if there is a policy, unless there is a specific endorsement or policy language covering the additional insured. This may come in the form of an endorsement specifically naming the beneficiary and granting additional insured status or policy language insuring a class of additional insureds to which the beneficiary belongs. The ACORD 25 Certificate of Liability Insurance warns the beneficiary of this limitation with the following warning:

Important: If the certificate holder is an additional insured, the policy(ies) must have additional insured provisions or be endorsed. . . . A statement on the certificate does not confer rights to the certificate holder in lieu of such endorsement(s).

Therefore, if the beneficiary seeks to become an additional insured, then not only must the policy actually exist, but there must be either a provision extending additional insured coverage generally or there must be an endorsement naming the additional insured. If your client wants additional insured protection, you must check the policy carefully to make sure that your client is covered by the additional insured provision because frequently the provision is not as broad as you think.⁵⁷

Endnotes

1. With due apologies to the Rolling Stones (*Let It Bleed*, 1965).
2. New York Real Property Actions and Proceedings Law Section 881, a surprise to the uninitiated, allows an owner of real property to obtain a license allowing access to adjoining property when necessary to improve or repair the licensee’s property, “upon such terms as justice requires.” Those terms always includes providing insurance because Section 881 also provides, “[t]he licensee shall be liable to the adjoining owner or his lessee for actual damages occurring as a result of the entry.”
3. After struggling with possible terms to use to keep the language concise and avoid wasting too much paper, I have settled on “insured” to refer to the primary insured who is asked to provide insurance and “beneficiary” to refer to the certificate holder, mortgagee, landowner, etc. who requires someone else to obtain insurance for her/him/it.
4. *Consol. Edison Co. of New York, Inc v. Allstate Ins. Co.*, 98 NY2d 218, 218 (2002).
5. ACORD Corporation is a not-for-profit corporation consisting of members primarily from the insurance industry, either carriers, agents or brokers, created to standardize industry data and forms. ACORD can exist without violating anti-trust laws because insurance companies are substantially exempt from anti-trust

- scrutiny under the McCarran-Ferguson Act to the extent that they are subject to state regulation. 15 U.S.C. §§ 1011-1015.
6. Although the Form 25 is a “Certificate” and Form 28 is “Evidence,” this article will refer to both as a “Certificate of Insurance.”
 7. NYS Dep’t. of Law OGC Op No. 10-11-16 (November 16, 2010).
 8. Insurance Law Sections 501-505 (McKinney’s).
 9. *Landsman Dev. Corp. v RLI Ins. Co.*, 149 AD3d 1489 (4th Dept. 2017).
 10. The insurance policy provided an additional insured endorsement that stated that it applied to “blanket, as required by written contract,” but apparently, due to an affiliation between the contractor and the landowner, there was no “written” contract.
 11. *Landsman Dev. Corp.* at 490-91.
 12. *Tribeca Broadway Assoc., LLC v. Mount Vernon Fire Ins. Co.*, 5 A.D. 3d 198 (1st Dep’t. 2004.)
 13. *Id.* at 200.
 14. *Id.*
 15. *Landsman Development*, at 1491.
 16. *Vikram Const. Inc. v. Everest Nat. Ins. Co.*, 139 A.D.3d 720 (2d Dep’t 2016).
 17. *Id.* at 721.
 18. *Sevenson Envtl. Services, Inc. v. Sirius Am. Ins. Co.*, 74 A.D.3d 1751 (4th Dep’t 2010).
 19. *Id.* at 1753.
 20. *Allied World Natl. Assur. Co. v. Peerless Ins. Co.*, 61 Misc., 3d 1222(A) (Sup.Ct. Niagara Co., 2017), *aff’d sub nom Allied World Natl. Assur. Co. v. Peerless Ins. Co. a Stock Co.*, 166 A.D.3d 1524 (4th Dep’t 2018).
 21. *Id.*
 22. *Greater New York Mut. Ins. Co. v. White Knight Restoration, Ltd.*, 7 A.D.3d 292 (1st Dep’t 2004).
 23. *Id.* at 293. See also *Summit Const. Services Group, Inc. v. Act Abatement, LLC.*, 54 Misc. 3d 505 (Sup. Ct., Westchester Co., 2016).
 24. *Cendant Car Rental Group v. Liberty Mut. Ins. Co.*, 48 A.D.3d 397 (2d Dep’t 2008).
 25. *Id.* at 398.
 26. *Penske Truck Leasing co., L.P. v. Home Ins. Co.*, 251 AD2d 478 (2nd Dep’t 1998).
 27. *Id.* at 479.
 28. *Chartis Seguros Mexico, S.A., de C.V. v. HLI Rail & Rigging, LLC*, 11 CIV, 3238 ALC GWG, 2014 WL 988574 (S.D.N.Y. Mar 13, 2014).
 29. *Id.* at *4.
 30. Tort claims for fraud by a broker in issuing a knowingly false COI are not addressed in Article 5 of the Insurance Law.
 31. McKinney’s N.Y. Insurance Law Article V.
 32. McKinney’s N.Y. Insurance Law Section 501 (a).
 33. McKinney’s N.Y. Insurance Law Section 502(c).
 34. “No one gives what they don’t have.” Sorry for the Latin phrase, but I offer it in honor of my mother, who passed away last year at age 96. She was raised in an Orthodox Jewish home and kept strictly kosher in her own house, but insisted to me as a young boy that if I wanted to grow up to be a lawyer, I needed to learn Latin. I did not, but I would occasionally sprinkle Latin phrases into communication with her.
 35. This provision highlights a common problem when, for example, a COI is presented, although it adds nothing to the existing law that the COI could not vary the terms of the policy itself. See Note 37 and accompanying text.
 36. Memorandum in Support of Legislation, New York Bill Jacket, 2015 A.B. 4616, Ch. 8.
 37. See, eg, New York State Department of Financial Services General Counsel Opinion 5-20-2003 (#3), 2003 WL 24312408 (NY INS BUL), which states, “Therefore, licensed producers may not add terms or clauses to a Certificate of Insurance that alter, expand, or otherwise modify the terms of the actual policy. As stated in Circular Letter No. 15 (1997), the Department may seek disciplinary measures against producers who act in this manner.”
 38. New York State Department of Financial Services (formerly the NYS Insurance Department) General Counsel Opinion 11-2-2001 (#2), 2001 WL 36038789 (NY INS BUL).
 39. *Springer v. Aetna Life Ins. Co. of New York*, 94 N.Y.2d 645, 649 (2000).
 40. *In re September 11th Liab. Ins. Coverage Cases*, 333 F. Supp 2d 111(S.D.N.Y.2004).
 41. *Id.* at 119-120.
 42. In my experience representing banks in commercial mortgage lending, ACORD forms issued by brokers are provided more than 75% of the time. Insisting on a legally enforceable binder is often met by either “The ACORD form is the same as the binder,” or “I can’t get a binder or a policy or a policy number because it is not available yet.” The response, “That means there’s no insurance, right?” to the latter allegation usually causes great consternation in the broker.
 43. New York State Department of Financial Services General Counsel Opinion 11-2-2001 (#2), 2001. WL 36028789 (NY INS BUL).
 44. Banking Law Section 6-j, adopted 1990 N.Y. Sess. Law Serv. 445 (McKinney’s).
 45. My first foray into legislative lobbying was a failed attempt to defeat the legislation adding this provision. The legislation was proposed by independent insurance agents who had difficulty getting complete insurance policies fast enough to satisfy lenders. They argued successfully that a binder was just as good as a policy and we could find no case law at the time in which a lender had suffered a loss because it accepted a binder rather than insisting on a policy.
 46. Banking Law Section 6-j (2) (McKinney’s). It was over 25 years ago, but I am reasonably certain that these two requirements were the only concessions that Cliff Weber, a current member of the Business Law Section and then counsel to the savings banks trade association, and I were able to get from our lobbying efforts. He and I wrote these two requirements because we wanted to make sure that the lenders at least got something on which they could legally rely.
 47. “A broker is the agent of the insured, but it customarily looks for compensation to the insurer, not the insured, and it is sometimes the insurer’s agent also—for example, when collecting premiums.” *People ex rel. Cuomo v. Wells Fargo Ins. Services, Inc.*, 16 NY3d 166, 171 (2011).
 48. *St. George v. W.J. Barney Corp.*, 270 A.D.2d 171.172 (1st Dep’t 2000).
 49. The liability of a broker for providing a COI that is inaccurate is an issue outside the scope of this article. For information on that issue, the reader is directed to *Tucci v. Hartford Cas. Ins. Co.* 167 A.D.2d 387, 388.(2d Dep’t 1990) and *Brian Foy Constr. v. Morstam Gen. Agency*, 90 A.D. 3d 796, 798 (2d Dep’t 2011).
 50. Food for thought, but a Hail Mary not otherwise discussed in this article or hinted at in any other source I could find.
 51. As originally adopted, Section 502(d) stated, “(d) No person or governmental entity shall request or require either in addition to or in lieu of a certificate of insurance, an opinion letter, warranty, statement, supplemental certificate or any other document or correspondence that such person or governmental entity knows to be inconsistent with the prohibitions of this section. However, an insurer or insurance producer may prepare or issue an addendum to a certificate that clarifies and explains the coverage provided by a policy of insurance and otherwise complies with the requirements of this section, provided such authority is granted

to the producer by the insurer.” NY LEGIS 552. (2014), 2014 Sess. Law News of N.Y. Ch. 552 (S. 6545-A) (McKinney’s).

52. Letter from David M. Cherubin (Chief Counsel and Assistance Commissioner of the DOT) to Seth H. Agata (Acting Counsel to the Governor), January 8, 2015.
53. See NY LEGIS 8 (2015), 2015 Sess. Law News of N.Y. Ch. 8 (A. 4616) (McKinney’s) for the amendment deleting former Section 502(d).
54. The New York City Building Department regulations require that a COI must be “accompanied by a sworn statement in a form prescribed by the Department from a licensed insurance broker certifying that the insurance certificate may be relied upon as accurate in all respects and that the insurance certificate thereon is in force.” New York City, N.Y., Rules, Tit. 1, 104-02 (b)(2)(iii).
55. The PGLI form is computer generated at <https://a810-e-filing.nyc.gov/Renewal/GeneralLiabilityInsurancePDF> as part of the Building Department application process.
56. The immortal Yogi Berra; no citation required.
57. See *Landsman, supra*, and the discussion in Note 10 as an example of a technical defect that obviated coverage.

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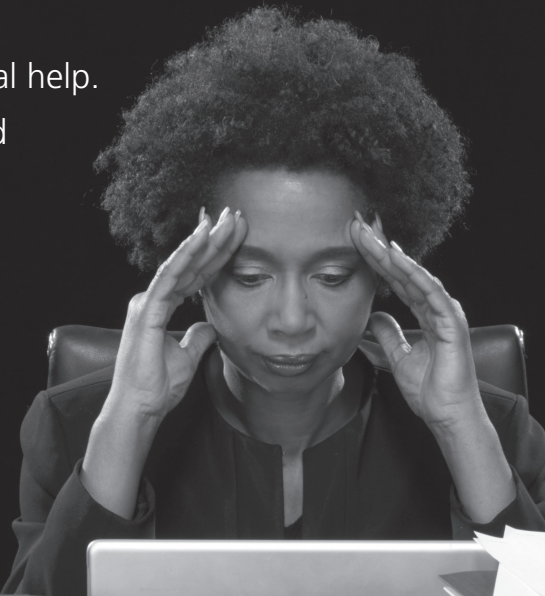


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“New York Lawyers: Be Afraid, Be Very Afraid...!”

By C. Evan Stewart

As careful readers of the *NY Business Law Journal* should know,¹ all of life’s important lessons can be learned from *Godfather* (Paramount 1972) and *Godfather Part II* (Paramount 1974).² Notwithstanding, let me start by quoting from Michael Corleone in *Godfather Part III* (Paramount 1990)—which is otherwise a terrible movie: “Just when I thought I was out... they pull me back in.”

Since 2003, I have been worried about what would happen *when* (not if) a lawyer follows the dictates of the state in which she is licensed to practice instead of following the very different dictates mandated by the rules and regulations promulgated by the U.S. Securities and Exchange Commission after the Sarbanes-Oxley Act of 2002 went into effect.³ A few years ago, I thought I knew the answer,⁴ but now I am somewhat less sure. Because of the dangers posed to lawyers (and, in particular, to New York lawyers), this uneasy state of affairs needs to be fully aired.

The SEC vs. the States

Under the SEC’s Sarbanes-Oxley *modus operandi*, a capital markets lawyer *may* disclose “material violations” (past, current, future) to the Commission. If a lawyer does not handle this “permissive” disclosure obligation correctly, she can be subject to a liability whipsaw: If she fails to disclose to the SEC and she is wrong, the SEC (and possibly the plaintiffs’ bar) can go after her; if she discloses to the SEC and she is wrong, clients and stockholders can sue her. (This places a pretty high premium on lawyers *always* being right!) In judging the appropriateness of her conduct, the SEC (with the benefit of hindsight) will judge her under the “reasonable lawyer” standard (i.e., *not* based upon what she actually knew), and the Commission has at its disposal the full panoply of sanctions under the Securities Exchange Act of 1934 to punish the offending lawyer.

A number of states have *generally* come into line with the SEC’s “permissive” disclosure mandate, but a number of others have not.⁵ Besides Washington and California,⁶ another principal outlier is New York. Under New York Rule 1.6, New York lawyers *may* use their discretion to make permissive disclosure (1) to prevent death or substantial bodily harm, or (2) to prevent a crime. New York specifically carves out *financial fraud* from permissive disclosure; furthermore, disclosure of *past* client conduct is prohibited. New York also *declined* to adopt in Rule 1.13 a provision allowing lawyers representing corporations to “report out” if they are unable to get their clients to “do the right thing” (i.e., follow their advice) and the corporations face “substantial injury” relating to that advice (taken or not taken).⁷

Preemption (per the SEC)

While acknowledging that “a number of commentators questioned the Commission’s authority to preempt state ethics rules, at least without being explicitly authorized and directed to do so by Congress,” the SEC staff in the final release implementing its Sarbanes-Oxley rules and regulations also wrote: “[T]his... does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the Commission reaffirms that its rules shall prevail over any *conflicting* or *inconsistent* laws of a state or other United States jurisdictions in which an attorney is admitted or practices.”⁸

Some non-compliant states immediately challenged the SEC on the preemption issue;⁹ in responding to those states, the SEC cited the U.S. Supreme Court’s decision in *Sperry v. State of Florida*—a ruling that is demonstratively inapposite on its face.¹⁰ Not only did that brouhaha end up in an unresolved standoff, but when the New York State Bar authorities put forward New York’s non-conforming Rule 1.6 in 2009, they did so (1) in full awareness that its Rule 1.6 would place materially different disclosure obligations on New York State lawyers than those required by the SEC, and (2) in full awareness of the SEC’s position on preemption.

With the preemption issue thus pretty well teed up, what have the courts done with the issue (to date)?

Quest Diagnostics

On October 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.¹¹ Bibi, together with two other former Unilab executives, had sued Unilab’s new owner, Quest Diagnostics, on the ground that the company had engaged in a pervasive kickback scheme. At the district court level, legal academic ethics experts proffered dramatically opposing opinions: Prof. Andrew Perlman of Suffolk University Law School supported Bibi, testifying that Bibi was entitled to “spill his guts” because

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he believed Unilab's actions were criminal; Prof. 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 Rule 1.6) and not breaching said confidences (especially to profit thereby). But in order to get to that ruling, the court first had to address Bibi's contention that the False Claims Act preempted New York State's Rules of Professional Conduct.

Judge José Cabranes, writing for the panel, initially noted that courts have "consistently" looked to state ethical rules to determine whether attorneys had conducted themselves properly. He then reviewed whether the federal statute did anything to change that traditional approach, but found that "[n]othing in the False Claims Act evidences

a clear legislative intent to pre-empt state statutes and rules that regulate an attorney's disclosure

of client confidences." As authority for the "clear legislative intent" standard, Cabranes cited two Supreme Court precedents, both of which stand for the proposition that "we [the U.S. Supreme Court] assume a federal statute has not supplanted state law *unless* Congress has made such an intention clear and manifest."¹²

This determination seemingly left the SEC in a pretty precarious position. Why? Because there is not one scintilla of evidence that Congress manifested *any* intent to supplant state-based rules for lawyers when it passed Sarbanes-Oxley.¹³

Hays v. Page Perry

The following year, the U.S. District Court for the Northern District of Georgia weighed in on this topic in *Hays v. Page Perry*.¹⁴ Dismissing a malpractice action against a law firm, Judge Thomas Thrash held that the firm had no duty to report its client's possible securities fraud to the SEC.

In a prior ruling, Thrash had opined that "Georgia law...never obligates a lawyer to report even the most serious client misconduct to regulators."¹⁵ On a motion to have the judge reconsider his prior ruling, he was even more emphatic, finding the plaintiff's theory "a strange perversion of lawyers' professional responsibilities" and its legal claim "profoundly flawed". If the plaintiff were

to be correct, he reasoned, there would be dire consequences: "The risk of civil penalties would cause attorneys, out of self-preservation, to err on the side of disclosure when in doubt. Consequently, such a rule could even deter potential clients from seeking advice from a lawyer."¹⁶

Thrash also (correctly) noted that another flaw in the plaintiff's approach was that it "conflate[d] attorney-client confidentiality with the attorney-client *evidentiary* privilege." Violating the former (an ethical rule), of course, could subject a disclosing attorney to being disbarred;¹⁷ the privilege, on the other hand, is something that is owned by the client (not her attorney), and can be waived *only* by the client.

Wadler v. Bio-Rad Labs

Notwithstanding these two decisions, in December 2016, a California-based federal Magistrate Judge went

in another direction in *Wadler v. Bio-Rad Laboratories*.¹⁸ Sanford Wadler, the former general counsel for 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 the 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;¹⁹ and (2) the State of California's restrictive confidentiality obligations were preempted by the SEC's Sarbanes-Oxley rules and regulations governing attorney conduct.

As to the Magistrate Judge's preemption ruling, he lifted his decision almost verbatim from an amicus brief filed by the SEC. The Magistrate Judge wrote that the SEC's rules and regulations are "entirely consistent" with ABA Model Rule 1.6, the "vast majority" of states, and federal common law. He was essentially right on the first point, but manifestly not on the second two.²⁰ More important to the Magistrate Judge was the fact that "the SEC has now endorsed this interpretation of its own regulation" in its amicus brief, and the SEC's interpretation of its "own regulation" was entitled to deference.²¹

"Judge José Cabranes, writing for the panel, initially noted that courts have 'consistently' looked to state ethical rules to determine whether attorneys have conducted themselves properly."

Sorry, but a *Chevron* deference analysis does not have any relevance to federal preemption.²² The fact that the SEC believes—by its own invocation, but *absent any indication* of Congressional intent—that there is preemption is evidence of nothing. The Magistrate Judge wrote that this outcome was “one of the methods Congress chose”—but that is simply not true; as noted above, Congress said *zero* about preemption, and the Magistrate Judge cited nothing to support his claim.²³

Conclusion

The SEC’s position on preemption seems (at the very least) on *extremely* weak ground—even the former head of the Commission’s Enforcement Division believes the SEC’s preemption position is baseless.²⁴ But the SEC—despite having a pretty lackluster track record in litigation²⁵—has shown dogged determination in pursuing strategic objectives through the litigation process over many years—for example, in the case of holding secondary actors (such as lawyers) accountable under the Securities Exchange Act of 1934.²⁶ Thus, even if *Bio-Rad* is not well-grounded as a matter of law, the Commission does have it as a precedent to go after lawyers who follow their states’ ethical standards and not the Sarbanes-Oxley protocols. This fact of life should give every New York licensed lawyer significant cause for concern.

Endnotes

1. See C.E. Stewart, *Exes and the Attorney Client Privilege*, NY Bus. L.J. (Summer 2017) (footnote 32).
2. E.g. “It’s not personal, Sonny. It’s strictly business.”; “Leave the gun; take the cannoli.”; “Keep your friends close, your enemies closer.”; “A man who doesn’t spend time with his family can never be a real man.”; “I’m gonna make him an offer he can’t refuse.”; “[D]on’t ever take sides with anyone against the family again. Ever.”; “I’m a businessman. Blood is a big expense.”; “It’s a Sicilian message. It means Luca Brasi sleeps with the fishes.”; “Goddamn FBI don’t respect nothin’.”; “I believe in America.”; “Certainly, he can present a bill for such services; after all, we are not Communists.”; “I made my bones when you were still dating cheerleaders.”; “In Sicily, women are more dangerous than shotguns.”; “Never tell anyone outside the family what you’re thinking!”.
3. See, e.g., C.E. Stewart, *Sarbanes-Oxley: Panacea or Quagmire for Securities Lawyers?* N.Y.L.J. (March 21, 2003); C.E. Stewart, *This Is a Fine Mess You’ve Gotten Me Into: The Revolution in the Legal Profession*, N.Y. Bus. L.J. (Summer 2006); C.E. Stewart, *The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?* 40 Sec. Reg. & L. Rep. (Feb. 18, 2008); C.E. Stewart, *New York’s New Ethics Rules: What You Don’t Know Can Hurt You*, NY Bus. L.J. (Fall 2009); C.E. Stewart, *Here’s Johnny: Carnacing the Future of the SEC’s Preemption Overreach*, 46 Sec. Reg. & L. Rep. (April 28, 2014); C.E. Stewart, *Navigating State-Based Ethics Rules and Sarbanes-Oxley Requirements*, N.Y.L.J. (Sept. 21, 2015); C.E. Stewart, *The Fork in the Road: The SEC and Preemption*, N.Y.L.J. (May 10, 2017).
4. See “Fork,” “Navigating,” and “Here’s Johnny!,” *supra* note 3.
5. There are, in essence, five different groupings of states in their approaches to Rule 1.6. See *The Pit, the Pendulum, and the Legal Profession*, and *Here’s Johnny!*, *supra* note 3.

6. Washington’s and California’s interplay with (and challenge to) the SEC’s disclosure regime is set forth in detail in *Here’s Johnny!* See *supra* note 3.
7. New York also does not use the “reasonable lawyer” standard, opting instead to judge lawyers’ behavior on an “actual knowledge” standard. This is a very important safeguard for lawyers, protecting them from harsh 20-20 hindsight judgments. See, e.g., *In re Jordan H. Mintz* and *In re Rex R. Rogers*, SEC Release Nos. 59296 & 59297 (Jan. 26, 2009).
8. See SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003) (emphasis added).
9. See *supra* note 6.
10. 373 U.S. 379 (1963). In *Sperry*, the State of Florida sued for (and got) an injunction against an individual who prosecuted patent applications before the U.S. Patent Office. Florida’s basis for its action was that the individual (a non-lawyer) had engaged in the unauthorized practice of law. The U.S. Supreme Court vacated the injunction because Florida did not have the power to enjoin a non-lawyer who was properly registered to practice before the U.S. Patent Office (even if such conduct constituted the unauthorized practice of law in Florida). But that is a far cry from the state of affairs involving the SEC’s Sarbanes-Oxley rules and regulations. Why? For at least three reasons: (1) Congress’s authority to establish the patent office is expressly set forth in the U.S. Constitution; (2) Congress expressly granted the Commissioner of Patents the authority to determine who can appear before the U.S. Patent Office; and (3) non-lawyers appearing before the U.S. Patent Office was a time-honored practice long before Congress enacted its grant of authority.
11. *United States ex rel. Fair Lab Practices Assocs. v. Quest Diagnostics*, 734 F.3d 154 (2d Cir. 2013), *aff’d*, 2011 U.S. Dist. LEXIS 37014 (S.D.N.Y. April 15, 2011). I recently wrote about this decision and the *Bio-Rad Labs* decision in the *NY Business Law Journal* with respect to their importance vis-à-vis lawyers’ whistleblower claims. See *Lawyers as Rats: An Evolving Paradigm?* (Winter 2018).
12. *Bates v. Dow Agrosciences*, 544 U.S. 431, 449 (2005) (emphasis added); *Cipollone v. Liggett Grp.*, 505 U.S. 504, 516 (1992). *Accord Chadbourne & Parke v. Troice*, 134 S. Ct. 1058 (2014); *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991); *Santa Fe Industries v. Green*, 430 U.S. 462, 479 (1977); *Fla. Lime & Avocado Growers v. Pauli*, 373 U.S. 132, 144 (1963). See also *ABA v. FTC*, 430 F.3d 457, 466 (D.C. Cir. 2005) (Congress did not delegate to the FTC the authority to regulate the practice of law under Gramm-Leach-Bliley).
13. See “Here’s Johnny!” *supra* note 3.
14. See [http://www.bloomberglaw.com/public/document/Haysv. PagePerry_LLC_No_113CV3925TWT_2015_8L_71863_ND_Ga_Mar_17_](http://www.bloomberglaw.com/public/document/Haysv.PagePerry_LLC_No_113CV3925TWT_2015_8L_71863_ND_Ga_Mar_17_).
15. 26 F. Supp. 3d 1311 (N.D. Ga. 2014).
16. Indeed, such a result would have been directly at odds with what the SEC had previously identified as being critical to ensuring greater legal compliance by clients. See *In re Carter and Johnson*, 47 SEC 471, Fed. Sec. L. Rep. (CCH) ¶ 82-847 at 84,145, 84,167, and 84,172-73 (Feb. 28, 1981). In that same year, the U.S. Supreme Court came to the same result/conclusion, when it extended the attorney-client privilege to all corporate employees, justifying that step on the ground that full and candid communications between lawyers and their business colleagues/clients are essential to ensuring effective compliance with the law. See *Upjohn v. United States*, 499 U.S. 383 (1981). For a full vetting of these two decisions and their interaction, see C.E. Stewart, *Liability for Securities Lawyers in the Post-Enron Era*, 35 Rev. Sec. & Comm. Reg. (Sept. 11, 2002).
17. The judge noted that while Georgia’s Rule 1.13(c) allows “reporting out,” that disclosure option is permissive (the drafters of the rule changed “shall” to “may”). In New York, as noted above (see *supra* note 7 and accompanying text), there is no “reporting out” option.

18. 2016 WL 7369246 (Dec. 20, 2016).
19. As previously discussed in *Lawyers as Rats* (see *supra* note 11), the Magistrate Judge—on this issue—followed the lead of the Fifth Circuit in *Willy v. Administrative Review Board*, 423 F.3d 485 (5th Cir. 2005). That appellate court had allowed an in-house lawyer to affirmatively use—without limitation—attorney-client privileged materials to prove his claim. This use was permitted (according to the Fifth Circuit—and now Magistrate Judge Spero) because the ABA changed Model Rule 1.6 to add the words “claim or” before “defense” (and this is now the normative standard nation-wide); previously the Model Rule had allowed for the revealing of client confidences “to establish a defense on behalf of the lawyer.”
- Unfortunately, there are more than a few problems with this analysis: (1) the ABA Model Rules are not in effect *anywhere*—and they certainly do *not* constitute federal common law; (2) the change to Model Rule 1.6 to add “claim or” has not been adopted by a great number of states (e.g., California, New York, etc.); and (3) both decisions suffer from the same problem identified by Judge Thrash: they equate the attorney-client privilege—an evidentiary concept, and a privilege owned by the client—with a lawyer’s ethical obligation to maintain client confidences. This last “problem” is no small one; even if a lawyer may no longer be ethically obligated to keep client confidences, that has no bearing on whether she 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 sue her company.
20. See C.E. Stewart, *Lawyers as Rats: An Evolving Paradigm?* NY Bus. L.J. (Winter 2018); C.E. Stewart, *Whistleblower Law: What Rights Do Ratting Lawyers Have?* N.Y.L.J. (March 14, 2014); C.E. Stewart, *New Confidentiality Rules: Traps for the Unwary*, N.Y.L.J. (May 25, 2010).
21. Gone was the SEC’s earlier invocation of *Sperry* (see *supra* note 10) as its preemption “authority” (not surprisingly).
22. See *Chevron USA v. Natural Resources Defense Council*, 487 U.S. 837 (1965). And even when correctly invoked, the *Chevron* deference doctrine has become highly controversial. See I. Somin, *Gorsuch Is Right About Chevron Deference*, Washington Post (March 23, 2017).
23. The Magistrate Judge, ignoring all of the Supreme Court precedent focusing on “clear legislative intent” (see *supra* note 12), labeled this instead “a textbook example of ‘obstacle preemption,’” citing *Nation v. City of Glendale*, 804 F.3d 1292, 1297 (9th Cir. 2015). But by the very language cited by the Magistrate Judge, such preemption is *only* warranted when a state law “stands as an obstacle to the accomplishment and execution of the full purpose and objectives of Congress.” *Id.* (emphasis added). That is not the case here—Congress stood totally silent on this front. See *supra* note 13 and accompanying text.
24. See W. McLucas, I. Wertheimer, A. June, *Attorneys Caught in the Ethical Crosshairs: Secret-keepers as Bounty Hunters Under the SEC Whistleblower Rules*, 46 Sec. Reg. & L. Rep. (April 14, 2014) (citing, *inter alia*, the Second Circuit’s *Quest Diagnostics* ruling).
25. See C.E. Stewart, *The SEC and Litigation: Oil and Water?* N.Y.L.J. (November 8, 2011); C.E. Stewart, *The SEC’s Setbacks in Litigation*, N.Y.L.J. (May 17, 2007).
26. See *Lorenzo v. Securities and Exchange Commission*, No. 17-1077, ____ S. Ct. ____ (March 27, 2019); C.E. Stewart, *Fourth Time a Charm? The Supreme Court Takes Another Whack at Secondary Liability*, N.Y.L.J. (December 27, 2018).

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The Attorney-Client Privilege and Its Application to Communications with Former Corporate Employees

By Michael J. Hutter

You are general counsel/lead outside counsel to X Corp., a large consumer products manufacturing firm with its principal place of business in Westchester County. The corporation's CEO has requested your advice regarding a developing matter. The CEO has been informed that in the past month there have been several reported product failures involving the corporation's most popular product in terms of dollar sales. The CEO wants you to lead an investigation to determine whether the product failures are isolated cases or whether there may be a flaw with respect to the design or manufacturing process of the product, creating a risk of legal liability and harm to the corporation's reputation, and upon its conclusion advise the corporation as to what action needs to be taken, if any.

The investigation plan you come up with will start with an interview of the widget's product manager during the time of the widget's development and initial marketing. However, it is disclosed to you that the product manager has recently retired but is available and willing to meet with you. You set up a meeting with the former employee, with the intent of having the former employee tell you everything known about the product's development and manufacturing processes, including concerns that may have surfaced about such processes, so that you can create and execute the best legal strategy to eliminate or at least minimize a potential corporate "crisis" in the event of a problem with the widget.

The immediate concern you have is, of course, whether the communications between the former employee and yourself are protected from disclosure by New York's attorney-client privilege, as codified in CPLR 4503(a)(1). In this regard, it is well settled in New York that corporations are entitled to invoke the privilege,¹ and that no distinction exists between in-house counsel and outside counsel as to the applicability of the privilege, provided the attorney is acting as the corporation's legal advisor.² Furthermore, New York law recognizes that communications made in the context of an internal investigation will generally be protected by the privilege, provided the investigation is being undertaken for the purpose of rendering legal advice even if the gathering of factual information is involved.³ However, New York law does not provide a ready answer as to whether the privilege will attach to communications between a former employee of the corporation and the attorney for the corporation that occur during the investigation. This article will address the issue and its ramifications.

Analysis starts by determining the scope of the privilege in the corporate context, namely, whether a corporation may assert the privilege whenever a present corporate employee, regardless of position or rank, communicated with the corporation's attorney for purposes of securing legal advice for the corporation. To answer the question, the vast majority of courts in the United States follow the lead of the Supreme Court's decision in *Upjohn Co. v. United States*.⁴

Upjohn rejected the then-prevalent "control group" standard which held the privilege only extended to communications involving corporate counsel from and to an employee who was in a position of control within the corporation.⁵ It held the privilege may extend to communications involving the attorney for the corporate client and low and mid-level employees of the corporation. While *Upjohn* did not enunciate a specific rule, most courts have interpreted *Upjohn*, based upon the circumstances it stressed, to require for the privilege to be applicable to such communications that they concerned matters within the scope of the employee's duties; employers were communicating at the direction of their corporate supervisors; communications were made for the purpose of providing a basis for legal advice to the corporation; and the communications were considered confidential when made.⁶ Notably, the privilege, when applicable, is the corporation's privilege and not the employee's privilege.⁷

While the New York State Court of Appeals has not addressed the *Upjohn* issue, the lower courts in New York have embraced *Upjohn* and its holdings.⁸ With this recognition of *Upjohn* in New York, there should be no doubt that in the circumstance posited, the communication between you and the project managers, if they occurred during employment, would be privileged. The question now is whether that privileged status continues when the communications occur post-employment.⁹

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This former employee issue involves two different types of communications: (1) communication made by the employee while employed; and (2) communication made by the employee after the employment had ended.¹⁰ They will be addressed separately.

As to pre-termination communications, state and federal courts in New York, as well as courts in other jurisdictions, uniformly hold that privileged communications which occur with corporate counsel during the course of an individual's employment remain privileged even after the employment relationship has been terminated.¹¹ As one commentator has stated: "Whatever communications are privileged communications during the course of the former employee's employment should clearly remain privileged. No reason exists to terminate privileges that have attached during the course of the employment along with the termination of the employment. Indeed, were that to be the case any former employee could terminate preexisting privileges at will."¹² Thus, any privileged information obtained by an employee while an employee of the corporation, including any information conveyed by corporate counsel, remains privileged upon termination of employment.

As to post-termination communications, it must first be noted that the courts in the United States disagree as to whether confidential communications between former employees and corporate counsel are privileged. The majority view is that the privilege is applicable to confidential communications between former employees of a corporation and corporate counsel, provided the *Upjohn* standard referred to above is complied with.¹³ In light of the purpose underlying the privilege, namely, to "[foster] the open dialogue between lawyer and client that is deemed essential to effective representation,"¹⁴ this holding is warranted. As observed by a commentator: "[A] formalistic distinction based solely on the timing of the interview [between corporate counsel and the knowledgeable employee] cannot make a difference if the goals of the privilege . . . are to be achieved"¹⁵

However, a number of courts have declined to extend the privilege to post-employment communications between a former employee and corporate counsel.¹⁶

The rationale of these courts used to support their holding is, as stated by the Washington Supreme Court in *Newman v. Highland School Dist.*, that "[E]verything changes when employment ends. When the employer-employee relationship terminates, this generally terminates the agency relationship. . . . Without an ongoing obligation between the former employee and employer that gives rise to a principal agent relationship, a former employee is no different from other third-party fact witnesses to a lawsuit, who may be freely interviewed by either party."¹⁷

In essence, these courts take the position that the termination of the employment relationship precludes the application of the privilege to new communications. The

dissenters in the *Newman* decision aptly commented that the refusal to extend the privilege to former employees is "at odds with the functional analysis underlying the decision in *Upjohn* and ignores the important purposes and goals that the attorney-client privilege serves."¹⁸ In this regard, the dissenters persuasively argued that former employees "may possess relevant information pertaining to events occurring during their employment needed by corporate counsel to advise the client with respect to actual or potential difficulties. Relevant information obtained by an employee during his or her period of employment does not lose relevance simply because employment has ended."¹⁹ Thus, the dissenters would extend the privilege to confidential communications with former employees concerning matters that occurred during employment.

