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NY Business Law Journal



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



The *Journal's* Milestone Issue: Reflections on the Occasion
Stuart B. Newman

Updates from the SEC
Guy P. Lander

How Sausage Is Made: The Latest Judicial Takes on Privilege and Work Product
C. Evan Stewart

The Terrifying New York Definition of a Franchise
Thomas E. Pitegoff

The *Journal's* Milestone Issue: Reflections on the Occasion

By Stuart B. Newman

This issue marks the 25th anniversary of the *NY Business Law Journal*. When we began publication in 1996, the concept and purpose of the *Journal* was to provide timely and practical information on topics of interest to business practitioners in New York State, free of charge to members of the Business Law Section as an additional membership benefit.

Over the past 25 years and some 50 issues, hundreds of articles have appeared covering recent caselaw, new legislation, practice tips and practical suggestions, ethics, developments in business and in business transactions and trends affecting business practitioners and their clients. A compendium of articles that have appeared in the *Journal* over these first 25 years will be included in the next edition.

Judging from feedback received by the authors of articles appearing in the *Journal* and from surveys conducted by NYSBA and the Section, the *Journal* has thus far fulfilled its mission and is widely recognized as one of the most important tangible benefits of Section membership. The success of the *Journal* is due entirely to the commitment and support of a number of indispensable institutions and individuals who have contributed to its success.

The *Journal* is published twice each year by the Business Law Section of NYSBA, which finances publication costs out of the Section's budget, in cooperation with Albany Law School. The law school provides research and editorial support through its faculty and students. The Section is extremely grateful to the law school for its collaborative efforts and for the opportunity to introduce its students at an early stage in their careers to the activities of, and the importance of membership in, NYSBA.

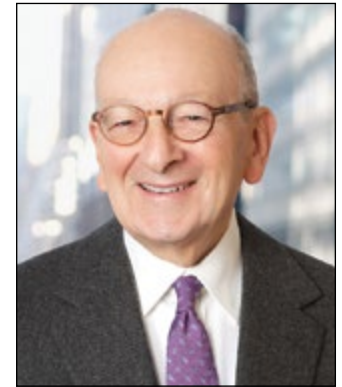
Albany Law School's Prof. James D. Redwood has shouldered the editorial burden of the *Journal* from the beginning, serving as editor-in-chief and currently as its managing editor. Simply said, the *Journal* would not be possible without the continued efforts and devotion Jim has provided to the publication of each issue over the last 25 years.

David L. Glass, former Chair of the Section, took over the responsibilities of editor-in-chief when I stepped down a number of years ago, and has worked hard to ensure content for each issue.

Production and distribution of the *Journal* has been the responsibility of NYSBA and its section publications staff, currently headed by Lori Herzing, with assistance from NYSBA's Gina Bartosiewicz who is its liaison to the Section.

In addition to these organizations and individuals, there would be no *Journal* at all without the pipeline of articles provided by those professors, law students and practitioners who supply manuscripts. To paraphrase the real estate industry, the three most valuable attributes for any publication are content, content, content. The Section deeply appreciates the contribution of articles from the many authors whose work has filled the pages of the *Journal* for the past 25 years. It is our intention to continue publishing articles that are topical, useful and of importance to business practitioners. This depends on keeping content flowing in that pipeline. Seeing your thoughts and words in print and sharing them with other practitioners in a lasting and meaningful way is its own reward. CLE publication credit for the authors is an added bonus. Please consider being a contributor to the *Journal's* content pipeline by submitting your thoughts on a business law topic to the *Journal*. The raw material for an article is all around you—recent cases of interest, new legislation of significance or important trends or developments in a trade or industry where you focus your practice. For example, you may have recently researched an issue for a client that could be developed into an article that would be of value to other practitioners. If so, let us have the opportunity to consider publishing your article.

If you have suggestions for improving the *Journal* and enhancing its value to the Bar, let us know about that as well. If you are not already an active member of the Section, please consider joining us and contributing to the Section's efforts to provide valuable resources and assistance to other business practitioners.



Stuart B. Newman

Stuart B. Newman is a member of the Business Law Section's Executive Committee. He was the founder of the *NY Business Law Journal* in 1996, and currently serves as Chair and Advisor Emeritus of the *Journal's* Editorial Advisory Board. He is a principal of Offit Kurman, P.A., concentrating his practice on M&A and other business transactions, general corporate law and commercial representation.

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New York State Bar Association
In Cooperation With
Albany Law School

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NY Business Law Journal

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Message from the Chair

Greetings to all readers and a special thank you for your interest in the *NY Business Law Journal's* celebratory anniversary issue of its 25th consecutive year in publication. This historic issue, including an eloquent preface from the *Journal's* founder and initial editor-in-chief, Stuart B. Newman, is proudly presented at a time when the *Journal* now ranks among the preeminent legal resources on the practice of business law in New York. Yet, as we celebrate the *Journal's* illustrious 25-year history, we do so against the backdrop of a challenging and momentous time in our nation's history.

The preceding year was singularly defined by the worldwide COVID-19 pandemic. On or about mid-March 2020, it became apparent New York City and eventually the state were to be the nation's initial epicenter of a rapidly fomenting and fatal worldwide pandemic. By year end, more than 30,000 New Yorkers lost their lives on account of COVID-19-related illness.

I mention this tragic backdrop only to emphasize that in spite of the ominous challenges faced by the New York State Bar Association and the dramatic impact the COVID-19 pandemic had on the personal and professional lives of our Section's members (including those members who live and work outside the United States), NYSBA remained well intact and, against all odds, the Business Law Section proved to have an incomparably successful 2020.

As technology proved to be the predominant means by which NYSBA functioned daily, the Section's ability to function improved. It actually became easier to organize, coordinate and view CLE programming with all attendees being online; the same was true with attending and participating in committee meetings and virtual networking events. Technology further eased the cost and complexity of marketing the Section's programs, activities, and initiatives to members and non-NYSBA members alike.

The proof is evident in the numbers. More than 30 CLE programs were organized and presented by the Section's committees during the pandemic period (mid-March 2020 through December 2020), all exclusively viewed by registrants online. One-third of these CLE programs were presented in direct response to COVID-19, whereby the agenda of the Section's leadership was to guide and facilitate the continuous practice of business law despite the devastating consequences of the pandemic. One such program, "The Stimulus Package Survival Guide: What Solos and Small Firms Should Know," had 997 registrants on the date it was broadcast online and has since been viewed from the Section's online archives by an additional 1,060 lawyers and other professionals.

The Section's analysis and submission of commentary to proposed legislative initiatives in 2020, whether in response to calls for overhauling the state's health code to permit mandatory COVID-19 vaccinations or determining which businesses should be classified by the state as "essential" (thus warranting special concessions under existing state law), served a dual purpose in the face of the pandemic – first, to ensure the collective expertise of the Section's members proactively responded to the public interest when advising on the evolution and impact of state law and, second, by upholding the Section's preeminent obligation to assess the scope, application, fairness, and efficiency of proposed laws to our state's businesses.



Anthony Q. Fletcher

In acknowledgment of the foregoing, which also evinced the Section's expanded role within NYSBA, the Section responded to the increased import of corporate-social responsibility during the pandemic by forming an ESG Committee and concurrently reformulating its Public Utility Law Committee by broadening its mission and renaming it the Energy and Climate Law Committee. As emerging trends in business law continue to develop, whether attributable to the pandemic or its residual effects, the Section's leadership has committed to survey the members' level of interest in forming additional committees (e.g., on Cybersecurity for Businesses and Consumer Protection Laws) to ensure the Business Law Section remains relevant, both to practitioners in business law and the business community in general.

Proudly, even at a time when the pandemic has forced many newly admitted and young lawyers to the brink of financial hardship, the Section has answered the call by broadening its Diversity Agenda to incorporate an online job placement and professional mobility program—available to NYSBA members, regardless of race or gender. Again, through leveraging NYSBA's technology platform, the Section's Diversity Committee launched an online portal for its longstanding Mentoring Program, affording a seamless means for experienced lawyers to counsel younger lawyers in managing professional hardship, while also mentoring them to be more proficient at retaining their jobs when new placements are sparse in number.

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HeadNotes

As this issue was going to press we are in the early days of the new Biden Administration. The president has signaled that his number one priority is to get control over the COVID pandemic. While the president was hoping for a bipartisan approach, at this writing the two parties are far apart and it appears that the Democratic version will be enacted without Republican support. Given the narrow margin in both Houses and the administration's many other priorities, as well as the impeachment trial of former President Trump in the Senate, significant new regulatory legislation in banking or other industries seems unlikely. Nonetheless, the new administration is expected to pursue more aggressive regulatory actions in areas such as finance and environment through the agencies themselves, reversing some of the deregulatory actions of the prior administration.

One area affecting business in which bipartisan support for new legislation seems possible is data privacy—members on both sides of the aisle agree on the need for federal privacy legislation, although there are still significant disagreements on details. To some extent, California has forced the federal government's hand with its enactment of the California Privacy Rights Act, which imposes additional privacy requirements on businesses that were already scrambling to comply with the state's Consumer Privacy Act that took effect earlier in 2020.

Also in the consumer protection area, the president is likely to reactivate the Consumer Financial Protection Bureau (CFPB), largely dormant under President Trump. As structured by a Democratic Congress under President Obama, the CFPB had a single director with plenary power to act; unlike other regulatory agencies (the SEC, CFTC, FDIC *et al.*) there was no bipartisan governing board. Furthermore, the director could not be removed by the president for 10 years except for cause—unlike Cabinet members and most other agency heads, who serve at the pleasure of the president. In a case last year, the Supreme Court held unconstitutional the law's provision denying the president the authority to fire the director at will, as violating the separation of powers between Congress and the Executive (while also ruling that this provision was severable, so the remainder of the law remains valid). So President Biden is free to install his own, presumably much more activist, director. Financial companies are likely to see a ramped-up level of enforcement, with more investigations and larger fines. Banks and other lenders are also likely to see more aggressive enforcement of loan forbearance provisions under the Coronavirus Aid, Relief and Economic Security (CARES) Act. Cooperation with state attorneys general in cracking down on abusive debt collection practices also seems likely (recall that President Biden's late son Beau at one time served as Delaware Attorney General).

Meanwhile, the scope of practical problems facing New York business attorneys in advising their clients continues to present their own unique challenges. Leading off this issue, Stuart Newman addresses one such problem that is likely to arise at some point in the cycle of representing a business owner: what happens when the owner has decided to sell. In an earlier article published in the *Journal's* Summer 2020 issue, Mr. Newman had discussed the reasons a business owner might consider selling even before she or he is ready to retire ("Is This the Right Time To Sell My Business?") In "Before I Sell My Business," he turns his attention to the preliminary planning that should be undertaken before an actual sale can take place—from assembling the team of advisors, lawyers and accountants, through identifying potential impediments to closing at an early stage, to tax and other considerations, he lays out a clear and comprehensive road map for attorneys who find themselves in the position of advising a client on the sale of a business. Mr. Newman, a principal with Offit Kurman, is Advisor Emeritus to the *Journal* and Chair of its Advisory Board.



David L. Glass

Next up are two timely and practical articles on two recent actions by the Securities and Exchange Commission, both aimed at making it easier for issuers to raise capital. Historically private securities offerings have been confined to "accredited investors" and "qualified institutional buyers (QIBs)," categories of investors that are deemed to be more sophisticated and thus not in need of the extensive, and expensive, disclosures and other protections required to sell securities to the public. In "SEC Expands Accredited Investor and Qualified Institutional Buyer Definitions to Allow More Participation in Private Offerings," Guy Lander reviews a number of changes aimed at expanding the definitions of "accredited investor" and QIB in order to identify other investors who may be considered sophisticated and thus eligible to participate in private offerings. Some of these are new; others codify existing SEC policy. The economics are compelling; as the article notes, in 2019 registered offerings totaled \$1.2 trillion (only about 30% of total offerings) as compared to \$2.7 trillion (nearly 70%) for exempt offerings. The article provides a clear and practical checklist for attorneys who represent issuers, as well as those who represent investors.

In the second article, Mr. Lander turns his attention to another aspect of exempt offering reform. In "SEC Adopts Rules to Improve the Framework for Exempt Offerings,"

he describes new rules adopted by the SEC to simplify and improve the framework for types of offerings exempt from SEC registration. The new rules are aimed at expanding access to capital for small and medium-sized businesses and entrepreneurs. The article clearly and concisely lays out an overview of the new rules, which liberalize the requirements for multiple different types of offerings. An especially useful feature is a table laying out an overview of the features of each type of exemption, as modified by the new rules. Mr. Lander, a partner in Carter Ledyard & Milburn, is a past Chair of the Business Law Section and a member of the *Journal's* Advisory Board.

Perhaps the best known and most litigated SEC rule of all, Rule 10b-5, is a powerful tool of redress for investors who are the victims of fraudulent practices in the offering and sale of securities. Attorneys who practice in this area have been creative in identifying new causes of action; a substantial drop in the price of a stock may well trigger a 10b-5 litigation, with shareholders contending that the drop in price resulted from some newly public information that was improperly concealed. With the growing emphasis on corporate ethics and codes of conduct, aggrieved investors are increasingly focused on potentially misleading statements in corporate codes and policies—including policies relating to, for example, sexual harassment. But a key element in a fraud case is materiality—the asserted misstatement must have been material, and not mere “puffery.” In “Material or Puffery? Avoiding Securities Fraud Exposure Based on Corporate Codes and Statements of Policy,” Joseph Rossello takes the reader through a series of recent cases which address this issue. Concise, clearly written, and thoroughly researched, the article is required reading for any attorney who advises public corporations in the development of internal codes of conduct and corporate policies. Mr. Rossello is a candidate for the JD degree at Touro Law School.

Another area in which entrepreneurs are getting a boost is the internet. One of the SEC reforms noted by Mr. Lander (see above) is a dramatic increase, from \$1.3 million to \$5 million, in the amount of capital a small business can raise in a given 12-month period over the internet through “crowdfunding”—a means of raising money from small investors without registration, usually over the internet. In 2019 the *Journal* published an article by Kei Komuro that analyzed the issues entrepreneurs need to address when contemplating raising capital through crowdfunding. In this issue Mr. Komuro turns his attention to another concern for entrepreneurs in using the internet. In “Compliance Problems in Website Accessibility and Implications for Entrepreneurs,” Mr. Komuro notes that by 2018 some two-thirds of all small businesses had established a website. With the challenges posed by the coronavirus and lockdown, the need for a business to market online is even more compelling. Mr. Komuro lays out, in clear and logical sequence, the issues that a business contemplating a website for the first time needs to consider—from choosing a name that avoids

copyright issues, to the proliferating privacy rules such as the new California Consumer Privacy Act (CCPA) that mandates care in the use of customer data, to the need to assure access to disabled persons under the Americans With Disabilities Act (ADA). Any attorney who advises small businesses will find this article an invaluable guide and checklist in guiding her client to a successful website launch. Mr. Komuro is a student at Fordham Law School; in 2020 he took second prize in the Business Law Section’s annual law student writing competition for his 2019 crowdfunding article.

The interplay of attorney-client privilege with the attorney work product doctrine has been an ongoing source of confusion among lawyers, clients—and the courts. In “How Sausage Is Made: The Latest Judicial Takes on Privilege and Work Product,” C. Evan Stewart notes that as tricky as it may be to litigate these issues if the process has been properly handled, if it is not properly handled it is “asking too much to expect a court to do somersaults to misapply the law to help you and your client out of self-imposed jams.” To illustrate the point, he takes the reader through three recent federal cases, showing the pitfalls that companies and their lawyers may create by not properly handling work papers and other documents from the outset. The result may be the loss of the attorney-client privilege or a ruling that the work product doctrine does not protect against disclosure. For example, the work product doctrine generally only applies if the work product is prepared in contemplation of litigation, and if it expresses a legal opinion and not merely a recitation of facts. Mr. Stewart is a partner in Cohen & Gresser LLP; his writings on legal ethics issues are a longstanding and invaluable feature of the *Journal*.

For nearly 10 years the *Journal* has been proud to partner with the attorneys at Skadden Arps in publishing their invaluable “Inside the Courts,” an exhaustive compendium of business and securities law cases currently pending in the state and federal courts. Each case is described in a succinct summary, designed to alert the reader not only to its status, but more importantly to its potential significance for business attorneys and their clients. It is an invaluable tool, and the editors are grateful as always to the attorneys at Skadden for sharing their knowledge and experience with us.

Business attorneys in New York may well find themselves surprised to learn that the state’s franchise law applies to business arrangements that one would not normally think of as franchises. In “The Terrifying New York Definition of a Franchise,” Thomas Pitegoff explains how the New York Franchise Sales Act (NYFSA) “is a trap for the unwary.” A business lawyer advising his client regarding a marketing agreement, or a trademark licensing agreement, may be inadvertently giving “ammunition to an aggrieved licensee” or inviting prosecution by the state’s attorney general, if due consideration has not been given to complying with the NYFSA. The problem is that

most state franchise laws, and the Federal Trade Commission's franchise rule, define a franchise in terms of three elements: a fee, a trademark, and a marketing plan prescribed in large part by the franchisor. The NYFSA, by contrast, has only two elements: a fee, and either a trademark or a marketing plan. As a result, Mr. Pitegoff explains, the NYFSA can catch arrangements that would not normally be thought of as franchises. He argues for a revised definition that will avoid inadvertently creating problems for these business arrangements. Mr. Pitegoff, a principal with Offit Kurman, is currently treasurer of the Business Law Section and a past Chair of its Franchise Law Committee.

A contract should mean what it says, and the words in a contract matter. These principles seem obvious, even tautological. And yet the unwary attorney may find herself in a position where a court negates the intended meaning of the contract, unless she has been very care-

Message from the Chair

Continued from page 3

Notwithstanding the pandemic, the Section pressed forward and advanced its 2020 agenda, albeit modified to account for the inability of members to meet in-person for CLE programs, committee meetings, and networking events. Despite NYSBA's prudent prohibition on conducting Section business in-person, the Section's completion of more than 20 CLE programs with record attendance by mid-August 2020 prompted NYSBA to grant Section members the courtesy of attending CLE programs thereafter at no cost. Indeed, this courtesy shall continue through the end of May 2021, provided the Section continues as NYSBA's exemplar of successful CLE programs and networking events. This unique "value-added" benefit to membership in the Business Law Section should, by itself, motivate many to renew as Section members or join now if heretofore a non-Section member.

On balance, the marvel of the *NY Business Law Journal's* 25-year anniversary, and this celebratory issue's publication in the midst of the worldwide COVID-19 pandemic, are likewise illustrative of the Section's commitment to excellence in all, regardless of the challenge at hand. The scholarly articles herein and the artful publication hereof evidence this very fact. No doubt just the same the Section shall continue for another 25 years to ardently support and patronize what is to many its most cherished resource.

**Godspeed,
Anthony Q. Fletcher
Chair, Business Law Section**

ful in the choice of wording. In "I Meant What I Wrote, and I Wrote What I Meant," Robert Kantowitz describes a recent case in which the court effectively disregarded the plain words of a real estate contract, boilerplate though they may be, in favor of "the dubious doctrine of 'C'mon, this is the way everyone does it.'" He shows how the application of this "dubious doctrine" can lead to absurd or unreasonable results. Most importantly, he demonstrates how the parties could have avoided the issue altogether by the simple expedient of tailoring the contract to more explicitly express what the parties intended. Mr. Kantowitz, an attorney, investment banker and tax advisor, practices through his firm, Sandburg Creek LLC in Lawrence, N.Y.

**David Glass
Editor-in-Chief**



Business Law Section

Virtual Events

For decades, volunteers have been developing and presenting seminars, preparing rich collections of written materials and raising the bar for legal practice in New York. We're happy to provide continuing education programming and events for our Section members, and hope you will join us as we continue to add more to our schedule.