Federal courts in New York court uniformly follow the majority rule.²⁰ *Indergit v. Rite Aid Corp.* is illustrative.²¹ In this action brought by store managers of Rite Aid alleging violations of the federal Fair Labor Standards Act and the New York Labor Law regarding overtime pay, an issue arose as to the privileged status of communications between Rite Aid's counsel and former Rite Aid district managers who supervised several of the plaintiffs. The district court held that counsel's conversations with the former district managers concerning their conduct and duties while employed by Rite Aid would be within the privilege.²² The district court also noted that because the privilege is Rite Aid's and not the personal privilege of the former employees, none of these individuals had the ability to waive the privilege; only Rite Aid could waive the privilege.²³

The New York state courts have not fully addressed the issue of post-termination communications. At least one court has indicated post-termination communications would fall within the privilege.²⁴ Despite the dearth of state court precedent, it is reasonable to conclude that the state courts would follow the majority rule. In this connection, the underlying rationale of the majority view is consistent with New York policy underlying the attorney-client privilege, and there is nothing in state precedent which would indicate that the courts would adopt the minority view.

With this background, you should feel comfortable about a candid discussion with the former employee. But do not get too comfortable. The reason is the privilege only protects communications about the former employee's conduct while employed.²⁵ It does not protect any communications beyond the former employee's activities within the course of the employee's employment. Expressed differently, communications regarding matters and developments that occurred post-termination fall outside the privilege.

The decision in *Peralta v. Condent Corp.* illustrates this limitation.²⁶ In *Peralta*, plaintiff alleged claims of employment discrimination. Plaintiff's counsel sought to depose Klaber, plaintiff's former immediate supervisor and alleg-

edly the decision-maker with regards to plaintiff's claims. At the time of the deposition, Klaber was no longer employed by defendant. The district court, in applying the majority rule as to what matters Klaber could be examined on, held as follows:

To the extent that conversations between defendant's counsel and Klaber went beyond Klaber's knowledge of the circumstances of plaintiff's employment and termination, and beyond Klaber's other activities within the course of her employment with the defendant, such communications, if any, have not been shown to be entitled to defendant's attorney-client privilege. If, for example, [counsel] informed Klaber of facts developed during the litigation, such as testimony of other witnesses, of which Klaber would not have had prior or independent personal knowledge, such communications would not be privileged, particularly given their potential to influence a witness to conform or adjust her testimony to such information, consciously or unconsciously.²⁷

The final matter to be addressed is whether there can be protection for discussions that fall outside the scope of the attorney-client privilege. In theory, CPLR 3101(d) (2) has potential application. This provision provides a qualified privilege for otherwise discoverable material prepared in advance of litigation.²⁸ Factual information obtained from interviews with a third party, such as a former employee, is potentially protected from disclosure by this provision.²⁹ However, to be immune from discovery, the party resisting discovery "must demonstrate that the material sought was prepared exclusively for litigation."³⁰ Thus, multipurpose reports are not within CPLR 3101(d) (2).³¹ With this limitation, you may have difficulty in establishing protection as it cannot be said at the outset that the investigation is being conducted solely and exclusively for litigation.³²

Turning now to your planned interview with the former program direction for X Corp.'s product, you can now have some comfort—indeed, a lot of comfort—as to whether your discussions will have to be disclosed in future litigation or proceedings. So long as you limit discussions to what the program director learned and was involved in while employed by X Corp., any confidential communications that pertain to legal matters will be privileged. To further assure the application of the privilege, you should also provide the *Upjohn* warning before discussions start.

Endnotes

1. *Rossi v. BlueCross and BlueShield of Greater New York*, 73 N.Y.2d 588, 591-592 (1989); Barker and Alexander, *Evidence in New York State and Federal Courts* (2d ed) § 5:8.
2. Barker and Alexander, *supra* n. 1 at § 5:8. See *Ambac Assur. Corp. v. Countrywide Home Loans, Inc.*, 27 N.Y.3d 616, 624 (2016). Communications that relate solely to non-legal personal or business matters fall outside the privilege. See *Spectrum Sys. Intl. Corp. v. Chemical Bank*, 78 N.Y.2d 371, 377-378 (1991) ("The communication itself must be primarily or predominantly of a legal character").
3. See *Spectrum Sys.*, 78 NY2d at 378; *In re Woolworth Corp. Securities Class Action Litig.*, 1996WL 306576 (S.D.N.Y.).
4. 449 U.S. 383 (1981).
5. See *City of Philadelphia v. Westinghouse Elec. Corp.*, 210 F.Supp. 483, 485-486 (ED Pa. 1962).
6. See *State of New York v. Salazar*, 2011 WL 13205947 *3-4 (ND NY); Martin, Capra & Rossi, *New York Evidence Handbook* (2d ed) § 5.2.5.1; 3 *Weinstein's Federal Evidence* § 503.22.
7. *Id.*
8. See *Doe v. Poe*, 189 A.D.2d 132, 135 (2d Dep't 1993). In this regard, the corporate attorney when speaking with the employee should give the so-called "Upjohn warning." (See *United States v. Rueble*, 583 F.3d 600 (9th Cir. 2009); *Rules of Professional Conduct* (NY)1.13(a).
9. Although several of the employees involved in *Upjohn* had terminated their employment before their interviews with corporate counsel, the lower courts did not address that fact, and the Supreme Court "decline[d] to decide it without the benefit of treatment below." (*Upjohn*, 449 U.S. at 394, n. 3). In a concurring opinion, Chief Justice Burger was of the view that the privilege should apply when "an employee or former employee speaks at the direction of the management with an attorney regarding conduct or proposed conduct within the scope of employment." (*Upjohn*, 449 U.S. at 403).
10. See, generally, 1 Greenwald, Stauffer and Schrantz, *Testimonial Privileges* (Oct. 2017) § 1:42.
11. See *e.g.*, *Radovic v. City of New York*, 168 Misc.2d 58, 60-61 (Sup. Ct. N.Y. Co. 1996) ("The termination of the employment relationship did not dissolve the attorney-client privilege, which forever protects the client . . . from disclosure against its will of protected communications between a former employee and former employer."); Salazar, 2011 WL 1320597 at *4; see also *In re Coordinated Pretrial Proceedings, Etc.*, 658 F.2d 1355, 1361 n. 7 (9th Cir. 1981) ("[T]he privilege is served by the certainty that conversations between the attorney and the client will remain privileged after the employee leaves").
12. Epstein, 1 *The Attorney-Client Privilege* 223 (6th ed. 2017).
13. See, *e.g.*, *In re Allen*, 106 F.3d 582, 606 (4th Cir. 1997); *Admiral Ins. Co. v. U.S. Distr. Ct. for Dist. of Ariz.*, 881 F.2d 1486, 1492-93 (9th Cir. 1989); *Sories v. Air France*, 2001 WL 815522 at *6 (S.D.N.Y.). ("The vast majority of federal cases hold that communications between company counsel and former company employees are protected by the attorney-client privilege if they are focused on exploring what the former employee knows as a result of his prior employment about the circumstances giving rise to the lawsuit"); Spahn, *The Attorney-Client Privilege and The Work Product Doctrine* (3d ed.) § 6.1202 (collecting cases).
14. *Spectrum Sys.*, 78 N.Y.2d at 377; see also *Trammel v. United States*, 445 U.S. 40, 51 (1980) (privilege "rests on the need for the advocate and counselor to know all that relates to the client's reasons for seeking representation if the professional session is to be carried out").
15. Sexton, *A Post- Upjohn Consideration of the Corporate Attorney-Client Privilege*, 57 NYU L. Rev. 443, 499 (1982).

16. See, e.g. *Newman v. Highland School Dist.*, 381 P.3d 1188, 1191-1194 (Wash. Sup. Ct. 2016); *United States v. Merck-Medco Managed care, LLC*, 340 F.Supp.2d 554, 557-558 (ED Pa. 2004); *Infosys., Inc. v. Cerridian Corp.*, 197 F.R.D. 3030, 306 (ED Mich. 2000).
17. 381 P.3d at 1192-1193.
18. *Id.* at 1195.
19. *Id.* at 11957.
20. See, e.g. *Subramanian v. Lupin, Inc.*, 2019 WL 1771556 at 2 (SD NY); *MF Global Holdings Ltd. v. Pricewaterhouse Coopers LLP*, 232 F.Supp.3d 558, 569 (S.D.N.Y. 2017); *Gioe v. AT&T Inc.*, 2010 WL 3780701 at 2 (S.D.N.Y.).
21. 2016 WL 6441566 (S.D.N.Y.).
22. *Id.* at *3.
23. *Id.*
24. *Radovic*, 168 Misc.2d at 60-61.
25. *GlobalrockNetworks, Inc. v. MCI Communications Servs.*, 2012 WL 13028650 at *4 (N.D.N.Y.) (collecting cases).
26. 190 F.R.D. 38 (D Conn. 1999).
27. *Id.* at 41.
28. 4 Haig, *Commercial Litigation in New York State Courts* (4th ed.) §.5:29.
29. See, e.g., *DeGourney v. Mulzac*, 287 A.D.2d 680 (2d Dep't 2001); see also *Subramanian*, 2019 WL 1771556 at *51; *Gioe*, 2010 WL 3780701 at 3. However, the notes and memoranda made in connection with an attorney's interview of a witness prepared in the course of litigation constitutes attorney's work product, which is absolutely exempt from discovery. See *Siemens Solar Industries v. Atlantic Richfield Co.*, 246 A.D.2d 476 (1st Dep't 1998).
30. *Carden v. Allstate Ins. Co.*, 105 A.D.2d 1048, 1049 (3d Dep't 2013).
31. See *Madison Mut. Ins. Co. v. Expert Chimney Servs., Inc.*, 103 A.D.3d 995, 996 (3d Dep't 2013).
32. See *Plimpton v. Massachusetts Mut. Life Ins. Co.*, 50 A.D.3d 532, 533 (1st Dep't 2008).

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Federal Reserve Proposes Comprehensive Regulation for Determining “Control”

By the Attorneys of Sullivan & Cromwell LLP

Summary

On April 23, 2019, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) approved a much-anticipated notice of proposed rulemaking (NPR) to revise its “control” rules under the Bank Holding Company Act of 1956, as amended (the “BHC Act”).¹ Historically, the formal codification of the control rules has been limited, with much of the jurisprudence on control arising from the Federal Reserve’s case-by-case interpretations, some of which have not been published. The NPR is intended to “provide substantial additional transparency on the types of relationships that the board would view as supporting a determination that one company controls another company” by codifying, and in some cases modifying, the Federal Reserve’s presumptions in a formal regulation.²

Under long-standing practice, the question of whether control exists for purposes of the BHC Act is a factual determination that depends on the circumstances of each case. Over time, however, the Federal Reserve “has identified a number of factors and thresholds that [it] believes generally would be indicative of [control].”³ The NPR proposes to amend the Federal Reserve’s Regulation Y⁴ to implement a tiered framework based on share ownership of any class of voting securities (below 5%, 5% to 9.99%, 10% to 14.99% and 15% to 24.99%) that would “significantly expand” the number of presumptions for use in control determinations—including a number of rebuttable presumptions of control and a new, rebuttable presumption of noncontrol—depending on the percentage of a class of voting securities held by the investor.⁵ As the investor’s ownership percentage in a class of a company’s voting securities increases into a higher tier, its other relationships with the company generally must decrease for the investor to avoid being deemed to control the company under the expanded presumptions of control.⁶ These expanded presumptions are intended to be generally consistent with historic practice, and in many cases do not significantly revise the Federal Reserve’s existing control framework, but there are important “targeted adjustments” that liberalize certain aspects of the Federal Reserve’s historic guidance.⁷

Generally, the NPR only modestly liberalizes, as a practical matter, the current rules with respect to investments by bank holding companies in other companies. More liberal treatment is, however, provided to investors in banks (including private equity investors and possibly

activist hedge funds) through such modifications as the level of permissible directors and their role, clarification on proxy contests and the apparent removal of so-called passivity commitments (which are not mentioned in the NPR). Another key change is the liberalization of the so-called “tear down” rule, enabling an investor to exit its investment over time.

The Federal Reserve is seeking comment from the public and has asked nearly 60 questions covering almost every aspect of the NPR. Comments on the proposal are due 60 days after the NPR’s date of publication in the Federal Register.

Background

The issue of “control” is a central concept under the BHC Act. Among other things, control determines: whether an investor in a bank is subject to the requirements and restrictions of the BHC Act (by becoming a “bank holding company”); whether a bank holding company’s investment in a company is permissible under the BHC Act and/or subjects the investee company to the requirements and restrictions of the BHC Act; and whether an investor in any depository organization is subject to the Volcker Rule. As a result, a determination of whether an investment constitutes “control” is often determinative of whether an investment can be made (or, at least, must be restructured to avoid control).

Section 2(a)(2) of the BHC Act⁸ applies a three-part test to determine whether a company “controls” a bank or other company for purposes of the statute: (i) the company, directly or indirectly, owns, controls, or has power to vote 25% or more of any class of voting securities of the bank; (ii) the company controls in any manner the election of a majority of the directors or trustees of the bank; or (iii) the Federal Reserve determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a “controlling influence” over the management or policies of the bank. It is the third of these three tests that has created almost all the issues regarding whether control exists.

Congress added the so-called “controlling influence test” to the BHC Act in 1970⁹ to recognize that “actual control of any bank, even at less than 25%, is sufficient to require the controlling company to register as a bank holding company.”¹⁰ Over the ensuing decades, the

Federal Reserve has interpreted the controlling influence test in a variety of regulations, policy statements and guidelines, interpretations, and formal determinations, as well as in other informal advice, which has resulted in a complex, and not always consistent or transparent, framework for determining whether control exists.

Between 1970 and 1982, the Federal Reserve's interpretations of the controlling influence test were largely consistent with the legislative history and focused on whether a company actually controlled a bank.¹¹

During the 1980s, the Federal Reserve issued a series of interpretative letters, formal statements and revisions to Regulation Y that expanded the concept of controlling influence beyond the Federal Reserve's earlier interpretations.¹² This expansion of the controlling influence test began in response to so-called interstate "stakeout" investments in banks and bank holding companies.¹³ At that time, several bank holding companies had begun to explore investments in non-voting securities of banking organizations in other states in anticipation of potential state approval of some form of interstate banking (which was effectively precluded at that time). In other cases, bank holding companies made minority investments in financial services companies, such as insurance agencies, in anticipation of legislative or regulatory amendments to expand the BHC Act's "closely related to banking" test for permissible activities under Section 4. These investments generally included convertible preferred securities or merger agreements that would be activated only in the event of a change in law that would permit the transaction.

The Federal Reserve's interpretations and policy statements then imposed a number of restrictions, including:

- a restriction on any equity investment to 25% of the investee's total equity (with equity being deemed to include subordinated debt);
- a limitation on common shares equivalent to 25% of the pro forma common shares, combined with a requirement of wide disposition;
- severe restrictions on business relationships between the investor and the investee;
- restrictions on covenants designed to assure the soundness of the investment;
- a prohibition on requirements of extensive consultation on financial matters;
- prohibitions or limitations on interlocking directors, interlocking management officials and consultation on major decisions;
- prohibitions on director representation for a company that acquired between 10 and 24.9% of a bank's voting stock; and

- prohibitions on financial covenants such as maximum leverage ratios.

The Federal Reserve subsequently issued policy statements and changes to Regulation Y that liberalized to a degree some of the Federal Reserve's earlier restrictions. For example, under the Federal Reserve's Policy Statement on Equity Investments in Banks and Bank Holding Companies (2008) (the "2008 Policy Statement"), the Federal Reserve clarified that a minority investor's ability to appoint a single representative to a bank's board of directors (noting that a typical board has 9 or 10 members) generally would not result in control.¹⁴ Notwithstanding the 2008 Policy Statement and other guidance, the Federal Reserve's current rules on control extend beyond the earliest interpretations that focused on actual control. Another feature of the current regulatory regime on the question of control has been a sharp dichotomy in the standards for initially acquiring control ("build-up") and divesting control ("tear down"). For many years, the Federal Reserve has taken the position that the restrictions on a tear down to avoid or end control must be more stringent than on a build-up investment. As just one example, the Federal Reserve has required that a tear down investment be reduced to below 5% (or, in some cases, even to zero) of total equity to avoid a continuing control determination.

Recognizing the *ad hoc* manner in which the Federal Reserve has developed its framework around "control," and the complexity of, and lack of transparency surrounding, the control rules, the Federal Reserve has determined to "provide substantial additional transparency" by codifying its existing presumptions of control (with "targeted adjustments") in the Federal Reserve's regulations.¹⁵

Discussion

As indicated, the Federal Reserve is proposing to put in place a tiered framework, based on the percentage of a class of voting securities held by a company. Under that framework, a company would be presumed to control a second company¹⁶ if relationships exceeded the applicable threshold for that tier, as set forth in the following chart.¹⁷

Although many of these presumptions do not alter the Federal Reserve's current framework for determining whether control exists, certain of the NPR's "targeted adjustments" represent a departure from the Federal Reserve's existing guidance, as discussed below. Although the codification of these presumptions may increase the "transparency" of the Federal Reserve's existing control framework, they only "clarify whether certain common fact patterns are likely to give rise to a controlling influence" and are intended to assist the Federal Reserve in determining whether control exists.¹⁸ "Notwithstanding the presumptions of control or noncontrol, the [Federal Reserve] may or may not find there to be a controlling influence based on the facts and circumstances presented by a particular case."¹⁹

Summary of Tiered Presumptions

(Presumption of control is triggered if any relationship exceeds a threshold set forth for the applicable tier of ownership of a class of voting securities)

At the same time, however, the NPR suggests that an investor that does not trigger a presumption of control under the tiered framework could only be held to be in control in unusual circumstances.

	Ownership of Class of Voting Securities			
	Less than 5%	5%–9.99%	10% –14.99%	15% –24.99%
Directors	Less than 50%	Less than 25%	Less than 25%	Less than 25%
Director Service as Board Chair	No threshold	No threshold	No threshold	No director representative is chair of the board
Director Service on Board Committees	No threshold	No threshold	25% or less of a key committee(1)	25% or less of a key committee(1)
Business Relationships	No threshold	Less than 10% of revenues or expenses(2)	Less than 5% of revenues or expenses(2)	Less than 2% of revenues or expenses(2)
Business Terms	No threshold	No threshold	Market terms	Market terms
Officer /Employee Interlocks	No threshold	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Total Equity	Less than 33.33%	Less than 33.33%	Less than 33.33%	Less than 25%

(1) These are committees that have the power to bind a company without the approval of the full board of directors. Consistent with historic practice, examples provided by the Federal Reserve include the audit committee, compensation committee and executive committee.

(2) This threshold is exceeded and the presumption of control is triggered if the revenues or expenses attributable to the business relationship exceed the threshold revenues or expenses of *either* the first company *or* the second company.

A. Major Changes Resulting From the Framework

Key changes resulting from this framework include the following:

- **Below 5%:** a formal presumption of non-control.
- **Five percent to 9.99%:** an increase in the percentage of business relationships; a management interlock (other than the chief executive officer).
- **10% to 14.99%:** board representation up to 24.9% director service as board chair; expanded committee representation; increase in the percentage of business relationships; a management interlock (other than the chief executive officer).
- **15% to 24.99%:** board representation up to 24.9% expanded committee representation.

As noted, a key change not mentioned in the NPR is the apparent elimination of the requirement for passivity commitments at higher investment levels.

B. “Tear Down” Rule

In the NPR, the Federal Reserve proposes to revise the so-called “tear down” rule related to divestiture of control. As noted, under the Federal Reserve’s current guidance, the Federal Reserve has made it far easier to achieve a finding of non-control of a company than to divest control once it is acquired. Under this so-called “tear down” rule, the Federal Reserve has generally required a company to divest a significant portion of its investment (frequently to less than 5%, or in some cases as low as 0% of total equity); remove its director appointees from the board; terminate business relationships; and/or enter into a series of passivity commitments before the Federal Reserve will accept that the first company no longer controls a second company for purposes of the BHC Act.

The NPR creates a presumption that the first company generally would not be presumed to control a divested second company if certain conditions are met. Under the NPR, the first company would not be deemed to control a second company that was a subsidiary of the first company if:

- the first company (a) divests to below 15% of any class of voting securities of the second company and (b) no other presumptions of control apply (such as business relationships) (however, if the first company's ownership were to increase to 15% or more of any class of voting securities of the second company at any time during the two years following divestiture, then the first company would be presumed to control the second); or
- the first company (a) divests to between 15 and 25% of a class of voting securities of the second company, (b) two years pass and (c) no other presumptions of control apply (such as business relationships).

In addition, the first company generally would not be presumed to control the second if:

- the first company sells a subsidiary to a third company and a majority of each class of voting securities of the second company that is being sold is controlled by a single unaffiliated individual or company; or
- the first company sells a subsidiary to a third company and receives stock of the third company as some or all of the consideration for the sale (so long as the selling company does not control the acquiring company).

This change would significantly facilitate divestitures, which are often structured so as to have the divesting company take back equity of the purchaser. This change also may be of particular benefit to so-called fintech and other financial services companies that have been precluded from seeking a banking charter because of the presence of a large shareholder.

C. Calculation of Ownership

As set forth in the 2008 Policy Statement, a company may control another company if its total equity investment, including both voting and nonvoting securities, exceeds certain thresholds. Under current practice, the Federal Reserve calculates a company's ownership percentage in a class of voting securities and in a bank's total equity using its own method, commonly referred to as "Fed math." Options, warrants or other securities that are freely convertible into a class or series of stock are deemed to be converted and/or exercised as of the day the first company acquires the convertible interest, regardless of whether it is in the money or whether the first company actually intends to exercise the option

or warrant. For example, options or warrants for common stock are treated as common stock and calculated as voting securities on an as-exercised basis. Moreover, the Federal Reserve generally calculates the first company's percentage of the class of applicable securities (and of total equity) as if *no other investor* exercised its options or warrants. This can lead to untoward results for a company that holds a relatively small percentage of a class of voting securities of a second company on a fully diluted basis, but that would hold a greater percentage under this method of calculation.

Importantly, the NPR would exclude from the "Fed math" calculation options, warrants or convertible instruments that an investor holds to avoid having the investor's position diluted in the event the company were to increase the number of its outstanding voting securities. That is, "Fed math" would not apply to convertible instruments as long as such instruments do not give the investor the right to acquire a higher percentage of the class of voting securities held immediately prior to conversion.

The NPR also provides the standard for calculating a company's "total equity" percentage in a second company that is a stock corporation that prepares financial statements under U.S. generally accepted accounting principles (GAAP). Although by its terms the standard for calculating total equity would apply only to stock corporations that prepare financials under GAAP, the Federal Reserve recognized that there may be other circumstances where it is possible to apply the standard to entities that are not stock corporations or that do not prepare GAAP financial statements, and would apply the same standard to those entities to "the maximum extent possible consistent with the principles underlying the general standard."²⁰

The Federal Reserve's calculation of total equity has been challenging in a number of situations, but particularly in investments in start-ups and early stage fintech companies that have experienced a history of operating losses. Moreover, the Federal Reserve has not previously provided public guidance on the calculation of total equity and, therefore, the proposed approach may differ from methodologies bank holding companies or other investors have used to calculate their total equity positions.

The NPR provides adjustments for more complex structures such as when a first company holds equity investments in a second company and the second company's parent. The calculation of total equity of the second company owned by the first company would include both the direct total equity of the second company controlled by the first company, and the indirect total equity of the second company controlled by the first company, "weighted by the total equity percentage of the second company's parent company in the second company."²¹

The NPR also provides that certain debt instruments may be included in some circumstances in the calculation of total equity if they include certain equity-like features,

including applicable tax law treatment of the debt instrument as equity, extremely long-dated maturity or the qualification of the instrument as equity under GAAP or other applicable accounting standards, or if the issuance of the debt is not on market terms.²² Moreover, other interests that are functionally equivalent to equity, such as one that entitles a company to share profits of a second company, could be treated as equity for purposes of the calculation.

The calculation of total equity for purposes of applying the applicable presumptions of control would be required any time the first company acquires control or ceases to control equity instruments (or other instruments that are treated as equity) of the second company.

D. Solicitation of Proxies

Historically, the Federal Reserve has taken the position that the solicitation of proxies by a company in opposition to a recommendation of a second company's board, including to elect directors to the second company's board, may cause the first company to be deemed to control the second company.

The NPR would, however, liberalize this position by enabling a company controlling 10% or more of any class of voting securities of a second company to solicit proxies to appoint a number of directors that represents less than a quarter of the second company's board without being presumed to control the second company. Significantly, the NPR proposes that proxy solicitation is not a presumptive control factor for an investor holding up to 9.99% of a class of voting securities. It is rare for an activist to cross the 10% line because doing so imposes requirements for disclosure and approval under the Change in Bank Control Act and analogous state laws.

E. Investment Advice

Historically, many institutions have limited their own investments in investment funds to which the institution serves as an investment adviser to less than five percent of total equity to avoid being deemed to control the investment fund. The NPR provides that when a first company serves as investment adviser to a second company that is an investment fund, the first company would be presumed to control the second company only if the first company controls 25% or more of the total equity capital or more than 5% of any class of voting securities of the second company. This presumption of control would not apply, and the first company investment adviser would be permitted to hold additional equity of the second company, during a limited seeding period.

F. Accounting Consolidation

The Federal Reserve has previously expressed in informal guidance a view that the consolidation of a company on another company's financial statements under GAAP does not necessarily result in control. However, under the NPR, a company would be presumed to control

a second company if the second company is consolidated on the first company's financial statements under GAAP. This presumption is not intended to suggest that a company would not control a second company in the absence of consolidation.²³

G. Appointment of Directors

Although one of the BHC Act's tests for control is whether a company controls the election of a majority of directors of a second company, the Federal Reserve historically has taken a far more conservative position under the controlling influence test, in some cases precluding any director interlock. In the 2008 Policy Statement, the Federal Reserve took the position that a minority investor's right to appoint a single director would not result in a controlling influence.²⁴ However, the Federal Reserve also noted that boards of banking organizations typically have 9 or 10 directors, and that director representation may be proportionate to the investor's total interest.

In addition, the appointed director would not be permitted to serve as chairman of the board or any committee or to serve on any committee in which the director would represent 25 percent or more of the committee's members (i.e., the committee must consist of at least five members).²⁵ In some cases, the Federal Reserve has gone even further and required that the director not serve on a "key" committee, such as the executive committee or audit committee.

The NPR's proposed presumptions would permit a company to appoint any number of directors that constitute less than 25 percent of the total members of the second company's board before a presumption of control would be triggered. The NPR liberalizes this presumption even further for a company holding less than five percent of any class of voting securities, which would not be presumed to control a second company unless it were to appoint 50 percent or more of the total members of the board. Companies may also avoid a presumption of control even if a director appointee serves as chairman of the board, if the investment is under 15 percent of a class of voting securities, or if the appointee sits on board committees, including, in some cases, "key" committees, as summarized in the above table.

H. Business Relationships

Historically, the Federal Reserve took the position that material business transactions or relationships between the investor and the banking organization or the banking organization and the investee could result in control under the controlling influence test, and then defined the term "material" as more than *de minimis*. In the 2008 Policy Statement, the Federal Reserve noted that "not all business relationships . . . provide the investor a controlling influence over the management or policies of the banking organization . . . particularly where an investor's voting securities percentage in the banking organization was closer to 10 percent than 25 percent."²⁶ In practice,

the Federal Reserve makes determinations of whether a business relationship is permissible for a noncontrolling investment on a case-by-case basis, but is far more likely to find that a business relationship results in a controlling influence where an investor holds 10% or more of a class of voting securities. In addition, business relationships that are exclusive, not on market terms or that cannot be terminated without penalty almost always result in a determination that such relationships create a controlling influence.

Under the NPR's tiered approach, a presumption of control would be created depending on the first company's amount of voting equity, as summarized in the above table. Notably, a company that holds less than 10% of any class of voting securities of a second company would not trigger a presumption of control by entering into business relationships with the second company that are not on market terms. The NPR does not discuss presumptions related to business relationships that are exclusive or that cannot be terminated without penalty.

The NPR also provides that the thresholds that would trigger presumptions of control are based on revenues or expenses and apply to both the investor and investee. Historically, for control purposes, bank holding companies have generally analyzed their investments based on the percentage of total revenues the business relationship generates for each of the bank holding company and the second company. Under the NPR, bank holding companies would also definitively be required to analyze the expenses that the business relationship creates for both parties.

I. Officer Interlocks

Historically, the Federal Reserve has taken the position that management interlocks, particularly those related to senior management positions, combined with an equity investment, cause a company to control a second company under the controlling influence test.

The NPR proposes to eliminate the existing presumption of control of shared management interlocks coupled with an investment in five percent or more of any class of voting securities where there is not a larger shareholder.²⁷ Instead, the NPR would permit a company to maintain certain senior management interlocks before a presumption of control is triggered, as summarized in the above table. Importantly, a company that holds less than five percent of any class of voting securities of a second company could maintain any number of officer interlocks with the second company without triggering a presumption of control under the NPR.

Endnotes

1. Federal Reserve, Draft Notice of Proposed Rulemaking, *Control and Divestiture Proceedings* (April 23, 2019), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/control-proposal-fr-notice-20190423.pdf>. The NPR would also amend the Federal Reserve's Regulation LL, 12 C.F.R. Part 238, in a substantially similar manner to revise determinations of control under the Home Owners' Loan Act (HOLA) with respect to savings and loan holding companies. HOLA contains substantially similar tests for control as the BHC Act, and the Federal Reserve "believes that the statutory construct for controlling influence under HOLA is sufficiently similar to the BHC Act that it is appropriate to apply the same presumptions and related provisions to determinations of controlling influence under each statute." NPR at 79. Importantly, the NPR would only change the Federal Reserve's rules for control under the BHC Act and HOLA. The proposal would not, for example, affect the requirement to obtain approval from the applicable regulators under the Change in Bank Control Act prior to acquiring control of a bank or bank holding company or the related presumption that a person seeking to acquire 10% or more of any class of voting securities of a bank or bank holding company would, in certain cases, control the bank or bank holding company for purposes of the Change in Bank Control Act.
2. NPR at 1.
3. *Id.* at 6.
4. 12 C.F.R. Part 225.
5. PR at 1.
6. *Id.* at 6.
7. *Id.* at 1.
8. 12 U.S.C. § 1841(a)(2).
9. Pub. Law 91-607 (Dec. 31, 1970).
10. 15 Cong. Rec. H10561 (daily ed. Nov. 5, 1969) (statement of Rep. Ashley).
11. *See, e.g., Patagonia Corp.*, 63 Fed. Res. Bull. 288, 292 (1977) ("The original amendment [to the BHC Act to add the controlling influence test] was offered by Congressman Ashley, and from statements by him and Congressman Patman it was clear that they intended to reach situations of actual control."). Since *Patagonia*, however, the Federal Reserve has largely ignored the "actual control" standard articulated by the legislative sponsor. There is, for example, no reference to this standard in the NPR.
12. *See, e.g.,* Federal Reserve, Policy Statement on Nonvoting Equity Investments by Bank Holding Companies, 47 Fed. Reg. 30965 (July 16, 1982) (the "1982 Policy Statement").
13. *See, e.g.,* 1982 Policy Statement ("In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding . . . located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the [BHC Act] . . . , the [Federal Reserve] believes it is appropriate to provide guidance regarding the consistency of such arrangements with the [BHC Act]").
14. See 12 C.F.R. § 225.31; 2008 Policy Statement, available at <https://www.federalreserve.gov/bcreg20080922b1.pdf>.
15. NPR at 1.
16. For purposes of consistency with the NPR, the "Discussion" section of this memorandum uses the terms "first company" and "second company," as defined in the NPR. "First company" means "the company whose control over the second company is the subject of a determination of control by the [Federal Reserve]." "Second company" means "the company the control of which by the first company is the subject of a determination of control by the [Federal Reserve]." NPR at 53.

17. The summary chart is substantially reproduced from Vice Chair for Supervision Quarles' Memorandum to the Board of Governors, Notice of Proposed Rulemaking to Revise the Board's Rules for Determining Whether a Company Has Control Over Another Company (April 16, 2019) Appendix, *available at* <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-proposal-board-memo-20190423.pdf>.
18. NPR at 6, 14.
19. *Id.* at 14.
20. *Id.* at 68.
21. *Id.* The NPR provides an example of this calculation: assuming that "(i) the first company has direct control over 10 percent of the total equity of the second company; (ii) the first company has 10 percent of the total equity of a third company that controls the

second company; and (iii) the third company has 50 percent of the total equity of the second company," then "the total equity of the first company in the second company would be 15 percent—the 10 percent direct total equity interest plus a five percent indirect total equity interest (*i.e.*, 10 percent of the 50 percent total equity interest that the third company has in the second company)."

22. *Id.* at 69.
23. *Id.* at 43.
24. *Id.* at 6.
25. *Id.* at 8.
26. *Id.* at 13.
27. 12 C.F.R. § 225.31(d)(2)(iii).

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Financial Stability Oversight Council Seeks to Change How It Determines Systemic Risk

By Kathleen A. Scott

For the first time since it was established, the Financial Stability Oversight Council (FSOC) has proposed material changes to how it will determine systemic risk to the U.S. financial system among nonbank financial companies. Instead of designating specific nonbank financial *companies* as systemically important financial institutions (SIFIs), it will instead focus on designating specific financial *activities* as systemically important. The FSOC proposal does not preclude completely the ability of the FSOC to designate a SIFI, but that process will be used only in limited instances.

This article will trace the history of the FSOC from its establishment through the new proposal (“Proposed Guidance”), which was published on March 13, 2019, in the *Federal Register*, the official publication for administrative rules, proposals and other official administrative pronouncements.¹

Creation of the FSOC

After the last decade’s financial crisis, many in Congress and the Obama Administration saw the need for financial reform. The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) was signed into law on July 21, 2010.² Dodd-Frank made major changes to financial services regulation in the United States, with systemic risk a key provision underlying many of the legislative changes.

Under Dodd-Frank, U.S. banking organizations, and non-U.S. banking organizations with U.S. banking operations, with total consolidated assets (*i.e.*, global), of \$50 billion or more were deemed by statute to be a risk to the financial stability of the U.S. financial system and became subject to a series of prudential standards imposed by the Board of Governors of the Federal Reserve System (Federal Reserve Board), including stress testing, liquidity risk management, capital buffers, enhanced risk management, and single counterparty credit limits. In 2018, the \$50 billion threshold was raised to \$250 billion in the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA).³

The FSOC was established in Dodd-Frank. Chaired by the Secretary of the Treasury, the FSOC consists of 10 voting members and five non-voting members, all representatives from federal or state government agencies, except for an independent appointee with insurance expertise.⁴ FSOC was established to:

- (A) identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
- (B) promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the government will shield them from losses in the event of failure; and
- (C) respond to emerging threats to the stability of the United States financial system.⁵

A major responsibility of the FSOC is to designate nonbank financial companies, the material financial distress of which would be a threat to the stability of the U.S. financial system.⁶ SIFIs are subject to regulation and supervision by the Federal Reserve Board,⁷ and the designations are to be reevaluated by the FSOC at least annually.⁸ “Nonbank financial companies” are companies that derive 85% or more of their annual gross revenues from financial activities; or 85% or more of their consolidated assets relate to financial activities.⁹ “Financial activities” are tied to the definition in the Bank Holding Company Act for financial holding companies.¹⁰

The FSOC may designate a nonbank financial company as a SIFI if it determines that (1) the company could pose a threat to the financial stability of the United States if it encountered material financial distress, or (2) the company’s nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of nonbank financial company could pose a threat to the financial stability of the United States.¹¹

The Federal Reserve Board originally was required to establish prudential standards for bank holding compa-

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nies (and non-U.S. banks with banking operations in the United States) with total consolidated assets of \$50 billion or more, a threshold raised to \$250 billion by EGRRCPA, as noted above. The Federal Reserve Board has issued proposals to revise the current prudential standards to more closely reflect the risk profiles of the affected companies for both U.S. bank holding companies¹² and non-U.S. banks with U.S. banking operations.¹³

The Federal Reserve Board can impose one or more of those (or other) prudential standards on SIFIs on a case-by-case basis. The Federal Reserve Board also may impose stricter regulation on certain financial activities or products if it determines that those activities or products may pose a systemic risk to the U.S. financial system.¹⁴

Designation of SIFIs

On April 11, 2012, the FSOC published interpretive guidance¹⁵ regarding how it would conduct the SIFI determination process, and Supplemental Procedures, in 2015.¹⁶ Under those guidelines, between 2013 and 2014, the FSOC initially designated four nonbank financial companies as SIFIs: American International Group (AIG),¹⁷ GE Capital Corporation,¹⁸ Prudential Financial,¹⁹ and MetLife.²⁰

These SIFI designations were lifted in subsequent years. FSOC lifted the designation of GE Capital Corporation as a SIFI in 2016 after it reorganized itself and sold many of its financial services operations.²¹ MetLife sued the FSOC, contesting its designation as a SIFI, and after a prolonged court fight and a change in the presidential administration, won its fight in 2018 to be de-designated.²² After re-evaluation, the FSOC lifted the SIFI designations for AIG and Prudential in 2017²³ and 2018,²⁴ respectively.

November 2017 Report

With the change in administration to Donald J. Trump, the President ordered reviews of the regulatory rulemaking process. At the President's direction, Treasury Secretary Steven Mnuchin undertook a review of the FSOC determination process and issued a report in November 2017, "Financial Stability Oversight Council Designations."²⁵

Treasury identified five goals that the FSOC's processes should be designed to achieve:

- Leverage the expertise of primary financial regulatory agencies;
- Promote market discipline;
- Maintain a level playing field among firms;
- Appropriately tailor regulations to minimize burdens; and
- Ensure the Council's designation analyses are rigorous, clear, and transparent.²⁶

Recommendations made in the Treasury Report, some of which appear in "Proposed Guidance," include:

- Simplifying the FSOC designation process and focus on an activities-based or industry-wide approach to addressing risks to U.S. financial stability;
- Assessing the likelihood of a firm's material financial distress as part of a SIFI analysis;
- Conducting a cost benefit analysis as part of the SIFI determination process, only designating a company as an SIFI if the expected benefits to financial stability outweigh the costs of a SIFI designation and providing a clear "off-ramp" for lifting the SIFI designation when the designated nonbank financial company no longer meets the SIFI criteria; and
- Improving the FSOC's communication with non-bank financial companies under review for potential designation, undertaking greater engagement with companies' primary regulators and increasing transparency to the public regarding the basis for any SIFI determinations.

The New Proposal

"Proposed Guidance" would make several key changes from the current 2012/2015 "Guidance." The most significant is the change in focus to an activities-based approach to determining systemic risk to the U.S. financial system. Specific entities still could be designated as SIFIs, but only if an activities-based approach will not address the identified potential risk or threat. The changes would revise the current Appendix A to 12 C.F.R. Part 1310.

Activities-Based Approach

"Proposed Guidance" describes a two-step activities-based approach. In step one, the FSOC will "monitor diverse financial markets and market developments, in consultation with relevant financial regulatory agencies, to identify products, activities, or practices that could pose risks to financial stability."²⁷

The analysis will focus on what "Proposed Guidance" characterizes as four "framing questions": (1) potential risk trigger factors; (2) how adverse effects of such potential risk may be transmitted to financial markets or their participants; (3) the effects the potential risk could have on the financial system; and (4) whether the adverse effects of such potential risk could impair the U.S. financial system such that those effects could harm the U.S. economy's nonfinancial sector.

If that analysis does produce a potential risk, then in step two of the activities-based approach, the FSOC will work with the relevant financial regulators to implement actions to address said potential risk. If the FSOC determines that the regulators' actions are insufficient, it can publicly issue recommendations, albeit nonbinding, to the regulators to apply new or heightened standards and

safeguards for a financial activity conducted by a bank holding company or nonbank financial company. The Proposed Guidance specifically states that any recommendations it does make will be consistent with the relevant financial regulator's statutory mandate.

SIFI Determinations

As discussed above, the FSOC may designate a nonbank financial company as a SIFI if it determines that (1) material financial distress at the nonbank financial company could pose a threat to U.S. financial stability (the "First Determination Standard"); or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to U.S. financial stability (the "Second Determination Standard"). The Proposed Guidance focuses on the First Determination Standard, noting that "threats to financial stability . . . are most commonly propagated through a nonbank financial company when it is in distress."²⁸

"Proposed Guidance" does not eliminate the SIFI determination process, but evaluating a specific nonbank financial entity for SIFI designation is expected to occur under a limited set of circumstances: (1) the FSOC's collaboration with the financial regulators described in step two of the activities-based approach did not adequately address the potential risk that had been identified by FSOC, or the potential threat does not come within the legal authority or jurisdiction of a financial regulator, and (2) the potential threat could be addressed by the FSOC making a SIFI determination for one of more nonbank financial companies.

If the evaluation of systemic risk gets to this point, the revised two-stage SIFI determination process will include a cost-benefit analysis by the FSOC prior to a determination and an assessment of the extent to which a particular SIFI designation may promote US financial stability. During stage one of the determination process, the FSOC will provide notice to the nonbank financial company that it is under SIFI review, and intends for FSOC staff to meet with the nonbank financial company to discuss the key risks that had been identified thus far. While not required at that point, the nonbank financial company will be able to submit what it considers to be relevant information for the FSOC to consider in the determination process.

In stage two, the FSOC will undertake a more in-depth evaluation, issuing a "Notice of Consideration" to a nonbank financial company that it is under review for a potential SIFI designation, and requesting that the nonbank financial company provide information that the FSOC deems relevant to its evaluation. At this stage, the FSOC's review will focus on "whether the nonbank financial company could pose a threat to U.S. financial stability because of the company's material financial distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company."

The FSOC will consult with the relevant financial regulators during the designation determination process, and if it feels that the financial regulators have been able to adequately address the potential identified risks, the FSOC could discontinue its review before a determination is made.

If the FSOC votes to issue a Proposed Determination of a SIFI designation to the nonpublic financial company, the FSOC will inform the company and the company's financial regulator and publish its explanation for the issuance of the Proposed Determination. The company may request a nonpublic hearing to contest the Proposed Determination.

If the FSOC votes to issue a Final Determination of a SIFI designation to the nonpublic financial company, it will inform the company and the company's financial regulator of the decision and the basis for the designation, and issue a public decision. Under Dodd-Frank, the nonbank financial company may contest its designation as a SIFI in U.S. District Court.

On the same day that "Proposed Guidance" was published, March 13, 2019, the FSOC also published a final rule stating that it will not amend or rescind its guidance on the nonbank financial company determinations without notice to the public and providing an opportunity for comment.²⁹

Comments on "Proposed Guidance" were due by May 13, 2019. A projected date for finalization was not known as of early May 2019.

Endnotes

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8. Dodd Frank, § 113, 12 U.S.C. § 5323.
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Employment Law Update: Reference Checks for Employees Discharged Due to Misconduct

By Jeffrey S. Klein and Nicholas J. Pappas

Over the past year and a half, spurred in part by the #MeToo movement, many employers have begun taking additional steps to expand and enhance their sexual harassment policies. Yet when employers take disciplinary action against an employee for engaging in sexual harassment, particularly termination, they face another difficult question: to what extent should employers inform their former employees' prospective employers about the employees' misconduct in connection with a reference check?

Many employers have reference check policies that provide only minimal information. Some employers, for example, might provide prospective employers with only their employee's dates of employment and the last position held. Such employers reason that they have no legal obligation to provide references in the first place, and more detailed or candid disclosures regarding a former employee—particularly a disclosure of a fact that could be taken in a negative light—may form the basis of a potential defamation claim by the former employee. In the #MeToo era, at least one legislature has sought to protect employers from defamation arising from references that mention sexual harassment. The California legislature recently enacted a law that explicitly grants employers a qualified privilege to disclose to prospective employers whether an employee has engaged in sexual harassment.

Whether other states will follow California's approach remains to be seen. However, in light of the heightened focus on employees discharged due to misconduct, employers would be well advised to familiarize themselves with the law governing reference checks, and what employers can and cannot say in response to inquiries about former employees. In this article, we examine the risk of defamation arising from reference checks, discuss California's new sexual harassment-related reference check law, and offer some suggestions as to how employers might approach these situations.

Background

Employers generally do not have an affirmative duty under the law to act for the benefit of others, including by responding to reference checks. But when employers *do* provide more information, such as explaining the reason for an employee's termination, for example, the employee might thereafter claim that the employer's statement was defamatory.¹

Defamation is the act of communicating false statements about a person that injure the reputation of that person. To state a claim for defamation in many states, a

former employee must show that his or her former employer: (i) made a false statement; (ii) published the statement to a third party, such as a prospective employer; (iii) without privilege or authorization; and (iv) the statement caused special harm or constituted defamation *per se*.²

While the law provides employees with recourse for alleged defamatory statements, in many states, the law also provides employers with legal protection to communicate information in response to reference checks. In New York, for example, employers may provide parties who share a common interest in the subject matter, such as prospective employers, with honest information about the character of a former employee, even though the information may ultimately prove to be inaccurate.³ The protection is not absolute, however. To overcome this privilege, an employee can demonstrate: (i) that the information is false; and (ii) that the employer acted with actual malice (i.e., "personal spite or ill will, or culpable recklessness or negligence").⁴

Other states provide employers with similar protections. Though the jurisdictions' standards vary, many states' qualified privilege is similar to New York's. Other states provide legal protection to employers unless they knew, or reasonably should have known, that the information that they communicated was false.⁵ Yet in others, employers can only provide information with the consent of their former or current employees.⁶

Recent Developments

California recently passed AB 2770, a statute that became effective in January 2019, which explicitly exempts certain sexual harassment-related communications made by employers from defamation claims. The goal of the new law is to encourage employers in good faith to provide information regarding their previous employees, particularly where they may have been disciplined for sexual harassment.

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California's AB 2770 is not the state's first law regarding the qualified privilege. Even before the new statute, California employers possessed a qualified privilege to share information without malice and with an innocent motive to interested parties, such as prospective employers. (See Cal. Civ. Code § 47(c).) The qualified privilege covered communications to prospective employers concerning the job performance or qualifications of an applicant for employment, based upon credible evidence. California's new defamation law extended these protections to—or, at a minimum, stated explicitly that the state's existing law covered—three categories of communications that specifically relate to sexual harassment:

- **Complaints of sexual harassment:** “complaint[s] of sexual harassment by an employee, without malice, to an employer based upon credible evidence”;
- **Investigations regarding sexual harassment:** “communications between the employer and interested persons [e.g., witnesses], without malice, regarding a complaint of sexual harassment”;
- **Communications during reference checks regarding sexual harassment:** the law authorizes current or former employers “to answer, without malice, whether or not the employer would rehire a current or former employee and whether the decision to not rehire is based upon the employer’s determination that the former employee engaged in sexual harassment.” (*Id.*)

The California legislature recognized that absent these explicit provisions extending the qualified privilege to communications regarding sexual harassment, employers were “deter[red] . . . from telling others about a genuine harasser.” (CAL. S. FLOOR ANALYSIS, Bill No. AB 2770, at 4 (2018).) California legislators believed that the new law “would protect employers and allow them to warn potential employers about an individual’s harassing conduct during a reference check without the threat of a defamation lawsuit.” (*Id.*)

“Compelled Self-Publication”

California’s new statute may affect other areas of California’s body of defamation law. The law might impact, for example, California’s recognition of the doctrine of “compelled self-publication defamation.”⁷ As noted above, in traditional defamation cases, the employee typically claims that the former employer published the alleged defamatory statement to a third party. However, under the “compelled self-publication defamation” theory, some states may find defamation even where the former employer did not publish the alleged defamatory reason for the former employee’s dismissal.⁸ Rather, the discharged employee claims to have been “compelled” by the former employer to repeat the defamatory reason given by the employer for the termination of employment during the process of applying for a new job.

AB 2770 might abrogate California’s “compelled self-publication defamation” doctrine, at least in the context of communications related to sexual harassment. Under the new law, if an employer articulates to an employee the company’s reasons for its decision to terminate the employee, it is conceivable—though it has not yet been litigated—that those communications, too, could be immune from liability under AB 2770 for claims of “compelled self-publication defamation.”

Practice Suggestions

Notwithstanding the new legal protections for employers afforded in California, employers should remain concerned that communications about a former employee’s misconduct could form the basis of a defamation lawsuit. To take advantage of the qualified privilege, employers must have acted without malice, an inherently fact-based inquiry. In a defamation case, the question of whether the malice element has been met may or may not be resolved by the court at the pleading stage, thereby exposing the employer to litigation. Accordingly, to avoid the risk and cost of lawsuits arising from reference checks of employees discharged for misconduct, employers should proceed with caution, and consider the following measures to increase the likelihood that courts will condone their actions:

- **Implement Policies for Fielding Reference Checks Regarding Former Employees.**

As we previously noted, employers should continue to consider formulating an appropriately tailored procedure for responding to inquiries from prospective employers as to the reasons for an employee’s dismissal. Employers often institute procedures limiting the information that they will provide to prospective employers to the employee’s dates of employment and final positions held. Alternatively, with respect to problematic dismissals, if the employer makes any statement whatsoever, the employer may wish first to obtain the employee’s agreement to the exact wording to be used in such a statement. This is often accomplished by way of a separation agreement with the employee as part of the consideration for a general release of claims.

- **Direct Reference Checks to a Single Source**

As part of a procedure for responding to reference checks, employers should consider directing all inquiries to a single source in the organization. That aspect of company policy would ensure that managers are not free to speak on behalf of the employer when they receive calls from prospective employers which could unwittingly form the basis of a defamation action.

- **Understand the Law in the Applicable Jurisdiction.**

As noted above, states differ with respect to their approach to reference checks, creating challenges for multi-state employers. To date, California appears to

be one of the few states with a statute that explicitly addresses sexual harassment-related communications in response to reference checks.⁹ Additionally, even though the California legislature appears to have intended to protect employers from the threat of defamation lawsuits in the context of sexual harassment-related communications, courts have not yet analyzed the law in any published case to date.

•Other Laws

This article focuses primarily on state law with respect to reference checks, but employers should consider additional federal, state, and local employment laws that may be relevant to the hiring process. For example, federal and state laws provide employees with protections from discrimination. If employers request information from previous employers, prospective employers should adopt or maintain a policy with respect to reference checks and treat all candidates equally. Other laws regulate additional aspects of the employment reference check process, including, for example, requests for genetic information and family medical history.

•Whether to Conduct Reference Checks For New Hires

In New York, employers generally have no legal duty to perform reference checks.¹⁰ Generally speaking, though, many employers decide to conduct reference checks in an effort to avoid hiring employees who may engage in résumé fraud, promote the hiring of qualified candidates, and, particularly in the #MeToo era, inquire about possible instances of misconduct. If employers do conduct reference checks, and they learn facts that would lead a “reasonably prudent person” to investigate, then they have a duty to conduct such an investigation. Employers who fail to conduct an investigation upon learning facts that would lead a “reasonably prudent person” to investigate may expose themselves to a future claim of negligent hiring.¹¹

Endnotes

1. See, e.g., *Lavin v. Trezza*, No. 01 Civ. 135, 2002 WL 57247, at *5 (D. Me. Jan. 15, 2002) (denying an employer’s motion to dismiss a defamation claim after the employer had disclosed to its former employee’s prospective employer that the employee was terminated for sexual harassment); *Deutsch v. Chesapeake Ctr.*, 27 F. Supp. 2d 642, 644 (D. Md. 1998) (plaintiff brought a defamation action against his former employer because his employer disclosed to a prospective employer that the employee was fired for sexual harassment); see also *Harris v. Superior Court of Arizona in & for Cty. of Maricopa*, No. 02 Civ. 0494, 2009 WL 775462, at *12 (D. Ariz. Mar. 23, 2009), vacated on other grounds sub nom. *Harris v. Maricopa Cty. Superior Court*, 631 F.3d 963 (9th Cir. 2011) (denying the defendant’s motion for the award of attorney’s fees on plaintiff’s defamation claim because the plaintiff’s claim was not frivolous; the plaintiff alleged that the false and defamatory statement that he had been fired for sexual harassment was published to prospective employers).
2. See *Dillon v. City of New York*, 261 A.D.2d 34, 38, 704 N.Y.S.2d 1 (1st Dep’t 1999) (“The elements [for a claim of defamation] are a false statement, published without privilege or authorization to a third party, constituting fault as judged by, at a minimum, a negligence standard, and it must either cause special harm or constitute defamation per se.”); *Makaeff v. Trump Univ., LLC*, 715 F.3d 254, 264 (9th Cir. 2013) (“Under California law, defamation is the intentional publication of a statement of fact which is false, unprivileged, and has a natural tendency to injure or which causes special damage.” (citation and internal quotation marks omitted)).
3. See *De Sapio v. Kohlmeier*, 52 A.D.2d 780, 781, 383 N.Y.S.2d 16 (1st Dep’t 1976) (“A qualified privilege exists for the purpose of permitting a prior employer to give a prospective employer honest information as to the character of a former employee even though such information may prove ultimately to be inaccurate.”); see also *Serratore*, 293 A.D.2d at 465–66 (affirming dismissal of the plaintiff’s defamation claim against his former employer based on the former employer’s response to an employment reference questionnaire from the plaintiff’s prospective employer because the former employer’s communications were protected by the qualified privilege).
4. *Shapiro v. Health Ins. Plan of Greater New York*, 7 N.Y.2d 56, 61, 163 N.E.2d 333 (N.Y. 1959); see also *De Sapio*, 52 A.D.2d at 780–81 (affirming dismissal of plaintiff’s defamation claim against his former employer because the plaintiff failed to demonstrate that the employer’s “statements [to the plaintiff’s prospective employer] were made with actual malice”).
5. See, e.g., Ind. Code Ann. § 22-5-3-1(b)(3) (“An employer that discloses information about a current or former employee is immune from civil liability for the disclosure and the consequences proximately caused by the disclosure, unless it is proven by a preponderance of the evidence that the information disclosed was known to be false at the time the disclosure was made.”); Colo. Rev. Stat. Ann. § 8-2-114 (providing qualified immunity unless “[t]he information disclosed by the current or former employer was false; and [t]he employer providing the information knew or reasonably should have known that the information was false”).
6. See, e.g., Nev. Rev. Stat. Ann. § 41.755(1) (providing an employer with a qualified privilege to disclose information “at the request of an employee”); Conn. Gen. Stat. Ann. § 31-128f (absent an employee’s consent, employers generally may only verify the employee’s dates of employment, title or position, and wage or salary; though when an employee consents to the employer’s disclosure of information, the employer has a qualified privilege to disclose information).
7. See Jeffrey S. Klein and Nicholas J. Pappas, *Compelled Self-Publication Defamation*, N.Y.L.J., Aug. 2, 2004, at 18, available at <https://www.weil.com/articles/compelled-self-publication-defamation>, for an in-depth discussion of the “compelled self-publication defamation” doctrine.

8. States differ with respect to their approach to the doctrine of “compelled self-publication defamation.” New York courts, for example, have shied away from recognizing the doctrine. See *Wieder v. Chem. Bank*, 202 A.D.2d 168, 169–70, 608 N.Y.S.2d 195 (1st Dep’t 1994); *Caesars Entm’t Operating Co. v. Appaloosa Inv. Ltd. P’ship I*, 48 Misc. 3d 1212(A), 18 N.Y.S.3d 577 (N.Y. Sup. Ct. 2015) (“[The] ‘compelled self-publication’ theory is unavailing because the First Department has rejected this theory.” (citation omitted)). Other states that previously recognized the doctrine, such as Texas, have since rejected it altogether. See *Exxon Mobil Corp. v. Rincones*, 520 S.W.3d 572, 581 (Tex. 2017) (“We expressly decline to recognize a theory of compelled self-defamation in Texas.”). Yet in other states, such as California, some courts have recognized the “compelled self-publication defamation” doctrine. See *Rangel v. Am. Med. Response W.*, No. 09 Civ. 01467 (AWI), 2013 WL 1785907, at *17 (E.D. Cal. Apr. 25, 2013) (“Under the compulsion doctrine, a defendant may be liable for the foreseeable republication of a defamatory statement by a plaintiff where ‘the person defamed [is] operating under a strong compulsion to republish the defamatory statement and the circumstances which create the strong compulsion are known to the originator of the defamatory statement at the time he communicates it to the person defamed.’” (quoting *McKinney v. County of Santa Clara*, 110 Cal.App.3d 787, 797, 168 Cal.Rptr. 89 (1980))).
9. Cf. Minn. Stat. Ann. § 181.967, subdvs. 2, 3(a)(5) (extending the state’s qualified privilege to employers that disclose “acts of . . . harassment documented in the personnel record that resulted in disciplinary action or resignation and the employee’s written response, if any, contained in the employee’s personnel record”); Neb. Rev. Stat. Ann. § 48-201(1)(a) (upon an employee’s consent, providing employers with a qualified privilege to disclose “harassing acts . . . related to the workplace or directed at another employee”).
10. See, e.g., *Kenneth R. v. Roman Catholic Diocese of Brooklyn*, 229 A.D.2d 159, 163, 654 N.Y.S.2d 791 (N.Y. 1997) (“There is no common-law duty to institute specific procedures for hiring employees unless the employer knows of facts that would lead a reasonably prudent person to investigate the prospective employee”).
11. See *T.W. v. City of New York*, 286 A.D.2d 243, 245–46, 729 N.Y.S.2d 96 (1st Dep’t 2001) (denying the employer’s motion for summary judgment on a negligent hiring claim because a jury could have reasonably concluded that the employer had a duty to conduct an investigation regarding an employee’s background).



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Inside the Courts

By the Attorneys of Skadden Arps

Definition of a Security

California District Court Reverses Course, Grants Preliminary Injunction in Crypto Case Alleging Section 17 Violation After Initially Denying Such Injunction

SEC v. Blockvest, LLC, No. 3:18-cv-02287-GPC-MSB (S.D. Cal. Feb. 14, 2019)

Judge Gonzalo P. Curiel granted the Securities and Exchange Commission's (SEC) motion for partial reconsideration of the court's November 2018 order denying a preliminary injunction against Blockvest for violating Section 17(a) of the Securities Act. In its original November 2018 order, the court found that the SEC had failed to make the requisite showing that Blockvest's "BLV" tokens were "securities" under the federal securities laws because there was insufficient evidence that Blockvest's early test investors had invested money in the tokens with an expectation of profits. After the SEC moved for reconsideration, however, Judge Curiel granted the motion for preliminary injunction, holding that the SEC had sufficiently established a *prima facie* case that Blockvest's promotional materials concerning the initial coin offering (ICO) of its BLV tokens constituted an offer of unregistered securities in violation of Section 17(a).

To obtain a preliminary injunction, the SEC first had to establish a *prima facie* case of a violation of federal securities laws. Here, the SEC alleged that Blockvest violated Section 17(a) by offering unregistered securities.

In analyzing whether the SEC sufficiently made the requisite showing for purposes of a preliminary injunction, the court first addressed whether the SEC had made out a *prima facie* case that the BLV tokens constitute "securities" within the meaning of the federal securities laws. Section 2(a)(1) of the Securities Act defines "security" to include, *inter alia*, "any note, stock, treasury stock . . . bond . . . [or] investment contract." 15 U.S.C. § 77b(a)(1). The district court employed the U.S. Supreme Court's three-part test from *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), to determine if the BLV tokens could be considered an "investment contract." That three-part test requires (1) an investment of money (2) in a common enterprise (3) with an expectation of profits produced by the efforts of others. The district court emphasized that, "[i]n determining whether a transaction constituted a 'security' based on an offer and/or sale to investors, the Ninth Circuit looks to the specific promotional materials presented to the 'investors.'" The court also recalled the Supreme Court's guidance in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943): "The test [for determining whether an instrument is a security] . . . is what character the

instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."

Here, as to the first *Howey* requirement, the court found that BLV tokens were an investment of money because the evidence presented indicated that the company's website and the white paper the company posted online invited potential investors to exchange currency for BLV. With regard to the second *Howey* requirement, the Blockvest promotional materials that the SEC submitted to the court described BLV as a common enterprise, wherein funds from the tokens would be pooled and distributed according to a profit-sharing formula. As for the third *Howey* requirement, the court determined on the record before it that the profits of BLV were to come solely from the efforts of others because the company's website and white paper sought "passive" investors and claimed that the tokens would generate "passive income." Given the statements in the specific promotional materials that the defendants had presented to investors, the court held that the SEC had met its burden at the preliminary injunction stage to show that BLV tokens were a security, and that Blockvest's website, white paper and social media posts concerning the ICO of the BLV tokens constituted an "offer" of unregistered securities, in violation of Section 17(a).

New Jersey District Court Denies Motion to Dismiss, Finds Plaintiff Adequately Alleged That Cryptocurrency Was a Security

Solis v. Latium Network, Inc., No. 18-10255 (SDW) (SCM) (D.N.J. Dec. 10, 2018)

Judge Susan D. Wigenton denied Latium's motion to dismiss a claim brought under Section 12(a)(1) of the Securities Act, holding that the plaintiff plausibly alleged that Latium's cryptocurrency, LATX, was a security and, therefore, also plausibly alleged that Latium had offered and sold unregistered securities in violation of the statute.

To bring suit under the federal securities laws, an investor must make the threshold showing that the interest in question is a "security." The defendant did not dispute the first requirement under *Howey*. With regard to the second requirement, the court held that the plaintiff plausibly alleged that Latium was a common enterprise because the company pooled funds from LATX to develop the platform, and investors' return on their investment was proportional to their LATX tokens. As for the third requirement, the plaintiff plausibly alleged that investors expected profits from the efforts of a third party because

Latium referred to LATX as a “unique investment opportunity,” and investors were dependent on the company to develop the platform.

Fiduciary Duties

Court of Chancery Concludes That *Corwin* Does Not Entitle Directors to Business Judgment Rule Due to Uninformed Vote

In re Tangoe, Inc. Stockholders Litig., C.A. No. 2017-0650-JRS (Del. Ch. Nov. 20, 2018)

On November 20, 2018, Vice Chancellor Joseph R. Slight III denied a motion to dismiss filed by directors of Tangoe, Inc. and held that (1) the *Corwin* doctrine did not apply and (2) the plaintiff pleaded a nonexculpated claim for breach of the duty of loyalty.

The action arose from a tender offer by a private equity firm to take Tangoe private. In March 2016, Tangoe announced that the SEC had detected false statements in its financials and that it would have to restate them for several years. Tangoe struggled to complete the restatement, which prompted Nasdaq to delist its stock and the SEC to threaten deregistration. The restatement also impacted the directors’ compensation, which largely consisted of equity incentives, because the issuance of equity compensation was barred while the restatement was pending. Accordingly, Tangoe entered into equity award replacement compensation agreements (EARCAs) with each of the directors that would be triggered only upon a change of control and would provide them with the same amount of equity compensation they would have received had their normal awards been available. At that point, the board pivoted from completing the restatement to selling the company. Private equity firm Marlin Equity Partners (Marlin), one of several large stockholders threatening to launch a proxy contest, initiated a tender offer at \$6.50 per share (a 28% negative premium), and on April 27, 2017, the board approved the proposed transaction, and a majority of Tangoe’s stockholders tendered their shares.

The complaint alleged that the directors breached their fiduciary duties by agreeing to sell the company for an inadequate price and for failing to disclose all material information to stockholders. The directors moved to dismiss the complaint, arguing that (1) they were entitled to business judgment rule deference under *Corwin* and (2) the plaintiff failed to plead a nonexculpated claim against them for breach of the duty of loyalty.

First, the court held that *Corwin* did not apply because it was reasonably conceivable that the stockholder vote was uninformed. The court explained that Tangoe’s disclosures regarding the proposed transaction omitted material information by (1) failing to provide stockholders with audited financial statements and (2) failing to disclose whether (or when) the restatement would be completed. With respect to the first disclosure deficiency, the

court explained that stockholder approval of the transaction was not fully informed in the absence of adequate financial information because stockholders faced an information vacuum, given the sporadic and heavily qualified financial information the board provided to stockholders and the company’s failure to file multiple quarterly reports and hold an annual meeting. With respect to the second disclosure deficiency, the court explained that the stockholders’ need for information regarding the restatement was critically important when considering whether to tender into the transaction because the restatement stakes were high, given Tangoe’s delisting from Nasdaq, threats of deregistration from the SEC and the proxy contest. The court held that information about the restatement process was also material because the delisting depressed the amount potential acquirers were willing to pay for Tangoe, and stockholders needed to understand whether the delisting was likely to continue or whether the company had a legitimate prospect of completing the restatement and regaining its listed status with Nasdaq.

Second, the court held that the plaintiff had pleaded a nonexculpated claim for breach of the duty of loyalty because it was reasonably conceivable that the directors approved the underlying transaction for self-interested reasons. One source of conflict, the court explained, was the EARCAs, which incentivized the directors to steer Tangoe into a sale of the company, because a sale was the most likely means by which the directors would receive the equity awards they would have received if the company had completed the restatement. The court emphasized that the timing of the agreements further supported the plaintiff’s theory of director self-interest because it allowed for a reasonable inference that a temporal connection existed between the adoption of the EARCAs and the decision to shift course toward a sale of Tangoe. The court also identified the looming threat of a proxy contest, evidenced by letters the board had received from large stockholders (including Marlin) threatening to replace them, as a second source of director conflict, because the threat of a proxy contest was coupled with other pleaded facts, including the board’s struggles to complete the restatement, its adoption of the EARCAs and its recommendation to stockholders to accept steadily decreasing offers from Marlin to acquire the company.

Forum Selection Provisions – Corporate Charters

Court of Chancery Finds Federal Securities Law-Related Forum Selection Provision Invalid as Matter of Delaware Law

Sciabacucchi v. Salzberg, C.A. No. 2017-0931-JTL (Del. Ch. Dec. 19, 2018)

Vice Chancellor J. Travis Laster invalidated a forum selection provision contained in a Delaware corporation’s charter designed to regulate the forum where claims related to the corporation could be brought under the

Securities Act. He reasoned that “[a] 1933 Act claim is an external claim that falls outside the scope of the corporate contract.”

The three nominal defendants in the action each had filed a registration statement in connection with their respective initial public offerings (IPOs). Before filing the statement, each company had adopted similar “charter-based” federal forum provisions that required any claim under the Securities Act to be filed in federal court. One of the companies, Blue Apron, adopted a federal forum provision with a “savings clause.” The nominal defendants adopted these provisions to prevent securities holders from bringing Securities Act claims in state court. After the federal forum provisions were adopted, the plaintiff bought shares of each corporation and then filed suit in the Court of Chancery, seeking a “declaratory judgment that the Federal Forum Provisions are invalid.” On cross-motions for summary judgment, the court found the provisions invalid.

In invalidating the provision, the court relied on related precedent in this area of law that “stressed that Section 109(b) [of the DGCL] does *not* authorize a Delaware corporation to regulate external relationships.” Such prior decisions had “noted that a bylaw cannot dictate the forum for tort or contract claims against the company, even if the plaintiff happens to be a stockholder.” The court drew an analogy to that reasoning, holding that the “distinction between internal and external claims answers whether a forum-selection provision can govern claims under the 1933 Act. It cannot, because a 1933 Act claim is external to the corporation.” In reaching this conclusion, the court reasoned that “[b]ecause the state of incorporation creates the corporation, the state has the power through its corporation law to regulate the corporation’s internal affairs. ... But the state of incorporation cannot use corporate law to regulate the corporation’s external relationships.” The court explained, among other things, that “[a] claim under the 1933 Act does not turn on the rights, powers, or preferences of the shares, language in the corporation’s charter or bylaws, a provision in the DGCL, or the equitable relationships that flow from the internal structure of the corporation. ... [A] 1933 Act claim is distinct from ‘internal affairs claims brought by stockholders *qua* stockholders.’”

Finally, the court rejected a ripeness and savings clause argument, finding that “facial challenges” to the legality of charter provisions are regularly decided by the court, and the savings clause defense failed “because there is no context in which Blue Apron’s Federal Forum Provision could operate validly.”