Visit [NYSBA.ORG/BUSINESS](https://nysba.org/business) and click on "Upcoming Events" tab for more info.



Take a look at what's coming up next...

OFAC Sanctions: Recent Regulatory And Enforcement Trends From Treasury And The SEC | April 21, 2021
11:30 a.m. – 12:30 p.m. | 1.0 MCLE Credit

Cross-Border Bankruptcy Issues Facing Foreign Transferees
May 19, 2021 | 11:30 a.m. – 12:30 p.m. | 1.0 MCLE Credit

Save the Date! Business Law Virtual Spring Meeting
May 20, 2021 | 1:00 p.m. – 5:00 p.m. | More information to come!

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Before I Sell My Business

By Stuart B. Newman

In a previous article this author suggested that there are strategic and financial reasons why the owner of a successful business today should consider the advantages of selling that business long before arriving at that stage in life usually associated with a decision to sell, i.e., retirement plans or health considerations. This article focusses on making sure that when the owner is presented with the opportunity, and is ready to accept it, all preliminary steps will have been taken by the owner and by the business to execute that exit plan expeditiously and with a minimum of unexpected hurdles and delays. Timing is everything in the world of M&A, and once a sale transaction is put in motion delays can be costly, or even fatal to the transaction.

Assembling the Team

When an owner has decided that the time has come to sell his business, the very first step should be to assemble his team of advisors. In some instances, identifying a strategic buyer who would be interested in discussing a purchase may be fairly easy and obvious for the owner without any outside assistance—a long-term competitor, a vertical business relationship (vendor or customer), etc. However, an independent advisor, someone with M&A and current market investment banking experience, is an invaluable asset to an owner who has never gone through a sale process. Retaining an investment banking advisor will add value to the transaction, open the doors to a wider field of competitive buyers, and provide insight regarding current valuation metrics, current M&A trends and negotiating tactics.

The owner should also make sure that the attorney who will represent him in the transaction has solid and current M&A expertise to negotiate the purchase agreement to the maximum advantage and protection of the seller. The owner's long-term business attorney and loyal friend surely has an important role to play in the transaction, but if that attorney does not possess significant and current experience with private equity or similar types of transactions, an attorney who does should be engaged at the earliest stages to guide the owner to a successful closing.

The third and equally important member of the seller's transaction team is the business' accountant. Although a successful business owner may have a long and loyal relationship with an accountant who has been coming in, usually quarterly, for tax filings, doing a great job over the years, the sale of the business is a one-time event that requires a different set of skills and a deeper dive into the financials. A buyer is likely to ask questions that have probably not been asked before. This new

scrutiny of both the business' balance sheet and earnings statements may need the extra assistance of an accountant capable of responding to this higher level of financial statement scrutiny, of anticipating questions about the quality of earnings, balance sheet questions regarding asset valuation and depreciation, and handling tax-related questions.

Know Thyself

The first task of the investment firm engaged by the owner is to understand, fully, the business being sold, not only the express nature of the business—what it is selling and to whom-- but the strengths and weaknesses, some of which may not be obvious at first glance. A "book" on the business, in the form of a Confidential Memorandum, has to be written as an indispensable marketing tool. Writing that book is usually a great opportunity to flush out the reasons that underlie the real value and future potential of the business, as well as to get a head start on uncovering the problems or weaknesses that will need to be addressed to the satisfaction of the buyer. The owner can help accelerate this project early on by doing an initial write-up describing the development history and precise nature of the business, the background of the owner, and identifying the key members of management. This is the time for the owner to start thinking about what role he wants, or needs, to play for the buyer after the closing. Will the owner want to stay on after the closing; for how long; with what job description and responsibilities; and for what additional compensation? The same is true for each key manager that the buyer may deem, at least initially, to be critical—in the seller's opinion-- for the buyer to retain, and what it may take to retain them—additional compensation, equity or the promise of equity or its equivalent going forward.

This is also the time to give thought to the consequences of NOT retaining key players of the existing business. Start by confirming the status of non-disclosure and non-compete agreements: do they exist, are they still current, how likely are they to be enforceable, and do they need to be amended or refreshed?

A related and very important question is at what point in time is it advisable for these key players to be brought into the tent about the plan to sell the business?

Stuart B. Newman is a member of the Business Law Section's Executive Committee and is Chair and Advisor Emeritus of the Journal's Editorial Advisory Board. He is a principal of the firm of Offit Kurman.

Obviously, the answer to that question is fact-specific and will vary with each individual and the individual's duties and responsibilities within the organization, but more often than not, the best advice in this M&A process is to keep the circle of knowledge about a possible sale transaction as small as possible, on a need-to-know basis.

Ducks in a Row

Nothing makes an M&A deal go smoother, or not, than making sure at the earliest stages, even before a letter of intent with the buyer is negotiated, that all your ducks are lined up. Nothing is more frustrating, for both sides in the transaction, than to discover in midstream the existence of an impediment to closing, be it a third-party consent, a pre-existing contractual obligation, or an impairment of title to a key asset.

“. . . the examples of such painful discoveries are endless, and frequently embarrassing, if not discovered and disclosed early.”

From years of experience, the examples of such painful discoveries are endless, and frequently embarrassing, if not discovered and disclosed early: a lease or contract provision that makes change of ownership or control a default; a key item of intellectual property, the ownership of which is not indisputably within the seller's control; a permit or other renewable right or registration that got overlooked or forgotten; even proof of equity ownership of the business itself when a founder or former owner exited decades ago without the company obtaining and retaining proper documentation of a buyout.

A seller should expect that as soon as a letter of intent is inked, the buyer's attorney will commence an exhaustive due diligence exercise with delivery to the seller of an initial due diligence checklist and request for documents. Since the letter of intent is likely to specify a relatively short due diligence time period, the response from the seller will need to be prompt, as well as accurate and complete. It would be advisable for the seller to try to get ahead of this process by asking its transaction attorney for a sample acquisition checklist of the items likely to be expected from the buyer so it can get started on assembling answers and documents. Internally, the seller should identify the point person within the company best qualified to work with the transaction team in finding the documents and answering the questions on the buyer's checklist.

Tax Analysis

It would be remiss not to list an analysis of tax considerations among the earliest items on the to-do list of a business owner contemplating a sale of the business. The need for a tax analysis of the proposed structure of the sale from the standpoint of the seller is obvious. The transaction team assembled as discussed above should be capable of providing the seller with the tax consequences of various structures that could be used to transfer ownership of the business to the buyer. Some compromises may be required as part of the negotiations because it is entirely possible that buyer and seller will not be on the same page regarding the tax effect of certain elements of the proposed transaction. The buyer may even recommend a preliminary step wherein the business entity is restructured; for example, requiring the business and its assets to be transferred from a corporation to a limited liability company immediately prior to the sale. The seller will need to be briefed by its team of advisors on the consequences, if any, of doing so.

There is another tax analysis to consider—as early in the process as possible, even before the search for a buyer begins—and that is the steps if any that the owner(s) of the business may want to consider, from a personal perspective, separate and apart from a tax analysis of the structure of the transaction. For example, if an owner thinks a sale of the business is a likely event in the coming years, the owner might reconsider his official state of residence. If the owner's family has more than one home in different states there may be different tax consequences depending on which of those states is the state of residence at the time the transaction takes place.

In addition to income tax considerations, when dealing with a closely held business, estate tax considerations may also be relevant. An owner contemplating the sale of the family business would be well advised to consult with his estate planning attorney early in the process to explore whether there are estate planning structures that would be advisable to establish before embarking on the project to sell the business.

Conclusion

The sale of a closely held business is a seminal event in the owner's life. Typically it takes years to build a successful business. But a sale is forever and the owner only gets one chance to get it right. Having a target sales price in mind at the outset is one thing. It's quite another thing entirely to determine what the current range of market valuations are reasonable to achieve, and then to actually pull off a successful closing within that range of valuations in the most tax-efficient manner. The suggestions set forth above should give the owner better odds for achieving that successful transaction.

SEC Expands Accredited Investor and Qualified Institutional Buyer Definitions to Allow More Participants in Private Offerings

By Guy Lander

The U.S. Securities and Exchange Commission recently amended the definition of “accredited investor” under the Securities Act of 1933 (the “Securities Act”). These amendments add new categories of natural persons and entities and make other modifications to the existing definition that essentially allow more investors to participate in private offerings. The amendments are intended to identify sophisticated investors with sufficient knowledge and expertise to participate in investment opportunities that do not have the disclosure, procedural requirements, and investor protections provided by registration under the Securities Act. The amendments are part of a broader effort to improve the exempt offering framework under the Securities Act to promote capital formation and expand investment opportunities while maintaining appropriate investor protections.

The amendments add new categories of natural persons that may qualify as accredited investors based on certain professional credentials or their status as a private fund’s “knowledgeable employee,” expand the list of entities that may qualify as accredited investors, add entities owning \$5 million in investments, add family offices with at least \$5 million in assets under management and their family clients, and extend coverage to “spousal equivalents.”

The SEC expanded the list of entities eligible for qualified institutional buyer status to be consistent with the amendments to the accredited investor definition, maintaining the \$100 million threshold for these entities to qualify for qualified institutional buyer status, so called “QIBs.”

The final rule became effective December 8, 2020.

In 2019, registered offerings accounted for \$1.2 trillion (30.8%) of new capital, compared to approximately \$2.7 trillion (69.2%) that was raised through exempt offerings. Of this, the estimated amount of capital being raised in private offerings under Rule 506(b) and 506(c) of Regulation D was approximately \$1.56 trillion. The accredited investor definition is a central component of the Rule 506 private offerings and plays an important role in other exemptions and other federal and state securities law contexts. Qualifying as an accredited investor is significant because accredited investors may participate in investment opportunities that are generally not available to non-accredited investors.

I. Amendments to the Accredited Investor Definitions

The SEC amended the accredited investor definition to add the following new categories of natural persons and entities:

1. Natural Persons Holding Professional Certifications

Any natural person in good standing holding any of the following credentials will qualify as an accredited investor: the General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Licensed Investment Adviser Representative (Series 65).

2. Knowledgeable Employees of Private Funds

For a private fund offering, natural persons who are “knowledgeable employees” of a private fund issuing the securities will qualify as accredited investors for investments in the fund. A “knowledgeable employee” has the same definition as under Rule 3c-5(a)(4) under the Investment Company Act of 1940 (the “Investment Company Act”), which covers: (i) an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the private fund or an affiliated management person (i.e., who oversees the Fund’s investments, such as the manager) as defined in Rule 3c-5(a)(1) of the private fund; and (ii) an employee of the private fund or the manager of the private fund who participates in the investment activities of the private fund, other private funds, or investment companies, the investment activities of which are managed by the manager of the private fund, provided that such employee has been performing such functions and duties for at least 12 months.

A knowledgeable employee’s accredited investor status is extended to his or her spouse for joint investments made by the knowledgeable employee and his or her spouse in a private fund.

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3. Registered and Unregistered Investment Advisers

Any SEC registered or state registered investment adviser and any exempt reporting adviser under Section 203(l) or (m) of the Investment Advisers Act of 1940 in Rule 501(a)(1) have been added to the list of financial institutions in the definition of accredited investor in Rule 501(a)(1).

4. Rural Business Investment Companies

The SEC added rural business investment companies (RBIC) to the definition of accredited investor in Rule 501(a)(1).

“In 2019, registered offerings accounted for \$1.2 trillion (30.8%) of new capital, compared to approximately \$2.7 trillion (69.2%) that was raised through exempt offerings.”

5. Limited Liability Companies

Limited liability companies were added to the list of entities that qualify as accredited investors in Rule 501(a)(3) if they have total assets in excess of \$5 million and were not formed for the specific purpose of acquiring the securities being offered. This codifies a longstanding SEC position.

Under Rule 501(a)(4) and Rule 501(f) managers of limited liability companies are included as accredited investors.¹

6. Catch-all for Other Entities Meeting an Investments-Owned Test

The SEC added a new catch-all category in the accredited investor definition for any entity owning “investments,” as is defined in Rule 2a51-1(b) under the Investment Company Act,² in excess of \$5 million that is not formed for the specific purpose of acquiring the securities being offered. This covers entities not already listed in Rule 501(a)(1), (a)(2), (a)(3), (a)(7), or (a)(8), such as Indian tribes, labor unions, governmental bodies and entities organized under the laws of a foreign country, as well as those entity types that may be created in the future.

7. Family Offices

“Family offices,” as defined in Rule 202(a)(11)(G)-1 under the Advisers Act, are added to the definition of accredited investors if they meet the following criteria: (i) have assets under management in excess of \$5 million, (ii) that are not formed for the specific purpose of acquiring

the securities offered, and (iii) whose prospective investment is directed by a person who has such knowledge and experience in financial and business matters that such family office is capable of evaluating the merits and risks of the prospective investment (“Eligible Family Offices”).

“Family offices” are entities established by families to manage their assets, plan for their families’ financial future, and provide other services to family members. Family offices are excluded from regulation under the Advisers Act under certain conditions. Under Rule 202(a)(11)(G)-1, a family office generally is a company that has no clients other than “family clients.” “Family clients” generally are family members, former family members, and certain key employees of the family office, as well as certain of their charitable organizations, trusts, and other types of entities.

8. Family Clients

Added to the definition of accredited investor are “family clients” (as defined in the family office rule, Rule 202(c)(ii)(G)-1) whose prospective investment in the issuer is directed by that Eligible Family Office. This change provides additional comfort to some family offices investing on behalf of family members who may not have technically qualified as accredited investors, even though the investment decision was being driven by a sophisticated family office with substantial assets

9. Permitting Spousal Equivalents to Pool Finances for the Purposes of Qualifying as Accredited Investors

Natural persons may now include joint income from spousal equivalents when calculating joint income under Rule 501(a)(6), and also include spousal equivalents when determining net worth under Rule 501(a)(5). Spousal equivalents are defined as a cohabitant occupying a relationship generally equivalent to that of a spouse.

a) Note to Rule 501(a)(5)

The SEC added a note to Rule 501 to clarify that the calculation of “joint net worth” for purposes of Rule 501(a)(5) can be the aggregate net worth of an investor and his or her spouse or spousal equivalent and that the securities being purchased by an investor relying on the joint net worth test of Rule 501(a)(5) need not be purchased jointly.

b) Note to Rule 501(a)(8)

Under Rule 501(a)(8), an entity qualifies as an accredited investor if all the equity owners of that entity are accredited investors. The SEC added a note to Rule 501(a)(8) to clarify that, in determining accredited investor status under Rule 501(a)(8), one may look through various forms of equity ownership to natural persons. Thus, if those natural persons are themselves accredited investors, and if all other equity owners of the entity are accredited investors, the entity would be an accredited investor under Rule 501(a)(8).

II. Amendments to the Qualified Institutional Buyer Definition

Rule 144A provides an exemption from registration under the Securities Act for resales of certain restricted securities to QIBs. Rule 144A(a)(1)(i) specifies the types of institutions that are eligible for qualified institutional buyer status if they meet the \$100 million in securities owned and invested threshold. The SEC expanded the list of entities that are qualified institutional buyers. The SEC added RBICs, limited liability companies, institutional accredited investors under Rule 501(a), and the catch-all category added to the accredited investor definition of an entity type not otherwise already included in 144A by adding a new paragraph (J) to Rule 144A(a)(1)(i) if they satisfy the \$100 million investment threshold. This includes Indian tribes, governmental bodies, and bank-maintained collective investment trusts.

Eligible purchasers under Rule 144A(a)(1)(i) include entities formed solely for the purpose of acquiring restricted securities under Rule 144A, if they satisfy the test for qualified institutional buyer status.

III. Conforming Amendments to Securities Act Rule 163B

In light of these rule changes, the SEC made generally conforming changes to Rule 163B regarding testing-the-waters, which now enable exempt testing-the-waters with entities such as governmental bodies under Rule 501(a)(9) and certain family offices and institutional family clients under Rules 501(a)(12) and (13).

IV. Additional Details and Notes

Natural Persons Holding Professional Certifications

In the future the SEC may designate additional credentials as qualifying for accredited investor status. The SEC will consider the following non-exclusive list of attributes in determining which professional certifications and designations or other credentials qualify a natural person for accredited investor status:

- the certification, designation, or credential arises out of an examination or series of examinations administered by a self-regulatory organization or other industry body or is issued by an accredited educational institution;
- the examination or series of examinations is designed to reliably and validly demonstrate an individual's comprehension and sophistication in the areas of securities and investing;
- persons obtaining such certification, designation, or credential can reasonably be expected to have sufficient knowledge and experience in financial and

business matters to evaluate the merits and risks of a prospective investment; and

- an indication that an individual holds the certification or designation is either made publicly available by the relevant self-regulatory organization or other industry body or is otherwise independently verified.

The professional certifications and designations and other credentials currently recognized by the SEC as satisfying the adopted criteria will be posted on the SEC's website. That the individual holds the certification or designation should also be made publicly available by the relevant self-regulatory organization or other industry body.³

Endnotes

1. Rule 501(a)(4) includes as an accredited investor any director, executive officer, or general partner of the issuer of the securities being offered or sold. The term "executive officer" is defined in Rule 501(f) as "the president, any vice president in charge of a principal business unit, division or function, as well as any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer." Managers of limited liability companies perform a policy making function for the issuer equivalent to that of an executive officer of a corporation under Rule 501(f).
2. Investments under Rule 2a5-1(b) under the Investment Company Act include securities, real estate, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; and cash and cash equivalents.
Rule 501(a)(4) and Rule 501(f) include managers of limited liability companies. Rule 501(a)(4) includes as an accredited investor any director, executive officer, or general partner of the issuer of the securities being offered or sold. The term "executive officer" is defined in Rule 501(f) as "the president, any vice president in charge of a principal business unit, division or function, as well as any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer." Managers of limited liability companies perform a policy making function for the issuer equivalent to that of an executive officer of a corporation under Rule 501(f). Therefore, Rule 501(a)(4) and Rule 501(f) include managers of limited liability companies.
3. Investments under Rule 2a5-1(b) under the Investment Company Act include securities, real estate, commodity interests, physical commodities, and non-security financial contracts held for investment purposes; and cash and cash equivalents.

SEC Adopts Rules to Improve the Framework for Exempt Offerings

By Guy P. Lander

In November 2020, the U.S. Securities and Exchange Commission adopted new rules to simplify and improve the framework for offerings exempt from SEC registration. These rule changes reduce regulatory friction and expand access to capital for small and medium-sized businesses and entrepreneurs.¹ Generally, the rules are effective March 15, 2021.

These amendments are the second set of rule changes intended to improve and update the framework for exempt offerings. The first set of rule changes expanded the definition of “accredited investor” and “qualified institutional buyer.” Together these rule changes will allow more individuals and institutions to invest in exempt offerings under an improved, streamlined regulatory framework.

I. Summary

The amendments address:

- 1) **“Testing-the-Waters” Generic Solicitation of Interest and “Demo Day” Communications; General Solicitation:** The new rules permit an issuer to use generic solicitation materials to “test-the-waters” for an exempt offer of securities before determining which exemption will be used. The new rules permit crowdfunding issuers to “test-the-waters” before they file an offering document the same way Regulation A issues can. The new rules also provide an exemption for certain communications for demo days and similar events from general solicitations or general advertising.
- 2) **Integration:** Integration relates to whether two seemingly separate offerings are treated as one integrated offering, which could destroy the exemptions being relied on because each of the exemptions has different conditions. This threat of integration affects the ability of issuers to conduct two or more offerings simultaneously, move from one exemption to another, or between registered and exempt offerings. The SEC replaced the outdated five-factor test with a general integration principle that looks at the particular facts and circumstances of two or more offerings along with four specific safe harbors to enable issuers to move from one exemption to another.
- 3) **Rule 506(c) Verification:** For offerings under Rule 506(c), which permits general solicitation, the issuer must take reasonable steps to verify that each purchaser is an accredited investor. The amendments add an additional safe harbor, verification method that, in effect, provides a five-year time-limit for a prior verification.

4) **Regulation D Financial Information:** The amendments change the financial statements that must be provided in a Rule 506(b) private offering to non-accredited investors. The new requirements align the Rule 506(b) financial statements with financial statements that must be provided to investors in Regulation A offerings. The new financial statement requirements are as follows:

a) For offerings up to \$20 million: Consolidated balance sheets of the issuer for the two previous fiscal years; consolidated statements of comprehensive income, cash flows, and stockholders’ equity of the issuer; not more than nine months old. These do not have to be audited statements

b) For offerings over \$20 million: Two years audited financial statements (if the issuer is more than two years old).

- 5) **Confidential Information Standard:** The amendments change the standard for when redaction of confidential information is permitted in an SEC filing. Issuers may now redact information that is not material that the issuer treats as confidential, and issuers no longer have to demonstrate that disclosure of the confidential information would cause competitive harm.
- 6) **Increased Offering and Investment Limits in Offerings under Regulation A, Regulation Crowdfunding and Rule 504:** The SEC increased the offering limits for:
 - Regulation A, Tier 2, from \$50 million to \$75 million;
 - Regulation A for secondary sales under Tier 2, from \$15 million to \$22.5 million; and
 - Regulation Crowdfunding, from \$1.07 million to \$5 million.

The SEC also increased the Regulation Crowdfunding investor investment limits.

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We have attached as Table 1 an overview of the most commonly used exemptions from registration, as amended by the new rules under the release.

II. General Solicitation and Offering Communications

The SEC has controlled publicity efforts in exempt offerings through its definition of the term “offer,” which the SEC has interpreted very broadly. The SEC has taken the position that publicity efforts made in advance of a proposed financing, which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities, constitutes an offer.” This has extended the SEC restrictions on publicity to the terms “general solicitation” and “general advertising,” which are not defined. Examples of general solicitation and general advertising include advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars where attendees have been invited by general solicitation or general advertising, and other uses of publicly available media, such as unrestricted websites.

Section 4(a)(2) of the Securities Act exempts from registration “transactions by an issuer not involving any public offering,” but does not define the phrase. This is the “classic” private placement exemption. Whether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of the surrounding circumstances, including factors such as the relationship between the offerees and the issuer, and the nature, scope, size, type, and manner of the offering. The SEC adopted Rule 506 of Regulation D in 1982 as a non-exclusive safe harbor under Section 4(a)(2), to provide objective standards on which an issuer could rely to meet the requirements of the Section 4(a)(2) exemption, including a prohibition on the use of general solicitation to market the securities.

A. Generic Solicitation of Interest Exemption

Under new Rule 241, an issuer or any person authorized to act on behalf of an issuer may communicate orally or in writing to determine whether there is any interest in a contemplated offering of securities exempt from registration under the Securities Act. The new rule allows an issuer to gauge market interest in an exempt-securities offering before incurring the expense of preparing and conducting an offer, which enables it to tailor the size and terms of the offering (possibly with input from potential investors) and to reduce the cost of conducting an exempt offering.

1. The conditions of the rule are as follows:

a) No Exemption Chosen

The issuer cannot have already identified the specific exemption from registration on which it intends to rely for the subsequent offering.

b) No Money or Binding Commitments

No solicitation or acceptance of money or other consideration nor any commitment, binding or otherwise, from any person is permitted until the issuer determines the exemption it will rely on and commences the offering in compliance with that exemption.

c) Legends

The generic testing-the-waters materials must provide specified disclosures notifying potential investors about the limitations of the generic solicitation. The issuer’s communications must state that:

- (i) The issuer is considering an offering of securities exempt from registration under the Securities Act, but has not determined a specific exemption from registration the issuer intends to rely on for the subsequent offer and sale of the securities;
- (ii) No money or other consideration is being solicited, and if sent in response, will not be accepted;
- (iii) No offer to buy the securities can be accepted and no part of the purchase price can be received until the issuer determines the exemption under which the offering is intended to be conducted and, where applicable, the filing, disclosure, or qualification requirements of such exemption are met; and
- (iv) A person’s indication of interest involves no obligation or commitment of any kind.

2. Permitted Reply Information

The communication may include a means for a person to indicate interest in a potential offering, and an issuer may require the indication to include the person’s name, address, telephone number, and/or email address.

The rule provides an exemption from registration only for the generic solicitation of interest, and the solicitation will be deemed to be an offer of a security for sale for purposes of the antifraud provisions of the federal securities laws.

3. May Be General Solicitation

Depending on the method of dissemination of the information, the generic testing-the-waters offer itself may be considered a general solicitation. Rule 241 provides an exemption from registration only for the generic solicitation of interest not for a subsequent offer or sale. If the generic solicitation is done in a way that would constitute general solicitation, and the issuer ultimately decides to conduct an unregistered offering under an exemption that does not permit general solicitation, the issuer will need to assess whether that solicitation and the subsequent private offering will be integrated, thereby making

unavailable an exemption that does not permit general solicitation.

An issuer will not be able to follow a generic solicitation of interest that constituted a general solicitation with an offering under an exemption that does not permit general solicitation, such as Rule 506(b), unless the issuer has a reasonable belief, based on the facts and circumstances, for each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer's behalf) either did not solicit such purchaser through the use of general solicitation or established a substantive relationship with such purchaser before the commencement of the exempt offering prohibiting general solicitation. For example, an issuer may reasonably conclude on its own that "testing-the-waters" activity is limited to QIBs and IAs would not constitute general solicitation depending on the facts and circumstances, or, the issuer could wait 30 days after terminating testing-the-waters before commencing a private offering. The best practical solution may be not to rely on Rule 241 and instead conduct the testing-the-waters in a manner that does not constitute general solicitation.

"These rule changes will allow more individuals and institutions to invest in exempt offerings under an improved, streamlined regulatory framework."

4. Non-Accredited Investors

If an issuer sells securities under Rule 506(b) to any purchaser that is not an accredited investor within 30 days of the generic solicitation of interest, it must provide such purchaser with a written communication used under Rule 241 a reasonable time before sale. This requirement applies whether or not the issuer engaged in general solicitation through its communications under Rule 241 and whether or not the generic solicitation would be subject to integration with the Rule 506(b) offering.

5. No State Blue Sky Exemption

Rule 241 does not preempt any state blue sky laws for these offers.

B. Exemption from General Solicitation for "Demo Days" and Similar Events

New Rule 148 provides that certain "demo day" communications would not be deemed general solicitation or general advertising. A communication will not be a general solicitation if it is made in connection with a semi-

nar or meeting in which more than one issuer participates that is sponsored by a college, university, or other institution of higher education, a state or local government or instrumentality of a state or local government, a nonprofit organization, or an angel investor group, incubator, or accelerator.²

The conditions of the exemption are as follows:

- 1) The advertising for the event may not reference any specific offering of securities by an issuer and the information conveyed at the event regarding any offering of securities by or on behalf of the issuer is limited to: (i) notification that the issuer is in the process of offering or planning to offer securities; (ii) the type and amount of securities being offered; (iii) the intended use of the proceeds of the offering; and (iv) the unsubscribed amount in an offering.
- 2) For communications at demo days to be covered, the Sponsor may not:
 - (i.) Make investment recommendations or provide investment advice to attendees;
 - (ii.) Engage in any investment negotiations between the issuer and investors attending the event;
 - (iii.) Charge attendees any fees, other than reasonable administrative fees;
 - (iv.) Receive any compensation for making introductions between attendees and issuers, or for investment negotiations between the parties; or
 - (v.) Receive any compensation for any other activity that would require it to register as a broker or dealer under the Exchange Act, or as an investment adviser under the Advisers Act.
- 3) Online participation in the event must be limited to: (i) individuals who are members of, or otherwise associated with the sponsor organization (for example, members of an angel investor group of students, faculty, or alumni of a college or university); (ii) individuals that the sponsor reasonably believes are accredited investors; or (iii) individuals who have been invited to the event by the sponsor based on industry or investment-related experience reasonably selected by the sponsor in good faith and disclosed in the public communications about the event.³

III. Integration: New Rule 152

The integration doctrine seeks to prevent an issuer from avoiding registration by artificially dividing a single non-exempt offering into multiple exempt offerings. New Rule 152 provides an integration framework for all offerings, registered and exempt. It is composed of a general integration principle of new Rule 152(a) that looks to facts and circumstances and four safe harbors apply to specific

situations. The new Rule 152 replaces the five-factor test with the SEC's more modern approach to integration, which among other things reduces the time period outside of which separate offers would not be considered integrated from six months to 30 days. Attached as Exhibit 2 are Tables 2(a) and 2(b), which provide an overview of the general integration principle and safe harbors in new Rule 152, each of which is discussed in more detail below.

A. Rule 152(a) General Principle

The Rule 152(a) general principle provides that, for all offerings not covered by a safe harbor in Rule 152(b), offers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the Securities Act, or that an exemption from registration is available for the particular offering.

1. For Exempt Offerings When General Solicitation Is NOT Permitted (Rule 152(a)(1))

Rule 152(a)(1) provides that for an exempt offering for which general solicitation is not permitted, offers and sales would not be integrated with other offerings close in time if the issuer has a reasonable belief, based on the facts and circumstances for each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or its agent) either:

- a) Did not solicit such purchaser through the use of general solicitation; or
- b) Established a substantive relationship with the purchaser before the commencement of the exempt offering prohibiting general solicitation.

2. For Exempt Offerings When General Solicitation IS Permitted (Rule 152(a)(2))

For two or more concurrent offerings each relying on a Securities Act exemption permitting general solicitation,⁴ in addition to satisfying the requirements of the particular exemption that relied on general solicitation, offering materials for one offering (the "first offering") that includes information about the material terms of a concurrent offering (the "second offering") under another exemption may constitute an "offer" of the securities in that other (second) offering. Therefore, the first offer must also comply with all the requirements for, and restrictions on, offers under the exemption being relied on for that other offering, including any necessary legends or communications restrictions for that other (second) offer.⁵

3. How the Rule Works

Under the new Rule 152(a), issuers may conduct at the same time (or within 30 days), a Rule 506(c) offering (which permits general solicitation) and a Rule 506(b) private placement (which prohibits general solicitation), or any other combination of offerings, involving an offering prohibiting general solicitation and another offering permitting general solicitation, such as registered offerings,

without integration, so long as Rule 152(a)(1) and the other conditions of the applicable exemptions are satisfied.⁶ That is, the offerings would not be integrated if the purchasers in the Rule 506(b) offering were not solicited through the use of the general solicitation, or the issuer established a substantive relationship with the purchaser before the Rule 506(b) offering commenced.⁷

4. Pre-Existing Substantive Relationship

New Rule 152(a)(1)(ii) allows a purchaser with whom the issuer or person acting on its behalf has a pre-existing, substantive relationship to participate in the offering that prohibits general solicitation even though the issuer is conducting a concurrent offering that permits general solicitation as long as that relationship was not established through that concurrent offering. The existence of such a relationship before the commencement of an offering is one means, but not the exclusive means, of demonstrating the absence of a general solicitation in a Regulation D offering.

A "pre-existing" relationship is one that the issuer has formed with an offeree before the commencement of the offering or, alternatively, that was established through another person (for example, a registered broker-dealer or investment adviser) before that person's participation in the offering.⁸ A "substantive" relationship is one in which the issuer (or a person acting on its behalf, such as a registered broker-dealer or investment adviser) has sufficient information to evaluate, and does, in fact, evaluate, an offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor.

Generally, whether a "pre-existing, substantive relationship" exists turns on procedures established by broker-dealers in connection with their customers. This is because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and thus, implies that a substantive relationship exists between the broker-dealer and its customers. However, the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case. Thus, there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a "pre-existing, substantive relationship" sufficient to avoid a "general solicitation."

Issuers may develop pre-existing, substantive relationships with offerees. However, in the absence of a prior business relationship or a recognized legal duty to offerees, it is likely more difficult for an issuer to establish a pre-existing, substantive relationship, especially when contemplating or engaged in an offering over the internet. Issuers would have to consider not only whether they have sufficient information about particular offerees, but also whether they in fact use that information appropri-

ately to evaluate the financial circumstances and sophistication of the offerees before commencing the offering.

Investors with whom the issuer has a pre-existing substantive relationship may include the issuer's existing or prior investors, investors in prior deals of the issuer's management, or friends or family of the issuer's control persons. Similarly, such investors may also include customers of a registered broker-dealer or investment adviser with whom the broker-dealer or investment adviser established a substantive relationship before the participation in the exempt offering by the broker-dealer or investment adviser.

Self-certification alone (by checking a box) without any other knowledge of a person's financial circumstances or sophistication would not be sufficient to form a "substantive" relationship for these purposes.

B. General Anti-Evasion Provision

The introductory language to the rule provides that although it may be possible to structure two or more offerings such that they appear to technically comply with the terms of applicable exemptions, if that structuring is part of a plan or scheme to evade the registration requirements of the Securities Act, the offerings would still be integrated even if the offerings technically fit within one of the four safe harbors below.

C. Integration Safe Harbors (New Rule 152(b))

Rule 152(b) provides four non-exclusive safe harbors from integration for offers and sales meeting the conditions of the relevant safe harbor.

1. 30-Day Integration Safe Harbor (Rule 152(b)(1))

This safe harbor applies to both registered offerings and exempt offerings. Rule 152(b)(1) provides that any offering terminated or completed more than 30 calendar days before the commencement of another offering, or commenced more than 30 calendar days after the termination or completion of another offering, will not be integrated with the other offering.⁹ This rule shortens the prior integration safe harbor from six months to 30 days outside of which other offerings will not be integrated.

However, for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more after an offering that allows general solicitation, the issuer must have a reasonable belief that either: (i) each purchaser was not solicited through the use of general solicitation, or (ii) the issuer (or its agent) established a substantive relationship with such purchaser before the commencement of the exempt offering prohibiting general solicitation.

If an issuer waits less than 30 days after terminating or completing an offering before commencing a subsequent offering, and therefore cannot rely on the safe harbor in Rule 152(b)(1), it may still avoid integration if it

meets the terms and conditions of the general principle of integration in Rule 152(a).

Limit on Non-Accredited Investors

In light of new Rule 152(b)(1) and its 30-day safe harbor, for a Rule 506(b) offering, the SEC changed the number of non-accredited investors purchasing in Rule 506(b) offerings to no more than 35 within a 90-calendar-day period.

2. Rule 701, Employee Benefit Plans and Regulation S (Rule 152(b)(2))

Under Rule 152(b)(2), all offers and sales made in compliance with Rule 701, under an employee benefit plan, or in compliance with Regulation S, will not be integrated with other concurrent offerings.

For Regulation S offerings, Rule 152(b)(2) provides that offshore transactions made in compliance with Regulation S will not be integrated with contemporaneous registered domestic offerings or exempt domestic offerings. However, care must still be taken that general solicitation for exempt U.S. offerings are not directed selling efforts precluded under Regulation S, which would depend on the facts and circumstances of a particular situation. For example, the use of the same website to solicit U.S. investors under Rule 506(c) and offshore investors under Regulation S could raise concerns about the issuer's compliance with the prohibition on directed selling efforts in Regulation S because the offering material on the website could be deemed to have the effect of conditioning the market in the United States. In such situations, the issuer should take steps to distinguish the Regulation S and domestic offering materials, pursuant to previous SEC guidance.¹⁰

3. Subsequent Registered Offerings (Rule 152(b)(3))

Under Rule 152(b)(3), an offering for which a Securities Act registration statement has been filed will not be integrated if it is made after: (i) a terminated or completed offering for which general solicitation is not permitted, (ii) a terminated or completed offering for which general solicitation is permitted but made only to Qualified Institutional Buyers (i.e., Rule 144A) and Institutional Accredited Investors (i.e., Reg. D entities), or (iii) any offering for which general solicitation is permitted that terminated or was completed more than 30 calendar days before the registered offering. This permits capital raising around the time of an IPO, which can help issuers obtain funds during the IPO process.

4. Offers or Sales Before Exempt Offerings Permitting General Solicitation (Rule 152(b)(4))

Under new Rule 152(b)(4), offers and sales made in reliance on an exemption for which general solicitation is permitted will not be integrated if made after any other terminated or completed offering. Offers and sales that precede exempt offerings that permit general solicitation

generally are not the type of offerings that condition the market for the subsequent offering.

The SEC provided guidance concerning an issuer's ability to rely on Rule 152(b)(4) for an offering that was commenced under an exemption that does not permit general solicitation, but that the issuer wishes to continue under an exemption that does permit general solicitation. An issuer may rely on the safe harbor in new Rule 152(b)(4) if, for example, the issuer commences an offering under Rule 506(b) and thereafter engages in general solicitation in reliance on Rule 506(c) so long as once the issuer engages in general solicitation, it relies on Rule 506(c) for all subsequent sales, thereby effectively terminating the Rule 506(b) offering, including by selling exclusively to accredited investors and taking reasonable steps to verify the accredited investor status of each purchaser. The use of general solicitation in reliance on Rule 506(c) will not affect the exempt status of prior offers and sales of securities made in reliance on Rule 506(b). It is also not necessary for an issuer to use different offering materials for offerings that rely on different exemptions, so long as the issuer satisfies the disclosure and other requirements of each applicable exemption.

D. Commencement, Termination, and Completion of Offerings (Rules 152(c) and 152(d))

New Rule 152 provides a non-exclusive list of factors to consider (rather than fixed definitions) in determining when an offering will be deemed to be commenced, terminated or completed, for purposes of both the general principle of integration under Rule 152(a) and the safe harbor rules under Rule 152(b).

New Rule 152(c) states that an offering of securities will be deemed to commence for purposes of Rule 152 at the time of the first offer of securities in the offering by the issuer or its agents.

For determining when an offering commences, the non-exclusive list of factors covers registered and exempt offerings, noting that an issuer or its agents may commence an offering in reliance on:

Rule 241, (Solicitation of Interest) on the date the issuer first made a generic offer soliciting interest in a contemplated securities offering for which the issuer has not yet determined the exemption under the Securities Act under which the offering of securities would be conducted;

Section 4(a)(2), Regulation D, (Exempt Offerings) on the date the issuer first made an offer of its securities in reliance on these exemptions;

A registration statement filed under the Securities Act for:

(a) A continuous offering that will commence promptly on the date of initial effectiveness, will likely be

deemed to commence on the date the issuer first filed its registration statement for the offering with the SEC, or

(b) A delayed offering, on the earliest date on which the issuer or its agents commenced public efforts to offer and sell the securities, which could be evidenced by the earlier of: (i) the first filing of a prospectus supplement with the SEC describing the delayed offering, or (ii) the issuance of a widely disseminated public disclosure, such as a press release, confirming the commencement of the delayed offering.

“Due to their non-public nature, communications between an issuer, or its agents and underwriters, and QIBs and IAs, including those that would qualify for the “testing-the-waters” safe harbor in Rule 163B, will not be considered as the commencement of a registered public offering for purposes of new Rule 152. ”

Due to their non-public nature, communications between an issuer, or its agents and underwriters, and QIBs and IAs, including those that would qualify for the “testing-the-waters” safe harbor in Rule 163B, will not be considered as the commencement of a registered public offering for purposes of new Rule 152. In contrast, the commencement of private communications between an issuer, or its agents, including private placement agents, and prospective investors in an exempt offering in which general solicitation is prohibited, such as under Rule 506(b) or Section 4(a)(2), may be considered as the commencement of the non-public exempt offering for purposes of new Rule 152, if such private communication involves an offer of securities.