Insider Trading

Second Circuit Affirms Conviction of Law Firm Partner for Insider Trading

United States v. Klein, No. 17-3355 (2d Cir. Jan. 10, 2019)

The Second Circuit affirmed the district court’s judgment convicting a former law firm partner of conspiracy to commit securities fraud in violation of 15 U.S.C. § 371 and of securities fraud in violation of Section 10(b) of the Securities Exchange Act. A jury had found that the former law firm partner had engaged in a conspiracy to trade in the securities of his client — a pharmaceutical company — using material, nonpublic information about a potential merger he obtained through his representation, by telling his financial advisor and friend that “it would be nice to be [the pharmaceutical company] for a day.”

Although the former partner argued that the government presented no evidence that he intended for his financial advisor to trade on the comment he made, the Second Circuit held that the jury was entitled to disbelieve that he only made that statement. The Second Circuit reasoned that “[A]s a matter of common sense,” the former partner had to have communicated additional information to his financial advisor, who immediately thereafter traded the pharmaceutical company’s stock. The Second Circuit further noted that the trial record was “replete with evidence” supporting an inference that the former partner intended for his financial advisor to trade on the information. The financial advisor had discretionary authority to trade in his account and in fact bought hundreds of thousands of dollars of the pharmaceutical company’s stock after receiving the tip, including for the former partner’s benefit. Additionally, the financial advisor had previously purchased stock in one of the former partner’s clients.

The Second Circuit reasoned that there is no requirement that the government provide evidence of multiple conversations between co-conspirators or that the government provide direct testimonial evidence regarding a defendant’s intent. The Second Circuit also held that the evidence supporting the inference that the former partner intended for his financial advisor to trade on the insider information was not on balance with evidence supporting an inference that he intended merely to boast about the company.

Interpreting *Omnicare*

District of Massachusetts Dismisses Claims That Women’s Apparel Company Misled Investors in Connection With IPO

The Pension Trust v. J.Jill, Inc., Civil Action No. 1:17-cv-11980-LTS (D. Mass. Dec. 20, 2018)

Judge Leo. T. Sorokin dismissed claims brought by a putative class of investors against a women’s apparel company alleging that the company violated Sections 11 and 12(a)(2) of the Securities Act by including false and misleading statements in its offering documents filed in advance of its March 2017 IPO and during a subsequent earnings call. The complaint alleged that the company, which touts an “omni-channel” marketing platform, in-

cluding online and brick-and-mortar retail stores, failed to disclose that it was susceptible to certain retail trends and considerations that affect the retail industry as a whole. The complaint further alleged that the company failed to disclose that it needed to increase promotional efforts to sell slow-moving inventory, that a number of the company's brick-and-mortar stores were failing and would shutter, and that the company's ability to service its debt had been materially impaired. The complaint alleged that these omissions violated Items 303 and 503 of SEC Regulation S-K. The complaint further alleged that the company's executives misled investors during a May 2017 earnings call by conveying expectations for reduced growth margin rates in upcoming quarters without fully disclosing the underlying reasons, which did not come to light until an October 2017 press release where the company lowered its expectations for the fiscal quarter.

Judge Sorokin held that the complaint failed to adequately allege a misstatement or omission. He first determined that the statements made in the May 2017 earnings call were inactionable opinions under the U.S. Supreme Court's decision in *Omnicare v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015). Judge Sorokin also determined that "[a]t most, the call suggests what the executives said expressly, that in light of then-current adverse general economic conditions, they were providing cautious guidance for the remainder of the year." Judge Sorokin rejected the argument that the opinion statements were nonetheless actionable because they were made without sufficient inquiry, finding that the complaint had "identified no particular and material facts relating to the inquiry [the company] purportedly did not conduct." Judge Sorokin also found that the statements made in the IPO offering documents about the company's future prospects were improperly pleaded as "fraud by hindsight." Finally, he determined that the "risk factor" disclosures contained the very risks that the complaint alleged the company had failed to disclose.

Mutual Fund Litigation

District of New Jersey Dismisses Excessive Advisory Fee Case After Eight-Day Bench Trial

In re BlackRock Mut. Funds Adv. Fee Litig., No. 3:14-cv-01165-FLW-TJB (D.N.J. Feb. 8, 2019)

Judge Freda L. Wolfson of the District of New Jersey ruled in favor of certain subsidiaries of BlackRock, Inc. on \$1.55 billion in claims brought under Section 36(b) of the Investment Company Act concerning two of BlackRock's largest mutual funds. The case is one of the largest cases ever filed involving the mutual fund industry.

Section 36(b) imposes a fiduciary duty on investment advisers with respect to the receipt of compensation they receive for providing services to mutual funds. Under Section 36(b) and relevant precedent, an adviser may not charge the funds it manages a fee that is so disproportion-

ately large that it bears no reasonable relationship to the services rendered and could not be the product of arm's length bargaining. Against that backdrop, the plaintiffs — investors in the funds at issue — brought suit claiming that BlackRock breached its fiduciary duty under Section 36(b) by charging excessive fees to the funds. According to the plaintiffs, BlackRock's advisory fees during the relevant period were excessive because it charged lower fees to provide allegedly substantially the same services as a subadviser to variable annuity mutual funds managed by third-party advisers.

After hearing evidence, the court found that the plaintiffs' comparison of an investment adviser's advisory and subadvisory services was inapt. In particular, the court found that BlackRock's limited subadvisory services were not "remotely comparable" to the "robust" suite of advisory services it provides to the funds at issue. In particular, the court found that advisory and subadvisory services are substantially different, including (but not limited to) with respect to: "(i) compliance; (ii) board administration; (iii) regulatory and financial reporting; (iv) determination and publication of daily NAV; and (v) managing service providers," such as accountants, transfer agents and custodians. In so holding, the court also acknowledged the value of BlackRock's coordination and oversight of the funds' third-party service providers, which it found to require "substantial effort," and the unique risks borne by BlackRock as adviser that it did not bear in its capacity as subadviser.

Ponzi Schemes

Tenth Circuit Affirms Lower Court Ruling on Purported Internet Advertising Services Company, Concluding That Its Products Are Securities

SEC v. Scoville, No. 17-4059 (10th Cir. Jan. 24, 2019)

A panel of the Tenth Circuit affirmed a preliminary injunction prohibiting a purported internet advertising services company from operating its business, and also affirmed a related district court order appointing a receiver over the company's business and assets. While the SEC argued that the company was operating a Ponzi scheme, the company asserted that it was a "legitimate internet traffic exchange offering internet advertising services" to its members, 90 percent of whom were located outside the United States. One of its products was AdPack, which entitled a member to receive a certain number of visits to the member's website and share in the company's revenues, provided that the member clicked on other members' advertisements a requisite number of times. Members could also earn money by recruiting other members. The SEC contended that these practices violated Sections 17(a)(1) and (a)(3) of the Securities Act and Section 10(b) of the Securities Exchange Act. After an evidentiary hearing, the district court granted the SEC's request for a preliminary injunction.

On appeal, the Tenth Circuit first concluded that the anti-fraud provisions of the federal securities laws applied to sales of AdPacks overseas. As the Dodd-Frank amendments made clear, federal courts have jurisdiction over proceedings involving conduct taken within the United States that constitutes a significant step in furtherance of a violation of the securities laws. The court found that this test was satisfied because the company was created in the United States, AdPacks were promoted by the company's founder who resided in the U.S. and the company's computer servers were located in the U.S.

The Tenth Circuit further concluded that AdPacks were "securities" within the meaning of the federal securities laws, since they qualified as "investment contracts" under the three-part test set forth in *Howey*. AdPacks offered their purchasers an opportunity to share in the company's revenue and AdPack purchases were investments in common enterprises. AdPacks also provided members with "a reasonable expectation of profit derived from the entrepreneurial or management efforts of others," as members expected the company's success to depend on its efforts to sell its advertising services.

Eighth Circuit Affirms Grant of Summary Judgment for Defendant Bank on Claim of Aiding and Abetting a Ponzi Scheme

Zayed v. Associated Bank, N.A., No. 17-1250 (8th Cir. Jan. 10, 2019)

The Eighth Circuit affirmed the grant of summary judgment by the District of Minnesota to the defendant bank on claims of aiding and abetting a Ponzi scheme. A receiver appointed to control the remaining assets in the business entities used to perpetrate the scheme brought the case in an effort to recover assets for victims of the fraud. The receiver sued Associated Bank, which provided banking services to some of the scammers' businesses, alleging the bank aided and abetted the fraudsters in committing the torts of conversion, breach of fiduciary duty, fraud and negligent misrepresentation under Minnesota law. The receiver alleged that a former bank employee, who helped the scammers open accounts and serviced those accounts, had knowledge of and assisted in the Ponzi scheme. The district court granted the defendant bank's motion for summary judgment, concluding there was insufficient evidence that the bank knew of and provided substantial assistance to the scammers' tortious conduct.

In analyzing the evidence in the summary judgment record, the Eighth Circuit similarly found no direct evidence that Associated Bank had knowledge of the Ponzi scheme. The receiver's own expert witness stated that no one at the bank concluded the scammers' entities were engaged in a Ponzi scheme, two of the scammers testified that the bank employee did not know about the scheme and the circumstantial evidence did not collectively allow for a conclusion of knowledge without resorting to

speculation. The court rejected the receiver's alternative argument that constructive knowledge is sufficient under Minnesota law and found it unsupported by the record even if it were.

The court further held that no reasonable fact-finder could conclude the bank provided substantial assistance in the commission of torts. Under Minnesota law, substantial assistance requires more than providing routine professional services. The court found no evidence in the record of anything beyond "routine banking services or, at worst, sloppy banking." Accordingly, the Eighth Circuit affirmed the district court's grant of summary judgment to the defendant.

PSLRA – Safe Harbor Provision

Pennsylvania District Court Denies Motion to Dismiss, Finding Plausible Allegations About Drug Abuse

SEB Inv. Mgmt. AB v. Endo Int'l, PLC, CIVIL ACTION NO. 17-3711 (E.D. Pa. Dec. 10, 2018)

Judge Timothy J. Savage denied the defendants' motion to dismiss claims brought under Section 10(b) of the Securities Exchange Act, holding that the alleged misrepresentations were not subject to the PSLRA's safe harbor provision.

The plaintiffs alleged that Endo misrepresented and omitted facts about the safety and efficacy of Opana ER, an opioid pain medication. From 2011 to 2017, Endo sought approval from the Food and Drug Administration (FDA) to label the drug as "abuse-deterrent." During this time, certain Endo officers made claims that data regarding the safety of the drug was "robust," "very encouraging" and reflected an 80 percent reduction in abuse compared to a previous version of the drug. In June 2017, the FDA asked Endo to withdraw the drug from the market because of data showing that the drug was highly susceptible to abuse. The plaintiffs allege that while Endo was seeking FDA approval, the company knew about data showing that the drug was susceptible to abuse and knew the impact that data would have on the FDA's approval. The defendants argued that the allegedly misleading statements were protected by the PSLRA's safe harbor provision.

The court found that while some of the alleged misstatements were protected under the safe harbor provision, others were not. The court explained that although the PSLRA's safe harbor protects forward-looking statements that include cautionary language, even facially forward-looking statements are not protected when "considered in context" with known, contradictory data on the drug's safety and efficacy. The court found that statements that the data was "robust," "very encouraging" and showed lower abuse rates touted the safety of Opana ER while ignoring contrary data. Thus, these statements did not fall under the safe harbor provision.

Section 220 – Books and Records

Delaware Supreme Court Provides Guidance on Availability of Electronic Documents Through Section 220 Demand

KT4 Partners LLC v. Palantir Techs. Inc., No. 281, 2018 (Del. Jan. 29, 2019)

On January 29, 2019, the Delaware Supreme Court reversed a decision of the Court of Chancery on two issues raised in an appeal of a stockholder Section 220 Delaware General Corporation Law (DGCL) action for books and records. The stockholder, KT4 Partners LLC, prevailed below on its demand for several categories of the books and records of Palantir Technologies Inc. but argued that the Court of Chancery had erred in not requiring the production of electronic communications and in denying its proposed exception to a jurisdictional use restriction.

On the first issue, the Delaware Supreme Court held that a production order limited to formal board minutes and board materials was insufficient because Palantir did not keep formal minutes. The Supreme Court stated that “[i]f the only documentary evidence of the board’s and the company’s involvement in the amendments comes in the form of emails, then those emails must be produced.” Because KT4 presented sufficient evidence that Palantir did not honor traditional corporate formalities and acted through email in connection with the alleged wrongdoing that KT4 was seeking to investigate, the Supreme Court concluded that KT4 had made a sufficient showing that emails were necessary to investigate potential wrongdoing related to amendments to an LLC agreement. The Supreme Court noted, however, that “[i]f a corporation has traditional, non-electronic documents sufficient to satisfy the petitioner’s needs, the corporation should not have to produce electronic documents.” The Supreme Court continued, “if a company observes traditional formalities, such as documenting its actions through board minutes, resolutions, and official letters, it will likely be able to satisfy a § 220 petitioner’s needs solely by producing those books and records.”

As to the second issue, the Supreme Court held that the Court of Chancery abused its discretion by refusing KT4’s request to limit a jurisdictional use restriction the Court of Chancery had imposed. In its final order below, the Court of Chancery had imposed a broad restriction on the use of the materials KT4 was entitled to inspect, such that KT4 could not use them in litigation outside the Court of Chancery. The Court of Chancery rejected KT4’s requests that it be allowed to bring suit either (1) in the first instance in the Superior Court of Delaware, where other litigation between the parties was pending; or (2) in a court located in another jurisdiction for any nonderivative action where one of Palantir’s directors, officers or agents is named as a defendant and that person would not consent to personal jurisdiction in Delaware. The Supreme Court held that because the Court of Chancery

found a credible basis to investigate potential wrongdoing related to the violation of contracts executed in California, governed by California law and among parties living or based in California, the Court of Chancery lacked reasonable grounds for limiting KT4’s use in litigation of the inspection materials to Delaware and specifically the Court of Chancery.

Court of Chancery Orders Production of Fiduciaries’ Emails and Text Messages in Books and Records Action

Schnatter v. Papa John’s Int’l, Inc., C.A. No. 2018-0542-AGB (Del. Ch. Jan. 15, 2019)

Chancellor Andre G. Bouchard ordered the production of emails and personal text messages of the directors and certain officers of Papa John’s International, Inc. in an action brought pursuant to Delaware’s corporate books and records statute, and declined to adopt a bright-line rule that “emails and text messages from personal accounts and devices” are not subject to production in a statutory books and records action.

The case arose from a demand for books and records pursuant to Section 220 of the DGCL by John Schnatter, the company’s founder, former CEO and chairman, and current board member, related to the company’s decision to sever certain relationships with him in the aftermath of Schnatter’s 2017 controversial comments on the NFL and race in America. Schnatter brought the books and record demand both as a stockholder and as a director. Schnatter’s stated purpose was to investigate whether members of the company’s board breached their fiduciary duties to the company’s stockholders with regard to the termination of Papa John’s various agreements and relations with Schnatter. Schnatter had already initiated a separate fiduciary duty action against the board while his books and records proceeding was pending.

The court rejected the defendant’s argument regarding Schnatter’s prior pending fiduciary action and distinguished past decisions that suggested that action rendered his Section 220 request improper. In doing so, the court noted that the Section 220 action was also brought in Schnatter’s capacity as a director and that directors with a proper purpose are entitled to “virtually unfettered” access to a company’s books and records. With respect to the scope of production and the text messages and emails sought, the court eschewed a “bright-line rule.” Relying on prior decisions, it concluded that communications “that affect the corporation’s rights, duties, and obligations” can constitute the “books and records of a corporation for purposes of Section 220.”

Applying these principles, the court held that custodians who used personal devices to communicate about issues central to the Section 220 request, the termination of relationships with the founder and former CEO and whether such action was consistent with the custodians’ fiduciary duties, “should expect to provide that informa-

tion to the Company.” Specifically, the court explained that if the identified custodians “used personal accounts and devices to communicate about changing the Company’s relationship with Schnatter, they should expect to provide that information to the Company” and noted that this is not limited just to emails but includes text messages, which “in the court’s experience often provide probative information.” While ordering production under these circumstances, the court acknowledged that it “has both granted and denied access to personal email accounts and devices of directors and officers in Section 220 actions.”

Securities Exchange Act

Northern District of Texas Court Follows Third and Ninth Circuits’ Loss Causation Standard in Securities Fraud Actions Involving Privately Traded Securities

O’Connor v. Cory, CIVIL ACTION NO. 3:16-CV-1731-B (N.D. Tex. Jan. 3, 2019)

The court held that in cases involving privately traded securities — as in cases involving publicly traded securities on an efficient market — establishing loss causation for securities fraud claims requires plaintiffs to show that the alleged misrepresentation caused the claimed economic loss.

Plaintiffs Tammy O’Connor and Michael Stewart entered into an agreement to sell their interest in a company to Atherio, Inc. The plaintiffs later learned that Atherio’s chief financial officer, Thomas Farb, would be leaving his position. The plaintiffs sued Farb as well as other Atherio executives, alleging that the purchase agreement contained misrepresentations because the defendants failed to disclose that Farb was stepping down as CFO.

The plaintiffs asserted claims for securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, as well as a claim for common law fraud. The defendants moved for summary judgment, arguing, among other things, that there were no misrepresentations, and that the plaintiffs failed to establish loss causation because they had adduced no evidence that the alleged fraud caused their economic loss. The court found the plaintiffs cited sufficient evidence to create a triable issue as to whether the defendants made misrepresentations.

Turning to loss causation, the court noted that the largest swath of cases from the U.S. Supreme Court and Fifth Circuit addressing this requirement involve publicly traded securities on an efficient market, where a fraud-on-the-market theory (which focuses on the effect a price-inflating misrepresentation and subsequent disclosure has on a security’s price in the marketplace) can be applied. The court remarked, however, that neither the Supreme Court nor the Fifth Circuit has addressed loss causation involving privately traded securities where there is no marketplace

for the disclosure of negative truthful information to cause a price decline.

Noting the lack of binding precedent on what is needed to prove loss causation in securities fraud cases not involving the purchase of publicly traded securities in an efficient market, the court looked to the Third and Ninth circuits, which have addressed loss causation in this context. The court remarked that in *McCabe v. Ernst & Young, LLP*, 494 F.3d 418 (3d Cir. 2007), the Third Circuit held that although typical fraud-on-the-market cases were inapplicable to private securities sales (because the plaintiff acts based on a personalized misrepresentation that does not implicate larger market forces), the general standard for pleading loss causation is the same regardless of whether the securities were publicly or privately traded. In each case, the plaintiff must demonstrate that the defendant misrepresented or omitted the very facts that were a substantial factor in causing the plaintiff’s economic loss. In *Nuveen Mun. High Income Opportunity Fund v. City of Alameda*, 730 F.3d 1111 (9th Cir. 2013), the Ninth Circuit likewise held that the same loss causation analysis applied to both typical Section 10(b) cases (involving publicly traded securities) and nontypical cases (involving the sale of privately traded securities). In both, a plaintiff must “reliably distinguish among the tangle of factors affecting a security’s price,” regardless of the market.

Following these principles, the court stated that the proper showing for loss causation, even outside the fraud-on-the-market context, is whether the very facts the defendant misrepresented or omitted were a substantial factor in causing the plaintiff’s economic loss. Therefore, the court held that to establish loss causation in this case, it was not sufficient for the plaintiffs to show they were “duped or induced into a transaction”; the plaintiffs must show that the misrepresentation regarding Farb’s position as CFO was at least a substantial factor in bringing about their economic loss — *i.e.*, the devaluation of the company. Having concluded the plaintiffs failed to meet that standard, the court granted the defendants’ summary judgment motion.

Securities Fraud Pleading Standards

Third Circuit Dismisses Fraud Class Action for Failing to Allege Material Misrepresentation

City of Cambridge Ret. Sys. v. Altisource Asset Mgmt. Corp., No. 17-2471 (3d Cir. Nov. 14, 2018)

The Third Circuit affirmed the district court’s dismissal of the plaintiffs’ claim brought under Section 10(b) of the Securities Exchange Act, finding the plaintiffs failed to adequately allege a false or misleading statement.

The plaintiffs, former shareholders, alleged two categories of misrepresentations. First, they alleged that defendant Altisource misled investors by representing its affiliate relationship with mortgage company Ocwen as a

“competitive advantage” and an opportunity to “maximize the value of its loan portfolios” when in reality, according to the plaintiff, Ocwen’s services were outdated and the company was subject to regulatory violations in the wake of the housing crisis. Second, the plaintiffs alleged that the defendant made misrepresentations regarding its recusal policy.

The court found that the plaintiffs did not plausibly allege that either category of statements was materially misleading. With regard to the statements concerning the defendant’s relationship with Ocwen, the court concluded that the plaintiffs failed to plausibly allege that those statements were false because Ocwen met its servicing obligations and there was no reason to think it would not continue to do so. With regard to the recusal policy, the court concluded that the plaintiffs’ failure to identify a single transaction in which a purportedly conflicted company officer improperly participated rendered the allegations too speculative to meet the PSLRA’s strict requirements. In dismissing the suit, the court opined that, “[w]hen a stock experiences the rapid rise and fall that occurred here, it will not usually prove difficult to mine from the economic wreckage a few discrepancies in the now-deflated company’s records. Hindsight, however, is not a cause of action.”

Georgia District Court Denies Motion to Dismiss in Equifax Data Breach Case

In re Equifax Inc. Sec. Litig., CIVIL ACTION FILE NO. 17-CV-3463-TWT (N.D. Ga. Jan. 28, 2019)

Judge Thomas W. Thrash, Jr. denied Equifax’s motion to dismiss a putative federal securities class action alleging misrepresentations regarding the company’s data security, holding that the complaint adequately alleged that certain company statements were false or misleading.

The plaintiffs alleged that, prior to a 2017 data breach, Equifax misled investors about its data security, the personal information in Equifax’s custody, the vulnerability of its systems, and Equifax’s compliance with laws and best practices. Specifically, the plaintiffs claimed it was misleading for Equifax to describe itself as a “trusted steward” of personal data and to tout its “advanced security protections,” “highly sophisticated data information network” and “rigorous enterprise risk management program targeting ... data security.” In seeking to dismiss the claims, Equifax argued that the plaintiffs did not plausibly allege that the statements were false because the mere existence of a breach did not establish that Equifax’s data security was inadequate. Equifax further argued that the alleged misrepresentations were “corporate optimism” and “puffery” that are not actionable under the federal securities laws.

The court agreed with Equifax that the existence of a breach alone “may not necessarily” prove that a company’s data security is inadequate. However, the court held

that the plaintiffs alleged a “variety of facts” showing that Equifax’s security was outdated, below industry standards, vulnerable to attack and a low priority. Additionally, the court found that the statements were not puffery because shareholders could have relied on the statements, given that data security is a core aspect of Equifax’s business.

California District Court Dismisses Securities Claim Arising Out of PayPal Data Breach

Sgarlata v. PayPal Holdings, Inc., Case No. 17-cv-06956-EMC (N.D. Cal Dec. 13, 2018)

Judge Edward M. Chen granted defendant PayPal’s motion to dismiss the plaintiffs’ claims brought under Section 10(b) of the Securities Exchange Act alleging a failure to disclose a data breach, finding that the plaintiffs failed to plausibly allege scienter and loss causation.

In November 2017, PayPal announced the discovery of “security vulnerabilities” within a PayPal subsidiary. In December 2017, PayPal announced that the subsidiary had experienced a data breach that compromised the personal information of 1.6 million customers. The stock price dropped in response to that disclosure. The plaintiffs alleged that PayPal knew about the breach at the time of its November 2017 announcement and that, therefore, its statement that there were only “security vulnerabilities” was materially misleading because it gave the impression that there was not already a data breach.

In assessing the plaintiffs’ allegations, the court analyzed scienter and loss causation together. The court noted that the plaintiffs argued that the stock price drop in December 2017 was caused not only by the revelation of the data breach but also by disclosure that the breach was so far-reaching as to affect 1.6 million customers. Given that theory, the plaintiffs had to plausibly plead that, at the time of the November 2017 announcement, the defendants knew both that there had been a breach and that the privacy of 1.6 million customers had potentially been compromised as a result. The plaintiffs primarily relied on three former employees’ statements to allege such knowledge. In finding those allegations insufficient, the court reasoned that, at most, the former employees’ statements established that some PayPal employees “may have known” about the breach. However, the statements did not show that the defendants knew the magnitude of the breach, *i.e.*, that it affected the personal information of 1.6 million customers.

SLUSA Covered Class Action

Seventh Circuit Affirms Dismissal of Suit Barred by SLUSA as Covered Class Action

Nielen-Thomas v. Concorde Inv. Servs., LLC, No. 18-2875 (7th Cir. Jan. 24, 2019)

The Seventh Circuit affirmed dismissal of a suit that was precluded by the Securities Litigation Uniform Standards Act (SLUSA) as a “covered class action.” Plaintiff Nielen-Thomas originally filed a class action complaint in Wisconsin state court, alleging she and others similarly situated were defrauded by their investment adviser. The putative class consisted of at least 35, but not more than 49, members and the complaint contained nine state law claims. The defendants removed the case to the Western District of Wisconsin and moved for dismissal, arguing that the action was precluded by SLUSA as a “covered class action.” The plaintiff contended that her lawsuit did not fall under that definition because her proposed class had fewer than 50 members. The district court dismissed the case with prejudice, holding that the case was a “covered class action” under SLUSA because the plaintiff brought it on behalf of unnamed parties in a representative capacity.

The Seventh Circuit agreed. It noted that Congress passed SLUSA as a response to litigant attempts to file state law class actions in an effort to circumvent barriers to federal securities class actions embodied in the Private Securities Litigation Reform Act. Under SLUSA, a single lawsuit qualifies as a “covered class action” when damages are sought on behalf of more than 50 prospective class members or when a named party seeks to recover damages on a representative basis, and questions of law or fact common to other members of the prospective class predominate. The Seventh Circuit held that SLUSA “unambiguously” precludes the plaintiff’s lawsuit, as she sought to bring state law claims on a representative basis and alleged that common questions of law or fact predominate. Accordingly, it affirmed the district court’s dismissal with prejudice.

Standing

Western District of Oklahoma Dismisses Putative Class Claims Brought by Investors in Oil and Gas Trust

Duane & Virginia Lanier Trust v. Sandridge Mississippian Trust I, Case No. CIV-15-634-G (W.D. Okla. Jan. 18, 2019)

Judge Charles B. Goodwin dismissed putative class claims against an oil and gas trust (Trust I) brought under Section 10(b) and 20(a) of the Securities Exchange Act. In 2011, an energy company monetized its existing oil and gas assets and created two trusts: Trust I (Oklahoma assets) and Trust II (Oklahoma and Kansas assets). Investors purchased units in both trusts, but the lead plaintiffs—investors had purchased units in only Trust II. The lead plaintiffs alleged that Trust I made material misstatements in its registration statement about its oil projections in Oklahoma. The lead plaintiffs alleged that the misstatements about Trust I caused them to purchase units in Trust II because the oil for both trusts came from the same locations. The plaintiffs also alleged that the two trusts shared the same management.

Judge Goodwin dismissed the lead plaintiffs’ claims for lack of standing against Trust I. He reasoned that Section 10(b) only allows purchasers of a security to bring a private civil suit and determined that the amended complaint established that trust units were “independent securities sold by two different entities and publicly traded under two distinct ticker symbols.” Judge Goodwin also held that the two trust units were not contractually linked to each other, and “neither is a derivative instrument whose value is tied to that of the other.”

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Critical Audit Matters: Improving Disclosure Through Auditor Insight¹

By Katherine A. Cody

Introduction

Audit opinions provide assurance² to the investing public³ and creditors who rely on a public company's financial statements.⁴ The independent auditor's report, financial statements, and Management's Discussion and Analysis (MD&A) are all included in Form 10-K,⁵ which is filed annually with the Securities and Exchange Commission (SEC) and accessible by the public. The independent auditor's report is the sole line of communication between the auditor and the users of the financial statements⁶ as the remainder of Form 10-K is written from the company's perspective.⁷ Despite the adoption of the MD&A requirement in 1980,⁸ technological changes in financial reporting,⁹ and the release of new accounting standards,¹⁰ prior to this change, the independent auditor's report has remained consistent since the 1940s.¹¹ These opinions are relatively short, at one or two pages in length,¹² considering that many 10-Ks are over 100 pages.¹³

Audit opinions traditionally followed a "pass/fail" model.¹⁴ A passing opinion, known as an unqualified opinion, concluded that the company's financial statements "present[ed] fairly, in all material respects,"¹⁵ but provided no detail on any areas of the audit that were higher risk, complex, or required additional time. Conversely, when a company failed the audit, the auditors issued either: (1) a "qualified opinion" which concluded that the financial statements "present[ed] fairly except for the noted issues";¹⁶ or (2) an "adverse opinion" which concluded that the financial statements were not in conformity with Generally Accepted Accounting Principles (GAAP).¹⁷

Federal securities laws are designed to protect the "reasonable investor."¹⁸ However, multiple schools of thought exist as to whether the "reasonable investor" is an institutional investor,¹⁹ an individual investor, or if this term is capable of having a single definition.²⁰ Individual and institutional investors have different needs and goals, which is why it is important to identify which investors the laws are designed to protect. The use of "reasonable investor" in this article refers to individual investors, a definition supported by Congress' intent.²¹ As noted by the SEC Investor Advocate, individual investors tend not to participate in the notice and comment process of administrative rulemaking.²² By using this definition of "reasonable investor," this article focuses on this underrepresented but affected group.²³

Currently, in the United States' financial reporting landscape there is a broad goal to update existing disclosures. The SEC adopted "a comprehensive 'Disclosure

Effectiveness Initiative' to review and modernize public company reporting requirements in Regulation S-K and Regulation S-X."²⁴ A focus of this initiative is to eliminate provisions that are "duplicative, overlapping, outdated, or unnecessary."²⁵ Congress echoed the need to update public company financial disclosures, specifically Regulation S-K, in 2012 in the Jumpstart Our Business Startups Act and in 2015 in the Fixing Americas Surface Transportation Act.²⁶ The *Auditor's Report Standard (Audit Standard 3101)*, issued by the Public Company Accounting Oversight Board (PCAOB),²⁷ is part of the broader initiative to update disclosure. Following the PCAOB, the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board, which issues standards that cover audits of non-public companies, is reviewing a proposed standard that closely aligns with the critical audit matters (CAM) standard.²⁸

This article argues that Audit Standard 3101(AS 3101) should include a rebuttable presumption that "significant risks" are "critical audit matters."²⁹ Although the CAM disclosure is usable to individual investors, further updates to existing disclosures must be made to close the gap between institutional and individual investors. Part I discusses AS 3101 and its legislative history. Part II describes the U.S. federal securities laws and the issues that the mandatory disclosure system attempts to address. Part III argues that the updated audit opinion is an effective disclosure device. Part IV argues for a rebuttable presumption that significant risks are "critical audit matters." Finally, Part V addresses the cost of implementing the standard and the proposed changes.

I. The Road to SEC Approval and the Final Standard Under AS 3101

This part begins with an overview of the critical audit matters standard that goes into effect for large accelerated filers, those with a public float exceeding \$700 million, for fiscal years ending on or after June 30, 2019.³⁰ Afterwards, this part provides an overview of the legislative history leading up to approval, including some examples of changes effected in response to public comments.

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A. The Final Standard: AS 3101: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

The final standard, AS 3101, *The Auditor's Report on the Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires the following changes to the Independent Auditor's Report: (1) "Communication of Critical Audit Matters"; (2) "Disclosure of Auditor Tenure"; and (3) improvements to "clarify the auditor's role and responsibilities."³¹ This article focuses solely on change 1, "Communication of Critical Audit Matters."³²

Critical audit matters are "communicated or required to be communicated to the audit committee" and both should "(1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment."³³ The threshold question in this multi-prong analysis is whether the matter was communicated to the audit committee.³⁴ Currently, auditors are required to communicate with the audit committee the company's "significant accounting policies and practices," "critical accounting policies and practices," "critical accounting estimates," and "significant unusual transactions."³⁵ These communications are supplemented by any other issues or topics that the auditor chooses to discuss with the audit committee.³⁶ Accordingly, the source of a CAM could be a required or elective audit committee communication.³⁷

For each CAM, the auditor's report must include: a description of the item; "specific language explaining why" the item was determined to be a CAM; how this "matter was addressed during the audit" — which may include a description of the procedures performed and the results of those procedures — and the financial statement accounts, disclosures, or both the account and disclosure affected.³⁸

B. Legislative History

In response to the Great Recession of 2008-2009, the PCAOB published a concept release on updating the Independent Auditor's Report.³⁹ The proposed updates would "increase [the audit report's] transparency and relevance to financial statement users"⁴⁰ and "enhanc[e] communication to investors."⁴¹ As part of their outreach, the PCAOB held a series of discussions with financial statement users including institutional investors, investor advocates, money managers, auditors, and members of academia.⁴² Investors stated that they valued the audit because of the vast information available to external auditors and the insight auditors have as an "independent third party."⁴³ Investors noted that auditors had a "better perspective regarding the risks of material misstatement in a company's financial statements."⁴⁴ The caveat attached to this praise was that the audit report did not "adequately communicate the results of such an extensive audit process."⁴⁵

Standards proposed by the PCAOB undergo notice and comment procedures of administrative rulemaking but must ultimately be approved by the SEC to become binding law.⁴⁶ The PCAOB received comments from accounting firms, law firms, and company representatives on the initial proposed standard and the re-proposed standard. Once the final standard was submitted to the SEC in July 2017,⁴⁷ and subsequently published in the Federal Register, the SEC had their own notice and comment period prior to approving it on October 23, 2017.⁴⁸

Some commentators expressed concern that the CAM disclosure would include non-public information.⁴⁹ This concern was grounded in the belief that "the issuer should be the original source of any disclosure about the issuer or its results of operations or financial position."⁵⁰ The PCAOB failed to address these commentators' unease in the original draft in 2013.⁵¹ However, in 2017, the following language was added: "[T]he auditor is not expected to provide information about the company that has not been made publicly available by the company,"⁵² suggesting that they agreed with the underlying premise of this comment. PCAOB staff guidance clarified that "publicly available" information is broader than the quarterly and annual reports containing the financial statements but could also include information in "press releases, or other public statements."⁵³

The chance of CAM disclosures revealing non-public information about the issuer is small.⁵⁴ Other sections of Form 10-K likely contain the information that would appear in the CAM disclosure because materiality⁵⁵ is a component of both the broad categories that MD&A covers⁵⁶ and the first prong of the critical audit matters analysis.⁵⁷ Thus, the only new information revealed by CAM disclosures would be the information on the audit procedures performed and the results,⁵⁸ which are not specific to the issuer or its financial position.