New Rule 152(d) provides a non-exclusive list of factors that should be considered in determining when an offering is deemed to be “terminated or completed.” Rule 152(d) states that termination or completion of an offering is likely to be deemed to occur when the issuer and its agents cease efforts to make further offers to sell the issuer's securities under such offering.

1. An offering made in reliance on Section 4(a)(2), Regulation D, would be considered “terminated” or “completed” on the later of the date:

(a) The issuer entered into a binding commitment to sell all securities to be sold under the offering (subject only to conditions outside of the investor's control)¹¹; or

(b) The issuer and its agents ceased efforts to make further offers to sell the issuer's securities under such offering;

2. An offering made pursuant to a registration statement filed under the Securities Act would be considered "terminated" or completed", on:

(a) The withdrawal of the registration statement after an application is granted or deemed granted under Rule 477;

(b) The filing of a prospectus supplement or amendment to the registration statement indicating that the offering, or particular delayed offering in the case of a shelf registration statement, has been terminated or completed;

(c) The entry of an order of the SEC declaring that the registration statement has been abandoned under Rule 479;

(d) The date, after the third anniversary of the initial effective date of the registration statement, on which Rule 415(a)(5) prohibits the issuer from continuing to sell securities using the registration statement, or any earlier date on which the offering terminates by its terms; or

(e) Any other factors that indicate that the issuer has abandoned or ceased its public selling efforts in furtherance of the offering, or particular delayed offering in the case of a shelf registration statement, which could be evidenced by:

1.) The filing of a Current Report on Form 8-K; or

2.) The issuance of a widely disseminated public disclosure by the issuer, or its agents, informing the market that the offering, or particular delayed offering, in the case of a shelf registration statement, has been terminated or completed.

Issuers may terminate an offering of securities in reliance on one exemption and simultaneously commence an offering of the same securities in reliance on another exemption if an issuer and its agents ceased efforts to make further offers to sell the issuer's securities under the exemption for the terminated offering.

A particular delayed offering may be deemed terminated or completed, even though the issuer's shelf registration statement may still have unused capacity, or an aggregate amount of securities available to offer and sell in a later delayed registered offering.

IV. Rule 506(c) Verification Requirements

Rule 506(c) permits issuers to generally solicit and advertise an offering, provided that all purchasers in the offering are accredited investors, the issuer takes reasonable

steps to verify that purchasers are accredited investors, and certain other conditions in Regulation D are satisfied.

The SEC added a new item to the non-exclusive list of verification methods that an issuer may use. An issuer may establish that an investor that the issuer previously took reasonable steps to verify as an accredited investor in accordance with Rule 506(c)(2)(ii) remains an accredited investor at the time of a subsequent sale if the investor provides a written representation that the investor continues to qualify as an accredited investor and the issuer is not aware of information to the contrary. However, there is a five-year time limit on the ability of issuers to rely on a prior verification.

The SEC reaffirmed and updated its prior guidance for the principles-based method for verification, and in particular what may be considered "reasonable steps" to verify an investor's accredited investor status. The following factors are among those an issuer should consider:

- a) The nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- b) The amount and type of information that the issuer has about the purchaser; and
- c) The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.¹²

In some circumstances, the reasonable steps determination may not be substantially different from an issuer's development of a "reasonable belief" for Rule 506(b) purposes. For example, an issuer's receipt of a representation from an investor as to his or her accredited status could meet the "reasonable steps" requirement if the issuer reasonably takes into consideration a prior substantive relationship with the investor or other facts that make apparent the accredited status of the investor. That same representation from an investor may not meet the "reasonable steps" requirement if the issuer has no other information about the investor or has information that does not support the view that the investor was an accredited investor.

Issuers are not required to use any of the methods set forth in the non-exclusive list and can apply the reasonableness standard directly to the specific facts and circumstances presented by the offering and the investors. However, the SEC reiterated that an issuer will not be considered to have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, require only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.

Table 1: Overview of Capital-Raising Exemptions*

Type of Offering	Offering Limit within 12-month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Section 4(a)(2)	None	No	None	Transactions by an issuer not involving any public offering. <i>See SEC v. Ralston Purina Co.</i>	None	Yes. Restricted securities	No
17 CFR 230.506(b) (Rule 506(b) of Regulation D)	None	No	"Bad actor" disqualifications apply	Unlimited accredited investors Up to 35 sophisticated but non-accredited investors in a 90-day period	17 CFR 239.500 ("Form D")	Yes. Restricted securities	Yes
17 CFR 230.506(c) (Rule 506(c) of Regulation D)	None	Yes	"Bad actor" disqualifications apply	Unlimited accredited investors Issuer must take reasonable steps to verify that all purchasers are accredited investors*	Form D	Yes. Restricted securities	Yes
Regulation A: Tier 1	\$20 million	Permitted; before qualification, testing the waters permitted before and after the offering statement is filed	U.S. or Canadian issuers Excludes blank check companies, registered investment companies, business development companies, issuers of certain securities, certain issuers subject to a Section 12(j) order, and Exchange Act reporting companies that have not filed certain required reports. "Bad actor" disqualifications apply* No asset-backed securities.	None	Form 1-A, including two years of financial statements Exit report	No	No
Regulation A: Tier 2	\$75 million	Permitted; before qualification, testing the waters permitted before and after the offering statement is filed	U.S. or Canadian issuers Excludes blank check companies, registered investment companies, business development companies, issuers of certain securities, certain issuers subject to a Section 12(j) order, and Exchange Act reporting companies that have not filed certain required reports. "Bad actor" disqualifications apply* No asset-backed securities.	Non-accredited investors are subject to investment limits based on the greater of annual income and/or net worth, unless securities will be listed on a national securities exchange	Form 1-A, including two years of audited financial statements Annual, semi-annual, current, and exit reports	No	Yes
Rule 504 of Regulation D	\$10 million	Permitted in limited circumstances	Excludes blank check companies, Exchange Act reporting companies, and investment companies "Bad actor" disqualifications apply	None	Form D	Yes. Restricted securities except in limited circumstances	No

Type of Offering	Offering Limit within 12-month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Regulation Crowdfunding; Section 4(a)(6)	\$5 million	Testing the waters permitted before Form C is filed Permitted with limits on advertising after Form C is filed Offering must be conducted on an internet platform through a registered intermediary	Excludes non-U.S. issuers, blank check companies, Exchange Act reporting companies, and investment companies "Bad actor" disqualifications apply	No investment limits for accredited investors Non-accredited investors are subject to investment limits based on the greater of annual income and/or net worth	Form C, including two years of financial statements that are certified, reviewed or audited, as required Progress and annual reports	12-month resale limitations	Yes
Intrastate: Section 3(a)(11)	No federal limit (generally, individual state limits between \$1 and \$5 million)	Offerees must be in-state residents.	In-state residents "doing business" and incorporated in-state; excludes registered investment companies	Offerees and purchasers must be in-state residents	None	Securities must come to rest with in-state residents	No
Intrastate: Rule 147	No Federal limit (generally, individual State limits between \$1 and \$5 million)	Offerees must be in-state residents.	In-state residents "doing business" and incorporated in-state; excludes registered investment companies	Offerees and purchasers must be in-state residents	None	Yes. Resales must be within State for six months	No
Intrastate: Rule 147A	No Federal limit (generally, individual State limits between \$1 and \$5 million)	Yes	In-state residents and "doing business" in-state; excludes registered investment companies	Purchasers must be in-state residents	None	Yes. Resales must be within State for six months	No

*Table 1 is organized by typical offering size from largest to smallest. The information in this table is not comprehensive and is intended only to highlight some of the more significant aspects of the current rules.

Table 2(a): Overview of the General Integration Principle in New Rule 152**

Integration Principle in New Rule 152(a)	
General Principle of Integration	If the safe harbors in Rule 152(b) do not apply, in determining whether two or more offerings are to be treated as one for the purpose of registration or qualifying for an exemption from registration under the Securities Act, offers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the Securities Act, or that an exemption from registration is available for the particular offering.
Application of the General Principle to an exempt offering prohibiting general solicitation 17 CFR 230.152(a)(1) (Rule 152(a)(1))	The issuer must have a reasonable belief, based on the facts and circumstances, for each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer's behalf) either: (i) Did not solicit such purchaser through the use of general solicitation; or (ii) Established a substantive relationship with such purchaser before the commencement of the exempt offering prohibiting general solicitation.
Application of the General Principle to concurrent exempt offerings that each allow general solicitation 17 CFR 230.152(a)(2) (Rule 152(a)(2))	In addition to satisfying the requirements of the particular exemption relied on, general solicitation offering materials for one offering that include information about the material terms of a concurrent offering under another exemption may constitute an offer of the securities in such other offering, and therefore the offer must comply with all the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any legend requirements and communications restrictions.

**Rule 152 will not permit avoiding integration for any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the Securities Act. This Rule 152 anti-evasion applies to the entire rule, and not just the safe harbors.

Table 2(b): Overview of the Integration Safe Harbors in New Rule 152***

Non-Exclusive Integration Safe Harbors in new Rule 152(b)	
<p>Safe Harbor 1</p> <p>17 CFR 230.152(b)(1) (Rule 152(b)(1))</p>	<p>Any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with such other offering; provided that, for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation, the provisions of Rule 152(a)(1) shall apply.</p>
<p>Safe Harbor 2</p> <p>17 CFR 230.152(b)(2) (Rule 152(b)(2))</p>	<p>Offers and sales made in compliance with Rule 701, pursuant to an employee benefit plan, or in compliance with 17 CFR 230.901 through 230.905 ("Regulation S") will not be integrated with other offerings.</p>
<p>Safe Harbor 3</p> <p>17 CFR 230.152(b)(1) (Rule 152(b)(3))</p>	<p>An offering for which a Securities Act registration statement has been filed will not be integrated if it is made after: (i) a terminated or completed offering for which general solicitation is not permitted; (ii) a terminated or completed offering for which general solicitation is permitted that was made only to qualified institutional buyers (QIBs) and institutional accredited investors (IAIs); or (iii) an offering for which general solicitation is permitted that terminated or was completed more than 30 calendar days before the commencement of the registered offering. See 17 CFR 230.144(a)(1) for the definition of "qualified institutional buyer," and 17 CFR 230.501(a)(1), (2), (3), (7), (8), (9), (12), and (13) for a list of entities that are considered "institutional accredited investors."</p>
<p>Safe Harbor 4</p> <p>17 CFR 230.152(b)(4) (Rule 152(b)(4))</p>	<p>Offers and sales made in reliance on an exemption for which general solicitation is permitted will not be integrated if made after any terminated or completed offering.</p>

Table 3: Summary of Types of Offerings Not Integrated Under the Safe Harbor

Offering 1	Offering 2
<p>Any offering, which includes:</p> <p>Exempt offering permitting general solicitation, including:</p> <ul style="list-style-type: none"> • Regulation A • Regulation Crowdfunding • Rule 147 or 147A • Rules 504(b)(1)(i), (ii), or (iii) • Rule 506(c) <p>Exempt offering prohibiting general solicitation, including:</p> <ul style="list-style-type: none"> • 17 CFR 230.504(b)(1) • Rule 506(b) • Section 4(a)(2) <p>Securities Act registered offering</p>	<p>Exempt offering permitting general solicitation, including:</p> <ul style="list-style-type: none"> • Regulation A • Regulation Crowdfunding • Rule 147 or 147A • Rules 504(b)(1)(i), (ii), or (iii) • Rule 506(c)

Table 4: Current Regulation A Financial Statement Requirements

Offering Size	Financial Statement Information Required	Age of Financial Statements	Audit Required
Up to \$20 million (Tier 1):	<p>Consolidated balance sheets of the issuer for the two previous fiscal year ends (or for such shorter time that the issuer has been in existence);</p> <p>Consolidated statements of comprehensive income, cash flows, and stockholders' equity of the issuer; and</p> <p>Financial statements of guarantors and issuers of guaranteed securities, affiliates whose securities collateralize an issuance, significant acquired or to be acquired businesses and real estate operations, and pro forma information relating to significant business combinations</p>	Not more than nine months before the date of non-public submission, filing or qualification, with the most recent annual or interim balance sheet not older than nine months	No, unless issuer has already obtained an audit for another purpose
Up to \$50 million (Tier 2):	Financial statements in compliance with Article 8 of Regulation S-X	Not more than nine months before the date of non-public submission, filing or qualification, with the most recent annual or interim balance sheet not older than nine months	Yes (but see paragraph (c) in Part F/S of Form 1-A noting that interim financial statements need not be audited)

Endnotes

- SEC Release No. 33-10884 (November 2, 2020).
- "Angel investor groups," besides consisting of only accredited investors and holding regular meetings, are required to have "defined processes and procedures" for investment decisions, but these processes and procedures are not required to be written. Additionally, the group may not be associated or affiliated with brokers, dealers or investment advisers.
- Issuers may continue to rely on the SEC's previously issued guidance, and not be subject to the conditions of Rule 148, including the limit on communications, if the organizer of the event has limited participation in the event to individuals or groups of individuals with whom the issuer or the organizer has a pre-existing substantive relationship or that have been contacted through an informal, personal network of experienced, financially sophisticated individuals.
- Concurrent offerings permitting general solicitation include Rule 506(c), Regulation A, and Regulation Crowdfunding and intrastate or regional offerings under Rules 147 and 147A or Rule 504(b)(1)(i), Rule 504(b)(1)(ii), Rule 504(b)(1)(iii).
- For example, the limitations on advertising the terms of an offering under Rule 204 of Regulation Crowdfunding would limit the issuer's ability to reference the terms of that offering in a general solicitation in connection with a concurrent offering made under Regulation A, Rule 506(c), or Rule 147A.
- However, a general solicitation permitted in connection with one offering that mentions the material terms of a concurrent or subsequent exempt offering prohibiting general solicitation may constitute an offer for the concurrent or subsequent exempt offering prohibiting general solicitation and thereby violate the prohibition on general solicitation for that concurrent or subsequent offering prohibiting general solicitation.
- An issuer may not conduct a Rule 506(c) general solicitation in order to identify potential investors for the Rule 506(b) offering. In that instance, such Rule 506(b) offering may be deemed to be commenced at the time of such solicitation under new Rule 152(c).
- Certain offerings by private funds that rely on the exclusions from the definition of "investment company" set forth in Investment Company Act Sections 3(c)(1) and 3(c)(7) posted on a website or platform may be able to rely on a limited staff accommodation concerning the timing of the formation of a relationship. See Division of Investment Management no-action letter to Lamp Technologies, Inc. (May 29, 1997).
- Under Rules 147, 147A, and 251, subsequent offers and sales will not be integrated with offers and sales that are registered under the Securities Act, exempt from registration under Rule 701, Regulation A, Regulation S, or Section 4(a)(6) of the Securities Act, or made under an employee benefit plan. Further, generally, transactions otherwise meeting the requirements of an exemption will not be integrated with simultaneous offers and sales of securities being made outside the United States in compliance with Regulation S.
- Statement of the Commission Regarding the Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Release No. 33-7516 (Mar. 23, 1998).
- By limiting the conditions to those outside the investor's control, an issuer may take the position that an offering is terminated or completed at a point in time before the actual closing of the transaction, so long as the only remaining conditions are solely within the issuer's control.
- See *id.* at Section II.B.3.a.

Material or Puffery? Avoiding Securities Fraud Exposure Based on Corporate Codes and Statements of Policy

By Joseph Rossello

Shareholder lawsuits claiming securities fraud in violation of Rule 10b-5¹ have long had the potential to expose public companies to liability. These cases are often triggered by nothing more than a drop in stock price, after which shareholder plaintiffs allege that the change in price reflects newly public information that the company previously and improperly misrepresented or concealed.² Recently, a growing number of securities fraud suits have focused on statements or omissions in or about a company's code of conduct or code of ethics. These lawsuits allege that the code is misleading, or the company has failed to correct statements in the code, given widespread misconduct. These claims are increasingly common in so called "event-driven" cases—those that "arise out of otherwise unrelated legal and compliance issues."³ For example, bribery investigations might lead shareholders to claim that the code of conduct was misleading in its statement of ethics.⁴ More recently, the #MeToo movement has inspired sexual harassment victims to come forward and, in turn, securities fraud allegations that companies misrepresented their policy by not addressing widespread harassment.⁵ As the #MeToo movement grows, important questions will surely be raised concerning the conditions in which directors and officers can be held liable to shareholders for sexual misconduct in a securities fraud lawsuit.⁶

For shareholders to successfully prosecute a securities fraud claim, Rule 10b-5 requires that they allege that the defendant company has made a misstatement or omission. A company will be found liable under Rule 10b-5 only if the misstatement or omission is material. Materiality is generally a mixed question of law and fact, and is decided as a matter of law only when "reasonable minds could not differ on" the statement's importance.⁷ There are cases where this standard is met and alleged misstatements or omissions are deemed immaterial as a matter of law. For example, certain statements may be considered mere "puffery" when they are too general to induce a reasonable investor's reliance on them.⁸

This article focuses on allegations by shareholders that a corporation's policy statement, or alleged related omissions, violated Rule 10b-5. Securities fraud cases where shareholders claim that a company misrepresented its policy, or omitted material information in its policy, are not often successful, but if the statements of policy are specific enough, or the company fails to correct previous statements, the claims may be actionable. Many courts find that these claims are an attempt by shareholders to take advantage of a company's corporate mismanagement and turn it into their own fortune. In this context, this article will specifically address whether the codes of

conduct or statements of policy are material and, thus, give rise to a Rule 10b-5 claim. In this effort, it is imperative to differentiate between statements and omissions that are material, and those that are mere puffery.⁹

Rule 10b-5 Background: Materiality v. Puffery

To recover damages and avoid dismissal under Section 10(b) and Rule 10b-5, a complaint must plausibly allege: (1) a material misrepresentation (or omission); (2) scienter, i.e., a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.¹⁰ A complaint alleging securities fraud under § 10(b) of the Exchange Act must satisfy the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 (PSLRA).¹¹ These well-known standards require, in relevant part, that "securities fraud complaints specify each misleading statement . . . [and] state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹²

In order for plaintiff shareholders to be successful in suing a company based on a company's misrepresented policy or code of conduct, a key component is whether the company "materially" misrepresented its policy. An alleged misrepresentation is material if "there is a substantial likelihood that a reasonable person would consider it important in deciding whether to buy or sell shares of stock."¹³ Such a statement must, in the view of a reasonable investor, have "significantly altered the 'total mix' of information made available."¹⁴ Materiality depends upon a number of context-specific factors, including specificity, emphasis, and whether certain statements are designed to distinguish the company in some fashion that is meaningful to the investing public.¹⁵ The statement must also be "mislead[ing]," evaluated not only by "literal truth," but by "context and manner of presentation."¹⁶ Many times a company's Code of Ethics or Policy is general and vague, and courts, therefore, categorize these statements as mere "puffery."