The following example demonstrates where the issuer-specific information in a CAM disclosure could be found elsewhere in Form 10-K. The PCAOB utilized "the auditor's evaluation of the company's ability to continue as a going concern"—the risk that the company would no longer be able to continue operating for a reasonable time—as an example of a CAM.⁵⁹ The facts supporting a determination that the entity is no longer able to continue as a going concern would likely be addressed in the liquidity section of MD&A, as liquidity issues may be strong negative evidence that the company is unable to continue as a going concern.⁶⁰ Therefore, in the CAM disclosure the new information would only include the audit procedures, such as "[r]eview of compliance with the terms of debt and loan agreement" and "[c]onfirmation with related and third parties of the details of arrangements to provide or maintain financial support" and the results of those procedures.⁶¹ The use of the materiality threshold in the definition of CAMs and the potential overlap of a CAM with the broad scope of MD&A both

support the conclusion that disclosure of CAMs will not result in the disclosure of information that was not otherwise publicly available.

In response to comments received, the original proposed standard from August 2013 was subsequently revised to clarify and make more specific the CAM factors. The original proposal described CAMs as those involving “difficult, subjective or complex auditor judgment.”⁶² The original proposed factors referenced changes in the risk assessment based on the audit evidence obtained but failed to mention significant risks.⁶³ In response to commentator suggestions, the CAM factors were updated in 2016 to include “[t]he auditor’s assessment of the risks of material misstatement, including significant risks.”⁶⁴ Furthermore, the original proposed standard did not include the threshold requirement that the “critical audit matter” be communicated to the audit committee. Instead, the original proposed standard included audit committee communications on a list used to identify as being “of such importance” as to be critical audit matters.⁶⁵ The audit committee communication threshold requirement was added in 2016 in response to commentator suggestions.⁶⁶ The PCAOB noted that this change aligned with the component of the CAM definition “challenging, subjective, or complex auditor judgments.” These types of matters would likely have been communicated to the audit committee anyway, given the committee’s oversight role.⁶⁷

The addition of the audit committee communication threshold requirement raised concern that this standard would chill communications between the auditor and the audit committee⁶⁸ and cause auditors to hesitate “before every communication to consider the potential CAMs implications.”⁶⁹ It is well understood that open communication between the auditor and audit committee leads to better financial reporting.⁷⁰ When responding to the possible chilling effect, both the PCAOB and SEC stated that communications from auditor to audit committee would not be chilled because the auditing standards require certain communications.⁷¹ If auditors fail to make required communications, they will be checked by PCAOB inspections. Thus, from the PCAOB and SEC perspective, this risk related specifically to discretionary audit committee communications that “fall[] within the scope of a CAM.”⁷²

Additionally, the communication from the audit committee to the auditor will also retain the status quo because of the audit committee’s vast responsibilities and independence from the organization.⁷³ Audit committees are responsible for appointing and overseeing the auditors.⁷⁴ They ensure that the auditors have the resources and information necessary to issue their report. In recent years, audit committees have increased their involvement by discussing the scope of the audit and whether they feel that any further procedures need to be performed.⁷⁵ Furthermore, board members, a subset of whom form the audit committee, may be subject to liability for fail-

ing to perform their fiduciary duties.⁷⁶ As a result, audit committee members have an incentive to act in the best interest of shareholders,⁷⁷ who are ultimately paying for the audit. The communications between these parties will remain at the existing level, and potentially increase as the audit committee continues to expand its role. Despite the changes made during the notice and comment period, further changes—such as the addition of the significant risk presumption discussed in Part III—can still be made.

II. The U.S. Federal Securities Laws and the Necessary Balancing Act of Disclosure

This part provides a brief overview of the United States federal securities landscape and its role in the public securities markets. Section A discusses the role of federal securities laws generally. Sections B and C discuss the issues federal securities laws attempt to resolve, while also acknowledging the potential consequences of over-correcting these problems. Finally, Section D introduces characteristics of effective disclosure that benefit individual investors in the marketplace.

A. The Role of the Federal Securities Laws

Disclosure is the precursor to “informed judgment.”⁷⁸ Without it, investors cannot make decisions, good or bad.⁷⁹ Disclosure must be directed at and tailored to the investor to be usable.⁸⁰ There is a need for “credible disclosure,”⁸¹ whose accuracy is the reason for auditors.⁸²

Securities laws “put investors into a position from which they can help themselves.”⁸³ The SEC protects investors⁸⁴ and maintains “fair and honest markets.”⁸⁵ Congress and the SEC protect market participants⁸⁶ through securities regulation by allowing for “efficient and competitive capital formation,”⁸⁷ which is possible through accurate pricing of securities.⁸⁸ Without mandatory disclosure, the information voluntarily disclosed may be insufficient to inform investors in their decision making.⁸⁹

Under the Securities Exchange Act of 1934 (the “1934 Act”), certain “issuers” are required to file reports with the SEC to keep the information in their registration statements current.⁹⁰ Although the 1934 Act lists what information companies must disclose, it fails to define the term “disclosure.”⁹¹ The SEC provided that “[a] disclosure law would provide the best protection for investors. In other words, if the investor had available to him [/her] all the material facts concerning a security, [s/]he would then be in a position to make an informed judgment whether or not to buy.”⁹² This sentiment is echoed by the idea that disclosure of information leads to accurate pricing of securities.⁹³

The efficient capital market hypothesis explains what types of information are incorporated into stock prices. Under the “strongest form,” all existing, available public and private information is reflected in securities

prices,⁹⁴ so mandatory disclosure would not affect stock prices. In the “semi-strong form,” securities prices reflect past stock prices and currently available public information.⁹⁵ The United States securities market operates in the “semi-strong form”⁹⁶ because companies maintain information privately with only certain information made public due to government intervention through required disclosure.⁹⁷ In “semi-strong form” markets, disclosure improves market efficiency as the market incorporates the disclosed information into securities prices.⁹⁸ Consequently, there is competition for access to the newest public information first, before securities prices reflect it.⁹⁹ The challenge for the mandatory disclosure regime is finding the equilibrium between providing enough information that a disclosure is understood and providing too much information that it cannot be filtered and organized in a timely manner,¹⁰⁰ while encouraging investors to participate in the markets.

B. Information Asymmetry

Information asymmetry exists between investors and corporate insiders,¹⁰¹ and by extension between investors and auditors.¹⁰² The information asymmetry problem primarily deals with the availability of information or lack thereof.¹⁰³ This “public-private divide” defines the struggle in determining how much information should remain available only to insiders and how much should be available to outsiders (i.e., the public).¹⁰⁴ Economically, this is undesirable because markets should operate with perfect information.¹⁰⁵ Mandatory disclosure reduces the cost of searching for information by making it publicly available.¹⁰⁶

Consequences of information asymmetry have differing effects on different classes of investors. The information asymmetry divide between institutional and individual investors exists because institutional investors are better able to process the available information and use it in decision making.¹⁰⁷ Individual investors lack the ability to “process and contextualize . . . information,” which exacerbates information asymmetry between these parties when they have access to the same information.¹⁰⁸ Even if individual investors had the ability to process this information, it would take them a significant amount of time and resources to do so, widening the divide between individual and institutional investors in being able to react in the market based on the information.

The remedy for information asymmetry is introducing more information,¹⁰⁹ or in the case of the federal securities laws, expanding the scope of mandatory disclosure. Disclosure is positively correlated with world economic events.¹¹⁰ The federal government responds to market

events that are detrimental to investors by promulgating laws and regulations that require additional disclosures.¹¹¹ Nevertheless, too much information increases the risk of information overload and creates an environment for worse decision making in which investors have to “satisfice” instead of utilizing all the information available to them.¹¹²

C. Information Overload

Overcorrection of information asymmetry leads to information overload.¹¹³ Information overload is the “point where there is so much information that it is no longer possible effectively to use it.”¹¹⁴ At this point, investors “satisfice”¹¹⁵ and use a few attributes to draw comparisons among the available options for investment, often leaving much out of their analysis.¹¹⁶ The issue of information overload is not specific to securities disclosure, but is also found in food and drug disclosures, mortgage disclosures, and other areas where data must be organized and assembled for consumer use.¹¹⁷

Information overload reduces the effectiveness of disclosure because of the limitations on the human ability to process information.¹¹⁸ Information overload is caused by the “accumulation” of disclosures, as investors must

choose which disclosures to focus on.¹¹⁹ The information overload problem supports the need for specifically targeted disclosures, rather than relying on

“The remedy for information asymmetry is introducing more information, or in the case of federal securities laws, expanding the scope of mandatory disclosure. Disclosure is positively correlated with world economic events.”

the assumption that “more is better.”¹²⁰

The point where information is no longer usable is different for individual and institutional investors.¹²¹ Institutional investors have more resources to process and analyze all the information disclosed. For instance, they can perform pattern and trend analysis among industries that individual investors would not be able to do as easily or as quickly.¹²² Even if individual investors had the skills to perform this analysis,¹²³ any insight gained would likely already be incorporated in the stock price of publicly traded shares by the time they completed their analysis. This divide is also characterized by a cost issue—the cost associated with analyzing the overwhelming amount of information available¹²⁴—as it may not be worth the time and money investment for individual investors considering how much they have invested in the market. However, for the institutional investor, analyzing data may be worth the time and money investment due to the large amount of money in play¹²⁵ and the economies of scale created by the standardization of the analytical process. By focusing

on individual investors, securities laws can help close this time and cost divide.

D. Characteristics of Effective Disclosure

Disclosure can confuse investors.¹²⁶ Numerous scholars studied the characteristics of effective disclosure, considering the need to counteract bias and the limitations on the human ability to process information.¹²⁷ These characteristics must be considered as a whole, as satisfying any one of these on its own may be insufficient to make the disclosure more usable. The below characteristics are the ones this article uses to determine AS 3101's usability and effectiveness. First, length: this plays a critical role in an investor's ability to understand and analyze the information given¹²⁸ as investors may miss important information if the disclosure is too long.¹²⁹ Second, completeness: the disclosure must contain sufficient information, including "meaningful detail,"¹³⁰ for the reader to be able to interpret the disclosure correctly¹³¹ and be confident that relevant information is not missing. Third, "accumulation": in designing the disclosure, regulators must consider that it is not only an individual disclosure but all the disclosures provided that investors consider in choosing how to spend their time.¹³² Finally, standardization: standardization of disclosures promotes consistency,¹³³ which makes it easier for investors to evaluate them and compare among companies.¹³⁴ Standardization of "content, format, and timing"¹³⁵ such as through the use of charts, graphs or tables,¹³⁶ while promoting comparison among companies, prevents companies from opportunistically selecting the way in which their information is presented. The critical audit matter disclosure in the Independent Auditor's Report has all these characteristics and on its own constitutes an effective disclosure.

III. The Updated Audit Opinion Is an Effective Disclosure That Addresses Both Information Asymmetry and Information Overload Concerns

The critical audit matter disclosure strikes a balance between information asymmetry and information overload, reaching an equilibrium amount of information for individual investors to use the information provided as a data point in their decision making. This disclosure is usable to individual investors as it helps close the gap between the time they receive the information and the time they respond to it in the marketplace.

A. The Balancing Act Between Addressing Information Asymmetry and Preventing Information Overload

To counteract the information asymmetry and information overload problems, disclosures must provide information in a format that individual investors can directly synthesize and utilize in their decision making. Under the current system, due to the size of 10-Ks and the overwhelming and detailed information provided, individual investors must either wait for institutional in-

vestors to analyze the information and provide advice on whether to purchase or sell the stock or they must undergo the time-consuming process of reading the documents and analyzing the information themselves. In protecting individual investors, disclosures should target closing this time gap.

The inclusion of CAMs in the unqualified audit opinion is a concise way of conveying to financial statement users what the auditors determined to be the most "challenging, subjective or complex"¹³⁷ areas of the audit, based on their knowledge about this specific company and the industry as a whole.¹³⁸ The new audit report is a large departure from the lack of insight on a company's specific audit procedures and risks under the traditional pass/fail system. Audit reports without this addition only address the information asymmetry problem on a limited basis by assuring that all required disclosures are complete and accurate.

One commentator suggested that the CAM disclosure would provide "minimal additional value" because the information is already provided in the critical accounting policies section of MD&A.¹³⁹ However, given the lengthiness of MD&A, this likely does not counteract the information asymmetry problem because investors still must spend time searching for the required information and would need to possess some indicators of what information would be deemed critical to the audit to be able to thoroughly extract the same information. This analysis would be time-consuming and costly for individual investors. This format helps to "level the playing field"¹⁴⁰ between institutional and individual investors. Both groups of investors will have access to the same information at the same time. However, there will still be a time divide between individual and institutional investors as it relates to all other disclosures in public filings, which will hopefully be decreased as disclosures are reviewed and updated. Providing CAM information in this format will help close the time gap created when individual investors have to wait to analyze the information to incorporate it into their decision making.

B. Disclosure of Critical Audit Matters Is Usable to Investors

The disclosure of CAMs in the auditor's report satisfies all the characteristics noted above of effective disclosure. As it relates to length, the addition of CAMs will not add substantial length to the auditor's report, which is currently approximately one to two pages,¹⁴¹ or the 10-K. Additionally, the CAM discussion would appear under the heading "Critical Audit Matters," and would first define critical audit matters,¹⁴² isolating this section from the rest of the auditor's report. The separate heading for critical audit matters draws the readers' attention to this section and prevents investors from missing it.¹⁴³ This section would be short enough in comparison to the rest of the public financial statement filings that investors hopefully would be able to analyze it. The portion of

the audit opinion that discusses CAMs would be complete because it would address all the items that meet the definition. Describing why the matter satisfied the CAM definition and how it was addressed in the audit further supports completeness by providing investors sufficient detail and context to interpret the related disclosures.¹⁴⁴ Of the characteristics noted, “accumulation”¹⁴⁵ is the most difficult to attribute to this disclosure, given that it is found within the 10-K that is often over 100 pages in length and filled with financial information and explanations about the company.¹⁴⁶ This demonstrates the need for more disclosures to be reviewed. However, provided that CAMs focus on areas that are subjective or require complex judgment, it would make sense to encourage investors to devote their time to this disclosure at the expense of other disclosures that they may be less able to analyze effectively or that may not require the same level of analysis.

During SEC notice and comment, some commentators expressed concern that audit firms would use boilerplate language to describe CAMs.¹⁴⁷ While PCAOB guidance is clear that the language in the disclosure should be specific to the matter and audit,¹⁴⁸ even if over time these disclosures result in boilerplate descriptions of the risks or the procedures performed and their outcome,¹⁴⁹ this would nevertheless be beneficial in increasing standardization. The unintended standardization of these disclosures would ease the work of individual investors in comparing CAMs and the corresponding audit procedures performed.¹⁵⁰ The consistency in language would make it easier for investors to assess trends and whether the CAMs are industry specific or specific to that company. Currently, institutional investors have an advantage over individuals in trend analysis, whether based on industry, jurisdiction or other criteria, as they have teams of trained analysts to read these forms and they have computer software that can perform the analysis for them as 10-Ks contain electronic data tags based on a taxonomy used by all public requirements under the XBRL requirement.¹⁵¹

While all the above characteristics adequately describe the standard, over time, in response to post-implementation review,¹⁵² commentators expect that additional guidance will be released regarding the implementation and application of this standard in practice and make any changes as needed.¹⁵³ Since its approval in October 2017, PCAOB staff and audit professionals have been working through and discussing this standard. Some guidance has already been issued and there will likely be more as audit opinions begin to include the CAM disclosure.

IV. Significant Risks Should Be Presumed to Be Critical Audit Matters

The presumption that significant risks of material misstatement are critical audit matters is supported by the overlap in the factors considered in the identification of a “significant risk” with the qualifications to be a critical

audit matter, as well as the magnitude of the audit work performed surrounding a significant risk.

Significant risks “require special audit consideration”¹⁵⁴ and are required to be discussed with the audit committee,¹⁵⁵ satisfying the threshold question of the CAM analysis. Significant risks are identified by the auditor based on the risk assessment procedures performed during the planning stage of the audit. The planning process is necessary to determine the “nature, timing, and extent” of audit procedures.¹⁵⁶

The below argument uses the example of improper revenue recognition, which is always a significant risk of material misstatement because it is a “presumed fraud risk.”¹⁵⁷ However, under this standard as written and as stated in 2019 PCAOB *Staff Guidance*, revenue recognition would not necessarily be a CAM unless it entailed “challenging, subjective or complex auditor judgment.”¹⁵⁸ The methodology that a company uses to recognize revenue is included in MD&A as a “critical accounting policy,”¹⁵⁹ and is crucial for investors to understand the amounts in the income statement, as well as for comparability purposes across multiple companies in the same industry.¹⁶⁰ Further, revenue can be highly complex to audit because of the risk that a company may accelerate revenue that was earned in the next year into the current year.¹⁶¹ SEC enforcement actions involving the issue of “premature” or improper revenue recognition evidence this heightened risk.¹⁶² Considering the importance of revenue to assessing the health of a company¹⁶³ and the high risk of misstatement, it is surprising that revenue recognition is not required or presumed to be a CAM.

The critical audit matters standard is expected to undergo post-implementation review by the PCAOB with the assistance of the SEC Office of the Chief Accountant.¹⁶⁴ SEC Chairman Clayton noted that post-implementation review “is an important component of high-quality regulatory decision-making.”¹⁶⁵ Furthermore, the results of the post-implementation review may lead to the issuance of additional implementation guidance.¹⁶⁶ Issuing post-implementation guidance is the seemingly logical way to add the significant risk presumption, as both the SEC and PCAOB have referenced the need for post-implementation review and acknowledged that revisions to the standards may need to be made. However, this update could also be accomplished by amending the standard or through judicial interpretation if a CAM disclosure was challenged in court for lack of completeness. If the presumption is incorporated through post-implementation guidance, there is a risk of an administrative law challenge on the grounds that this change must be made through rulemaking. However, as noted below, based on the similarities between the significant risk and critical audit matter factors, there may not be much pushback from those affected because the change would likely not result in a substantial increase in the number of critical audit matters.

Table 1:¹⁶⁷

Significant Risk ¹⁶⁸	Critical Audit Matter ¹⁶⁹
Effect of the quantitative and qualitative risk factors discussed in paragraph 60 on the likelihood and potential magnitude of misstatements	The auditor’s assessment of the risks of material misstatement, <i>including significant risks</i>
Where the risk is a fraud risk	Nature of audit evidence obtained regarding the matter
Where the risk is related to recent significant economic, accounting, or other developments	The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures
The <i>complexity</i> of transactions	Challenging, subjective or <i>complex</i> auditor judgment
The degree of <i>complexity</i> or <i>judgment</i> in the recognition or measurement of financial information related to the risk, especially those measures involving a wide range of <i>measurement uncertainty</i>	The degree of auditor judgment related to areas in the financial statements that <i>involved the application of significant judgment</i> or estimation by management, including estimates with significant <i>measurement uncertainty</i>
Whether the risk involves significant transactions with related parties	The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter
Whether the risk involves <i>significant unusual transactions</i>	The nature and timing of <i>significant unusual transactions</i> and the extent of the audit effort and judgment related to those transactions

A. Overlapping Factors Support Similar Determinations

The overlap in the factors for consideration in the identification of a significant risk and a CAM supports the presumption that significant risks are critical audit matters. The use of the same words in both sets of factors would likely be interpreted to have the same meaning, providing consistency within the auditing standards as a whole.¹⁷⁰ In the release which formally approved the changes to the independent auditor’s report, the SEC compared the critical audit matter requirements with the required audit committee communications to assess the impact the final standard would have on communications between the auditor and audit committee.¹⁷¹ This analysis applies the same methodology to examine significant risks and critical audit matters. Table 1 details the factors to be considered in determining if an item is a significant risk and if an item “involved especially challenging, subjective, or complex auditor judgment” to be a critical audit matter.¹⁷² The language of the first factor in the CAM list specifically references significant risks, which provides strong initial support for the argument that significant risks should be presumed critical audit

matters. “Significant unusual transactions,”¹⁷³ a factor in both analyses, must be communicated to the audit committee.¹⁷⁴ This mandatory audit committee communication satisfies the threshold question for identification as a critical audit matter.¹⁷⁵ The significant risk guidance notes that auditors should consider the “complexity of transactions,”¹⁷⁶ which directly aligns with the “complex auditor judgment”¹⁷⁷ factor, as there is likely complex judgment in understanding, risk assessing, and designing audit procedures surrounding a complex transaction.

The audit procedures surrounding a financial statement amount involve determining the correct unit of account for measuring the amount on the financial statements and determining which financial statement period the amount should be reported in. The significant risk factor list provides that auditors should consider the “degree of . . . judgment in the recognition or measurement of financial information,”¹⁷⁸ implying that greater judgment would suggest a greater risk. This is similar to the “areas of financial statement that involved the application of significant judgment”¹⁷⁹ in the CAM factor list as a significant risk would likely require greater judgment. The overlap of numerous factors between the two analy-

ses increases the likelihood that items would be identified as both.

Although there is a possibility that requiring significant risks to be critical audit matters might make auditors hesitant to identify a risk as significant, the responsibility that auditors have to follow the established guidance mitigates this risk. This was the view of the SEC in their response to chilling of auditor communications that auditor responsibilities would mitigate the risk. As previously noted, PCAOB inspections provide an enforcement mechanism that may result in penalties to the accounting firm if the auditing standards are not followed.¹⁸⁰ Auditors are incentivized to be diligent in following the guidance regarding testing revenue recognition as this is an area that is frequently identified as having audit deficiencies in PCAOB inspection results.¹⁸¹

B. The Audit Procedures Required for Significant Risks Support Critical Audit Matter Factors on Audit Effort and Evidence

Once the auditor determines that an item is a significant risk, the auditor's substantive audit procedures (the process for testing an account balance or transaction) must be "specifically respons[ive] to the assessed risks."¹⁸² In practice, this requires further tests of details and additional selections when performing audit sampling when compared to non-significant risks.¹⁸³ The results of these additional procedures could be the basis for a strong and meaningful discussion of how a critical audit matter was addressed in the audit, which is a component of the CAM disclosure.

Audit evidence includes both internal and external evidence. Internal evidence is information provided by the company, contrasted with external evidence that is gathered from independent outside parties.¹⁸⁴ Because of its source, external evidence is considered to be more reliable than internal evidence and is therefore preferred when conducting audit procedures.¹⁸⁵ When testing significant risks, the PCAOB recommends obtaining evidence "directly from independent and knowledgeable sources outside the Company" to increase the persuasiveness and reliability.¹⁸⁶ For example, when testing revenue, an auditor would confirm the terms of a sale with a purchaser¹⁸⁷ or "review the company's contracts."¹⁸⁸ This demonstrates an increased "audit effort required to address the matter."¹⁸⁹ Confirmation provides persuasive evidence because the sale was verified by a source outside the company. The types of evidence tested as part of the procedures surrounding significant risks are highly persuasive, which would be considered in the CAM factor "Nature of Audit Evidence Obtained."¹⁹⁰

C. Including Significant Risks as Critical Audit Matters Is Necessary to Address Investor Information Needs

Including significant risks as critical audit matters aligns with investors' desire to better understand the findings of the "extensive audit process."¹⁹¹ Further, this inclusion supports the goal of protecting investors by persuading readers of financial statements to focus on the areas of significant risk.¹⁹² By highlighting CAMs in disclosures that are simple and complete, investors would be credibly informed of some of the risks faced by the company they are investing in.

However, the results of PCAOB inspections¹⁹³ of audit firms found "recurring audit deficiencies" because the audit procedures performed on significant risks were not "specifically responsive."¹⁹⁴ For example, in testing revenue, the audit procedures of only inquiring of management and reviewing information provided by the company were determined to be insufficient to test a significant risk.¹⁹⁵ Under the traditional pass/fail audit model, investors had no insight into the procedures used to support the auditor's conclusion, regardless of whether they were insufficient by PCAOB standards. By including the description of the audit procedures in the CAM disclosure, the investing public would be better informed of the types of evidence obtained and procedures performed in terms that should be understandable to those without technical auditing knowledge. These disclosures would enable investors to better assess the credibility of auditors' conclusions on areas of significant risk and hold auditors accountable.

D. A Rebuttable Presumption Fits Within the Limits of Subsequent Staff Guidance

The PCAOB *Staff Guidance* issued in March 2019 specifically addressed the question of whether significant risks would be CAMs.¹⁹⁶ The staff noted that they did not expect all significant risks to be CAMs, but acknowledged the overlap in the factors addressed in this article.¹⁹⁷ With a rebuttable presumption, the default would be that all significant risks are CAMs, but could be removed with sufficient consideration and documentation of the lack of "challenging, subjective, or complex auditor judgment."¹⁹⁸ The current PCAOB guidance does not eliminate the possibility of a rebuttable presumption. Even if official guidance on a rebuttable presumption is not released, audit firms should consider defaulting to this presumption to ensure the completeness of their CAM disclosures.

V. The Costs of Implementing the Final Standard

In promulgating these types of rules, the SEC considers the benefits to users of the financial statements compared to the costs of implementation, even though it may be difficult to compare them.¹⁹⁹ Addressing investor information needs in a useful way is beneficial to shareholders, but is difficult to quantify.²⁰⁰ However, the costs, which are ultimately borne by the shareholders, of an increase in audit hours and increases in professional

liability insurance premiums are easier to quantify. This is the backdrop of the discussion below on the cost of implementation.

A. Implementation Costs of the Standard as Approved

A recurring concern in the comment letters was the increased implementation costs arising from additional audit hours—time spent by the audit committee and issuers in reviewing additional disclosures.²⁰¹ The SEC acknowledged the challenges in quantifying the cost of implementation because many of the costs are based on engagement-specific variables.²⁰² However, when compared to the current scope and hours of an audit engagement, the additional time is relatively insignificant.

Overall audit hours are not likely to increase substantially because of the work that auditors are already required to perform. Auditors are currently required to perform risk assessments to determine the level of risk for each assertion for each account balance.²⁰³ The documentation of risk assessment procedures and findings would address multiple CAM disclosure requirements.²⁰⁴ The risk assessment work papers address why the item is identified as a critical audit matter, and identify the accounts and disclosures affected by it.²⁰⁵ Audit work papers already document the audit “procedures applied, evidence obtained and conclusions reached.”²⁰⁶ Therefore, the source data for the disclosure would already be prepared as part of the current audit process.

The additional costs of audit hours and audit committee time would be primarily on drafting and reviewing the disclosure. The incremental increase in audit hours would primarily relate to preparing this section of the opinion,²⁰⁷ as the information needed to compose this disclosure has historically been included in the audit file and in the prior year’s audit hours. Additionally, since all CAMs were communicated to the audit committee, the incremental increase in audit committee hours would also primarily consist of the review of the new disclosure.²⁰⁸ Since audit committees are already taking a larger role in assessing the procedures performed to determine if additional procedures need to be added to the scope of work,²⁰⁹ they would likely already be familiar with the detail in the disclosure. However, CAM disclosure contents “are the responsibility of the auditor—not the audit committee,” although they are expected to be discussed with the audit committee.²¹⁰ Based on these observations, it is likely that any increase in auditor and audit committee time as a result of implementation would not be as significant as some commentators suggest.

B. Small Potential Increase in Audit Fees Due to Increased Liability

Critics and advocates disagree over whether the disclosure of critical audit matters would increase or decrease audit firm liability and overall litigation.²¹¹ A

big four accounting firm that supported the changes to the Independent Auditor’s Report expressed concern that the “discussion of critical audit matters is likely to result in an increased potential for meritless claims under the securities laws by expanding the number and variety of statements that will be attributed to the auditor.”²¹² The PCAOB agreed.²¹³ In contrast, the SEC felt that the risk of increased litigation was mitigated by auditor judgment and the materiality aspects of CAMs, which provide a framework for auditors to apply in identifying CAMs.²¹⁴ Any increase in insurance premiums due to additional litigation liability will likely be reflected in the cost of audits.²¹⁵

Generally, increases in insurance claims are positively correlated with increases in insurance premiums.²¹⁶ The increasing costs of malpractice insurance will likely be passed on to the company through the costs of audits. This is especially true in light of the fact that, historically, new securities regulations have increased the cost of audits. For example, the costs of audits rose after the passage of the Sarbanes Oxley Act, which required auditors to express an opinion on the effectiveness of internal controls.²¹⁷ Shareholders have expressed their interest in having this information, and since they are the ones ultimately paying for audits, the benefit of addressing their needs outweighs the increase in costs.

C. Costs of Requiring Significant Risks to Be Critical Audit Matters

Considering the existing cost concern commentary, it is likely that there will be cost concerns with this proposed change to the standard. The incremental increase in costs as a result of this presumption will be minimal, as it is likely that it will not add many additional CAMs beyond what would be reported under the standard as written.²¹⁸

As for any additional CAMs that may result from this presumption, the additional audit committee hours would be insignificant because of the current communication and audit procedure requirements. Significant risks are required to be discussed with the audit committee,²¹⁹ so the additional audit committee hours would solely represent reviewing the disclosure as discussed above. Furthermore, it is likely that auditors’ hours would not increase at all, given the existing level of procedures and evidence needed to audit a significant risk,²²⁰ which would be the basis of the CAM disclosure. Thus, the auditors’ incremental recurring costs would solely represent drafting the CAM disclosure for the significant risks and discussing the disclosure with the audit committee. Considering these incremental costs in conjunction with the other costs of implementing this standard, the benefits to the investors of additional information and increased transparency will nevertheless outweigh these costs.

Conclusion

Updating the Independent Auditor's Report is an important step in simplifying disclosure to benefit individual investors and markets. The CAM disclosure increases fairness by creating a more level playing field between institutional and individual investors. If the current pattern of reacting to market events by adding new disclosures continues, the information asymmetry and information overload problems will be exacerbated to the detriment of individual investors. The insight provided in the CAM disclosure, while the first of its kind, aligns with Congress' original intent dating back to the 1930s of protecting ordinary investors through disclosure. The information provided in the CAM disclosure will be a data point in individual investor decision making and close the time and costs gaps between institutional and individual investors.

The final standard, while checking off many boxes of effective disclosure, still requires continued research and commentary by both scholars and practitioners to ensure that the desired aims are achieved. As this article argues, one change that should be made is to add a presumption that significant risks are critical audit matters to reduce the information asymmetry between investors and auditors and provide investors with greater context for the information provided in public financial statements. With the accumulation problem in mind, increasing the usability of one disclosure is not enough. There must be revision and updating of a larger number of disclosures to have a meaningful impact. Progress is not achieved overnight, but rather in small steps that cumulatively overhaul the securities disclosure regime.