Puffery is an expression of opinion, while a misrepresentation is a knowingly false statement of fact. Puffery is a finding that the statements are "not capable of objective verification."¹⁷ "[V]ague, generalized, and unspecific assertions" of corporate optimism or statements of "mere puffing" cannot state actionable material misstatements

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of fact under federal securities laws.¹⁸ Nonactionable puffing statements amount to nothing more than vague statements of optimism, and include words like “good,” “well-regarded,” or other feel-good monikers.¹⁹ Moreover, the Ninth Circuit has noted that investors do not rely on puffery when making investment decisions.²⁰

Codes of Conduct as “Aspirational” Puffery

Understanding whether a statement is material or puffery is critical when assessing whether a plaintiff shareholder will be successful in a securities fraud lawsuit under Rule 10b-5. In *Singh v. Cigna Corporation*, the Second Circuit characterized plaintiffs’ suit as a creative attempt to recast corporate mismanagement as securities fraud.²¹ There, Cigna Corporation made several statements regarding regulatory compliance. One of those statements was published in a corporate pamphlet entitled “Code of Ethics and Principles of Conduct” and it said: “it’s so important for every employee . . . to handle, maintain, and report on [Cigna’s financial] information in compliance with all laws and regulations.”²² Additionally, Cigna stated on its yearly Form 10-K that it “expects to continue to allocate significant resources” to compliance.²³ However, during the period these statements were released, Cigna’s Medicare operations experienced a series of compliance failures and, as a consequence, Cigna’s stock price dropped substantially, leading shareholders to file suit.²⁴

The shareholders argued that these policy statements were materially misleading because a reasonable stockholder would rely on these statements as representations of satisfactory legal compliance by Cigna.²⁵ The Second Circuit held that a reasonable stockholder would not “consider [these statements] important in deciding whether to buy or sell shares of stock,” and, thus, the statements did not constitute “material misstatements.”²⁶ The Second Circuit added that the statements in Cigna’s Code of Ethics were a textbook example of “puffery.”²⁷ The court reasoned that “general statements about reputation, integrity, and compliance with ethical norms are non-actionable ‘puffery,’ meaning that they are too general to cause a reasonable investor to rely upon them.”²⁸ In affirming the district court’s decision, the Second Circuit dismissed for failure to state a claim, holding that the shareholders failed to plausibly allege that a reasonable investor would view these statements “as having significantly altered the total mix of information made available.”²⁹

The content of policy statements is not always about a company’s finances. In *Ferris v. Wynn Resorts Limited*, shareholders claimed that Wynn Resorts did not take seriously or promptly investigate the alleged sexual misconduct of the company’s founder, Stephen Wynn.³⁰ The shareholders framed this as an alleged securities fraud violation based upon statements in the company’s Code of Conduct (“the Code”) about harassment and

discrimination. The shareholders alleged that “contrary to the Code’s statement that ‘[h]arassment’ and ‘discrimination of any sort will not be tolerated’ and its requirement that violators will be disciplined, such conduct by defendant Wynn was tolerated and condoned at the highest levels of management, and he was never disciplined.”³¹ They alleged that Wynn was not disciplined and a *Wall Street Journal* article “revealed the extent of his egregious conduct and forced his ouster from the Company.”³² The shareholders alleged that these statements and references to the policy were materially false and misleading, because the Code was not, as it stated, applied to “all employees, officers, directors and officers.”³³ Additionally, the shareholders alleged that the corporation “failed to report these incidents to the applicable gaming regulators, as required by law, thus jeopardizing the company’s critically needed gaming licenses.”³⁴

The corporation maintained that the Code, and references to the Code contained in the company’s annual reports, were “inherently aspirational,” and, therefore, did not support a claim for securities fraud.³⁵ The corporation also argued that, like every publicly traded company, Wynn Resorts is required to disclose whether it has adopted a code of ethics and, if so, the company must publish it.³⁶ It went on to explain that, pursuant to NASDAQ Rule 5610, each company shall adopt a code of conduct applicable to all directors, officers, and employees, which shall be publicly available.³⁷ Thus, “it simply cannot be that every time a violation of that code [of conduct] occurs, a company is liable under federal law for having chosen to adopt the code at all, particularly when the adoption of such a code is effectively mandatory.”³⁸

The district court in Nevada held for Wynn Resorts on the same grounds as the Second Circuit in *Singh*—that the references to the code were “inherently aspirational.”³⁹ Additionally, the district court in Nevada held that the statements were not actionable based on the company’s argument that it is effectively mandatory to adopt a code of conduct, and the company should not be held liable every time a violation occurs.⁴⁰

A shareholder in a securities fraud suit against Hewlett Packard (HP), also in the context of wider sexual misconduct allegations, met with a similar fate. In *Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.*, an investor asserted securities fraud based on the CEO’s violation of the corporate code of conduct that promoted the corporation’s high standards for ethics and compliance, and statements and omissions related to that code of ethics.⁴¹ Like the Second Circuit in *Singh*, the Ninth Circuit noted that the ethics code and statements promoting it were “transparently aspirational.”⁴² The Ninth Circuit held that the promotion of ethical conduct at HP did not reasonably suggest that there would be no violations of its code of ethics, by the CEO or anyone else.⁴³ Therefore, the securities fraud claims were not actionable.

When Codes of Conduct Might Give Rise to Actionable Securities Fraud Claims

While *Singh*, *Wynn* and *HP* might suggest that these securities fraud claims are not viable because codes of conduct are aspirational, more specific statements of policy may survive a motion to dismiss by showing that the statements made by a company are directly at odds with the conduct alleged in the complaint, and thus the statements are material and not merely puffery.⁴⁴

For example, in *In re Signet Jewelers Limited Securities Litigation*, an investor brought a securities fraud action against a corporation arising out of the company's misrepresentations of its alleged pervasive culture of sexual harassment.⁴⁵ There, Signet Jewelers Limited had been sued by a class of current and former female employees alleging that they were subject to gender discrimination through improper promotion and compensation practices, in violation of Title VII and the Equal Pay Act.⁴⁶ Among other allegations, the employees who filed suit alleged that the ranks of Signet's executives were filled with "womanizers," "playboys," and serial sexual harassers who made "sexual conquests of female associates."⁴⁷ They claimed that sexual harassment occurred in the ordinary course of business and at the company's annual "Managers Meetings," where male executives "sexually preyed" on female subordinates and engaged in "sexually promiscuous activity" with "subordinate female managers."⁴⁸ They also alleged that female employees were propositioned to engage in sexual behavior in exchange for employment advancement opportunities; those who accepted were rewarded by way of promotion, and those who declined or reported the activity to an anonymous hotline were retaliated against.⁴⁹ The day after these allegations were made public, the *Washington Post* wrote an article containing these details, and the day after the article was published, Signet's stock fell 8.3% by midday.⁵⁰

Among other things, the complaint in the *Signet* securities fraud action alleged that the emergence of the declarations from witnesses in the discrimination case rendered false and misleading Signet's public statements about its corporate culture and commitment to preventing gender discrimination. The securities fraud action claimed that the declarations from the previous discrimination lawsuit demonstrated that Signet had a "pervasive culture of sexual harassment."⁵¹ Plaintiff pointed to statements contained in Signet's Code of Conduct and Code of Ethics, which stated, among other things, that it was "committed to a workplace that is free from sexual, racial, or other unlawful harassment" and would not tolerate "[a]busive, harassing, or other offensive conduct . . . whether verbal, physical, or visual."⁵² The plaintiff alleged that these and other statements in Signet's Code of Conduct and Code of Ethics were "directly contravened by allegations in the [discrimination action] complaint that the company conditioned employment decisions on

whether female employees acceded to sexual demands and retaliated against women who attempted to anonymously report sexual harassment."⁵³

Signet moved to dismiss all securities fraud allegations in reliance on the Second Circuit's decision in *Singh v. Cigna Corp.* However, the District Court for the Southern District of New York rejected Signet's contention that the representations contained in Signet's Codes concerning their policies and procedures against sexual harassment constituted non-actionable puffery and, rather, held that the statements in Signet's Code of Conduct were material.⁵⁴

The main difference between *In re Signet* and *Singh* is that the statements contained in the Signet Codes were directly at odds with the conduct alleged in the complaint, thus making the statements actionable, whereas the general, open-ended or aspirational statements portrayed in *Singh* did not give rise to securities fraud.⁵⁵ In *Signet*, in the face of a credible accusation that the company suffered from widespread sexual harassment, the company sought to reassure the investing public that it did not in fact have a toxic workplace. It did so by denying the allegations in the prior lawsuit and by pointing to its corporate policies about sexual harassment and discrimination.⁵⁶ Signet's words were not truthful, and these same words were relied upon by a reasonable investor who otherwise would be concerned about how grave allegations concerning rampant sexual misconduct might affect their investment in Signet. In *Singh*, by contrast, the company did not deny anything in regards to legal compliance. Further, in *Wynn*, even though the company denied any misconduct in a press release statement, the court found that the shareholders failed to plead falsity with particularity, thus failing to satisfy the heightened pleading requirements of Federal Rule of Civil Procedure 9(b).⁵⁷ Where several defendants are alleged to be part of the fraud, "Rule 9(b) 'does not allow a complaint to . . . lump multiple defendants together but require[s] plaintiffs to differentiate their allegations when suing more than one defendant.'"⁵⁸

Similarly, the plaintiffs in *Richman v. Goldman Sachs Group, Inc.* were able to survive a motion to dismiss in a securities fraud action against Goldman Sachs.⁵⁹ There, the shareholders alleged that the company's generic statements about its business principles and conflicts of interest policy omitted material information about alleged conflicts of interest. The conflicts at issue involved several collateralized debt obligation (CDO) transactions involving subprime mortgages.⁶⁰ The shareholders alleged that, publicly, Goldman marketed Abacus as an ordinary asset-backed security, through which investors could buy shares in bundles of mortgages that the investors, and presumably Goldman, hoped would succeed.⁶¹ But behind the scenes, Goldman purportedly allowed the hedge fund Paulson & Co. to play an active role in selecting the mortgages that constituted the CDO. And Paulson &

Co., which bet against the success of the Abacus investment through short sales, chose risky mortgages that it “believed would perform poorly or fail.”⁶² The alleged plan worked, and Paulson made roughly \$1 billion at the expense of the CDO investors.⁶³

However, the plaintiffs in the securities fraud action were not the investors in the CDOs. They were Goldman’s own shareholders, and they argued that Goldman’s conduct “involved both client conflicts and outright fraud.”⁶⁴ They contended that Goldman created “clear conflicts of interest with its own clients” by “intentionally packaging and selling . . . securities that were designed to fail, while at the same time reaping billions for itself or its favored clients by taking massive short positions” in the same transactions.⁶⁵ Chiefly, they argued that Goldman made a material omission regarding Paulson’s role in the asset selection process when it spoke about the CDO.⁶⁶

Goldman moved to dismiss and argued that statements in its conflict policy and any alleged omissions were non-actionable. It argued that the statements were opinion, puffery, or mere allegations of corporate mismanagement and that Goldman’s conflict of interest disclosures foreclosed liability for any alleged omissions.⁶⁷

The District Court for the Southern District of New York recognized that expressions of puffery and corporate optimism do not give rise to securities violations.⁶⁸ However, optimistic statements may be actionable upon a showing that the defendants did not genuinely or reasonably believe the positive opinions they touted, or that the opinions implied certainty.⁶⁹ Moreover, by putting the “topic of the cause of its financial success at issue, a company then is ‘obligated to disclose information concerning the source of its success, since reasonable investors would find that such information would significantly alter the mix of available information.’”⁷⁰

Additionally, the court held that plaintiffs plausibly alleged that Goldman made a material omission regarding Paulson’s role in the asset selection process when it spoke about this topic.⁷¹ In general there is no duty to disclose a fact “merely because a reasonable investor would very much like to know that fact.”⁷² However, “[d]isclosure is required . . . when necessary ‘to make statements made, in light of the circumstances under which they were made, not misleading.’”⁷³ In other words, a duty to provide information exists only where statements were made that were misleading in light of the context surrounding the statements.⁷⁴ Once a company speaks on an issue or topic, even when there is no existing independent duty to disclose information, there is a duty to tell the whole truth. “A duty to disclose arises whenever secret information renders prior public statements materially misleading.”⁷⁵ Thus, when a company makes a disclosure about a particular topic, whether voluntary or required, the representation must be complete and accurate.⁷⁶ This is exactly why the court in *Richman* denied Goldman’s motion to dismiss. While Goldman publicly

marketed Abacus as an ordinary asset-backed security, Goldman allowed Paulson & Co. to play an active role in selecting the mortgages that constituted the CDO.⁷⁷ Because Goldman had not disclosed this to the public and the company’s investors, the court held that Goldman made a material omission, by concluding that Paulson’s role was “a fact that, if disclosed, would significantly alter the ‘total mix’ of available information.”⁷⁸ The court could not say that Goldman’s statements would be so obviously unimportant to a reasonable investor.⁷⁹ In *Richman*, the court determined that the omitted facts were of substantial importance to Goldman shareholders, and thus material.

Conclusion

The basic purpose of the federal securities regulatory statutes is to promote investor confidence by insuring honest securities markets.⁸⁰ Rule 10b-5 is designed to protect investors from fraudulent practices, by transcending the gaps and limits of the common-law actions available to securities traders injured by false representations or failures to disclose.⁸¹ The effects and protections afforded by Rule 10b-5 have to do with the investors of the company, not necessarily the people directly affected by the policy statement that gives rise to the securities fraud claim. It is crucial for both the investor and the company to recognize statements and omissions that are material, i.e., where there is a substantial likelihood that a reasonable investor would consider them important in deciding how to act. It is important to distinguish a material statement from a statement of puffery, a statement that does not support a claim of securities fraud and which includes vague, soft, or obvious hyperbole upon which a reasonable investor would not rely.⁸²

With a rising number of securities fraud lawsuits targeting statements in or about a company’s code of conduct or ethics, understanding the technicalities of a securities fraud lawsuit, specifically whether a statement or omission is material or not, will be the ultimate factor in determining whether a company will be found liable or not. It is imperative for companies to know that courts are less likely to credit a code-of-conduct based theory of securities fraud where the code of conduct contains broad and aspirational statements describing a company’s ethical goals; the code of conduct sets out standards or guidelines for employee behavior, as opposed to mandatory rules; and statements surrounding or about the code of conduct emphasize its aspirational nature.⁸³

Endnotes

1. See 17 C.F.R. § 240.10b-5.
2. See Adam F. Ingber, *10b-5 or Not 10b-5: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 Fordham L. Rev. S351, S354 (1993).
3. Davis Polk, Code of Ethics and Securities Litigation, Client Memorandum (April 30, 2020), available at https://www.davispolk.com/sites/default/files/codes_of_ethics_and_securities_litigation.pdf (last visited February 5, 2021).

4. *Id.*
5. *Id.*
6. See Daniel Hemel & Dorothy S. Lund, *Sexual Harassment and Corporate Law*, 118 Columbia L. Rev. 1583, 1589 (2018). (“The #MeToo movement will likely lead to many more such claims, raising important doctrinal questions for scholars and practitioners of corporate and securities law that the existing academic literature has yet to address.”).
7. *Litwin v. Blackstone Grp., L.P.*, 634 F.3d 706, 717 (2d Cir. 2011).
8. *City of Pontiac Policemen’s & Firemen’s Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014).
9. Sarah Lightdale, Ian Shapiro, and Linh Nguyen, *Puffery or Not? Courts Examine Corporate Codes of Conduct*, New York Law Journal. (2020).
10. *Halliburton Co v. Erica P. John Fund, Inc.*, 573 U.S. 263, 267 (2014).
11. *City of Pontiac Policemen’s and Firemen’s retirement System v. UBS AG*, 752 F.3d 176, 184 (2d Cir. 2014).
12. *Id.*
13. *Singh v. Cigna Corporation*, 918 F.3d 60, 63 (2d Cir. 2019).
14. *Id.*
15. *In re Signet Jewelers Limited Securities Litigation*, 398 F. Supp.3d. 233, 229 (S.D.N.Y 2019).
16. See Cigna Corporation, 918 F.3d at 63.
17. *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119 (10th Cir. 1997).
18. *Glen Holly Entertainment, Inc. v. Tektronix Inc.*, 352 F.3d 367, 379 (9th Cir. 2003).
19. *Oregon Public Employees Retirement Fund v. Apollo Group Inc.*, 774 F.3d 598, 606 (9th Cir. 2014).
20. *In re Cutera Sec. Litig.*, 610 F.3d 1103, 111 (9th Cir. 2010).
21. See Cigna Corporation, 918 F.3d at 60.
22. See *id.* at 61.
23. *Id.*
24. *Id.*
25. See *id.* at 63.
26. *Id.*
27. *Id.*
28. *Id.*
29. See *id.* at 64.
30. *Ferris v. Wynn*, 462 F. Supp.3d 1107, 1111 (D.NV 2020).
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. See *id.* at 1121.
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. See *id.* at 1122.
41. *Retail Wholesale & Department Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.*, 845 F.3d 1268 (9th Cir. 2017).
42. See *Hewlett Packard Co.*, 845 F.3d at 1278.
43. *Id.*
44. See *In Re Signet Jewelers Limited Securities Litigation*, 389 F.Supp.3d at 227.
45. See *id.* at 224.
46. *Id.*
47. See *id.* at 225.
48. *Id.*
49. *Id.*
50. *Id.*
51. See *id.* at 226.
52. *Id.*
53. See *id.* at 227.
54. See *id.* at 226.
55. See *id.* at 227.
56. See *id.* at 231.
57. See *Wynn*, 462 F.Supp.3d at 1127.
58. *Destifino v. Reiswig*, 630 F.3d 952, 958 (9th Cir. 2011).
59. *Richman v. Goldman Sachs Group, Inc.*, 868 F.Supp.2d 261, 277 (S.D.N.Y 2012).
60. *Arkansas Teacher Retirement System v. Goldman Sachs Group, Inc.*, 955 F.3d 254, 259 (2d Cir. 2020).
61. *Id.*
62. *Id.*
63. *Id.*
64. See *Goldman Sachs Group, Inc.*, 868 F.Supp.2d at 278.
65. See *Goldman Sachs Group, Inc.*, 955 F.3d at 260.
66. See *Goldman Sachs Group, Inc.*, 868 F.Supp.2d at 278.
67. See *id.* at 277.
68. *Id.*
69. *Id.* at 278.
70. *Id.*
71. *Id.* Notably, in April of 2020, the Second Circuit in *Arkansas Teacher Retirement System v. Goldman Sachs Group, Inc.* allowed a class action accusing the bank of hiding conflicts of interest when creating risky subprime securities before the 2008 financial crisis. Greg Stohr, *Goldman Gets High Court Review It Sought on Investor Suits*, Bloomberg. (2020). Goldman says that this decision makes it too easy for investors to band together in a single lawsuit. *Id.* Recently, the U.S. Supreme Court agreed to hear Goldman Sachs Group Inc’s appeal in the securities fraud case. *Id.* A decision is likely before the end of the court’s current term in June.
72. *In re Time Warner Inc. Securities Litigation*, 9 F.3d 261, 267 (2d. Cir. 1993).
73. *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011).
74. See *Hewlett Packard Co.*, 845 F.3d at 1278.
75. *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245 (2d. Cir. 2014).
76. *Id.*
77. See *Goldman Sachs Group, Inc.*, 955 F.3d at 259.
78. See *Goldman Sachs Group, Inc.*, 868 F.Supp.2d at 280
79. *Id.*
80. *Chadbourn & Parke LLP v. Troice*, 571 U.S. 377, 390 (2014).
81. Sally J.T. Necheles, *Cause of Action for Securities Fraud Under Section 10(b) of 1934 Securities Exchange Act and/or Rule 10b-5*, 74 Causes of Action 2d 567 (2016).
82. *Id.*
83. Sarah Lightdale, Ian Shapiro, and Linh Nguyen, *Puffery or Not? Courts Examine Corporate Codes of Conduct*, New York Law Journal. (2020).

Compliance Problems in Website Accessibility and Implications for Entrepreneurs

By Kei Komuro

Over the last decades, making a website has become a popular business decision for many entrepreneurs. According to the websites survey conducted by a marketing company in 2018, two-thirds of small businesses have their own websites; even for small businesses without a website, more than half of them plan to build their websites.¹ We can easily expect that a greater number of small businesses may want to develop their own websites, especially during this challenging time, when the country is under lockdown and otherwise operating in a business-unfriendly environment. Although a substantial number of entrepreneurs wish to establish websites, they face significant challenges in designing them. In this article, certain legal problems, in particular, trademark, privacy, and ADA compliance issues, will be explored, and recommendations will be made to address them.