Endnotes

1. The author wishes to thank Professor Francis Facciolo for all his assistance and guidance during the writing process. All opinions expressed are entirely my own.
2. Sec. & Exch. Comm'n, *All About Auditors: What Investors Need to Know*. (June 24, 2002).
3. See Ken Tysiac, *What Investors Want to See*, J. Acc'r., (Oct. 25, 2017), <https://www.journalofaccountancy.com/news/2017/oct/what-investors-are-looking-for-201717738.html> (citing a survey by the Center of Audit Quality, 84% of investors expressed confidence in external auditors).
4. A company's financial statements include: (1) Balance Sheet: "[A] snapshot of the company's assets (such as cash and inventory) and its liabilities (such as outstanding debt)" and (2) Income Statement: the report of the revenue earned and the expenses incurred to earn that revenue. See Nellie S. Huang, "Make the Most of an Annual Report," *Kiplinger's Personal Finance*, Mar. 2014, at 41.
5. U.S. Sec. & Exch. Comm'n, *Fast Answers: Form 10-K*, (June 26, 2009), <https://www.sec.gov/fast-answers/answers-form10khtm.html> ("The annual report on Form 10-K provides a comprehensive overview of the company's business and financial condition and includes audited financial statements.")
6. Pub. Co. Accounting Oversight Bd., *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards 2* (2011).
7. The majority of 10-Ks today is Management's Discussion & Analysis (MD&A), which is written from the perspective of the filer. See 17 C.F.R. § 229.303(a) (2017) (providing that MD&A must include "other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.") (emphasis added).
8. Troy Paredes, *After the Sarbanes-Oxley Act: The Future Disclosure System: Blinded By the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U.L.Q. 417, 425 n.27 (2003).
9. The SEC now requires that all documents be filed electronically and include data tags to "identify key items in financial statements using a standardized taxonomy." This is known as XBRL. Erik F. Gerding, *Disclosure 2.0: Can Technology Solve Overload, Complexity, and Other Information Failures?*, 90 TUL. L. REV. 1143, 1169 (2016).
10. See generally *Revenue From Contracts with Customers*, Statement of Fin. Accounting Standards No. 606 (Fin. Accounting Standards Bd. 2014). Changes in accounting standards affect comparability between periods covered by financial reports. See generally Denise Dickens et al. *Not All PCAOB Inspections Are Created Equal*, *The CPA Journal* (Aug. 2017), <https://www.cpajournal.com/2017/08/30/not-pcaob-inspections-created-equal/>.
11. *Notice of Filing of Proposed Rules on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures From Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards*, 82 Fed. Reg. 35396, 35396 (July 28, 2017) [hereinafter *Notice of Filing of Proposed Rules*]. But see Sarbanes Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, § 103(a)(2)(A)(iii) (2002) (requiring the issuance of an internal controls opinion in addition to the traditional auditor's report).
12. Despite their relatively short length, audit opinions represent the culmination of a substantial number of hours by audit firms to perform all the procedures necessary to issue these opinions. The average public audit is 22,539 hours. Financial Executives Research Foundation, *2016 Annual Audit Fee Survey* (2016). An auditor's time is spent understanding the company, its internal control environment, and inspecting the company's books and records, including testing account balances and assessing the adequacy of disclosures. See, e.g., *All About Auditors: What Investors Need to Know*, *supra* note 2.
13. See generally Berkshire Hathaway, Annual Report (Form 10-K) (Feb. 27, 2017); Macy's Inc., Annual Report (Form 10-K) (Mar. 29, 2017); The Goldman Sachs Group, Inc., Annual Report (Form 10-K) (Feb. 27, 2017).
14. Michael Cohn, *SEC Approves PCAOB Expanded Audit Report Standard*, *Accounting Today* (Oct. 23, 2017), <https://www.accountingtoday.com/news/sec-approves-pcaob-expanded-auditor-reporting-model-standard>.
15. See *Reports on Audited Financial Statements, Statement on Auditing Standards 3101.20* (Pub. Co. Accounting Oversight Bd. 2017); see also Berkshire Hathaway, Annual Report (Form 10-K) (Feb. 27, 2017).
16. *Id.*
17. *Departures from Unqualified Opinions & Other Reporting Circumstances*, Statement on Auditing Standards 3105 (Pub. Co. Accounting Oversight Bd. 2017). All financial statements filed with the SEC "must be prepared in accordance with (or reconciled to) generally accepted accounting principles ... [and] shall reflect all material correcting adjustments that have been identified by a registered public accounting firm in accordance with generally accepted accounting principles and the rules and regulations of the Commission." 15 U.S.C. § 78m(i) (2017).
18. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining "materiality" as "a substantial likelihood that a reasonable

- shareholder [investor] would consider it important in deciding how to vote”).
19. See Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1583 (2017) (“[H]ighly sophisticated institutional investors are the appropriate audience for corporate disclosure.”).
 20. See generally Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U.L. REV. 461 (2015).
 21. *Id.* at 466 n.24 (citing HR Rep No. 73-1383); see also Korsmo, *supra* note 19, at 1583 (stating that Congressional intent was the “average investor” as shown by comments using the terminology “informed lay person” and the plain English disclosure requirements).
 22. Rick A. Fleming, Investor Advocate, U.S. Sec. & Exch. Comm’n, Speech, *Moving Forward with the Commission’s Disclosure Effectiveness Initiative* (Nov. 19, 2016) (transcript available at sec.gov).
 23. The majority of submissions in the notice and comment process on the final standard were from law firms, accounting firms, and individuals who hold financial reporting positions at companies affected by the change in reporting requirements, supporting the claim that individual investors are not participating in the notice and comment process.
 24. Speech by Rick A. Fleming, *supra* note 22. Regulation S-K contains the requirements for disclosure in financial statements by public companies. Regulation S-X contains the rules for the financial statements (Balance Sheet, Income Statement, Statement of Cash Flows, and Statement of Stockholders Equity) which are included in the quarterly and annual public filings.; U.S. Sec. & Exch. Comm’n, Rules, Regulations & Schedules (Oct. 13, 2017), <https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml>.
 25. *Id.*
 26. *Id.* Congress’s intent is also evidenced by their inclusion of requirements that the SEC study disclosure and its simplification in the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, § 108 (2012) and the Fixing Americas Surface Transportation Act Pub. L. No. 114-94, 129 Stat. 1312, § 72002 (2015).
 27. The Public Company Accounting Oversight Board was created by Congress under the passage of the Sarbanes Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, § 101(a) (2002). The purpose of this board was “to oversee the audit of public companies . . . in order to protect the interests of investors and further the public interest in the preparation of information, accurate and independent audit reports . . .” The PCAOB’s responsibilities include “standard-setting, registration and inspection of audit firms, and enforcement authority.” Sec. & Exch. Comm’n, *Statement in Connection with the 2017 AICPA Conference on Current SEC and PCAOB Developments* (Dec. 4, 2017), <https://www.sec.gov/news/speech/bricker-2017-12-04>. In *Free Enterprise Fund v. Public Company Accounting Oversight Board*, the Supreme Court held the PCAOB constitutional. See 561 U.S. 477 (2010).
 28. The proposed AICPA standard is in consideration and was most recently discussed and marked up at the Accounting Standards Board January 2019 meeting. Am. Inst. Certified Public Accountants, Agenda Item 1B, *Communicating Key Audit Matters in the Independent Auditor’s Report*, (Jan. 14-17, 2019), <https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/asb/documents/mtg/1901/2019-01-asb-item1b.pdf>.
 29. Notice of Filing of Proposed Rules, *supra* note 11, at 35396 (July 28, 2017). Auditors assign risks levels to each area of the audit. “Significant risk” is the highest risk level that can be assigned. As the risk level increases, audit procedures and considerations are made with respect to that area.
 30. *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, Statement on Auditing Standards* 3101.11 (Pub. Co. Accounting Oversight Bd.) (2017) [hereinafter *Auditor’s Report Expressing an Unqualified Opinion*]. Although the CAM disclosure will not be included in audit reports for years ending in 2019, some practitioners are initiating conversations with their clients about what will likely be CAMs and what types of information will be disclosed about them. See, e.g., Michael Cohn, *Audit Committees will be Dealing with New Accounting Standards and Tax Reform This Year*, Accounting Today (Jan. 10, 2018), <https://www.accountingtoday.com/news/audit-committees-will-be-dealing-with-new-accounting-standards-and-tax-cuts-this-year>; see also Pub. Co. Accounting Oversight Bd., *Staff Guidance – Changes to the Auditor’s Report Effective for Audits of Fiscal Years Ending on or After December 15, 2017* (Dec. 28, 2017) (noting that companies may disclose CAMs in the audit reports before their mandatory inclusion in 2019). The PCAOB has received positive feedback from companies that are doing “dry runs” of the disclosure and are open to questions and comments as these practice disclosures are drafted. See Michael Cohn, *PCAOB Sees Successful ‘Dry Runs’ of Critical Audit Matter Disclosures from Companies*, Accounting Today (Dec. 20, 2018), <https://www.accountingtoday.com/news/pcaob-sees-successful-dry-runs-of-critical-audit-matter-cams-disclosures-from-companies>.
 31. Notice of Filing of Proposed Rules, *supra* note 11 at 35396.
 32. This article will not discuss the issue of auditor tenure as this information could be obtained by reviewing prior years 10-Ks that are publicly available. Further, audit committees have increasingly been disclosing this information on their own without a requirement. Ctr. for Audit Quality, *Audit Committee Transparency Barometer* 4 fig. 2 (2017). Additionally, the potential risk that one firm is a company’s auditor for a long duration is mitigated by the Audit Partner Rotation Rule that limits an audit partner’s service with the same public company to 5 years. 15 U.S.C. § 78j-1(j) (2017). This risk is further mitigated in large multinational public companies by regulations in other jurisdictions that require that companies change auditors periodically. However, there is no similar requirement in the U.S., which has resulted in companies keeping the same auditors for long periods of time, in some cases for over 100 years. See, e.g., Michael Rapaport, *At GE, KPMG Keeps Its 109-Year Streak Alive*, Wall St. J. (Mar. 13, 2018), <https://blogs.wsj.com/moneybeat/2018/03/13/at-ge-kpmg-keeps-its-109-year-streak-alive/>. But see Rick Clough, *GE Urged to Drop Auditor KPMG Following Accounting Missteps*, Bloomberg (Apr. 16, 2019), <https://www.bloomberg.com/news/articles/2019-04-16/ge-urged-to-drop-kpmg-as-auditor-following-accounting-missteps>.
 33. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30, at 11.
 34. The audit committee is a subcommittee of the Board of Directors. Under section 301 of the Sarbanes Oxley Act, it is required to be composed of independent board members and a financial expert. Adriaen M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure Under the SEC’s New Rules Governing Public Company Audit Committees*, 23 ANN. REV. BANKING & FIN. L. 673, 706 (2004). The financial expert is required to understand GAAP, have experience preparing or auditing financial statements, understand internal control and audit committee functions. *Id.*
 35. *Communications with Audit Committees, Statement on Auditing Standards* 1301.12 (Pub. Co. Accounting Oversight Bd.). However, these standards do not clearly define a threshold for what is significant. See generally *id.*
 36. An example includes feedback on how to improve the audit process. See EY Center for Board Matters, *Staying on Course a Guide for Audit Committees*, 1, 21 (2014), [http://www.ey.com/Publication/vwLUAssets/A_guide_for_audit_committees/\\$FILE/EY-Staying-on-course-guide-for-audit-committees.pdf](http://www.ey.com/Publication/vwLUAssets/A_guide_for_audit_committees/$FILE/EY-Staying-on-course-guide-for-audit-committees.pdf).
 37. Pub Co. Accounting Oversight Bd., *STAFF GUIDANCE, Implementation of Critical Audit Matters: Staff Observations from Review of Audit Methodologies*, (Mar. 18, 2019), <https://pacobus.org/Standards/Documents/Implementation-of-Critical-Audit>

- Matters-Review-Audit-Methodologies.pdf [hereinafter *Staff Observations from Review of Audit Methodologies*].
38. *Auditor's Report Expressing an Unqualified Opinion*, *supra* note 30, at 14; *Staff Observations from Review of Audit Methodologies*, *supra* note 37. The description of the audit procedures as well as the description of the CAM should be written so someone without specialized knowledge can understand the disclosure. Pub. Co. Accounting Oversight Bd., *STAFF GUIDANCE, Implementation of Critical Audit Matters: The Basics*, (Mar. 18, 2019), <https://pcaobus.org/Standards/Documents/Implementation-of-Critical-Audit-Matters-The-Basics.pdf>.
 39. See generally Pub. Co. Accounting Oversight Bd., *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (June 21, 2011), https://pcaobus.org/Rulemaking/Docket034/Concept_Release.pdf [hereinafter *2011 Concept Release*].
 40. *Id.* at 2.
 41. *Id.* at 3.
 42. *Id.* at app. C at C-1.
 43. *Id.* at 7.
 44. *Id.*
 45. *Id.* at C-2. The PCAOB Investor Advisory Group survey found that transparency into the audit process would be beneficial to capital markets by decreasing uncertainty. *Id.*
 46. Sec. & Exch. Comm'n, Order Granting Approval of Proposed Rules on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures from Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards Release No. 34-81916 10 (Oct. 23, 2017), [hereinafter *SEC Order Granting Approval*].
 47. Sec. & Exch. Comm'n, Form 19b-4 Proposed Rules by Public Company Accounting Oversight Board, File No. PCAOB 2017-01 1 (July 19, 2017).
 48. See generally *SEC Order Granting Approval*, *supra* note 46.
 49. See New York City Bar Committee on Financial Reporting, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228394-160810.pdf> (resulting in auditor becoming management); see also Sullivan & Cromwell LLP, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2227828-160777.pdf>.
 50. Sullivan & Cromwell LLP, *supra* note 49 (emphasis added).
 51. Pub. Co. Accounting Oversight Bd., *Proposed Auditing Standards—the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 app. A at 7-8 (Aug. 13, 2013), https://pcaobus.org/Rulemaking/Docket034/Release_2013-005_ARM.pdf [hereinafter *2013 Proposed Auditing Standards*].
 52. *Auditor's Report Expressing an Unqualified Opinion*, *supra* note 30, at 14 n.2 (Pub. Co. Accounting Oversight Bd. 2017).
 53. *Staff Observations from Review of Audit Methodologies*, *supra* note 37.
 54. See *id.* (focusing primarily on the risk that auditors would disclose original information regarding control deficiencies).
 55. It is highly likely that these materiality definitions would be given the same meaning to promote consistency within the federal securities laws. See James J. Brudney & Coret Ditslear, *Canons of Construction and the Elusive Quest for Neutral Reasoning*, 58 *VAND L. REV.* 1, 13 (2005).
 56. 17 C.F.R. § 229.303(a)(1)-(5) (2017) (including: Liquidity, Capital Resources, Results of Operations, Off Balance Sheet Arrangements and Contractual Obligations).
 57. Notice of Filing of Proposed Rules, *supra* note 11, at 35396 (critical audit matters must “[r]elate to accounts or disclosures that are material to the financial statements.”).
 58. *Id.* at 35404.
 59. *Id.* at 35399; see *The Going Concern Principle*, Accounting Tools, (Aug. 23, 2017), <https://www.accountingtools.com/articles/2017/5/14/the-going-concern-principle>.
 60. *Consideration of an Entity's Ability to Continue as a Going Concern*, Statement on Auditing Standards 2415 (Pub. Co. Accounting Oversight Bd.) (identifying examples of conditions and events which in the aggregate may indicate the doubt of ability to continue as a going concern which includes “default on loan or similar agreements, restructuring of debt, noncompliance with statutory capital requirements”); see also Pub. Co. Accounting Oversight Bd., *Staff Audit Practice Alert No.3, Audit Considerations in the Current Economic Environment* 15 (Dec. 5, 2008) (noting the strain on liquidity as a result of changes in the overall economic environment may affect a company's ability to continue as a going concern).
 61. *Consideration of an Entity's Ability to Continue as a Going Concern*, *supra* note 60.
 62. 2013 Proposed Auditing Standards, *supra* note 51 at app. 1 at A1-7.
 63. *Id.* app. 1 at A1-7.
 64. Pub. Co. Accounting Oversight Bd., *Proposed Auditing Standard—the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* 23 (May 11, 2016) [hereinafter *2016 Proposed Auditing Standard*].
 65. 2013 Proposed Auditing Standards, *supra* note 51, at app. 1 at A1-6–A1-7.
 66. 2016 Proposed Auditing Standard, *supra* note 64, at 17.
 67. *Id.*
 68. See Cleary Gottlieb Steen & Hamilton LLP, Comment Letter on PCAOB 2017-01 (Aug. 24, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2243327-160867.pdf>; see also Nasdaq, Comment Letter on PCAOB 2017-01 (Aug. 24, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2242843-160854.pdf>; New York City Bar Committee on Financial Reporting, *supra* note 49; Regions Financial Corp., Comment Letter on PCAOB 2017-01 (Aug. 17, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228209-160803.pdf>; Sullivan & Cromwell LLP, *supra* note 50.
 69. U.S. Chamber of Commerce, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228364-160809.pdf>.
 70. See Cleary Gottlieb Steen & Hamilton LLP, *supra* note 68. This was acknowledged by Jay Clayton, SEC Chairman, in his public statement on October 23, 2017, but he also stressed the importance of audit committees in producing quality public financial reporting. Jay Clayton, Sec. & Exch. Comm'n, *Statement on SEC Approval of the PCAOB's New Auditor's Reporting Standard* (Oct. 23, 2017) (transcript available at sec.gov).
 71. *SEC Order Granting Approval*, *supra* note 46, at 28.
 72. *Id.*
 73. Independence of all audit committee members is required by the NYSE and Nasdaq listing standards, as well as by SEC Rules. Jody K. Upham, *Audit Committees: The Policemen of Corporate Responsibility*, 39 *TEX. J. BUS. L.* 537, 546 (2004). The SEC rules provide that audit committee members are independent if they do not receive any other compensation from the Company except their board and audit committee compensation and that they are not affiliated with the company or any of its subsidiaries. *Id.* at 547.

74. H. David Sherman et al., *The Audit Committee's New Agenda*, Harv. Bus. Rev. 92, 92 (June 2009).
75. EY Center for Board Matters, *supra* note 36, at 21; *see also* Tatyana Shumsky, *Audit Committees Tell Investors More About Their Work*, WALL ST. J. (Nov. 1, 2017), <https://blogs.wsj.com/cfo/2017/11/01/audit-committees-tell-investors-more-about-their-work/> (recognizing the increase in information provided regarding the Audit Committee process to select the auditors and evaluate their work).
76. Directors' fiduciary duties include both the duty of care and the duty of loyalty. Under Delaware Corporate law, directors cannot be excused for breaches of the duty of loyalty which requires that they act in the best interest of the corporation and its shareholders. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2017).
77. Sherman et al., *supra* note 74 at 98.
78. Paredes, *supra* note 8, at 422 n.17 (citing SEC Release 33-5223).
79. *Id.*
80. Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U.L. REV. 1089, 1091 (2007).
81. Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 407 (2001).
82. Wm. Dennis Huber, *The Myth of Protecting the Public Interest: The Case of the Missing Mandate in Federal Securities Law*, 16 J. BUS. & SEC. L. 401, 422 (2016).
83. *Basic v. Levinson*, 485 U.S. 224, 259 (1988).
84. Paredes, *supra* note 82 at 422 n.17; *see also* Huber, *supra* note 83, at 402 (noting that the SEC's mission is "to protect the public interest").
85. Huber, *supra* note 82, at 417 (citing 15 U.S.C.S. § 78b).
86. *Id.* at 418.
87. *Id.* at 419.
88. Dalley, *supra* note 80, at 1094.
89. Paredes, *supra* note 8, at 421.
90. 15 U.S.C. § 78m (2017).
91. 15 U.S.C. § 78c (2017).
92. Paredes, *supra* note 8, at 423 n.17 (citing SEC Release 33-5223); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).
93. Edmund Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 764 (1995).
94. Paul Ferrillo et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof From Plaintiffs in Fraud on the Market Cases*, 78 ST. JOHN'S L. REV. 81, 103 (2004); *see also* Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 250 (2002).
95. Ferrillo et al., *supra* note 94, at 84.
96. Ferrillo et al., *supra* note 94, at 103 ("All public information is incorporated into stock prices.").
97. Securities prices only reflect publicly available information, unless insider trading occurs.
98. Franco, *supra* note 94, at 250.
99. Dalley, *supra* note 80, at 1094 ("[A]llowing it [information] to be distributed unevenly to selected market participants ... would be perceived to be unfair.").
100. Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 688 (2011).
101. Paredes, *supra* note 8, at 418.
102. Michael Cohn, *Auditors Prepare for PCAOB Audit Reporting Changes*, Accounting Today (Oct. 16, 2017 5:50 PM), <https://www.accountingtoday.com/news/auditors-prepare-for-pcaob-audit-reporting-changes-with-cams>.
103. Paredes, *supra* note 8, at 418.
104. Zachary J. Gubler, *Reconsidering the Institutional Design of Federal Securities Regulation*, 56 WM. & MARY L. REV. 409, 411 (2014).
105. Ryan Calo, *Privacy and Markets: A Love Story*, 91 NOTRE DAME L. REV. 649, 650, 654 (2015).
106. Charles R. Korsmo, *The Audience for Corporate Disclosure*, 102 IOWA L. REV. 1581, 1615 n.155 (2017). These are costs of investors, not the costs to the issuing companies in verifying the accuracy of the information they are required to disclose.
107. Calo, *supra* note 105, at 650-51.
108. *Id.* at 674.
109. *Id.* at 650.
110. Enron, WorldComm, The Great Recession.
111. *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and The SEC*, 56 STAN. L. REV. 1, 26 (2003); *see also* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 688 (2011) ("[C]atastrophe is the most important catalyst of new regulation").
112. Paredes, *supra* note 8, at 419.
113. Calo, *supra* note 105, at 651 ("[I]ntroducing more information exacerbates information asymmetry . . .").
114. Angela Edmunds & Anne Morris, *The Problem of Information Overload in Business Organisations: a Review of the Literature*, 20 Int'l J. Info. Mgmt. 17, 19 (2000).
115. Howard Latin, *"Good" Warnings, Bad Products, and Cognitive Limitations*, 41 UCLA L. REV. 1193, 1213 (1994).
116. *Id.* at 1212; *see also* Choi & Pritchard, *supra* note 111, at 4.
117. Ben-Shahar & Schneider, *supra* note 100, at 687.
118. Choi & Pritchard, *supra* note 111, at 4.
119. Ben-Shahar & Schneider, *supra* note 100, at 689.
120. *Id.* at 650.
121. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2378 (1998).
122. Paredes, *supra* note 8, at 431. The XBRL requirement increased the ability of data mining as the electronic data tags are consistent across all public filings. *See* Gerding *supra* note 9, at 1169.
123. Dalley, *supra* note 80, at 1101.
124. Korsmo, *supra* note 106, at 1615 n.155.
125. Romano, *supra* note 121, at 2366 n.17.
126. Choi & Pritchard, *supra* note 111, at 60.
127. Talia B. Gillis, *Putting Disclosure to the Test: Toward Better Evidence-Based Policy*, 28 LOY. CONSUMER L. REV. 31, 47 (2015).
128. Ben-Shahar & Schneider, *supra* note 100, at 687.
129. Choi & Pritchard, *supra* note 111 at 61.
130. Tom C.W. Lin, *A Behavioral Framework for Securities Risk*, 34 SEATTLE U. L. REV. 325, 355 (2011).
131. *See* Ben-Shahar & Schneider, *supra* note 100 at 688.
132. *Id.* at 689; *see also* Paredes, *supra* note 8, at 477-478 (noting that because of the length and detail of MD&A, SEC officials have suggested adding a requirement for a summary of MD&A to be included in public company financial statements).
133. Lin, *supra* note 130, at 351.
134. Paredes, *supra* note 8, at 475.
135. Franco, *supra* note 94, at 296.
136. Paredes, *supra* note 8, at 476.
137. 2013 Proposed Auditing Standards, *supra* note 51.

138. In many accounting firms, the audit practice is often subdivided into industry specific groups, often with audit teams serving multiple clients within the same industry. This allows them to see trends and patterns a specific industry is facing that may not otherwise be gleaned if it were not for the consistency of industry or clients.
139. Davis Polk & Wardwell LLP, Comment Letter on PCAOB 2017-01 (Aug. 18 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228750-160786.pdf>.
140. Colleen Honigsberg et al., *Mandatory Disclosure and Individual Investors: Evidence from the JOBS Act*, 93 WASH. U. L. REV. 293, 300 (2015). Empirical studies support the notion that “institutional investors are better able to process financial disclosures than individual shareholders.” *Id.* at 303.
141. See *supra* Introduction.
142. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30, at 15.
143. See Joseph Kimble, *Writing for Dollars, Writing to Please*, 6 Scribes J. Legal Writing 1, 8 (1996).
144. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30.
145. Ben-Shahar & Schneider, *supra* note 100, at 689. (2011).
146. Cohn, *supra* note 14.
147. See Davis Polk & Wardwell LLP, *supra* note 140; see also New York City Bar Committee on Financial Reporting, *supra* note 49; Aetna, Anthem, Cigna, Humana and United Health Group, Comment Letter on PCAOB 2017-01 (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228518-160811.pdf>.
148. *Staff Observations from Review of Audit Methodologies*, *supra* note 37.
149. See Pub. Company. Accounting Oversight Bd., *infra* 158, at .14 n.(c).
150. *SEC Order Granting Approval*, *supra* note 48, at 23.
151. Gerding, *supra* note 9
152. *SEC Order Granting Approval*, *supra* note 48, at 46 (expecting that the PCAOB will complete a post-implementation review).
153. See Michael Cohn, *SEC Approves PCAOB Expanded Audit Report Standard*, Accounting Today (October 23, 2017), <https://www.accountingtoday.com/news/sec-approves-pcaob-expanded-auditor-reporting-model-standard>.
154. *Identifying and Assessing Risks of Material Misstatement*, Auditing Standard 2110 app. A at A5 (Pub. Co. Accounting Oversight Bd. 2010).
155. *Communication with Audit Committees, Statement on Auditing Standards* 1301.09 (Pub. Co. Accounting Oversight Bd. 2012).
156. *Audit Planning, Statement on Auditing Standards* 2101.10(b) (Pub. Co. Accounting Oversight Bd. 2010).
157. Notice of Filing of Proposed Rules, *supra* note 11, at 35400.
158. *Id.* See Pub. Co. Accounting Oversight Bd., *Staff Guidance, Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs* (Mar. 18, 2019), <https://pcaobus.org/Standards/Documents/Implementation-of-Critical-Audit-Matters-Deeper-Dive.pdf>.
159. *Communication with Audit Committees, Statement on Auditing Standards* 1301.12 (Pub. Co. Accounting Oversight Bd. 2012).
160. It may be difficult to compare revenue across industries as often there are industry specific types of revenue earned which may have different standards for recognizing and reporting the revenue.
161. Darin Bartholomew, *Is Silence Golden When It Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 68. Accelerating revenue is a potential risk because Form 10-K is not required to be filed until at least 60 days after the company’s year-end. See U.S. Sec. & Exch. Comm’n, *Fast Answers: Form 10-K* (June 26, 2009), <https://www.sec.gov/fast-answers/answers-form10khtm.html>.
162. Bartholomew, *supra* note 161, at 68; see Pub. Co. Accounting Oversight Bd., *SEC Staff Audit Practice Alert No.12: Matters Related to Auditing Revenue in an Audit of Financial Statements* 10 (Sept. 9, 2014) (expressing concern on this issue in their discussion of cutoff procedures to be performed as part of revenue recognition testing); see, e.g., Jones Day, *SEC Enforcement in Financial Reporting and Disclosure—2017 Mid-Year Update 3* (July 2017), <http://www.jonesday.com/files/Publication/3ec4a6fd-d801-4b26-8f6f-fc2fa43adf75/Presentation/PublicationAttachment/82295301-1781-4cb8-9515-fdd30b3c64f0/SEC%20Enforcement%20in%20Financial%20Reporting.pdf>.
163. Andrew Zatlín, *The Importance of Revenues and Revenue Growth*, Yahoo! (Apr. 7, 2017), <https://finance.yahoo.com/news/importance-revenues-revenue-growth-153137026.html>.
164. Sec. & Exch. Comm’n, *Statement in Connection with the 2017 AICPA Conference on Current SEC and PCAOB Developments* (Dec. 4, 2017), <https://www.sec.gov/news/speech/bricker-2017-12-04>.
165. Cohn, *supra* note 153.
166. *SEC Order Granting Approval*, *supra* note 48, at 46.
167. The factors in the table have been reordered from how they appear in the standards for comparison purposes. Emphasis added by the author.
168. Pub. Co. Accounting Oversight Bd., *Identifying and Assessing Risks of Material Misstatement, Statement on Auditing Standards* 2110.71 (2010).
169. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30.
170. Kenneth A. Bamberger, *Normative Canons in the Review of Administrative Policymaking*, 118 Yale L.J. 64, 71 (2008); see also James J. Brudney & Corey Ditslear, *Canons of Constructive and the Elusive Quest for Neutral Reasoning*, 58 VAND. L. REV. 1, 12-13 (2005). Courts often use the canons of statutory interpretation to “provide stable rules of construction.” Robert A. Katzmann, *Judging Statutes* 50 (2014).
171. *SEC Order Granting Approval*, *supra* note 48, at 28.
172. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30, at .12.
173. See Pub. Co. Accounting Oversight Bd., *Identifying and Assessing Risks of Material Misstatement, Statement on Auditing Standards* 2110.71 (2011); see also *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30, at (c).
174. Pub. Co. Accounting Oversight Bd., *Communications with Audit Committees, Statement on Auditing Standards* 1301.12(d) (2012).
175. See *supra* Part I, Section B.
176. Pub. Co. Accounting Oversight Bd., *Identifying and Assessing Risks of Material Misstatement, Statement on Auditing Standards* 2110.71 (2011).
177. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30, at 11(2).
178. Pub. Co. Accounting Oversight Bd., *Identifying and Assessing Risks of Material Misstatement, Statement on Auditing Standards* 2110.71 (2011).
179. *Auditor’s Report Expressing an Unqualified Opinion*, *supra* note 30, at (b).
180. Donna M. Nagy, *The SEC at 70: Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1016 (2005). For example, in 2012, Ernst & Young was fined \$2 million in civil money penalties. Pub. Co. Accounting Oversight Bd., *Order Making Findings & Imposing Sanctions* (Feb. 8, 2012), https://pcaobus.org/Enforcement/Decisions/Documents/Ernst_Young.pdf.
181. In their 2017 inspections, PCAOB staff identified as deficiencies the level of insufficiency of tests of details on revenue and the internal controls over the systems used to determine the amount of revenue recognized. Pub. Co. Accounting Oversight Bd., *Preview of*

- Observations from 2017 Inspections of Auditors of Issuers* (Nov. 2017), <https://pcaobus.org/Inspections/Documents/inspection-brief-2017-4-issuer-results.pdf>. Their 2018 inspection results echoed the concern over substantive testing of revenue noting that revenue was only compared to internally generated invoices and evidence such as proof of delivery of the products or agreement of the invoice with the signed contract for the sale was not obtained.
- Pub. Co. Accounting Oversight Bd., *Staff Preview of 2018 Inspection Observations* (May 6, 2019), <https://pcaobus.org/Inspections/Documents/Staff-Preview-2018-Inspection-Observations.pdf>. The consistency in the inspections results should further incentivize auditors to take further precautions and increase their procedures when auditing this area.
182. Pub. Co. Accounting Oversight Bd., *The Auditor's Responses to Risks of Material Misstatement, Statement on Auditing Standards* 2301.11 (2010).
 183. *Id.* at 14.
 184. Pub. Co. Accounting Oversight Bd., *Audit Evidence, Statement on Auditing Standards* 1105.8. 2010).
 185. *Id.*
 186. *Id.* at 15-16.
 187. Pub. Co. Accounting Oversight Bd., *The Confirmation Process, Statement on Auditing Standards* 2310.08 (2015).
 188. *Id.* at 7.
 189. *Supra* Table 1.
 190. *Supra* Table 1.
 191. *2011 Concept Release, supra* note 39, at C-2.
 192. However, there is a risk that these disclosures would deter investors from considering in their investment decision additional areas of risk that did not rise to the level of a significant risk or a CAM may be identified in other areas of the Annual Report.
 193. Firms that audit public companies are required to register with the PCAOB. As part of their registration, these firms are subject to inspection by the PCAOB of their documentation to determine if they are in compliance with the auditing standards, accounting rules, and SEC rules. Pub. Co. Accounting Oversight Bd., SEC Section 4 Inspections Rule 4000, (Aug. 13, 2009), https://pcaobus.org/Rules/Pages/Section_4.aspx.
 194. Pub. Co. Accounting Oversight Bd., *Staff Inspection Brief: Preview of Observations from 2016 Inspections of Auditors of Issuers* 3 (Nov. 2017), <https://pcaobus.org/Inspections/Documents/inspection-brief-2017-4-issuer-results.pdf> (referring to inadequate compliance with the auditing standards on risks of material misstatement and evaluating audit results).
 195. Pub. Co. Accounting Oversight Bd., *Inspection Observations Related to PCAOB "Risk Assessment" Auditing Standards*, No. 8 through No. 15 (2015), <https://pcaobus.org/Inspections/Documents/Risk-Assessment-Standards-Inspections.pdf>. Deficiencies also related to the time period and specific revenue accounts covered by the testing to ensure that sufficient testing was performed to cover the whole period and that revenue regardless of its balance sheet impact was tested.
 196. *Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs, supra* note 158, at 7.
 197. *Id.*
 198. *Auditor's Report Expressing an Unqualified Opinion, supra* note 30.
 199. During the process of researching and drafting the proposed standards, the PCAOB weighed the benefits to investors against the cost of implementation, primarily through a qualitative analysis as these items were difficult to quantify. *SEC Order Granting Approval, supra* note 48, at 34.
 200. *Id.* at 35.
 201. *See* Davis Polk & Wardwell LLP, *supra* note 140; *see also* Sullivan & Cromwell LLP, *supra* note 49.
 202. *SEC Order Granting Approval, supra* note 48 at 35, 37-38 (discussing cost drivers such as additional audit procedures and the bifurcation of costs between one time and recurring).
 203. Pub. Co. Accounting Oversight Bd., *Communications with Audit Committees, Statement on Auditing Standards* 1301 (2012).
 204. The documentation would address whether the account is material and whether there is significant management judgment or complexity associated with the balance.
 205. The risk assessment guidance in the Auditing Standards provides that auditors should consider the "accounts and disclosures" in the potential misstatements that could occur in the financial statements. Pub. Co. Accounting Oversight Bd., *Identifying and Assessing Risks of Material Misstatement, Statement on Auditing Standards* 2110.59(a) (2010).
 206. Retention of Records Relevant to Audits and Reviews, Exchange Act Release No. 33-8180 (Jan. 27, 2003), <https://www.sec.gov/rules/final/33-8180.htm>.
 207. *SEC Order Granting Approval, supra* note 48, at 37.
 208. *Id.* at 33, 35.
 209. *See supra* Part 1.A.
 210. *Staff Observations from Review of Audit Methodologies, supra* note 37, at 3.
 211. Davis Polk & Wardwell LLP, *supra* note 50; PricewaterhouseCoopers, Comment Letter on PCAOB 2017-01, (Aug. 18, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2228004-160801.pdf>; Nasdaq, *supra* note 64; *see also* Sec. & Exch. Comm'n, *Statement on SEC Approval of the PCAOB's New Auditor's Reporting Standard* (Oct. 23, 2017). *But see* Council of Institutional Investors, Comment Letter on PCAOB 2017-01 (Aug. 8, 2017), <https://www.sec.gov/comments/pcaob-2017-01/pcaob201701-2197606-160364.pdf>.
 212. PricewaterhouseCoopers, *supra* note 211.
 213. Notice of Filing of Proposed Rules, *supra* note 11, at 35407.
 214. *SEC Order Granting Approval, supra* note 48, at 32.
 215. Deloitte & Touche LLP, Comment Letter on PCAOB Rulemaking Docket Matter No. 034 5 (Aug. 12, 2016), https://pcaobus.org/Rulemaking/Docket034/041c_Deloitte.pdf.
 216. George M. Cohen, *Legal Malpractice Insurance and Loss Prevention: A Comparative Analysis of Economic Institutions*, 4 CONN. INS. L.J. 305, 309 (1997/1998).
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 218. *Supra* Part III.
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Challenges and Implications for Potential Reforms of Crowdfunding Law for Social Enterprises

By Kei Komuro

Introduction

Over the last few years, crowdfunding has become a popular option for social entrepreneurs and investors. Although it is one of the major ways to raise capital, crowdfunding faces significant challenges, in particular fraud and limitations of capital and funding portals. These three challenges will be explored in this article, and recommendations will be made to address them.

Crowdfunding is known as the aggregation of funds from and the provision of capital by “an undifferentiated, unrestricted mass of individuals” or “the crowd” via the internet.¹ Generally, crowdfunding includes donative crowdfunding, rewards-based crowdfunding (pre-order crowdfunding or pre-sale crowdfunding), debt-based crowdfunding, and equity-based crowdfunding.² Crowdfunding volume grew rapidly from \$1 billion in 2011 to \$34 billion in 2015, and the volume is expected to expand to \$100 billion by 2025.³ As of 2015, crowdfunding, in terms of funding volume, consisted of 8% donation-based crowdfunding, 8% rewards-based crowdfunding, 73% debt-based crowdfunding, 7% equity-based crowdfunding, and 4% other types of crowdfunding.⁴

One of the major rules that has an impact on crowdfunding is Regulation Crowdfunding. In 2015, the Securities and Exchange Commission (SEC) adopted Regulation Crowdfunding to implement the requirements of Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012, which exempts crowdfunding from registering with the SEC and allows companies to raise capital under certain conditions, beginning in 2016.⁵ The regulations restrict the capital amount that can be raised in any 12-month period to \$1 million.⁶ Investors also have limitations; investors earning less than \$107,000 annually may invest up to \$2,200 or 5 percent of annual income or net worth, and investors earning more than \$107,000 annually may invest up to 10 percent of annual income or net worth.⁷ Offerings must occur through a registered broker-dealer or through a funding portal and can be advertised in only a “brief notice.”⁸

A. Social Enterprise and Crowdfunding: Why Social Enterprises?

Although the definition of social enterprise may vary depending on how “social” is interpreted, social enterprise is an organization engaged in “a public need to more expressly serve societal or environmental, as

well as financial, objectives, through business initiatives.”⁹ While there are several methods for raising capital, crowdfunding is the preferred option for social enterprises for a number of reasons. First, the retail investment market holds a large amount of capital.¹⁰ The median U.S. family’s total assets are \$189,900, and 51.9% of families owns some kind of stock.¹¹ Second, many retail investors are interested in investing for a combination of financial and social returns.¹² Approximately 30% of all the funds raised on crowdfunding platforms go toward social causes.¹³ Third, mutual and pension funds do not necessarily provide a way to match the interests of retail investors and social capitalists.¹⁴ Part of the reason may be due to the fact that an open-end mutual fund cannot invest more than 15% of its assets in private companies, and investment funds that invest heavily in small, private companies are typically limited to accredited investors.¹⁵ Although these features may evolve as entrepreneurs, investors, and other parties face new challenges and regulations, these factors can certainly provide the grounds for the current use of crowdfunding.

B. Challenges: Perception of Fraud, Capital Raising, and Funding Portals

Although crowdfunding is an important method by which social enterprises raise capital, it faces several challenges. One of the major challenges has been fraud.¹⁶ Today, there is significant public perception of fraud in crowdfunding.¹⁷ The perception of fraud and the actual existence of fraud raise another challenge: limitations on the capital amount that can be raised through crowdfunding. The maximum capital amount that can be raised by entrepreneurs in a 12-month period is \$1 million, and this restriction reflects several factors, including the desire to protect investors against fraud.¹⁸ It also leads to a third challenge: limitations on funding portals. Funding portals may not provide investment advice, conduct sales activities, or manage investor funds or securities.¹⁹ For clarity,

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the challenges faced by the different areas of crowdfunding are as follows:

Figure 1. To Which Types of Crowdfunding Do the Challenges Apply?

	Donative	Rewards-based	Debt-based	Equity-based
Fraud	○	○	○	○
Limitation of Capital Amount	-	-	○ (Profit-lending)	○
Limitations on Funding Portal	-	-	○ (Profit-lending)	○

Source: Created by Author (2018)

By exploring the challenges of crowdfunding, this article intends to enhance the understanding of the core issues in each challenge area and to examine what approaches can be taken.

C. Roadmap

Part 1 questions the current legal approach to fraud in crowdfunding—disclosure and the general restriction of solicitation and advertisement. Instead, several tools may help to diminish the stigma attached to crowdfunding. Statistics and screenings are examples. These approaches may not have as significant an influence as legal reforms might. However, unfilled gaps in the current regulations provide certain flexibility to both entrepreneurs and investors.

Part 2 of the article suggests that raising capital through Regulation Crowdfunding is not the only option social entrepreneurs have. At the same time, there is a basic question as to whether social enterprises need more than \$1 million. Although reforms may help entrepreneurs expand their opportunities, social entrepreneurs may not want to take the risk of receiving capital from investors who are not committed to their social missions.

Part 3 focuses on funding portals. The range of what funding portals may do is limited. Here, some kind of reforms may be necessary; however, drastic reform which explicitly expands funding portals' discretion may harm investors and eventually damage the crowdfunding market. Instead, the SEC could start by clarifying the criteria by which the portals will know what they can or cannot do serving issuers.

The final part of the article reinforces the importance of questioning whether challenges are really “challenges” and thinking flexibly about whether some challenges may also become opportunities that expand the options of crowdfunding for social entrepreneurs, investors, and other parties. Although reforms may be helpful to bring more opportunities in some areas of crowdfunding, those reforms must not

harm trust-building among the participants in crowdfunding.

Part 1: Fraud and Reality

A. How to Tackle Fraud and the Perception of Fraud

Today, the perception of fraud is still strong in crowdfunding activities. In a survey of 192 people conducted by Forbes, only 23.9% agreed with the statement that the “crowd” does an effective job of preventing fraud and abuse on crowdfunding sites (See Figure 1).²⁰ Although it may be challenging to measure the actual fraud rate as depending on definitions of the fraud rate,²¹ some data imply a pattern in a particular type of crowdfunding. For instance, in a survey of 381 Kickstarter projects (rewards-based crowdfunding) which had promised delivery dates for rewards to funders before July 2012, the fraud rate²² was 3.6%.²³ Although Figure 2 does not show the perception of crowdfunding by the types of crowdfunding, we may assume that certain gaps exist between the perception of fraud and the actual rate of fraud in rewards-based crowdfunding.

Figure 2. Public Image of Crowdfunding²⁴

Statement	Agree (%)	Neutral (%)	Disagree (%)
Crowdfunding is a legitimate way for entrepreneurs and other creatives to finance their work	84.4	13.9	3.2
People raising money via crowdfunding are usually honest people	27.9	60.4	12.2
The “crowd” does an effective job of preventing fraud and abuse on crowdfunding sites	20.1	56.6	24.0

Source: Forbes (2017)

One of the common legal approaches to fraud is to tighten disclosure requirements based on the belief that the disclosure allows “informed investors to fend for themselves.”²⁵ However, whether disclosure actually decreases fraud is questionable; in fact, a study shows that most consumers do not read the disclosure materials and in any case “cannot understand, assimilate, and analyze” them.²⁶ Some people also argue that the restriction of general solicitation and advertising helps to reduce fraud. However, crowdfunding is already subject to several restrictions on solicitations and advertisements, such as a “brief notice” requirement,²⁷ and further restrictions may result in discouraging entrepreneurs to use the crowdfunding scheme.²⁸

Instead, parties may use several tools to minimize the risk of potential fraud and the perception of fraud. Several studies provide statistics which not only deepen the readers' understanding of fraud but also help parties to avoid the risk of appearing as "fraud" funders. For instance, one of the exploratory studies of rewards-based crowdfunding shows a situation in which over 75% of projects are late.²⁹ Operating on the assumption that the late schedule may diminish the trust between enterprises and investors, parties might use this kind of data to set the termination period of a crowdfunding project.

Some crowdfunding sites even provide tools which may help relieve the anxiety of investors. Crowdfunding sites which have a "screening" function are good examples. For instance, Kickstarter has a function called "Project We Love," which is a badge showing that Kickstarter is passionate about the project.³⁰ Using such a tool, investors may feel more comfortable if they perceive that crowdfunding sites actually monitor some of their projects. Although it remains unclear how crowdfunding sites screen and to what extent "screening" gives investors a feeling of safety, crowdfunding sites may actively contribute to diminish the stigma attached to crowdfunding and actual instances of fraud.

B. Regulations – Detection of Fraud or Roadblock to Opportunities?

Several types of activities sometimes seen as fraud are either only partly regulated or wholly unregulated.³¹ Although reforms may help regulate these activities, whether reform is needed is questionable since some of these activities may also give opportunities for social startups to raise capital. For instance, imagine a case where entrepreneurs seek a large amount of capital without spending much time and expense. In order to raise a substantial amount of capital, the entrepreneurs may contemplate what factors, other than the content of their project, attract investors. The entrepreneurs also may assume that investors prefer projects which provide not only rewards but also the principal amount. At the same time, entrepreneurs may want to avoid SEC registration since it may be time-consuming and costly. In such a case, using a combination of nonprofit debt-based crowdfunding and rewards may match their interest. While such a combination may raise fraud concerns, it also may give entrepreneurs an opportunity to raise capital.

Caffé Withus, a Korean coffee company that provides training to mentally handicapped laborers to become baristas and acquire a job, is an enterprise that raised capital through a non-profit lending-based crowdfunding with rewards.³² The company provided repayment plus cold brew for providers over KRW100,000 (KRW1=\$0.0883 as of October 15, 2018);³³ repayment plus cookies and premium coffee beans for providers over KRW200,000; and repayment plus handmade leather bags equivalent to KRW300,000 for providers over KRW1,000,000.³⁴ If entrepreneurs were to try to use

the same scheme to raise capital in the U.S., regulations would limit such a venture.

C. Potential Outcome of "Blank Space" in Regulations

Under the *Howey* Test, an instrument is an investment contract, and thus a security if it involves an (1) investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) to come solely or primarily from the efforts of others.³⁵ Regarding (2), "the pooling of assets from multiple investors in such a way that all investors share in the profits and risks of the enterprise" constitutes a common enterprise.³⁶ When it comes to the definition of (3), profit means "either capital appreciation resulting from the development of the initial investment...or participation in earnings resulting from the use of investors' funds."³⁷ In the U.S., whether the rewards that Caffé Withus provides with repayment are considered as "profits" may be an issue. According to the definition of (3), if the repayment plus rewards appreciates over the value of the initial investment, the rewards might be considered as profits. In the Caffé Withus case, it is clear that some rewards have a certain value, such as hand-made leather bags equivalent to KRW300,000, whether rewards are considered "profits" may depend on their liquidity. However, entrepreneurs may need to register with the SEC in the U.S. Although the Caffé Withus case might be treated with suspicion in the U.S., the method used therein to raise funds might well allow social entrepreneurs to reach their desired goals.

Whether the government should engage in further reforms to reinforce disclosure requirements and to tighten restrictions on general solicitation and advertising is questionable. The current laws already place restrictions on disclosure and solicitation and advertising, and current gaps in the restrictions nonetheless provide flexibility to both entrepreneurs and investors by allowing the entrepreneurs to use various kinds of opportunities to raise capital while giving investors several attractive investment options.

Part 2: Limitation of the Capital Amount That Can Be Raised

A. How to Raise More than \$1 Million through Crowdfunding

Under Regulation Crowdfunding, entrepreneurs may not raise more than \$1 million from investors within 12 months.³⁸ This raises a problem for social entrepreneurs who need a large amount of capital due to their scale of business. A \$1 million cap only applies to capital raising under Regulation Crowdfunding; social entrepreneurs may seek more than \$1 million through other means.

Regulation D is one of the schemes that can enable such fundraising. Under Regulation D, Rule 506(b), entrepreneurs can raise an unlimited amount of capital from investors.³⁹ Although entrepreneurs are required

to submit a notice to the SEC and comply with state filing requirements,⁴⁰ entrepreneurs may establish special purpose vehicles (SPVs), a legal structure for a single purpose that pools accredited and non-accredited investors together, to lessen the filing workload with federal and state authorities.⁴¹ Formation of SPVs is allowed only under Regulation D, and it comes with some restrictions, one of which is that the number of investors cannot be more than 100.⁴²

The basic charge for establishing SPVs is not necessarily overly burdensome; for instance, SeedInvest, one of the companies that provides support to establish SPVs, charges about \$2,100 to \$3,000 upfront and \$150 for monthly maintenance fees.⁴³

One of the issues with capital raising through Regulation D crowdfunding, whether using SPVs or not, is the limitation on the number of unaccredited investors – no more than 35 unaccredited investors.⁴⁴ Given the limited number of unaccredited investors, we may question if it is still truly a “crowd” funding device.

If entrepreneurs wish to obtain a large amount of capital from an unlimited number of accredited and unaccredited investors, they might raise capital under Regulation A+ Tier 1 crowdfunding. Under this scheme, entrepreneurs may raise up to \$20 million in a 12-month period from any investors.⁴⁵ If entrepreneurs use Regulation A+ Tier 2 crowdfunding schemes, they could raise even more capital—up to \$50 million—in a 12-month

period, although there are limitations on the amount of money a non-accredited investor can invest.⁴⁶ There are several social enterprises that use Regulation A+ crowdfunding schemes to raise capital. For instance, a security robotics company, Knightscope,⁴⁷ raised over \$20 million in a Regulation A+ Tier 2 crowdfunding scheme.⁴⁸ Although using Regulation A+ schemes enables entrepreneurs to raise capital, filing requirements are relatively more intense under Regulation A+ than under the other types of regulation.⁴⁹ Furthermore, the SEC does not permit the establishment of SPVs under Regulation A+. Therefore, filing requirements under this regulation are more burdensome.⁵⁰

B. Potential Adverse Effect of Raising a Large Amount of Capital

Which crowdfunding regulations social entrepreneurs should use to raise capital depends on their interests and needs. However, when we step back and consider crowdfunding for social enterprises, we face the fundamental question—whether social enterprises need more than \$1 million.⁵¹ Social entrepreneurs may not want capital from investors who are not committed to their mission,⁵² and this may occur more easily if the amount of capital they raise is higher as more investors become involved. Moreover, it is important to note that while many enterprises turn into fast-growing enterprises with a job growth of 20% to 25% or more, about half of all new startups fail within five years.⁵³ In the growth of enterprises, starting capital does not have a significant effect on the startups’



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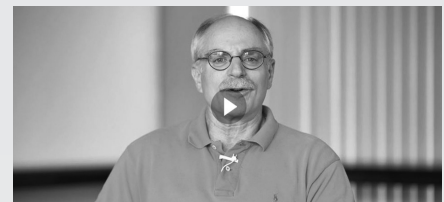
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success.⁵⁴ In light of this, Regulation Crowdfunding may be a sufficient tool for many social entrepreneurs.

C. Variety of Crowdfunding Options Available to Entrepreneurs

Having said that, under the SEC rules, enterprises may still utilize two different securities exemptions (Regulation Crowdfunding and Regulation D) at the same time.⁵⁵ Therefore, if capital raised under Regulation Crowdfunding does not provide sufficient funds, entrepreneurs may seek more than \$1 million from offerings under Regulation D. Entrepreneurs may even use Regu-

lation A+ if they can endure the relatively heavy filing requirements.⁵⁶

In 2017, the Treasury Department published a guide to the SEC and the Commodity Futures Trading Commission to recommend an increase in the amount that can be raised under Regulation Crowdfunding from \$1 million to \$5 million.⁵⁷ Although such reforms may expand entrepreneurs' opportunities to establish their business under Regulation Crowdfunding, entrepreneurs already have a number of options to raise capital, and thus reforms may not be necessary or effective under the current regulations.

Part 3: Limitations of Funding Portals

A. Any Incentives to Be Funding Portals?

When social entrepreneurs seek to raise more than \$53,000, they may consider raising capital through debt-based crowdfunding (profit-lending) or equity-based crowdfunding using funding portals.⁵⁹ When entrepreneurs use these types of crowdfunding, offerings must occur through funding portals.⁶⁰ Funding portals must comply with several regulations in order to conduct their business. Requirements for funding portals are listed in Figure 3.

While investors' protection is one of the key ideas behind the relatively severe restrictions on funding portals, it is questionable whether funding portals should be required to conduct their business under such restrictions.⁶¹ Although funding portals may receive an average fee of around 5.1% of proceeds,⁶² complying with all the SEC requirements may be a heavy burden. In order to ease the workload required to comply with all the regulations, it is theoretically possible for funding portals to use third parties like consulting firms or law firms to conduct a part of the funding portal's operations; however, this may be costly.

B. What Third Parties Can Do to Assist Funding Portals

As another approach, a third party might establish a comparison scheme for the funding portal; the idea would be something like Yelp for funding portals.⁶³ In reality, Crowdsunite provides such a comparison of crowdfunding platforms.⁶⁴ On the Crowdsunite website, investors can choose the country, industry, platform type (debt, donation, equity, reward, or real estate), and campaign type ("All or Nothing,"⁶⁵ in which entrepreneurs raise either a specified goal amount or must return all funds, or "Keep What You Raised,"⁶⁶ in which entrepreneurs can retain all capital actually raised) to narrow down the choices of crowdfunding platforms, and compare them.⁶⁷

Such a scheme would allow comparison of funding portals based on the data about various projects that are publicly disclosed on the SEC's EDGAR website (e.g., industry group, duration of offering, type(s) of securities offered, offering and sales amounts, etc.).⁶⁸ Using this comparison scheme, entrepreneurs who are seeking

Figure 3. Requirements for Funding Portals⁵⁸

May	May Not	Must
Receive financial interest compensation for services provided in connection with the offer or sale of securities	Have a financial interest in an issuer that is offering or selling securities	Establish means to keep accurate records of the holders of securities (due diligence)
Identify one or more issuers of offerings available on the portal on the basis of "objective" criteria	Require investors to establish an account to gain access to issuer offering information available on the portal	Conduct background and securities enforcement regulatory history checks
	Offer investment advice or recommendations	Deny access if there is the potential for fraud or if there are other investor protection concerns
	Solicit investments	Deliver educational materials to investors
		Determine if an investor has reached his or her investment limit
		Direct investors / issuers to transmit / return the funds directly via qualified third parties to issuers / investors
		Be designed to highlight a broad selection of issuers offering securities

Source: SEC

funding portals may find that some funding portals offer more securities for X industry, while other funding portals offer more securities for Y industry. Entrepreneurs could choose the funding portal that best matches their interests. Eventually, funding portals may face similar types of crowdfunding projects (in terms of industry group, duration of offering, types of securities offered, and offering and sales amounts, etc.), which would make their operation less burdensome. One of the major issues here is that the sites that offer such a comparison scheme may not have an incentive to do the comparisons since funding portals are not able to pay fees to those sites as they would then violate the rules on compensation.⁶⁹ Crowdsunite, for example, lists crowdfunding consultants, lawyers, accountants, and other experts at the same time, and provides additional resources for people who seek help.⁷⁰ Although this may work as a business model, it may be challenging for some parties to find and gather the experts in crowdfunding from different areas. Government institutions such as consumer protection offices can also create comparison schemes; however, it can be challenging for them to strike a balance between consumer protection, which is their focus, and the potential risks associated with funding portals.

C. Potential Reforms Are Necessary

Funding portals have to spend a substantial amount in compliance costs, and they are exposed to the risk of potential liability.⁷¹ The range of what funding portals are allowed to do is limited. For instance, funding portals may highlight certain enterprises, but they are subject to strict regulation. Under current SEC rules, funding portals must be “designed to highlight a broad selection of issuers offering securities through the funding portal’s platform [...] and be applied to all issuers and offerings.”⁷² If funding portals try to highlight a single issuer, they have to consider whether such a highlight is conducted based on “objective criteria.”⁷³ The SEC construes “objective criteria” as follows in Figure 4.

Following the current definition of objective criteria, funding portals may technically highlight one issuer by setting a narrow standard. This might, however, conflict with another rule that states that funding portals must be “designed to highlight a broad selection of issuers.” Where funding portals should draw the line is ambiguous. Although the SEC may regard the selection of a single or only a small number of issuers as conduct which may harm investors, the SEC should at least refine the objective criteria. For example, while the SEC does mention that objective criteria may include the geographic location of the issuer, the SEC does not explain whether funding portals may highlight the issuer by country, state, county, city or even town. Furthermore, the definition of a “broad” selections of issuers may also be interpreted in several ways. Although refining the preexisting objective criteria may or may not result in comforting the funding portals, it should at least bring more clarity to what

Figure 4. Objective Criteria⁷⁴

May include	May not include
Type of securities being offered	The advisability of investing in the issuer or its offering or an assessment of any characteristic of: the issuer’s business plans, management, or the risks associated with an investment.
Geographic location of the issuer	
Industry or business segment of the issuer	
Number or amount of investment commitments made	
Progress in meeting the target offering amount	
If applicable, the minimum or maximum investment amount	

Source: SEC

funding portals can do in their operations. Such clarification may help funding portals to construct their business and encourage them to offer more debt-based crowdfunding (profit-lending) or equity-based crowdfunding alternatives.

Conclusion

Although crowdfunding is one method to raise capital for social enterprises and to expand investors’ opportunities, it faces several challenges, including fraud, limitations on the amount of capital that can be raised, and limitations on the funding portals. Although those challenges exist, current crowdfunding environments provide various methods and tools to overcome them. Some challenges can even turn into opportunities for social enterprises and investors.

Having said that, there are certain areas of crowdfunding, like a funding portal, for instance, in which reforms may help enhance the efficiency and effectiveness of crowdfunding. Reforms, though, must be implemented in ways that do not harm the entire market. Allowing funding portals to highlight any kind of issuers at their own discretion may make them more attractive for both entrepreneurs and investors, although funding portals may lose credibility if investors lose their capital as a result. Instead, the SEC might begin by refining existing standards and making its objective criteria clearer. This may at least help funding portals to delineate a line between highlights that are acceptable and those that are not. As a result, the portals could consider including

more highlight features to benefit investors and increase transactions.

Considering these challenges and approaches alone, however, may not be sufficient to achieve a crowdfunding environment which is attractive for the parties involved.⁷⁵ An attractive crowdfunding environment may not only provide opportunities to social entrepreneurs, investors, and other participants, but may also encourage trust building between the parties. Lack of trust affects several features of crowdfunding, including the success rate of crowdfunding projects.⁷⁶

It is important for social enterprises, investors, and other participants to question whether the challenges they face are really “challenges,” and if so, they may want to consider what approaches they can take to overcome the burdens without damaging trust. Although trust is invisible and may be even more ambiguous in “crowd” or online transactions, parties must always keep in mind that a loss of trust is fatal in crowdfunding and it may even affect the entire crowdfunding market.

Endnotes


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6. See *id.*
7. See *id.*
8. See *id.*
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15. See Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612, 57 Fed. Reg. 9828 (Mar. 20, 1992).
16. To be clear, “fraud” in this article refers specifically to fraud in crowdfunding.
17. See David Thorpe, *Worries About Fraud Top List of Crowdfunding Concerns*, FORBES (Nov. 29, 2017, 9:46 PM), <https://www.forbes.com/sites/devinthorpe/2017/11/29/worries-about-fraud-top-list-of-crowdfunding-concerns/#1e00761a48f0>.
18. See Seth C. Oranburg, *Bridgdfunding: Crowdfunding and The Market for Entrepreneurial Finance*, 25 CORNELL J. L. & PUB. POL’Y 397, 419 (2015).
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21. For instance, in reward-based crowdfunding, one can define the fraud rate as the rate of the projects which do not deliver the rewards after the entrepreneurs raise capital, while others can define the fraud rate as the rate of projects that deliver the rewards late. Other definitions may also be applied.
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30. See *Introducing Badges for Projects We Love*, KICKSTARTER, <https://www.kickstarter.com/blog/introducing-projects-we-love-badges> (last visited Oct. 12, 2018).
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32. See Hyonsu Kim & Lieven De Moor, *The Case of Crowdfunding in Financial Inclusion: A Survey*, 26 STRATEGIC CHANGE 193, 198 (2017).
33. XE Currency Charts (KRW/USD), available at <http://www.xe.com/> (last visited Oct. 15, 2018).
34. See *id.*
35. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).
36. *SEC v. SG Ltd.*, 265 F.3d 42, 50 (1st Cir. 2001).
37. *Union Planters Nat’l Bank v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174, 1175 (6th Cir. 1981).

38. See U.S. SEC. AND EXCH. COMM'N, *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers* (May 13, 2016), <https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm>.
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40. See *id.*
41. See *Special Purpose Vehicle (SPV) Examples and How It Works*, SEEDINVEST, <https://www.seedinvest.com/academy/a-special-purpose-vehicle> (last visited Oct. 17, 2018).
42. See AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter, 2013 SEC NO-ACT LEXIS 294 (Mar. 28, 2013), available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf>.
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55. See U.S. SEC. AND EXCH. COMM'N, *Securities Act Sections* (Sep. 22, 2016), <https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm>.
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63. See Darian M. Ibrahim, *Crowdfunding Without the Crowd*, 95 N.C. L. REV. 1481, 1491 (2017).
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65. *Crowdfunding Sites*, CROWDSUNITE, <http://crowdsunite.com/crowdfunding-sites/> (last visited Oct. 22, 2018).
66. See *id.*
67. See *id.*
68. See U.S. SEC. AND EXCH. COMM'N, *Notice of Exempt Offering of Securities* (Jun. 1, 2016), https://www.sec.gov/Archives/edgar/data/1555353/000155535316000001/xslFormDX01/primary_doc.xml.
69. A registered funding portal may not compensate “employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform”. See U.S. SEC. AND EXCH. COMM'N, *Registration of Funding Portals* (Jan. 18, 2017), <https://www.sec.gov/divisions/marketreg/tmcompliance/fpregistrationguide.htm>.
70. See Michelle Goodman, *Thinking of Crowdfunding? This Review Site Helps You Choose Wisely*, ENTREPRENEUR (Jan. 12, 2014), <https://www.entrepreneur.com/article/230206>.
71. With respect to compliance costs, funding portals must spend a substantial amount to design and implement procedures to comply with several regulations. To mitigate the risk of potential liabilities, funding portals must conduct due diligence for the issuer's financial materials to see if there is any misleading or false information. See *So You Want to Be a Crowdfunding Portal? Top 10 Traps for the Unwary*, DAY PITNEY LLP, https://www.daypitney.com/~media/files/insights/publications/2014/01/so-you-want-to-be-a-crowdfunding-portal-top-10traps_for_the_unwary.pdf (last visited Nov. 24, 2018).
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The Patentability of Technology in the Information Age: How the Checks and Balances of the Courts in a Patent Suit Pathway Stimulate Innovation in the Field of Artificial Intelligence

By Danielle Kassatly

Introduction

In *Bilski v. Kappos*, the Supreme Court stated that the “[Information] Age...raises new difficulties for the patent law,” one of which is “striking the balance between protecting inventors and not granting monopolies over procedures that others would discover by independent, creative application of general principles.”¹

This article examines how the checks and balances of the courts in a patent suit pathway promote efficiency in the Information Age. It evaluates how the patent appellate pathway influenced the recent changes to software patents and discusses the beneficial impacts these changes have on the field of Artificial Intelligence. Further, it examines how these changes will likely increase efficiency in Artificial Intelligence by incentivizing investment in machine learning technology, such as Machine Learning and Deep Learning, in order to improve Artificial Intelligence software patents.^{2, 3, 4, 5} In particular, industries that rely on Artificial Intelligence software will benefit from investment in patent protection in light of recent patent law cases such as *KSR*, *Teva*, *McRO*, and *Amdocs*, which, taken together, increased the quality and certainty of software patent rights. This article will discuss these recent cases through the lens of the varying levels of technical and legal specialization within the appellate patent framework of Article Three courts. It will further consider how this framework decreases detrimental reliance on software patents in the Artificial Intelligence field.^{6, 7, 8}

A patent lawsuit is first reviewed by a generalist United States District Court, appealed to the specialized Federal Circuit, and given a final generalist review by the United States Supreme Court.⁹ This framework therefore provides an important system of checks and balances.

The Federal Circuit

The United States Court of Appeals for the Federal Circuit (“Federal Circuit”) is a specialized appellate-level court with jurisdiction to hear patent cases.¹⁰ The Federal Circuit was established in 1982 as a result of the merger of the United States Court of Customs and Patent Appeals and the appellate division of the United States Court of Claims.¹¹ In the Federal Circuit, jurisdiction is based on patent law subject matter. This is unlike the other federal Courts of Appeals, where jurisdiction is based on personal jurisdiction or geographic location.^{12, 13}

The Appellate Path of a Patent Suit

A patent lawsuit is first reviewed by a United States District Court, and can be appealed to the Federal Circuit, and thereafter to the United States Supreme Court.¹⁴ As a practical matter, the Federal Circuit is viewed as the court of last resort, as it is rare for the United States Supreme Court to grant certiorari to review patent cases.¹⁵ Since the Federal Circuit was established in 1982, the Supreme Court has heard approximately one case per year.¹⁶ However, in recent years there has been an uptick in the number of patent law cases the Supreme Court has accepted.^{17, 18} The influence of these cases elucidates the drastic difference in approach taken by the Supreme Court, as compared to the specialized Federal Circuit, with regard to impacting innovation, public disclosures, and the filing of patents.^{19, 20} Specifically, *KSR Int’l Co. v. Teleflex Inc.* and *Teva Pharm. USA, Inc. v. Sandoz, Inc.* highlight this difference.

Why Do We Need the Federal Circuit?

One may ask what makes patent law so unique a subject matter that it necessitated the creation of the specialized Federal Circuit for the primary purpose of reviewing patent litigation matters. To answer this question, one must first look to the nature of a patent in order to determine what distinguishes this subject matter from other types of legal issues.

Promoting the Progress of Science and Useful Arts

35 U.S.C. §154(a)(1) states that a patent is “the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States.”²¹ Patent rights include a 20-year limited right to exclude others from making and using the rights present in the patentee’s invention.²² The Patent and Copyright Clause of the United States Constitution establishes the intellectual property rights to a patent.²³ It provides that Congress shall have the power to promote the progress of science

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and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.²⁴ Patents were established in order to incentivize innovation and to promote the progression of technology by granting a 20 year exclusive right, or limited monopoly, to the inventor.²⁵ This monopoly gives the inventor the opportunity to generate licensing revenues from the patented invention, which provides the incentive to invest in discovery, research, and development.²⁶

Another advantage of the patent system is that it encourages inventors to make full disclosure of their technologies, which they would have otherwise withheld from the public as trade secrets.²⁷ Trade secrets decrease the public's exposure to innovation and hinder the improvement of technology as remarkable new inventions remain outside of the public's awareness.²⁸ Thus, in the absence of the patent system, scientists would partake in unnecessary, duplicative research in order to solve the same problems that the trade secret already solves, resulting in a decreased rate of innovation in the United States.²⁹ Additionally, it would be financially advantageous for competitors to reproduce inventions already in the market, rather than invest in costly research and development. Such an approach would decrease the inventors' incentive to innovate, as the inventors would no longer enjoy a competitive market advantage. As a result, this decreased incentive to innovate would ultimately lead to a significant decline in inventors' share in the market, leading to decreased innovation.

Patentability

The United States Constitution grants the broad power to "promote the progress of science and useful arts."³⁰ This patent power is more specifically defined in 35 U.S.C. § 101, which states that a patent must be a "new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement."³¹ In order to be "new" and "useful," as required by 35 U.S.C. § 101, the subject matter for which the inventor is seeking patent protection must be novel and more than a simple variation of the prior art in the industry.³² Invention is an art form that requires ingenuity and creativity beyond mere predictable improvements.³³ This often requires viewing technological problems through an untraditional lens and solving traditional problems in an untraditional way.³⁴ This ingenuity often makes patents difficult to understand and adds an additional layer of complexity to an already specialized technological field.³⁵

Additionally, patents are interpreted using the standard of by "one of ordinary skill in the art."³⁶ This is a much more specialized, case-specific standard than the objective, reasonable person standard that is applied to most other areas of law.³⁷ For example, the standard by which a patent is interpreted could be from the perspective of a person with a Ph.D. in electrical engineering. The

complexity of the subject matter being interpreted in the patent raises the question: should this highly specialized body of patent law be interpreted by generalist judges, who typically do not possess the technical background of "one of ordinary skill in the art" relevant to the invention, or should the specialized Federal Circuit play a larger role in interpreting and enforcing patent law?

Software as Patentable Subject Matter

The software industry has been deeply impacted by the Supreme Court's decision in *Alice Corp. Pty. v. CLS Bank Int'l*, where the Court ruled that implementation of an abstract idea on a computer is not patent eligible subject matter.^{38, 39} Post-*Alice* there was a 75% decrease in the granting of software related patents, including business method patents, resulting in a decrease in issued software patents.^{40, 41}

In response to the decrease in issuance of software patents, the Federal Circuit used *McRO, Inc. v. Bandai Namco Games Am. Inc.* as a way to overcome the software patent obstacles set forth by the Supreme Court in *Alice*.⁴² In *McRO*, the Federal Circuit held that a "method for automatically animating lip synchronization and facial expression of three-dimensional characters" was not an abstract idea because the "automation goes beyond merely organizing [existing] information into a new form or carrying out a fundamental economic practice."⁴³ In particular, the claims regarding the software patent at issue were directed to "a specific asserted improvement in computer animation, i.e., the automatic use of rules of a particular type."⁴⁴ The Federal Court reasoned that this was not an abstract idea because the process "use[d] a combined order of specific rules that renders information into a specific format that is then used and applied to create the desired result."⁴⁵ The specific rules and implementation of this process were beyond what "any animator engaged in the search for an automation process would likely have utilized," and therefore constituted patentable subject matter.⁴⁶

The Federal Circuit further supported the patentability of software in *Amdocs (Israel) Ltd. v. Openet Telecom, Inc.* There, the Federal Circuit held that the software patent at issue was patentable subject matter because the claims were "'directed to' a particular process that improve[d] upon the manner in which systems collect[ed] and process[ed] network usage information, and the claimed process [was] limited in a specific way."⁴⁷ Together, *McRO* and *Amdocs* clarified the uncertainty resulting from the prohibition of patents on abstract ideas set forth by the Supreme Court in *Alice* and made clear that software can, in fact, be patented.

The United States Patent and Trademark Office (USPTO) provided further guidance on these recent software patent cases in its 2019 *Revised Patent Subject Matter Eligibility Guidance*. There, the USPTO further clarified

that software can be patentable subject matter if it has been “integrated into a practical application.”⁴⁸ This notice by the USPTO serves as a guide to patent examiners when evaluating whether an invention merits a patent because it details the specific circumstances in which software satisfies the patentable subject matter requirement. Additionally, this notice allows patent attorneys to make better informed legal decisions on behalf of their clients.

Taken together, *McRO*, *Amdocs*, and the 2019 Revised *Patent Subject Matter Eligibility Guidance* clarified the types of software that are patentable. In so doing, they alleviated some of the uncertainty surrounding the eligibility of software for patent protection. In turn, this benefits the Artificial Intelligence field by allowing industries that rely on Artificial Intelligence software to make informed investment decisions by accurately evaluating the benefits associated with pursuing patent protection, determining the financial value of its current software patent portfolio, and conducting more precise cost-benefit analyses before licensing additional Artificial Intelligence software patents.