Part 1 of this article discusses the legal issues that may arise when entrepreneurs contemplate the names of their websites and the names of the original brand products that they plan to sell on them. Operators need to comply with several standards in choosing the names (e.g., operators should select a name that does not describe precisely what the product is). Even if the names satisfy certain criteria, entrepreneurs still need to check whether other parties have already used names that are identical or similar to the names the entrepreneurs plan to use.

Part 2 of the article focuses on privacy issues. As websites collect several kinds of information from the customers, entrepreneurs need to realize that they put themselves at risk if they do not inform customers that they collect, use, and disclose the customers' information. To minimize the risks, they need to consider not just federal laws but also state laws. California is one of several states that have privacy laws that require the operators to meet a higher standard of customer protection. It is important for entrepreneurs to be aware that once they go online, their customers are no longer local but national, which might expand the business but expose the entrepreneurs to greater risks.

Part 3 suggests what entrepreneurs may do to make their websites available to disabled individuals. As websites are likely considered "public accommodations" under the Americans With Disabilities Act, businesses that have websites need to make sure that people with disabilities have "equal and full enjoyment" of whatever is provided on the websites. In making the websites friendly for people with disabilities, business owners should design websites that comply with the Web Con-

tent Accessibility Guidelines created by the Worldwide Web Consortium. It is also important to note that the entrepreneurs may still be liable even if a third party wholly or partly operates the websites.

In each part, I use fictional characters to demonstrate what an actual business might be faced with when setting up a website. Although the article includes several points that readers may find useful, please note that this is written for educational purposes. Business owners should consult with legal professionals to ensure their websites are in compliance with federal and state laws.

Legal Problems and Operations

When entrepreneurs start to conduct a business online, they will consider what to include and what to not include on their websites. Some people prefer to create their websites themselves, while some ask third parties to develop the websites for them. Third parties provide different types of services; some parties design the website from scratch, while others offer templates business owners can choose from and customize.²

Whether entrepreneurs make the websites themselves or use third parties to build the platforms, they can easily fall into legal pitfalls. For instance, companies you never heard of might bring a lawsuit if they find out that their website's name is confusingly similar. Customers might claim that they feel uncomfortable when they put their personal information into the entrepreneur's website. Customers with disabilities might even sue the business if they cannot easily operate the website. Unless the business owners have legal expertise themselves or use third parties that provide high-level legal services, they often do not know what legal risks they are taking and how should they deal with them.

Now, let's suppose that John, the owner of a local coffee shop, Fordham Coffee,³ faced with the impact of the global pandemic on retail sales, decides to launch a website where his customers can buy coffee beans and other associated products. To save money, John tries to make the website almost entirely on his own. When he starts to think about the name of the website and Fordham Coffee's original brand products to be sold online, he faces several problems—how should he create the names that will be exposed to preexisting and potential customers on the internet? Should he care about trademark issues,

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even if he does not plan to register his business name as a trademark?

Part 1: Trademark Compliance

A. Factors Affecting the Choice of Name

Entrepreneurs should be aware if any substantive legal reasoning bars the use of the name, whether it is the name of the website or the name of the original brand products. From a trademark eligibility standpoint, business owners must consider several elements, including, but not limited to, the feature, distinctiveness, and descriptiveness of the name. There are several factors that the websites or original brand products may or must (or must not) have in their names.

1. May and Must: What Entrepreneurs Should Do To Comply

The name of the online business should be distinctive, and, wherever possible, related to the nature and purpose of the enterprise to be conducted; however, the name should not generically describe exactly what the product is, as such names are difficult to protect with trademarks.⁴ For instance, John's website should not be named "Online Coffee Store" because it is a generic description and therefore cannot be trademarked.

Instead, the name may be a coined term (i.e., a term that did not previously exist in the English language).⁵ The name may also be an arbitrary mark (i.e., a mark not commonly associated with the product or service).⁶ Furthermore, the name can be suggestive or something that requires the consumer to exercise some imagination to determine the nature of the goods or services.⁷

Accordingly, Fordham Coffee's original brand coffee may be named "Samurai" because the term may be non-English and does not have to be necessarily linked with coffee; it also may suggest strength and energy.

The name must not be merely descriptive or deceptively nondescriptive.⁸ For instance, the name must not describe an ingredient, quality, characteristic, function, feature, purpose, or use of the specific goods or services.⁹ Furthermore, the name must not convey misrepresentations.¹⁰

Going back to our example, then, Fordham Coffee's original brand coffee should probably not be named just "Decaf Blend," because it merely describes the feature of the product. The name of the original brand coffee should not include the word "decaf" if the coffee contains caffeine. This is because presenting regular coffee as decaf coffee misrepresents this feature of the product.

The name should also not be primarily geographically descriptive or primarily geographically deceptively nondescriptive, especially if the primary significance of the name is a generally known geographic location; consumers would be likely to think that the goods or

services originate in the geographic place identified in the mark, or that the name identifies the geographic origin of the products or services.¹¹ For instance, Fordham Coffee's original brand coffee should not be named "Columbian Coffee," if the coffee beans come from Ethiopia because it mistakenly describes where the coffee originated. Besides, even if the coffee beans come from Columbia, Fordham Coffee still should not name the product "Columbian Coffee," because it merely indicates the geographic origin of the coffee beans.

"The name of the online business should be distinctive, and, wherever possible, related to the nature and purpose of the enterprise to be conducted; however, the name should not generically describe exactly what the product is . . ."

Lastly, the name should not be merely someone's name.¹² For instance, John should not name his website "John's" or "John's Coffee."

It is important to note that even if entrepreneurs successfully come up with names that comply with the elements that are mentioned above, the names must be distinctive in describing the products' features, including, but not limited to, the sound, appearance, meaning, and commercial impression conveyed by the product or service.¹³ These features are considered only if consumers are likely to assume (mistakenly) that the associated goods/services come from a common source.¹⁴

Therefore, Fordham Coffee's website should not be named "Star Bags Coffee Club," because a company with a similar name already exists (Starbucks). Since there are chances that other companies have filed similar or identical names with the United States Patent and Trademark Office (USPTO), entrepreneurs cannot ignore the trademark issue. Even if they do not plan to register the name of their companies' websites or original brand products as the trademarks, they still risk being sued by the other companies. Businesses can prevent this by checking to see if an identical or similar names or trademarks have been filed by visiting the USPTO's website to see whether the name is available.¹⁵ This method alone, however, is insufficient to check whether the other parties use similar or identical names. Some parties might use the names, but don't file the names with the USPTO for several reasons (e.g., it's time-consuming and costly). Although it is difficult to fully ensure that only one entity uses the particular name, entrepreneurs should at least try to make sure that

other parties aren't using the names they want to use by searching the websites of the USPTO and other agencies.

With the help of an attorney, John comes up with the names of his website and original brand products, and he confirms that these names comply with the trademark rules. John decides to file the names with the United States Patent and Trademark Office to register them as trademarks so that he can make sure no one will use the names and that he will not be infringing on other businesses.¹⁶

Next John starts to think about how he will use his website to communicate with his customers. When the customers buy the coffee beans or associated products from John through the website, they need to put their addresses or other personal information on the websites. John is faced with several questions—to what extent should he care about the privacy of the customers? Does John need the consent of the customers when he provides their personal information to the coffee distributors, manufacturers, or other associated services?

Part 2: Privacy Compliance

A. The General Concept of Privacy

In the United States, the Federal Trade Commission plays a significant role in encouraging private businesses to make sure consumers know how they collect, use, and disclose the customers' personally identifiable information.¹⁷ If the companies fail to notify consumers when they receive the information, the FTC may file complaints against companies for collecting information without the customers' knowledge.¹⁸ The idea that the FTC emphasizes here is that consumers cannot offer consent where the website does not disclose what the operators do with the consumers' data.¹⁹

Although multiple definitions of personally identifiable information exist, it is essential to note that such information includes the data that can be "used to distinguish or trace an individual's identity, either alone or when combined with other personal or identifying information that is linked or linkable to a specific individual."²⁰ Examples of personally identifiable information include, but is not limited to, the Social Security Number, date and place of birth, personal financial information, employment record, and criminal record of an individual.²¹

When companies draft their privacy policies to inform the customers that they collect, use, and disclose personally identifiable information, they should mention these measures in detail. Importantly, the companies must identify the types of information that they collect and the ways they receive the information, how the company uses and protects the information, the kind of information that they share with third parties, and the customers' control over their information.²²

John starts to think about what kinds of customer information is necessary for his online coffee business. John noticed that his company collects various types of personal information, including contact information, payment information, shipping information of third parties (e.g., the address of the customer's friend), the customer's device identifiers (e.g., the IP address of the customer's computer), and the customer's browsing history.²³ After John identifies all the possible information that his online business will collect from the customers, John considers how such information will be collected. While some of Fordham Coffee's customers might purchase products with their computers, others might buy the products with their smartphones or tablets.²⁴ John also plans to use a system that allows Fordham Coffee's website to store the customer's information so that customers do not need to input their information every time they visit the website.²⁵

After John writes down the ways in which the personally identified information is collected, he should think about how he will use and protect the collected data. Since John wants to know which age group likes what kind of coffee, he would like to share the customer information with marketing companies and other service companies. John might also provide customer information to public authorities if he suspects there is fraud or criminal activity on his website. To prevent fraud and other types of crimes, John realizes that not only his company but also his customers need to put effort into protecting themselves; for instance, customers might make their passwords long and complicated to protect themselves from the chance of their passwords being stolen.²⁶ In addition, John realizes that it will be important to inform the customers that they can have a certain level of control over their personally identifiable information; they are able to adjust the amount of the information that they provide to John through the website.²⁷

Next John decides what to include in the privacy policy of Fordham Coffee. When he starts to draft the policy, he realizes that one substantial thing changes in the transition from a physical store to an online store—the scope of the customers. When John was operating his coffee business in his physical café, most of his customers were neighbors from the local area. Now, the customers are potentially from all U.S. states.²⁸ John takes a look at relevant statutory law to see if some states have any special privacy laws and learns that California has a unique privacy policy.

B. California Consumer Privacy Act (CCPA)

Although California has several complicated privacy laws, one of the most time-consuming laws to comply with is the California Consumer Privacy Act of 2018 (CCPA), which went into effect on January 1, 2020.

Under CCPA, the privacy policy must (1) disclose that California residents have the right to request the informa-

tion that the company collects from them, and that the companies are required to respond to the request, (2) provide alternative ways in which the customers may request the information (e.g., phone number, email address, etc.), (3) let the customers know that they have an option to opt out from giving their personally identified information to third parties, (4) list all the types of information the companies have collected, (5) disclose the sources of the information (i.e., the sources from which the companies receive the information), (6) disclose the purpose for col-

lection, we must look into the case law to determine the scope of a public accommodation.

In the *Winn-Dixie* case, the plaintiff, an individual with a vision disability, brought an action against the Winn-Dixie Stores, a regional chain of grocery stores, under Title III of the ADA.³² One of the issues discussed was whether the store's website, which was inaccessible to the plaintiff, was considered as a service of public accommodation. The federal court concluded that the website is a

“To design a website that is accessible to anyone . . . follow the four principles: it should be perceivable, operable, understandable, and robust . . . ”

lecting the information, and (7) list the information that the companies disclose to the third parties.²⁹

After John writes a memo about the provisions which specifically apply to California residents, he drafts a privacy policy. Meanwhile, he asks his web designer friend to help him create the Fordham Coffee website. When his friend asks about John's preferences for font, color, and sound features, John considers what kind of website will be attractive to his prospective customers. He remembers that one of his frequent customers is deaf. That prompts him to ask how he can make the website accessible for prospective customers with disabilities and wonders if he has to comply with any laws or guidelines.

Part 3: ADA (Americans With Disabilities Act) Compliance

A. Interpretation of “Public Accommodation”

Under the Americans With Disabilities Act (ADA), places of public accommodation are prohibited from discriminating based on disability and are required to comply with ADA standards.³⁰ It is a question whether a website is considered a public accommodation. Title III of the ADA states that a public accommodation is a facility whose business affects commerce and falls into one of 12 categories, including places of lodging, establishments serving food or drink, places of exhibition or entertainment, places of public gathering, sales or rental establishments, service establishments, public transportation terminals (depots or stations), places of public display or collection, places of recreation, places of education, social service center establishments, and places of exercise or recreation.³¹ Since the law does not explicitly state whether a website is included in the definition of public accom-

modation, where the website was “heavily integrated” with, and “operated as a gateway” to, the physical store locations.³³ In another case, *Gomez*, the court held that a website is not a place of public accommodation under the ADA, where the website is “wholly unconnected” to a physical store.³⁴ It might be questionable whether the companies whose websites are neither “heavily integrated” nor “wholly unconnected” with their physical stores should make their websites available for customers with disabilities. However, when we look at the ADA's purpose—that individuals with disabilities are to be given “full and equal enjoyment of the goods, services, facilities, privileges, advantages, or accommodations of any place of public accommodation”—we might find that even companies whose websites are slightly connected to physical stores should regard ADA as potentially applicable.³⁵ In other words, many private companies could be liable if their websites have not complied with ADA standards. It is important to note that even if third parties operate the websites, the businesses may still be liable if the websites lack accessibility.³⁶ Here, we face a substantial question—what standards should the companies comply with?

B. Web Compliance

While the ADA does not address particular standards that the companies should follow, the U.S. Department of Justice cites to the Web Content Accessibility Guidelines (WCAG) created by the World Wide Web Consortium, an international group that sets standards to improve web accessibility.³⁷ To design a website that is accessible to anyone, WCAG encourages website designers to follow four principles for their content: the websites should be perceivable (i.e., users must be able to perceive the information), operable (i.e., users must be able to operate the website), understandable (i.e., users must be able to

understand the data and the operation of the website), and robust (i.e., the content should remain accessible as technologies evolve).³⁸ Under these principles, the World Wide Web Consortium recommends compliance with 12 guidelines in creating accessible websites.³⁹

As for perceivability, the WCAG recommends that the website provide the following: (1) text alternatives (e.g., large texts and simpler language), (2) alternatives for time-based media (e.g., a screenplay for synchronized media content), (3) content that can be presented in different ways, and (4) content that is easy to see and hear.⁴⁰

As for operability, the WCAG recommends that the website provide the following: (5) the option to make every operation available from a keyboard, (6) enough time to read and use the content, (7) content that does not cause seizures, and (8) ways to help improve navigability by the users.⁴¹

As for understandability, the WCAG recommends that the website meet the following criteria: (9) readable and understandable, (10) functions in predictable ways, and (11) helps users avoid pitfalls (i.e., mistakes) in using the internet.⁴²

As for robustness, the WCAG advises that designers (12) maximize compatibility with developing technologies.⁴³

John researches the WCAG standards and instructs his web designer to include the features that satisfy all the 12 guidelines that the WCAG recommends. He also makes a note to regularly check the WCAG's website to see if there are any updates to help make sure that his website complies with any new accessibility standards in a timely manner.

Conclusion

While websites have been popular for many entrepreneurs, businesses face several challenges, including ensuring compliance with trademark, privacy, and ADA standards. Although these challenges are substantial, understanding the law will help business owners avoid potential lawsuits and can help them differentiate their business from others.

Having said this, considering these challenges alone may not be sufficient, because these are just some of the many number of issues that have to be addressed. Entrepreneurs need to look at specific laws concerning the type of business and products or services that they will provide online. For example, if John wants to sell online gift cards that can be used to purchase products on Fordham Coffee's website, John must avoid sales in excess of \$10,000 to a single person in any one day.⁴⁴ In addition to the three issues discussed here, entrepreneurs need to take a look at all laws that apply to their specific business. With regard to privacy, any website operators that

target children need to comply with the Children's Online Privacy Protection Act.⁴⁵

Although it is sometimes challenging to address all the issues around website accessibility, entrepreneurs need to stay up to date on website compliance laws if they wish to avoid legal pitfalls and to minimize potential risks as much as possible.

Endnotes

1. See *Small Business Websites in 2018*, Clutch, <https://clutch.co/website-builders/resources/small-business-websites-2018> (last visited February 2, 2020).
2. Several companies provide services whereby users can choose templates to create their own websites. Wix.com, Inc is one of such companies. See *About*, Wix.com, Inc, <https://ja.wix.com/about/us> (last visited February 2, 2020).
3. "John" and "Fordham Coffee" are fictional names used solely for the purpose of simulation.
4. See Isidore Kantrowitz et al. ¶ B301.01 Corporate Name Must Meet All Statutory Requirements, White, New York Business Entities (2020).
5. See Steven R. Gersz et al. §11.06 Utilizing Trademarks and Service Marks, LexisNexis Answer Guide New York Business Entities (2019).
6. See *id.*
7. See *Possible Grounds for Refusal of a Mark*, U.S. Patent and Trademark Office, <https://www.uspto.gov/trademark/additional-guidance-and-resources/possible-grounds-refusal-mark> (last visited February 10, 2020).
8. See *id.*
9. See *id.*
10. See *id.*
11. See *id.*
12. See *id.*
13. See *id.*
14. See *id.*
15. This method, however, might not show all ongoing filings. See *Search trademark database*, U.S. Patent and Trademark Office, <https://www.uspto.gov/trademarks-application-process/search-trademark-database> (last visited February 10, 2020).
16. Although the timing of filing depends on the entrepreneurs' preferences, it is generally recommended to file early to reduce the chance that another business might register a similar trademark. Furthermore, the registration allows entrepreneurs to file a trademark infringement lawsuit in federal court when the entrepreneurs find such infringement. See Jane Haskins, *When Is the Right Time to Trademark Your Brand*, LegalZoom.com, Inc. (Jun. 2017), <https://www.legalzoom.com/articles/when-is-the-right-time-to-trademark-your-brand>.
17. See Michelle Tyde & Brooke McGuffey, *Avoid Legal Traps When Drafting a Privacy Policy*, Daily Report (Oct. 26, 2016), <https://www.law.com/dailyreportonline/almID/1202770776395/avoid-legal-traps-when-drafting-a-privacy-policy/?sreturn=20200401144758>.
18. See Amanda Grannis, *You Didn't Even Notice! Elements of Effective Online Privacy Policies*, 42 *Fordham Urb. L. J.* 1109, 1170 (2016).
19. See *id.*
20. U.S. Gen. Serv. Admin, *Rules and Policies – Protecting PII – Privacy Act* (Jan. 12, 2020), <https://www.gsa.gov/reference/gsa-privacy-program/rules-and-policies-protecting-pii-privacy-act>.
21. See Office of Privacy and Open Gov't, *Safeguarding Information* (Oct. 7, 2019), https://www.osec.doc.gov/opog/privacy/pii_bii.html.

22. See Michelle Tyde & Brooke McGuffey, *Avoid Legal Traps When Drafting a Privacy Policy*, Daily Report (Oct. 26, 2016), https://www.law.com/dailyreportonline/a_lmiID/1202770776395/avoid-legal-traps-when-drafting-a-privacy-policy/?slreturn=20200401144758.
23. The author examined the privacy policy used by an actual company, Boxed Wholesale, an e-commerce startup, as an example. See *Privacy Policy*, Giddy Inc., <https://www.boxed.com/privacy-policy/> (last visited February 25, 2020).
24. See *id.*
25. Internet cookies are one of the popular systems that allow websites to collect and remember the customer's information. See *Internet Cookies*, Fed. Trade Comm'n, <https://www.ftc.gov/site-information/privacy-policy/internet-cookies> (last visited March 1, 2020).
26. See *Privacy Policy*, Giddy Inc., <https://www.boxed.com/privacy-policy/> (last visited February 25, 2020).
27. See *id.*
28. Here, we assume that John's business covers only the U.S.
29. Each section has specific rules that operators must comply with. For example, as for (1), customers can request that companies disclose their collected information twice per year, and the companies must respond to the request within 45 days upon receiving it. See Catherine D. Meyer, James R. Franco & Fusae Nara, *Countdown to the CCPA: Updating Your Privacy Policy*, 5-8 Pratt's Privacy and Cybersecurity Law Report 200 (2019).
30. See U.S. Dep't of Justice Civil Rights Div., *Information and Technical Assistance on the Americans with Disabilities Act*, https://www.ada.gov/ada_title_III.htm (last visited March 1, 2020).
31. See U.S. Dep't of Justice Civil Rights Div., *Americans with Disabilities Act ADA Title III Technical Assistance Manual Covering Public Accommodations and Commercial Facilities*, <https://www.ada.gov/taman3.html> (last visited March 1, 2020).
32. *Gil v. Winn-Dixie Stores, Inc.*, 257 F. Supp. 3d 1340, 1342 (S.D. Fla. 2017).
33. *Gil v. Winn-Dixie Stores* at 1348; see also *Nat'l Fed'n of the Blind v. Target Corp.*, 452 F.Supp.2d 946, 953-55 (N.D. Cal. 2006).
34. *Gomez v. Bang & Olufsen Am., Inc.*, No. [*1349] 16-23801, at 8, 2017 U.S. Dist. LEXIS 15457 (S.D. Fla. Feb. 2, 2017).
35. 42 U.S.C. § 12182(a).
36. See Minh N. Vu, *First Federal Court Rules That Having an Inaccessible Website Violates Title III of the ADA*, Seyfarth (June 13, 2017), <https://www.adatitleiii.com/2017/06/first-federal-court-rules-that-having-an-inaccessible-website-violates-title-iii-of-the-ada/>.
37. See Peter Boyd, *How To Test Your Website for ADA And WCAG Compliance*, Forbes (May 8, 2019), <https://www.forbes.com/sites/forbesagencycouncil/2019/05/08/how-to-test-your-website-for-ada-and-wcag-compliance/#71136bd467bf>.
38. World Wide Web Consortium, *Introduction to Understanding WCAG 2.1*, <https://www.w3.org/WAI/WCAG21/Understanding/intro#understanding-the-four-principles-of-accessibility> (last visited March 10, 2020).
39. World Wide Web Consortium, *Web Content Accessibility Guidelines (WCAG) 2.1*, <https://www.w3.org/TR/WCAG21/#toc> (last visited March 12, 2020).
40. See *id.*
41. See *id.*
42. See *id.*
43. See *id.*
44. See U.S. Dep't of the Treasury, *Frequently Asked Questions Regarding Prepaid Access* (Mar. 24, 2016), <https://www.fincen.gov/resources/statutes-regulations/guidance/frequently-asked-questions-regarding-prepaid-access>.
45. 15 U.S.C. § 6502(a)(1).

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How Sausage Is Made: The Latest Judicial Takes on Privilege and Work Product

By C. Evan Stewart

Readers of this distinguished journal have frequently been cautioned that litigating attorney-client privilege and work product issues is tricky enough when you handle the process correctly; handling the process incorrectly and then expecting a court to do somersaults to misapply the law to help you and your client out of self-imposed jams is likely to be asking too much.¹ Three recent federal court decisions in this space will test that proposition, and a review of them (in chronological order) should be helpful for litigators addressing these important matters.

SEC v. RPM International

In 2016, the Securities and Exchange Commission sued RPM International and its general counsel in federal court in the District of Columbia for failing to accrue and disclose properly for a DOJ False Claims Act investigation.² Six years earlier, in 2010, an individual had filed a sealed *qui tam* complaint against RPM. In March of 2011, the Department of Justice told RPM about the complaint, sent along a copy of it, and advised the company to treat the matter confidentially. Over the course of the next year RPM attempted to resolve the matter with DOJ. In January of 2013, RPM offered \$28.3 million; two months later DOJ countered with \$71 million. On April 1, 2013, RPM (for the first time) recorded on its books a contingency reserve of \$68.8 million to cover the matter. And three days later, RPM disclosed publicly the DOJ investigation and the company's financial accrual.³

On January 27, 2014, the SEC informed RPM that it had begun an investigation into the timing of RPM's accrual and disclosure. In July of the same year, the company's outside auditor, EY, informed RPM that it would not sign off on an upcoming 10-K unless the Audit Committee hired an independent law firm to investigate the matter. As a result, the committee hired Jones Day, which then proceeded to conduct 19 interviews of in-house and outside lawyers, RPM executives, and three EY auditors. On August 10, 2014, Jones Day made an oral presentation of its findings and conclusions to EY; thereafter, the lead EY partner prepared a written memorandum summarizing Jones Day's presentation. (Jones Day had also provided updates to EY over the course of its investigation, and the same EY partner wrote some memoranda on those updates.) In addition, Jones Day lawyers had prepared draft memoranda covering the 19 interviews.

On August 21, Jones Day provided to the SEC an oral summary of its investigation, subject to a non-waiver agreement.⁴ Later in 2014, EY, in response to an SEC document request, produced, *inter alia*, the lead partner's

memoranda reflecting Jones Day's presentations. Before they were sent to the SEC, RPM reviewed those documents and requested limited redactions; it did not object to EY producing the materials.

More than four years later, as the SEC was about to conclude discovery in federal court, the commission demanded disclosure of the Jones Day interview memoranda. RPM resisted, citing attorney-client privilege and work product. On February 12, 2020, Judge Amy Berman granted the SEC's motion to compel.

With respect to the work product argument, Judge Berman rejected it on two separate grounds. First, the memoranda were not prepared "because of" litigation,⁵ rather they were part of the effort to satisfy EY in order to get an approved 10-K. Second, the documents did not constitute opinion work product because they were "completely devoid of legal opinions, thoughts, or mental impressions" and "contain[ed] no analysis whatsoever." As to any company claim of attorney-client privilege, the judge ruled that RPM had waived the privilege by orally sharing the contents of the memoranda with a third party.⁶

Putting aside public hand wringing and anguished cries from the usual suspects,⁷ Judge Berman—in my view—got it right. The hiring of Jones Day by the Audit Committee had no contemporaneous recordings of litigation (anticipated or otherwise) having anything to do with the law firm's mandate. Big mistake. And interview memos by lawyers that are merely verbatim recountings of what witnesses said are, by definition, *not* opinion work product. Another mistake. As far as waiver by Jones Day disclosing actual witness statements (in quotes) to EY, lawyers need to remember that this is an area where there is a key difference between the privilege and work product. Lawyers can share work product with third parties (like accountants) working in unison with/under the direction of lawyers; but sharing client confidences with the same third parties kills the privilege. And, of course, here RPM went one waiver bridge further: it approved the EY documents with the "privileged" quotes going over to the SEC. Oy!⁸

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In re Fluor International

In 2017, Fluor instituted an internal investigation growing out of the conduct of an employee with respect to military contracts in Afghanistan. The matter was handled by inside counsel and it ultimately led to (i) the employee being terminated, and (ii) the company reporting the investigation's findings to the government, as is required when a government contractor has "credible evidence" that certain federal laws have been violated, including the False Claims Act.⁹

"The Fourth Circuit, clearly emboldened by a demonstrably wrongly decided set of earlier decisions by the D.C. Circuit, went against directly on point precedent by the U.S. Supreme Court in granting the writ of mandamus."

The employee thereafter brought suit against Fluor in federal court, asserting multiple claims, including wrongful termination, defamation, and negligence resulting from Fluor's investigation and disclosure thereof to the government. The employee sought Fluor's investigatory files in discovery, which the company resisted, citing attorney-client privilege and work product. The magistrate sided with Fluor, but the federal district judge disagreed. The judge ruled that four statements in the disclosure made to the government revealed "legal conclusions which characterize [the employee's] conduct in a way that reveals attorney-client communications." As a result, there had been a waiver of privilege as to the statements, and other communications on the same matters, as well as factual work product relating thereto.

With disclosure mandated by the court, Fluor brought a petition for a writ of mandamus to the Fourth Circuit on March 2, 2020. That petition was granted on March 13, and the appellate court ruled on March 25 (in an unpublished opinion).¹⁰

From a procedural standpoint, this is a problematic ruling. The Fourth Circuit, clearly emboldened by a demonstrably wrongly decided set of earlier decisions by the D.C. Circuit,¹¹ went against directly on point precedent by the U.S. Supreme Court in granting the writ of mandamus. As the Supreme Court has made crystal clear (I thought): "an interlocutory appeal is *not available* in attorney-client privilege cases."¹² The Fourth Circuit went on to poo-poo the efficacy of Fluor taking a contempt citation, although such a route is in fact the proper way to get interlocutory appellate review of such matters.¹³ The circuit court ultimately justified its grant of the petition to the fact that "the district court's decision has potentially far reaching consequences for companies subject to [the applicable, government] disclosure requirements.... [C]ompanies would err on the side of making vague or incomplete disclosures, a result patently at odds with the

policy objectives of the regulatory disclosure regime at issue in this case."¹⁴

On the substantive side, the decision fares better. The district court judge focused on four statements as constituting the waiver: (1) the plaintiff "appears to have inappropriately assisted . . ."; (2) "Fluor considers [that] a violation. . . ."; (3) the plaintiff "used his position . . . to pursue [improper opportunities] and . . . to obtain and improperly disclose nonpublic information. . . ."; and (4) "Fluor estimates that there may have been a financial impact. . . [as a result of] improper conduct." According

to the district judge, because these four statements were "conclusions which only a lawyer is qualified to make," they revealed privileged communications and thereby the privilege had been waived.

The circuit court found that determination to be clear error, ruling "the fact that Fluor's disclosure covered the same topic as the internal investigation or that it was made pursuant to the advice of counsel doesn't mean that privileged communications themselves were disclosed." That was a correct determination of privilege law. Indeed, the Fourth Circuit's prior precedent mandated that conclusion. In *In re Grand Jury Subpoena*,¹⁵ the same court had ruled that a party's statement on a public document—based upon the advice of counsel—did not waive underlying privileged communications regarding the document or its contents. As the court had previously noted, to rule otherwise "would lead to the untenable result that any attorney-client communications relating to the preparation of publicly filed legal documents—such as court pleadings—would be unprotected."¹⁶

The Fourth Circuit also rejected the district court's imaginative argument regarding "legal conclusions that only a lawyer could make." That is *not* the standard for whether a waiver has occurred; rather, "to find waiver, a court must conclude that there has been disclosure of *protected communications*" (emphasis added by the court).

Finally, the Fourth Circuit made quick work of the district court's reliance on *In re Martin Marietta Corp.*¹⁷ In that earlier Fourth Circuit case, the company's disclosure to the government included direct quotes from witness interviews that were memorialized in lawyers' notes and memoranda. That is nowhere near what happened in this case; the four "statements do no more than describe Fluor's general conclusions about the propriety of [the employee's] conduct."

United States v. Sanmina

This litigation arose from a \$503 million stock deduction claim by Sanmina that was challenged by the IRS. In support of its claim, Sanmina had provided the tax agency with a valuation report prepared by a law firm (DLA Piper) at the time the deduction was asserted. In the DLA Piper report there was a footnote referencing two memoranda prepared by the company's in-house tax counsel (without revealing the contents of those documents), and DLA Piper represented that it had relied upon the in-house counsel's work in reaching its conclusions. Sanmina also shared the in-house counsel's documents with two accounting firms, both of which had weighed in on the deduction. Not surprisingly, the IRS demanded that the in-house documents be turned over; equally not surprisingly, Sanmina refused, citing privilege and work product.

The district court, after an *in camera* review, found the memoranda were privileged and work product, but rejected Sanmina's arguments for confidentiality, finding a waiver by the company's conduct in sharing the documents with DLA Piper. The district court, as an alternative justification for its ruling, found the DLA Piper report's citation to and reliance upon the documents constituted a waiver under the "fairness" considerations underlying Section 502 of the Federal Rules of Evidence.

On appeal to the Ninth Circuit, that court affirmed the lower court in part and reversed in part, finding a waiver of the privilege, but *not* a waiver of work product.¹⁸ As to privilege, the Ninth Circuit ruled that DLA Piper had not been retained for purposes of giving legal assistance, and thus the law firm should be deemed a third party, with any privileged information conveyed thereto as being waived.¹⁹ According to the Ninth Circuit, DLA Piper's role was to prepare a *non-legal* valuation analysis, and the presumption that a person hires a lawyer for legal advice is rebutted when the lawyer is "employed without reference to his knowledge and discretion in the law."²⁰ Notwithstanding substantial evidence in the record that Sanmina and its law firm (DLA Piper) obviously thought they had a client-attorney relationship,²¹ the Ninth Circuit deferred to the district court's determination that DLA Piper's role/purpose was non-legal, finding that determination was not "clearly erroneous" because it was not "illogical, implausible, or without support in the record."²² Admittedly, the retention agreement and DLA Piper's report could have been better written to address the issue (especially given the obvious likelihood of the IRS's unfavorable reaction to the report and to Sanmina's deduction), but this ends-oriented outcome does not accord with well-established privilege law.²³ Moreover, clearly the sharing of the in-house memoranda with the two accounting firms *did* constitute a waiver of the privilege, but for some reason that evident, self-imposed blunder by Sanmina went without mention.

With respect to work product, the Ninth Circuit got to the right result, but by a *very* curious route. First off, the court looked at whether disclosure of the in-house documents to the company's law firm, DLA Piper, constituted a "disclosure to an adversary"! While it concluded it did not, query why the court even went there? (Indeed, the court acknowledged that the IRS was not contending there was such an adversarial relationship.)²⁴ The court next discussed whether there was an intent to selectively disclose (to DLA Piper, but not the government), but then deflected that issue by musing that obviously Sanmina intended for DLA Piper to assist the company in its anticipated litigation with the IRS (thereby undermining the court's earlier "analysis" of the law firm's role for purpose of the privilege).

As a final matter, the Ninth Circuit turned to whether giving the IRS the DLA Piper report with the footnote reference to the in-house memoranda created a subject matter waiver vis-a-vis those two documents. This part of the decision was primarily addressing the lower court's alternative concern about "fairness." Ultimately, because the IRS—based upon the same facts that Sanmina and DLA Piper possessed—could reach its own conclusions regarding the claimed deduction, there was no basis for providing the "mental impressions, conclusions, opinions or legal theories" of Sanmina's in-house lawyers.²⁵ As such, "fairness" only mandated the production of those portions of the in-house documents with factual, non-opinion work product.

Conclusion

The three decisions discussed above (and in the footnotes) demonstrate that the principal concerns set out in the introduction of this article continue to be the case: lawyers and clients still do not always correctly handle privilege and work product issues, and neither do courts. Caveat counselors!

Endnotes

1. See, e.g., *The D.C. Circuit: Wrong and Wronger!* NY Business Law Journal (Winter 2015); *Exes and the Attorney-Client Privilege*, NY Business Law Journal (Summer 2017); *Mom (as Always) Was Right: Don't Talk to Strangers*. NY Business Law Journal (Summer 2018).
2. 16 - cv - 1803 (ABJ) (D.D.C.) (Sept. 16, 2016).
3. In August 2013, RPM settled with DOJ for \$61 million.
4. Non-waiver agreements seldom are bulletproof. In addition, handling oral summaries of this sort with the government can be a very sticky wicket. See *SEC v. Herrera*, 2017 WL 60417 (S.D. Fla. Dec. 5, 2017); *Mom (as Always) Was Right: Don't Talk to Strangers*, *supra* note 1.
5. See *U.S. v. Adlman*, 134 F.3d 1194 (2d Cir. 1998); *FTC v. Boehringer Ingelheim Pharmacy, Inc.*, 778 F. 3d 142 (D.C. Cir. 2015).
6. Hoping to follow the legally flawed path earlier used by Kellogg Brown & Root to get a writ of mandamus, RPM sought a writ, first from Judge Berman and then from the D.C. Circuit. The company even employed the services of the U.S. Chamber of Commerce, which had been of such assistance to Kellogg Brown & Root before

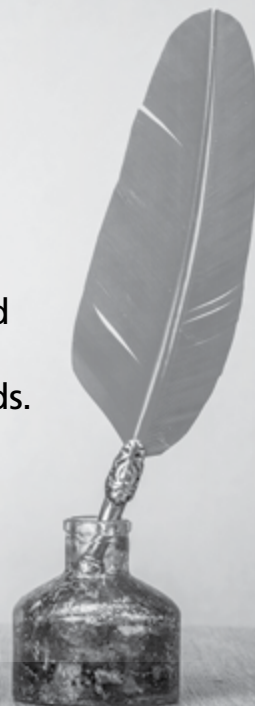
- the same court. Fortunately, unlike in the Kellogg Brown & Root litigation (see 756 F. 3d 754 (D.C. Cir. 2014) and 796 F. 3d 137 (D.C. Cir. 2015), this time the law was appropriately followed and a writ was not issued. See *The D.C. Circuit: Wrong and Wronger!* *supra* note 1.
7. E.g., the U.S. Chamber of Commerce, the Association of Corporate Counsel. See *id.* See also the amicus brief on RPM's behalf on the Chamber's website.
 8. Ultimately, RPM and its general counsel reached a settlement with the SEC in December 23, 2020. See SEC Litigation Release No. 24994. RPM paid a \$2 million fine; the general counsel agreed to a permanent books and records injunction and paid a \$22,500 fine.
 9. See 48 S.F.R. § 52.203-13(b)(3)(i).
 10. *In re Fluor Intercontinental, Inc.*, (1:19 - cv - 00289 - LO - TCB) No. 20-1241 (4th Cir. March 25, 2020) (per curiam).
 11. These, of course, are the wrongly decided D.C. Circuit cases involving Kellogg Brown & Root. See *supra* notes 1 & 6. The Fourth Circuit expressly embraced these flawed precedents.
 12. *Mohawk Industries v. Carpenter*, 558 U.S. 100 (2009); incredibly, the D.C. Circuit, in wrongly deciding the issue, actually cited this precedent as seemingly binding upon it, 756 F. 3d at 761 (emphasis added) (as did the Fourth Circuit). See also *Cheney v. U.S. Dist. Court*, 542 U.S. 367, 380 (2004) (also cited by the Fourth Circuit!).
 13. See *In re Murphy*, 560 F. 2d 326 (8th Cir. 1977).
 14. For the maraschino cherry on top of its policy rationale for directly flouting Supreme Court precedent, the Fourth Circuit then cited (what else) the Supreme Court's timeless observation that "[a]n uncertain privilege... is little better than no privilege at all." *Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981).
 15. 341 F. 3d 311 (4th Cir. 2003).
 16. *Id.* at 336.
 17. 856 F. 2d 619 (4th Cir. 1988).
 18. *U.S. v. Sanmina Corp.*, 986 F. 3d 1107 (9th Cir. Aug. 7, 2020).
 19. The Ninth Circuit enunciated an eight-step process for the privilege to attach. As readers of this distinguished journal will remember, this author prefers a simpler five-step process: the 5 C's. See *The D.C. Circuit: Wrong and Wronger!* *supra* note 1.
 20. Quoting *United States v. Chen*, 99 F. 3d 1495, 1501 (9th Cir. 1996).
 21. See, e.g., footnotes 2 & 3 of *U.S. v. Sanmina*, *supra* note 18.
 22. Quoting *United States v. Graf*, 610 F. 3d 1148, 1157 (9th Cir. 2010). The Ninth Circuit's deferral to the district court seems, in large measure (or more), to be based upon its extended discussion of whether to adapt a "dual purpose," "primary purpose," or "because of" test to determine whether a lawyer's services were retained to render legal advice (ultimately it chose not to adopt any of them). Regardless, none of these tests is appropriate in the context of privilege (vs. work product). Indeed, that is the only thing the D.C. Circuit got right in its two Kellogg Brown & Root disasters. That court rejected the district court's "but for" test, correctly observing that such a test "is not appropriate for [an] attorney-client privilege analysis;" and that court was also correct that there is "no Supreme Court or Court of Appeals decision that has adopted a test of this kind in this context," 756 F. 3d at 758-60. See *The D.C. Circuit: Wrong and Wronger!* (& note 8 therein), *supra* note 1.
 23. See *id.*
 24. In concluding it did not, the Ninth Circuit cited *United States v. Deloitte LLP*, 610 F. 3d 129 (D.C. Cir. 2010) (disclosure of work product to an independent auditor does not waive work product).
 25. Citing the seminal Supreme Court case on work product: *Hickman v. Taylor*, 329 U.S. 495, 508 (1947).