Not So Obviousness

A common defense to patent infringement is for the infringer to argue the invalidity of the plaintiff’s patent.⁴⁹ The infringer may prove that the patent does not satisfy the non-obviousness requirement, thus invalidating the patent. One way to do this is to show that the patented technology at issue is an obvious variation of the prior art, which is technology in the public domain.⁵⁰ The non-obviousness standard is articulated in 35 U.S.C. § 103, which states that a patent may not be obtained “if the differences between the claimed invention and the prior art are such that the claimed invention as a whole would have been obvious before the effective filing date of the claimed invention to a person having ordinary skill in the art.”⁵¹

Historically, the Federal Circuit has adopted the “Teaching, Suggestion, Motivation Test” to determine if the combination of prior art renders the patent obvious.⁵² Under the Teaching, Suggestion, Motivation Test, the patent is non-obvious if the invention did not have a teaching present in the prior art that suggested that the variables could be combined to produce the invention at issue.⁵³ This straightforward test provided inventors and patent prosecutors with a framework to assess the seemingly vague non-obviousness requirement.⁵⁴ Further, the Federal Circuit adopted the Teaching, Suggestion, Motivation Test as a well-articulated and unambiguous rule to combat hindsight bias.⁵⁵ Hindsight bias is the idea that every invention at its core is a combination of obvious variations of various past inventions.⁵⁶

However, *KSR v. Teleflex* profoundly changed the way courts determined the obviousness standard. Upon review, the Supreme Court clearly stated that the Teach-

ing, Suggestion, Motivation Test was not the sole test for non-obviousness, but did not reject the test itself. This suggests that the Teaching, Suggestion, Motivation Test is still a consideration but is not a dispositive indication of non-obviousness.⁵⁷ In addition, *KSR* allowed for the application of judicial common sense, the subjective interpretation of non-obviousness by a judge.⁵⁸

Following the Supreme Court’s *KSR* ruling in 2007, there has been an increased number of obviousness rejections by both the District Courts and the Federal Circuit.⁵⁹ The number of obviousness rejections in the District Courts increased from 6.3% pre-*KSR* to 40.8% post-*KSR*.⁶⁰ Similarly, the number of obviousness rejections in the Federal Circuit increased from 40% pre-*KSR* to 57.4% post-*KSR*.⁶¹ The significant increase in the number of patents being invalidated as non-obvious is largely attributable to the new obviousness analysis set forth in *KSR*.⁶²

The Impact of *KSR*

Analyzing the outcome of *KSR* allows for an evaluation of both the positive and negative aspects of the specialized Federal Circuit. *KSR* increased the number of patents rejected as obvious by allowing judicial common sense to factor into non-obviousness analysis.⁶³ The problem with obvious patents is that with every issuance of a utility patent comes the right to exclude the public from making or using the patented invention for 20 years from the date of filing the patent application.⁶⁴

The patent system is based on a trade-off between the inventor and the public: the public benefits from the disclosure of the patented technology and is informed on how to make and use a novel invention while, in exchange, the inventor gets the right to prevent the public from making or using the invention without a license.⁶⁵ This disclosure serves an important function in that it enables the public to learn from the invention and improve upon it.⁶⁶ However, by definition, an obvious patent has no public innovation value because it is simply a combination of what is already in the public domain.⁶⁷ Thus, granting an obvious patent skews the patent trade-off by preventing the public from using the patented technology without any public disclosure benefits, and forces those who want to use the invention to pay the licensing fee.

As it pertains to software patents, the post-*KSR* high threshold of non-obviousness has been satisfied by truly innovative inventions. For example, in *Intellectual Ventures I LLC v. Motorola Mobility LLC*, both the District Court and the Federal Circuit found the software patent at issue to be non-obvious, even in light of judicial common sense.⁶⁸ *Intellectual Ventures I LLC* and other post-*KSR* cases establish the higher standard of non-obviousness, but simultaneously permit the use of judicial common sense to evaluate the invention holistically. This arguably makes software patents even more valuable, as licensees of the

software patent have more certainty in the non-obvious quality of the patent to be licensed.

Artificial Intelligence industries, in particular, rely heavily on software development that involves substantial investments in a single product. By increasing the non-obviousness threshold, Artificial Intelligence companies can be assured that their licensed software patent is truly innovative and that others will not “freeride” off the company’s heavily invested innovation or create an obvious variety of the invention that would decrease the value of the licensed software. Additionally, Artificial Intelligence companies can be certain before investing heavily in the development and patent prosecution process that their software is not simply an obvious variety of their competitors’.

In sum, *KSR*’s heightened standard of non-obviousness increases the quality of software patents. In turn, this incentivizes software innovation and, therefore, benefits the field of Artificial Intelligence by providing more meaningful software licenses. In this way, *KSR* exemplifies how the system of checks and balances involving the Supreme Court’s adjusting the non-obviousness standard applied by the Federal Circuit has positively impacted industries that depend on Artificial Intelligence.

Patent Infringement: Claim Construction

The first step of patent infringement is to determine the metes and bounds of the patent rights. This is done through a process called claim construction, which interprets the meaning of particular terms within a patent.⁶⁹ After the patent claims are construed, they are compared to the allegedly infringing product to determine if this alleged infringing product falls within the claims of the patent.⁷⁰ If the allegedly infringing product falls within the claims of the patent at issue, then there is infringement.⁷¹

In determining whether patent infringement is best suited for a specialized or generalized court, it is essential to distinguish the role of the judge in patent law from the role of the judge in other areas of law. In most areas of law, the judge addresses questions of law, while questions of fact are reserved for the jury.⁷² However, in patent law, claim construction is a mongrel practice of both law and fact, which is left for the judge alone.⁷³ Thus, patent law is distinguishable in that the role of the judge extends beyond mere questions of law. The issue facing patent practitioners and inventors alike is whether it is preferable for the judge to have control over both the legal and factual issues in the case, or whether the traditional division of labor between the judge and jury is more beneficial.

The Seventh Amendment

The Seventh Amendment states “[i]n suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in

any court of the United States, than according to the rules of the common law.”⁷⁴ The Seventh Amendment makes it clear that the jury, not the judge, should make factual determinations.⁷⁵ Thus, the District Court judge’s determinations of both law and fact during claim construction appears to contradict the Seventh Amendment requirement.

The Supreme Court addressed this concern in *Markman v. Westview Instruments, Inc.* There, the Court stated that the Seventh Amendment was not violated when the judge decided the factual and legal issues during claim construction without a jury.⁷⁶ This is because patents did not include any claims at the time of the Seventh Amendment’s ratification, and therefore there were no claims to be construed by the jury.⁷⁷ Thus, the Seventh Amendment is not violated when the judges alone interpret claims during claim construction.⁷⁸

The Impact of District Court Judges Interpreting Patent Claims

The Seventh Amendment was created as a right to prevent government overreach and to allow for more democratic authority.⁷⁹ The right to trial by jury is one such check on government overreach.⁸⁰ Although there is an essential interest in having jurors, the vast complexity of the technology suggests that perhaps a jury of one’s peers might not be well-suited for claim construction.⁸¹ Additionally, patents are interpreted through the lens of a person of ordinary skill in the art, rather than the objective reasonable person.⁸² One reason that the jury system might not be well-suited for claim construction is that patents are difficult to understand because of their complex, novel, and technical nature.⁸³

Another manner in which patent law differs from other areas of law is the way that evidence is received and interpreted during claim construction.⁸⁴ In *Phillips v. AWH Corp.*, the court stated that intrinsic evidence is more significant than extrinsic evidence in interpreting patent claims.⁸⁵ Intrinsic evidence is the patent specification, claims, and prosecution history.⁸⁶ Extrinsic evidence is anything not within the patent and its prosecution history, such as dictionaries, treatises, and expert testimony.⁸⁷

Further, patent claims must be interpreted at the time of filing.⁸⁸ Intrinsic evidence is weighed more heavily because it is less biased than extrinsic evidence, as is part of the patent application itself.⁸⁹ Extrinsic evidence may be more biased and thus less valuable. For example, expert testimony may be biased as experts are hired by each specific party to prove a biased interpretation of the patent claim.⁹⁰ It is easy to see how the jury system may not be well-suited for claim construction as 1) there are nuances among various technology types; 2) the paid expert witnesses testifying on opposite sides may argue for different definitions of the same technical terms; and 3) the discussion of patent prosecution history will likely involve both

highly technical legal and scientific terms that are meant for a person of ordinary skill in the art, not for an objective reasonable jury member.

For the aforementioned reasons, while claim construction requires the interpretation of factual questions, the District Court judges are better equipped than the jury to perform this task.⁹¹ The judges' ability to interpret these complex factors outweighs the jury's credibility because of the societal interest in uniformity.⁹² The unique role of a District Court judge makes the standard of review on appeal an essential way in which the Federal Circuit is able to provide its expertise to ensure fair treatment by the District Court.

Claim Construction on Appeal

Claim construction is a mongrel practice of both law and fact.⁹³ Questions of law during claim construction are reviewed de novo on appeal, meaning that no deference is granted to the District Court's findings.⁹⁴ This gives the Federal Circuit more influence in deciding legal questions regarding claim constructions.

Prior to *Teva Pharm. USA, Inc. v. Sandoz, Inc.*, the Federal Circuit's reversal rate of the District Court's claim construction was 40%.⁹⁵ This led to a very high probability that litigation would be appealed from the District Court, which directly impacted litigation costs.⁹⁶

Additionally, claim construction often determines the outcome of patent litigation.⁹⁷ As a result, these reversals ensuing at late stages in the litigation process lead to increased uncertainty surrounding patent rights.⁹⁸ If claim construction results in a finding that the scope of the patent rights did not include the infringing device, then this would result in a verdict of noninfringement.⁹⁹ The negative result is that patent owners and technology companies become uncertain about their ability to make well-informed investment decisions regarding their patent rights.¹⁰⁰

In response to the effects of the high reversal rate, the Supreme Court decided in *Teva Pharm. USA, Inc. v. Sandoz, Inc.* that the fact-finding in claim construction must be reviewed for "clear error," as set forth by Federal Rule of Civil Procedure 52(a). This is a higher standard of review, resulting in a lower likelihood of reversal.¹⁰¹ *Teva* was significant as it was a step toward harmonizing aspects of patent law during claim construction with other types of law on appeal that must adhere to the Federal Rules of Civil Procedure.¹⁰² Additionally, the clear error standard of review gives more deference to the District Court in claim construction when relying on extrinsic evidence.¹⁰³ This gives greater weight to the fact-finding interpretation of the judge and makes these factual interpretations more difficult to appeal.

By changing the standard of review on appeal in *Teva*, the Supreme Court mitigated the power of the Federal

Circuit to review the District Court's findings. *Teva's* impact on the system of checks and balances directly influences researchers' incentives to invent by impacting the societal view of obtaining software patent rights, which can thereby increase the rewards of the patent system, resulting in increased industry investment in expensive software development.^{104, 105} The patent system benefits the field of Artificial Intelligence by incentivizing the increased discovery and disclosure of novel inventions, which decreases the time it takes for inventions to become commercially available.^{106, 107, 108}

Further, the patent system is driven by the incentive to invent as supported by the Dominant Economic Theory. Under this theory, the profits derived from patenting inventions induce inventors to vigorously pursue patentable inventions, resulting in an increased number of inventions reaching the public more quickly.¹⁰⁹ The speed at which novel inventions become commercially available is directly proportional to the Artificial Intelligence industry's ability to provide high quality and innovative software by the use of Machine Learning and Deep Learning software patents.¹¹⁰ Therefore, the patent system is essentially becoming the driving force governing the stimulation of novel software inventions in the Artificial Intelligence field.^{111,112}

The Quasi-Judicial Jury

By virtue of the increase in the standard of review on appeal to "clear error" in *Teva*, the District Court's role in the interpretation of claims during claim construction has arguably become that of a "quasi-judicial jury."¹¹³ This is similar to the traditional jury system because the generalist knowledge of the District Court judge is analogous to the generalist knowledge of the jury. In contrast to the generalist knowledge possessed by the District Court judge, the Federal Circuit has a more specialized knowledge of the law. The relationship between the District Court and the Federal Circuit is similarly analogous to traditional jury systems where the judge must review the jury's decision for clear error, as the jury is made up of one's peers and does not necessarily have expertise in the matter at issue. Although the District Court is an expert generalist in many different fields, it is less specialized in patent law compared to the Federal Circuit, and thus the District Court acts as a "quasi-judicial jury." This "quasi-judicial jury" prevents the Federal Circuit from interpreting patent law in a way that would stray too far from other legal fields.

The impact of this heightened standard of review for factual questions is that the Federal Circuit is unable to make changes to the facts of claim construction unless there is a "clear error." Arguably this leads to an increase in certainty at the cost of accuracy.^{114, 115} This increase in certainty reflects the loss of the experience of the more specialized Federal Circuit judges in interpreting the claims.¹¹⁶ However, this increased level of certainty is due

to the decreased reversal rate on appeal. This results in less detrimental reliance by both parties as they refer to the results of the claim construction.¹¹⁷

When determining the impact of the Federal Circuit's influence over the generalist District Court, it is important to compare the institutional competencies of the District Court and the Federal Circuit. While the District Court is closer to the facts, as it is the body that develops the record, the Federal Circuit has the benefit of experience in claim construction and has the specialized knowledge for interpreting patent cases accurately.

Arguably, the District Court is able to provide a clear and better-rounded interpretation of the patent claim as it applies to society because the District Court is well-versed in a variety of laws. The District Court is better equipped to understand the real-world impact of technology as it applies to the other fields of law, such as contract disputes, property rights, and privacy law.

In sum, claim construction exemplifies a procedural difference between patent law and other laws that rely on the Federal Rules of Civil Procedure by not requiring a jury for factual questions. Additionally, this interpretation of claim construction brings to light the trend of balancing the specialized experience of the Federal Circuit against the generalist expertise of the District Court in interpreting patent law claims in a similar fashion as that used in other legal fields.

Conclusion

The specialization of the patent law system, in having both generalized and specialized courts review the cases, allows for a holistic balance of specialized and generalized legal knowledge. The generalist District Court remains close to the facts of the case as it develops the record, which allows for the broad application of law and makes for a clear understanding of how the legal issues present themselves in the case without oversaturating it with the technical issues that often dilute the merits of a patent law case.

The Supreme Court has fashioned an additional balance to ensure that the strict and accurate interpretation of the law is Constitutional and relates back to the societal purpose of patents, "to promote the progress of science and useful arts."¹¹⁸ Furthermore, as there cannot be sufficient progress in the field of patent law by relying simply on expert knowledge, the generalist district court has been granted this power by the high court to assist in that progress through its ability to see the impact of particular cases not only on the patents at issue but also on society as a whole. The Supreme Court has thus allowed judges who have gained experience and understanding from various legal fields to play a vital role in the development of patent law.

On the other hand, the Federal Circuit has specialized knowledge and can provide a stricter interpretation of the

law as it applies to technology when needed. Its expertise allows the Federal Circuit to determine when the generalized court has gone too far beyond mere creativity and has misinterpreted the patents. The Federal Circuit provides predictability and accuracy in overseeing the lower courts.

In sum, there is a balance between generalization and specialization as a patent is interpreted by the generalist District Court, appealed to the specialized Federal Circuit, and finally holistically reviewed by the generalist Supreme Court. This system of checks and balances allows for comprehensive understanding of technical details that is balanced against the general application of law and societal impact.

Although there are times when the generalized and specialized courts have independently interpreted patent law in a way that had detrimental effects on the public, as a whole the balanced system allows for different levels of expertise at various stages of litigation. It is clear that the patent review system protects against both overly generalized and overly specialized points of view.

Thus, the Supreme Court's decisions in *KSR* and *Teva*, and the Federal Circuit's holdings in *McRO* and *Amdocs*, shed light on the positive impacts of the varying levels of specialization within the patent appellate framework of Article Three courts, and on how this framework supports the industries that rely on Artificial Intelligence in making more informed business decisions, incentivizing innovation, and developing high-quality Artificial Intelligence. The checks and balances provided by the courts in a patent suit pathway thus promote efficiency in the improvement of technology in the Information Age.

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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/BLSCcommittees.

Report from the Section Chair

The Business Law Section's calendar features three major events: the Fall Meeting, usually in October; the Annual Meeting together with the full Bar Meeting in January; and the Spring Meeting, which this year was held on May 29. At this year's Spring Meeting in New York City there were presentations by several of our committees on hot topics in Franchise, Bankruptcy, Insurance, Mergers & Acquisitions, Securities, Banking, Technology and Venture, and Ethics.

On February 28, we had a program that I hope will become a regular event for the Section. It was called "Beyond Inclusion: Diversity and Mentoring in the Legal Profession," and featured two panels, including Hon. George B. Daniels of the U.S. District Court for the Southern District, and Hon. Milton A. Tingling, County Clerk of the N.Y.S. Supreme Court for New York County, talking about the value of mentoring to their professions, their own mentoring of younger lawyers and steps law firms and other offices can take to use mentoring as a means of going from diverse hiring to a greater depth of inclusion of minority lawyers. The program was the brainchild of Anthony Fletcher, the chair of the Section's Diversity Committee, and hosted by Goodwin Procter.

Finally, this spring, we saw an example of the Section's participation in the legislative process, part of our mandate to have a voice and contribute our expertise to the improvement of laws in New York. In late 2018, the Elder Law and Special Needs Section of the NYSBA forwarded a draft amendment to the New York State Banking Law to support actions by banks to prevent financial exploitation of vulnerable elderly persons and persons with special needs. The members of our Section who reviewed the draft agreed that the law was beneficial and necessary to allow banks to do the right thing, but that it needed revision in some places. Over the next several months the Banking Law Committee, chaired by Tanweer Ansari, and aided by the time, efforts and expertise of Jay Hack, often working under tight deadlines, was able to work out changes that were acceptable to both sections. On May 2, I sent a letter to the ELSN Section reporting that the Executive Committee of our Section had voted to approve the text of the proposed amendments, and authorizing them to communicate that to the NYSBA Executive Committee for their determination whether to adopt the proposal as a legislative proposal of the Bar.

I will echo here what I said in my last report. If you have been involved in the work of the Section, we thank you. And if you are not involved yet, we need you.

Peter W. LaVigne, Chair

Banking Law Committee

The Banking Law Committee met on January 16, 2019, in conjunction with the Annual Meeting of the NYSBA at the New York Hilton Midtown. The Committee discussed Community Reinvestment Act (CRA) Reform led by Warren W. Traiger, Esq. of Buckley Sandler LLP, New York, NY. Subtopics included enthusiastic conversation on:

- Prospects for a Facelift of CRA as It Enters Its Fifth Decade
- OCC's Revised Policies and Procedures Manual
- OCC Stands Alone: Breaking 40 Years' Practice
- The Advance Notice of Proposed Rulemaking (ANPR): OCC CRA Reform Recommendations
- Preliminary Overview of ANPR Comments

The latter portion of the meeting revived previous discussions and stimulated new ones regarding data privacy and protection, which continues to be an area of primary concern in the banking world currently. Anna Rudawski, Esq. of Norton Rose Fulbright, New York, NY covered:

- The EU's General Data Protection Regulation (GDPR)
- The New California Consumer Privacy Act and How This Law Will Bring the E.U. Approach State-side
- Opportunities and Challenges that Come with Monetizing Data in This New Regulatory Climate

And lastly, this meeting marked the last Banking Law Committee Meeting I will be chairing. It has been an extremely quick and exciting period of time for me chairing this group of professionals in the various debates we've had. Scott Wortman of Blank Rome, New York, New York is the new chair effective June 1, 2019.

Tanweer Ansari, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee met 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 presented a CLE seminar entitled "2018: The Bankruptcy Year in Review." The feedback on the presentation was positive, and the attendees engaged in a spirited discussion with the panelists. The Committee met again on May 29, 2019, at the Business Law Section's Spring meeting. Neil Ackerman, Esq. of Ackerman Fox, LLP, spoke on "Liabilities of Individuals for Their Business's Debts." The presentation covered a review of the circumstances under which stockholders, officers, directors, members or partners of a corporation, LLC or LLP can be held personally liable for debts owed by the business. The presentation was well-attended and received.

Matthew Spero, Chair

Business Organizations Law Committee

I am honored to have had the opportunity to serve as the Chairman of the Business Organizations Law Committee since its formation last year. As a new committee, we are continuously seeking to expand and enhance our programs. 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 2018 at the Spring Meeting with a discussion surrounding the effects of new tax laws featuring a panel of respected professors and tax advisors to 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. In April, we presented at the Business Law Basics program, advising newer lawyers on the importance of choice of entity structure and what documents to have in establishing a secure foundation for all other legal processes.

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 and beyond.

Matthew Moisan, Chair

Derivatives and Structured Products Committee

The Derivatives and Structured Products Committee has had a busy year so far. We have had three CLE meetings since January. The first meeting was on the topic of the U.S. QFC Stay Rules and 2018 ISDA Resolution Stay Protocol and was hosted by Goodwin Procter, LLP. This was very timely because the compliance dates have begun to phase in and there was still confusion in the market on how covered entities would comply with the regulation. We also had a two-part series held over two months on clearing. The first meeting held in March was entitled “Cleared Derivatives Part 1: Introduction to Clearing” and Part II held in April was: “Legal Issues, Clearing.” Both of these meetings were hosted by Sullivan & Cromwell and assisted by lawyers from Bank of America and JP Morgan. The meetings were very well received and attended by committee members. In each case the law firm provided lunch and CLE. We are as always very grateful for the continued participation and support of our law firm partners for their time and effort in coordinating with their security and CLE departments in the preparation of materials, and in hosting lunch.

Rhona Ramsay, Chair
Ruth Arnould, Deputy Chair and Chair-Elect

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 2019 legislative session. The Committee participated in Section discussions on topics of interest for possible further development. The Committee continued to work closely with NYSBA’s governmental relations staff and to maintain contact with counterpart committees in other Sections. Bills monitored by the Committee included voidable transactions, public authorities, not-for-profit corporations, corporate practice of licensed professions, and financial transactions involving the elderly. The Committee welcomes suggestions and input

from all Section members, especially for help in planning for the next Legislative session.

Mike de Freitas, Chair

Mergers and Acquisitions Committee

The Mergers and Acquisitions Committee of the Business Law Section met at the New York Hilton in January for a panel discussion on M&A in cannabis-related businesses. Lawyers servicing this growing industry and industry investment bankers, investment professionals and data analytics experts conducted a lively panel. The Committee next met at the Section’s Spring Meeting in May to present a panel discussion on cross-border M&A. This panel addressed key legal, tax and business considerations for successful closing of a cross-border investment involving U.S. targets. James Rieger of Tannenbaum Helpen Syracuse & Hirschtritt LLP is the current Chair of the Committee. The Committee is happily accepting new members and welcomes ideas and suggestions for future programming. James can be reached at Rieger@thsh.com.

James Rieger, Chair

Membership Committee

As membership transitions to a new chair, this is a brief recap of some current past activities and initiatives recently shared with the Executive Committee.

- Update on recent initiatives to liaise with law students:
- In-person presence targeted law school events (e.g., Hofstra) for physical presence of the section at meet-and-greets, with different committees represented, such as Banking, Franchise, and Securities Regulation;
- In-person presence at Pathways to Profession and Diversity presentations (e.g., Cardozo), provided membership materials and direct pitch to attendees;
- Continued work with NYSBA staff for future scheduling at law schools after the summer break.

What’s behind this: Membership numbers are skewing slightly higher on the younger side. We believe that measures to introduce the Business Law Section at the start of careers will continue to bear fruit in the form of continued membership throughout an attorney’s career.

Update on use of NYSBA staff and resources for marketing:

- Staff identifying individuals within the Section interested in outreach and membership development (to combine with law school outreach efforts);

- Joint development with staff and Section Chair to identify “draws” and develop script for marketing plan; and

- Continued identification by staff to target other Sections with allied interests to coordinate shared CLEs and events to draw in members from similar Sections.

What’s behind this: Membership surveys show that connectivity is valued by many members. The Business Law Section’s ability to offer personal connections, professional resources, and networking are strengths that should be leveraged for membership growth.

Finally, this is an introduction to our new chair, Jessica Parker. Jessica brings a wealth of experience—some of you might know her from these pages already—and has tremendous ideas to increase section membership.

Carol Spawn Desmond, Chair

Not-for-Profit Corporations Law Committee

At our committee’s meeting as part of the Association’s 2019 Annual Meeting, we once again presented a CLE program in collaboration with the Attorney General’s Charities Bureau. The room was packed, and the program was very well-received. James Sheehan, Charities Bureau Chief, was our featured speaker. In addition to Charities Bureau Chief Sheehan, Assistant Attorney General Linda Heinberg presented on the work of the Charities Bureau Transactions Section. In coordination with the Association’s Deputy General Counsel and the Business Law Section’s Legislative Affairs Committee, our committee continues to monitor proposed amendments to the Not-for-Profit Corporation Law.

David Goldstein, Chair

Public Utility Law Committee

The Committee on Public Utility Law provided two CLE presentations in the first half of 2019. On January 16, 2019, Committee Chair George Pond gave a presentation entitled “What’s New in Public Utility Law” at the Bar Association’s Annual Meeting in New York City.

On May 2, 2019, the Committee presented a full-day program on public utility law at the Bar Association’s offices in Albany New York. 119 people registered for this event, which seemed to be well received by those in the audience. An on-demand webcast of this event is available at <https://nysba.ce21.com/guestbook/2242683>.

George Pond, Chair

Securities Regulation Committee

- January: William J. O’Brien from the Complex Litigation and Trials group at Skadden, Arps, Slate, Meagher & Flom LLP discussed several of the most significant securities litigation decisions from 2018, including the impact these decisions might have on practitioners and courts in 2019 and beyond. Collin Rose, Esq. and Mina Chang, Esq., also of Skadden, joined as speakers.
- February: The Private Investment Funds Subcommittee held a discussion with the SEC’s Division of Investment Management on Initiatives Impacting Private Funds. Speakers included Paul Cellupica, Chief Counsel of the Division of Investment Management, and Jennifer Songer, Branch Chief of the Private Funds Branch. The full committee also met in February. Ben Chivers, of Travers Smith LLP, London, and Jeffrey Berman, of Clifford Chance LLP, NYC, discussed recent Brexit related topics.
- March: Mirella deRose, Russell Johnston, Richard Margolies, and Michael Watling of King & Spalding, LLP, NYC discussed FINRA’s 2019 priorities and emerging concerns. Kenny Clowers and Jim Diercksen of ACA Compliance Group provided a current overview of the SEC Examination Priorities for registered investment advisers and shared some detail on current examinations including, among other things, unique document requests and recent issues identified by the staff.
- April: Tyler Rosen, of Skadden, Arps, Slate, Meagher, & Flom LLP’s political law practice provided an overview of the regulation of pay-to-play and procurement lobbying.
- May: The committee met at the Business Law Section Spring Meeting. Peter LaVigne and Meghan Spillane of Goodwin Procter and Jorge Tenreiro of the SEC addressed steps in the evolution of digital assets, coins or tokens as securities under the securities law.

Anastasia Rockas, Chair (by Kelley Basham)

Technology and Venture Law Committee

No report submitted.

Christopher Edwards, Chair

Welcome New Section Members

The following members joined the Section between January 1 and August 26, 2019:

FIRST DISTRICT

Alexander W. Barnett-Howell
Jennifer Rebekah Lynn
Bergenfeld
Jon-Paul Andre Bernard
Abigail Bertumen.
Ran Bi
Jessica Marie Blakemore
Spencer Brachfeld
Christopher W. Burden
Philip L. Cody
Jennifer Collins
Joseph Archie Crowley
Samuel Y. Davidson
Vivian Rose Depietro
Kyle E. Djurovic
Alexandria Dolph
Caroline Kathryn Eisner
Ross Jay Fiedler
Arthur E. Flynn, Jr.
Sheri Gev Graniero
Lee J. Hirsch
Boyoung Hyun
Danny Jiminian
Tarnetta Vashon Jones
Ken C. Joseph
Michael Evan Kar
Karolina Katsnelson
Calvin Ketchum
Maira Khamisani
Daniel James King
Laurin Blumenthal Kleiman
Hindy Korenblit
Steven R. Lapkoff
Lucy Qianwen Liu
Paula Sue Lowitt Call
Robert J. Lum.
Michael H. Martuscello
Patrick A. McGlashan
Shannon Patricia McNulty
Shunsuke Mitsumoto
Diana Theresa Mohyi
Sanjana Nafday
Christina Ngyyen
Hayley Nivelle
Miya T. Owens
Ernest T. Patrikis
Breton Harris Permesly
Neil A. Quartaro
Gunjan Rekhi
Timothy Matthew Rezendes
Jacob Pete Richards,
Maria Sylvia De Toledo Ridolfo
Neil C. Rifkind

Seyed Mohsen M. Rowhani
Andrew Ross Rubin
Stephen Semian
Xiaoye Shepardson
Meryl P. Sherwood
Jacob Gregory Shulman
Philip M. Sivin
Matthew Scott Smith
Alec David Smith
Juan D. Soto
Melissa Louise Steinberg
Howard Suckle
Jeffrey D. Symons
Joseph Szydlo
David L. Tsin
Gaurav Vasisht
Maria Velasco Zamudio
Teresa M. Venezia
Julia Von Turk
Stuart Andre Warner
Marissa Julia Welner
Satoru Yoshioka
Qi Zhang
Xuanyu Zhuang

SECOND DISTRICT

Mirella A. deRose
Edmund T. Donovan
Anna Elzbieta Florek-Scarfutti
Daniel Paul Fraser
Jaklin Guyumjyan
Michael Haber
Marc Muneer Kassib
Brian P. Lanciault
Brian Matthew Mulcahy
Alex W. Nordholm
Joseph Poggioli
Arrohon Rosskamm

THIRD DISTRICT

Kelly Busch
Mark P. Cawley
Bria J.M. Cunningham
Greg Kiley
Kendra C.J. Rubin

FOURTH DISTRICT

John T. Judd
Charles V. Wait, Jr.

FIFTH DISTRICT

John R. Clark
Daniel S. Jonas
Ian Sheldon Ludd

Ryan G. Redden
James E. Sparkes
David S. Tamber
Danielle Patricia Wilner
Tracy M. Wittenburg

SIXTH DISTRICT

Bruce J. McKeegan
Carrie A. Wenban

SEVENTH DISTRICT

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Bartholomew Chacchia
Aaron M. Gavenda
Andrea Interlicchia
Alson James McKenna
Kevin R. Pregent,
Tyler Wilson

EIGHTH DISTRICT

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Jia-Chir Chiu
Ricky Luthra
Carrie Rhea McElroy
Robert P. Merino
Thomas C. Pares
Natasha Prasad
Tammy L. Riddle
James Zawodzinski, Jr.

NINTH DISTRICT

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James H. Bathon
David Chambers
Marcello A. Cirigliano
Geraldine Cunningham-Sugrue
John M. Daly
Nancy Durand
Eric Esquivel
Todd K. Garvelink,
Hon. Craig E. Johns
Richard B. Margolies
William Daniel Marsillo
Mossi Myriam
Gregory Neilsen
Melissa Munoz Patterson
Mark Smalec
Douglas S. Trokie
Enrique Vargas
Camele-Ann D. White
Anthony Zitrin

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Timothy Clark B. Dauz
Laura M. Dilimetin
Nicole Marie Duggan
Maria Famiglietti
Krupa Golakiya
Kevin T. Hamilton
Suzanne Hassani
Summer Henrikson
Matthew Hettrich
Mikel J. Hoffman
Shamara Ramona James
Jerry Lagomarsine
Adam H. Lelonek
Carlee Litt
James M. Medwick
Maxwell Michael
Matthew Migliore
Robert M. Morgillo
Rebecca Paredes
Corrado Pulice
Yeu Ting Riess
Eric James Seltzer
Stephanie L. Tanzi
Panagiota B. Tufariello
Raymond Ude

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Francesco Catarisano
Barbie Paiyin Hsu
Jingyi Huang
Tural Khalilov
Ivan Lapikov
Hilary Hou Chi Lee
Alexandra Lopez
Johnny Nguyen
Violet E. Samuels
Jacob Evan Solomon
Stefanie Stannard

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Wadih El Riachi
Brian Palacios
Dara N. Smith

THIRTEENTH DISTRICT

Joseph W. Antonakos
Michael Reneo
Rasica Selvarajah

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NEW MEMBERS: OUT OF STATE/COUNTRY	Can Cui	Haifeng Hong	Ivan Alberto Prospero,	Scott G. Waldman
Teerin Vanikieti	Benjamin C. Curcio	Agata Edyta Jakubczak	Valentijn Nicolai Punt	Jiawan Wang
Mayss Mazen Hani Akasheh	Nicola Dean	Sarah Kadhum,	Tian Qiu	Ruoya Wang
Samantha Tilipman Alexander	Marc Diab Maalouf	Scott H. Kaiser	Stephen Mark Raicek	David Yangli Wang
Max Alles	Maria Fernanda Diago Romero	Matthew Kane	Faize Rasul	Alexa Warford
Farah N. Ansari	David Michael Dunne	Joshua A. Kaplan	Clifford A. Rathkopf, Jr.	Warren Yong Wen
Rukayat Ashogbon	Mahmoud Ezz	Jason Ezra Kolman,	Steven S. Rogers	Siyasanga Batandwa Wotshela
Sara Aziz	Michelangelo Fasoli	Wing Yee Lau	Gersende Marie Lucie Rollet	Ke Xu
Charles Blannaru	Jeffrey A. Fiarman	EunJu Lee	Michael Luigi Rosella	Tianran Xu
Stuart R. Blatt	Alexander P. Fraser	Erich Sanbeck Lee	Jonathan Ross	Yelu Xu
Richard J. Bohorfoush, Jr.	Tabata Elena Freitez-Arteaga	Shu-Ya Liu	Auriane Mathilde Marie Roussel	Hideki Yashiro
Maria Grigorievna Borodina	Pia Aarestrup Friis	Mark Loevinger	Osaid Saad	Colleen Olivia Yorke
Sylvie Bourdeau	Jamie Mariko Fukumoto	Maria Jimena Londono Ferrer	Timothy Saviola	Masashi Yoshino
Maria Salome Breen	Ahmed Magdy Galal	Colleen Mallon Casse	Arie Scharf	Weijian You
George Brencher IV	Zhe Gao	Ilya Mamin	Geunhak Shin	Kelin Zhang
Brandon Brown	Shawn Michael Garry	Shinsuke Matsumoto	Kei Shirakawa	Lingjun Zhang
David Buchalter	Ivane Gogelia	Jenny Dorothea May	Shanon Slack	Venera Ziegler
Gregory Aldon Buxton	Zachary Goldig	Laura Beth McCaskill	Bonnie Lee Smith	
Mathias Cabour	Jeremy Franklin Goldstein	Albert L. Mitzner	Gautham Srinivas	
Pietro Calzavara	Geraldine J. Gonzalez	Ambica Mohabir	Dr. Stefan Sulzer	
Lillian Andrea Cardona	Kiel Buchanan Green	Michael Moono	Yosuke Taguchi	
Wing Ki Chan	Marianne Guery	Katelin Ann Morales	Bogdan Y. Tereshchenko	
Dora Wing Lam Chan	Jingqiang Charles Guo	Alexandra M. Murdocca	William Tesler	
Lauriane Caroline Francoise Chauvet	Monique Anita Haynes	Sierra Murph	Navy Thompson	
Hung-yu Chi	Anqi He	Jordan Francis Murray	Mari Toriyama	
Sharil Ann-Marie Clarke	Clara Elizabeth Henderson	Kazumasa Nagayam	Mitsukuni Tsunoda	
William G. Clowdis, Jr.	Michael Henry Herman	Jesus Agustin Noriega Loya	Fadia Tuma Antunes	
Thomas Edward Colvin	Luis A. Hernandez-Situ	Akika Nose	Christi L. Underwood	
	Yoshinori Hirai	Oluwadamilola Omotunde	Carolina Urso Furquim Leite Casella	
	Ping Ho	Ifeoma Chinyere Ozomah	Michele Vangelisti	
		Pedro Pais De Almeida		
		Malcolm Peck-McQueen		

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