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By the Attorneys at Skadden, Arps, Slate, Meagher & Flom

Class Certification

Seventh Circuit Vacates and Remands Class Certification in Securities Fraud Action

Carpenters Pension Tr. Fund for N. Cal. v. Allstate Co., No. 19-1830 (7th Cir. July 16, 2020)

In a securities fraud case against Allstate Corporation, the Seventh Circuit vacated certification of a plaintiff class for legal error and remanded the case for further consideration.

In early 2013, Allstate announced it would be “softening” underwriting standards for its auto insurance business in an effort to attract new customers and increase profitability, but it acknowledged the softer standards held the risk of increasing auto claims frequency. The company’s CEO said the company would monitor claims frequency and adjust business practices as necessary. Two years later, Allstate announced that the growth strategy had indeed increased claims frequency and that it would be retightening underwriting standards. Its stock immediately dropped by more than 10%.

The plaintiffs, purchasers of Allstate securities after its 2013 announcement, brought a securities fraud class action against Allstate under SEC Rule 10b-5, alleging that claims frequency had increased almost immediately once the softened underwriting standards were implemented but that Allstate withheld this information until its announcement two years later.

As required by Rule 23(b)(3), the plaintiffs introduced evidence at the certification stage that questions of law or fact common to all the class members predominated over any questions unique to individual members. To show they could use common evidence to prove reliance, an element of a securities fraud claim, the plaintiffs invoked the Basic fraud-on-the-market presumption of reliance. Under *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), if plaintiffs prove that the securities at issue were traded in an efficient market, such that the security price reflected all public information (including the alleged misrepresentations), reliance is presumed.

Allstate offered rebuttal evidence that the alleged misrepresentations did not actually affect the price of the securities at issue, which the district court declined to examine. The district court concluded that the issue of price impact was too intertwined with the merits and so could not be decided at the class certification stage.

The Seventh Circuit remanded with instructions that the district court was to engage with Allstate’s evidence

on price impact for the purpose of assessing whether the plaintiffs properly invoked the *Basic* presumption. The district court was not permitted to draw even obvious inferences about topics forbidden at the certification stage, materiality and loss causation, despite the conceptual overlap.

The Seventh Circuit acknowledged that the same evidence may ultimately be relevant to proving all three issues but concluded that this bifurcated analysis was required by U.S. Supreme Court precedent in *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804 (2011), *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 568 U.S. 455 (2013), and *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014).

Cryptocurrency — Definition of a Security

S.D.N.Y. Holds That Cryptocurrency Is a Security

SEC v. Kik Interactive, Inc., No. 19 Civ. 5244 (AKH) (S.D.N.Y. Sept. 30, 2020)

Judge Alvin K. Hellerstein granted summary judgment to the Securities and Exchange Commission on its claims against a cryptocurrency coin issuer, alleging it violated Sections 5(a) and 5(c) of the Securities Act by offering and selling securities without a registration statement or an exemption from registration. The coin issuer argued that its coins were not securities, and even if they were, the coins were sold during a private presale, before its public offering, and thus were exempt from registration requirements under Regulation D.

The court held that the company’s coins were securities under the U.S. Supreme Court’s decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). Under *Howey*, an investment contract is a security where there is “(i) an investment of money (ii) in a common enterprise (iii) with profits to be derived solely from the efforts of others.” The court determined that the SEC adequately alleged a “horizontal commonality” in which the funds raised through purchases of the company’s coins were pooled together to develop the company’s blockchain technology, and the success of that technology would raise the value of the purchasers’ coins. The court also clarified that in the Second Circuit, the expectation of profits need not literally be “solely” from the efforts of others, but rather that “the scheme was being promoted as primarily an investment or as a means whereby participants could pool their own activities, their money and the promotor’s contribution

in a meaningful way.” The court determined that the coin issuer promoted the coin as an investment.

The court rejected the coin issuer’s argument that transactions from a private presale were exempt under Regulation D, finding that the presale was integrated with the public offering. Under Regulation D, the court must consider these factors to determine if the transactions are actually one integrated transaction: “(a) Whether the sales are part of a single plan of financing; (b) Whether the sales involve issuance of the same class of securities; (c) Whether the sales have been made at or about the same time; (d) Whether the same type of consideration is being received; and (e) Whether the sales are made for the same general purpose.” Giving more weight to the first and fifth factors, consistent with precedent, the court held that the presale and public offering “were part of a single plan of financing and made for the same general purpose,” as evidenced by, for example, the fact that the success of the presale relied on the public offering, that the purchasers all “received the same class of securities” and that the two sales “took place at about the same time.”

Derivative Litigation—Demand Futility

Eastern District of Missouri Dismisses Derivative Action Alleging Securities Violations

Carpenters Pension Fund of Ill. ex rel. Centene Corp. v. Nedorff, No. 4:18 CV 113 CDP (E.D. Mo. Sept. 15, 2020)

Judge Catherine D. Perry granted the directors and officers of Centene Corporation’s motion to dismiss a derivative action filed by several of its shareholders. The derivative action alleged that the board of directors issued or approved false and misleading statements related to Centene’s acquisition of Health Net. Specifically, the proxy statement and prospectus issued to shareholders prior to their approval of the merger failed to disclose Health Net’s financial problems and liabilities. Once these issues were disclosed, the plaintiffs alleged, Centene’s stock price dropped more than 8%.

The defendants moved to dismiss, arguing that the shareholders failed to state a claim upon which relief could be granted and failed to demonstrate demand futility. Among other allegations, the shareholders contended that the directors violated the Securities Act and the Securities Exchange Act by issuing false and misleading SEC statements that concealed Health Net’s financial issues.

The shareholders argued that demand was excused for their securities claims because making false and misleading statements in violation of securities laws is not protected by the business judgment rule. While the court agreed that such conduct would excuse demand, it held that the complaint failed to plead particularized facts supporting the allegation that the board acted with conscious awareness of illegality.

The complaint generally alleged the board faced liability for making false statements but only identified specific knowledge or conduct by one director and two audit committee members. The court found the board’s general approval of the SEC filings insufficient to infer knowledge of falsity, absent specific allegations of directors’ personal involvement in the preparation of the filings. Further, the complaint failed to plead that outside directors had sufficient knowledge of the day-to-day workings of Centene to impute knowledge of allegedly false statements made by the president and CEO. Finding no likelihood that the majority of the board faced personal liability for securities law violations, the court held that the complaint failed to plead particularized facts to cast reasonable doubt on the disinterest or independence of the majority of the board.

The court likewise found that the plaintiffs’ allegations related to breach of fiduciary duties, insider trading and unjust enrichment failed to demonstrate demand futility. Accordingly, the court granted the defendants’ motion to dismiss.

An appeal of this decision was filed with the Eighth Circuit on October 22, 2020.

Fiduciary Duties

Delaware Court of Chancery Denies Motion To Dismiss ‘Paradigmatic Revlon Claim’ Alleging Fraud on the Board

In re MINDBODY, Inc., Stockholders Litig., No. 2019-0442-KSJM (Del. Ch. Oct. 2, 2020).

The Delaware Court of Chancery denied a motion to dismiss breach of fiduciary duty claims against both the chairman/CEO and the chief financial officer/chief operating officer of MINDBODY, Inc. (“Mindbody”) arising from the sale of Mindbody to Vista Equity Partners. The court granted the motion to dismiss as to an outside director of Mindbody, who was nominated to the board by a venture capital stockholder.

Richard Stollmeyer founded Mindbody in 2001, and the company went public in 2015. In 2018, Mindbody made two strategic acquisitions and told stockholders that these acquisitions positioned Mindbody for growth in 2019. Despite Mindbody’s anticipated growth, Stollmeyer was personally motivated to force a sale of Mindbody due to his need for liquidity. Stollmeyer’s wealth was concentrated in Mindbody stock, and he analogized his ability to liquidate his holdings through a Rule 10b5-1 plan as “sucking through a very small straw.”

In late 2018, Vista expressed interest in Mindbody. Stollmeyer informed members of management of Vista’s interest but did not immediately disclose this information to the Mindbody board and instructed members of management not to discuss a sale of Mindbody with the board. On a November 2018 earnings call, management

lowered earnings guidance for the fourth quarter, which seemed inconsistent with the company's prior bullish tone on growth, causing a drop in the company's stock price.

The board formed a Transaction Committee to consider the sale of Mindbody. However, throughout the process, Vista received more information and in a more timely fashion than other potential acquirers. On December 23, 2018, the board unanimously approved the sale of Mindbody to Vista for \$36.50 per share. The merger agreement provided for a 30-day go-shop period, but the go-shop data room contained less diligence than Vista received and Stollmeyer was on vacation for most of that period. During the go-shop period, Mindbody received its fourth quarter results, which exceeded the company's lowered guidance for the fourth quarter. These results were provided to Vista during the go-shop period but not to other potential bidders. The results were also not disclosed to stockholders before the vote on the merger. The merger closed on February 15, 2019.

In denying the motion to dismiss the breach of fiduciary duty claim against Stollmeyer, the court explained that the "cash-for-stock Merger was a final-stage transaction presumptively subject to enhanced scrutiny under *Revlon*." The court held that the allegations of the complaint supported a reasonable inference that Stollmeyer was conflicted because he had an interest in near-term liquidity and an expectation that he would receive post-merger employment. The court also concluded that the complaint adequately alleged that Stollmeyer tilted the sales process in Vista's favor by: "(a) lowering guidance to depress Mindbody's stock and make it a more attractive target at a time Vista was looking to acquire Mindbody and (b) providing Vista with timing and informational advantages over other bidders." The court also held that the plaintiffs had adequately alleged that Stollmeyer was "a conflicted fiduciary [who] failed to disclose material information to the board," namely, Stollmeyer's alleged conflicts in the sales process and communications with Vista.

The court rejected an argument by the defendants that dismissal was appropriate under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), because the stockholder vote was not fully informed.

The court also denied the motion to dismiss as to Mindbody's CFO/COO, concluding that the plaintiffs adequately pleaded a claim for breach of the duty of care in his capacity as an officer because he allegedly acted with gross negligence and was at least recklessly indifferent to the steps Stollmeyer had taken to tilt the sales process in Vista's favor. Finally, the court granted the motion to dismiss fiduciary duty claims against an outside director appointed by a venture capital stockholder due to the lack of allegations that the outside director was conflicted because the venture capital firm was seeking to exit its in-

vestment or that the outside director had taken any action to tilt the process toward his personal interest.

Court of Chancery Dismisses Fiduciary Duty Claims Against Directors

In re USG Corp. Stockholder Litig., No. 2018-0602-SG (Del. Ch. Aug. 31, 2020)

The Delaware Court of Chancery dismissed breach of fiduciary duty claims against directors, rejecting a *Corwin* defense but holding that the complaint failed to state a non-exculpated claim for breach of the duty of loyalty.

The decision addressed a post-closing claim for money damages arising out of Gebr. Knauf KG's acquisition of USG Corporation. At the time of the transaction, Knauf owned 10.6% and Berkshire Hathaway owned 30.4% of USG's common stock. In January 2017, Knauf approached USG about a potential transaction, and in March 2017, Knauf reached out to Berkshire Hathaway to determine if it would be willing to sell its shares. Knauf made a proposal to acquire USG for \$40.10 in November 2017, which the board rejected. In March 2018, Knauf made another proposal to acquire USG for \$42 per share, which the board also rejected. Knauf then initiated a withhold campaign, soliciting proxies from USG's stockholders against USG's four director nominees in connection with the company's 2018 annual meeting. Berkshire Hathaway publicly supported Knauf's bid and campaign. The USG board vigorously opposed the withhold campaign, but Knauf nevertheless prevailed. The board reengaged with Knauf and, in June 2018, reached an agreement on an acquisition at \$44 per share.

The stockholder plaintiffs filed suit, seeking to preliminarily enjoin the transaction. The court denied that motion, and the transaction closed in April 2019. The plaintiffs then amended their complaint to seek money damages, alleging that USG's stockholders "did not receive the highest available value for their equity interest in USG" and "suffered the injury of an uninformed stockholder vote."

The court rejected the defendants' defense under *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), which held that where a transaction is approved by the fully informed vote of unaffiliated stockholders in the absence of a controller, fiduciary duty claims are subject to dismissal under the business judgment rule. The court held that the complaint failed to adequately allege that Knauf was a controller, noting that Knauf's 10.6% stake in USG was "far below the 50% threshold" and pointing to Knauf's withhold campaign, in which Knauf "fought tooth-and-nail" to prevent nominees from being elected to USG's board. However, the court held that the stockholder vote was not fully informed, rendering *Corwin* inapplicable. Specifically, the plaintiffs alleged that the board believed USG's intrinsic value was \$50

per share. Citing 15 references in the proxy to the board's focus on intrinsic value, the court held that the complaint adequately alleged that the board "had a belief as to the precise intrinsic value of USG," which was not disclosed and conceivably rendered the proxy materially misleading. As a result, *Corwin* could not apply.

Although the court declined to dismiss the claims under *Corwin*, it held that the complaint failed to state a non-exculpated claim for breach of fiduciary duty against the directors. The court rejected the plaintiffs' argument that after Knauf succeeded in its withhold campaign, the board abandoned its stand-alone plan for USG and acceded to an acquisition despite its "misgivings" about the deal, explaining, among other things, that the allegation that the board acted out of "fear" of Knauf was undercut by the fact that the board had "vigorously contested" the withhold campaign. The court also rejected allegations that certain director and officer positions at other public companies and board positions at nonprofit organizations rendered the directors interested because a proxy fight loss would damage the board members' reputations.

In addition, the court held that the complaint failed to adequately allege that the directors acted in bad faith, explaining that the material nondisclosure of the board's view of intrinsic value (which rendered *Corwin* inapplicable) did not automatically give rise to an inference of bad faith.

Finally, the plaintiffs also argued that even if the complaint failed to plead a non-exculpated breach of loyalty, it nevertheless pleaded a "freestanding" *Revlon* claim. The court rejected this argument, explaining that "an allegation implying that a Defendant failed to satisfy *Revlon* is insufficient on its own to plead a non-exculpated breach of the duty of loyalty, and a sufficient pleading must reasonably imply that the directors' failure to act reasonably to maximize price was tainted by interestedness or bad faith."

Court of Chancery Declines To Award Damages in Failed \$54 Billion Merger

In re Anthem-Cigna Merger Litig., Consol. C.A. No. 2017-0114-JTL (Del. Ch. Aug. 31, 2020)

In a lengthy post-trial opinion, the Delaware Court of Chancery awarded no damages to either party with competing damages claims in a trial over the failed merger of Anthem, Inc. and Cigna Corporation. The court concluded that neither party was entitled to recover from the other after holding that: (i) Anthem proved Cigna breached certain covenants to try to close the merger (Efforts Covenants); (ii) the breach of the Efforts Covenants did not lead to causally related damages because the merger had been enjoined, which was a failed closing condition, and Cigna's breach of the Efforts Covenants did not materially contribute to that failed condition; (iii) Cigna failed to prove that Anthem had breached a regula-

tory efforts covenant; and (iv) Cigna failed to prove that Anthem was liable for a reverse termination fee.

Anthem and Cigna entered into an agreement and plan of merger dated July 23, 2015. Anthem agreed to pay total consideration of over \$54 billion, reflecting a premium of 38.4% over Cigna's unaffected market capitalization. At the time, Anthem and Cigna were the second and third largest health insurers in the United States. The Department of Justice concluded that the merger would have anti-competitive effects and sued to enjoin the transaction. In February 2017, the District of Columbia enjoined the closing of the merger. In May 2017, the parties terminated the merger agreement and sued each other for breach of contract and billions of dollars in expectation damages.

"Although Anthem proved that Cigna breached the contract . . . Anthem failed to prove that Cigna's breaches led to causally related damages."

After trial, the Court of Chancery held that Anthem proved that Cigna breached its obligations under the Efforts Covenants. Specifically, after integration discussions revealed that Anthem intended to treat the merger as an acquisition rather than a merger of equals, Cigna's executive management team "wanted the transaction to fail so they could continue managing Cigna as an independent company." To try to achieve this goal, the court found, Cigna "obstructed Anthem's efforts to line up divestitures," "signaled [to the DOJ] that it opposed the Merger" and "undermined Anthem's defense" of the antitrust litigation.

Although Anthem proved that Cigna breached the contract by breaching the Efforts Covenants, Anthem failed to prove that Cigna's breaches led to causally related damages. The court found that Anthem had proved that Cigna's breaches contributed materially to the injunction, but that Cigna had proved that the transaction would still have been enjoined even if Cigna had complied with its contractual obligations.

The court also found that Cigna failed to prove that Anthem breached its obligations under the regulatory efforts covenant. Although Anthem's strategy could be criticized in hindsight, the court found that it "chose a sound strategy and took all of the actions necessary and appropriate to pursue it." The court also held that even if Cigna had proved that Anthem breached the regulatory efforts covenants, it still could not recover damages because termination of the merger agreement extinguished any liability on the part of any party except for "Willful

Breach,” and although Cigna’s breaches “were so strikingly egregious that Anthem would have proved a Willful Breach . . . the same is not true of Anthem’s conduct.” Finally, the court concluded that Cigna was not entitled to a reverse termination fee under the Merger Agreement’s provisions because “[b]y the time that Cigna purported to terminate . . . Anthem already had terminated the Merger Agreement.”

Insider Trading Claims

S.D.N.Y. Dismisses Section 16(b) Claim Against Holding Company Former Executive

Chechele v. Dundon, No. 19 Civ.10544 (GBD) (S.D.N.Y. Aug. 17, 2020).

Judge George B. Daniels dismissed claims brought by a shareholder of a holding company against a former company executive under Section 16(b) of the Securities Exchange Act, alleging that the former executive violated the short-swing profits provision of Section 16(b) through a purchase and sale of the company’s common stock within a six-month period. Under Section 16(b), a plaintiff must plead that there was (i) a purchase (ii) and a sale of securities (iii) by a statutory insider (iv) within a six-month period. The shareholder argued that the former executive purchased company shares (through exercising an option) and sold shares on the same date in November 2017 in violation of Section 16(b). The court disagreed, rejecting the shareholder’s argument that exercising an option constituted a “purchase.” The court instead determined that for purposes of Section 16(b), the former executive’s purchase of the shares occurred in January 2014, when he was granted the option to purchase company shares, and the exercise of the option in November 2017 was merely a change from an indirect to a direct form of beneficial ownership. The court concluded that because the purchase of the shares occurred in 2014 and the share sale occurred in 2017, there was no violation of Section 16(b).

Investment Company Act

District of Colorado Rules in Favor of Mutual Funds in ‘Excessive Fee’ Trial, Finding That Plaintiffs Failed To Meet Burden of Proof Under Investment Company Act

Obeslo v. Great-West Capital Mgmt., LLC, No. 16-cv-00230-CMA-SKC (D. Colo. Aug. 7, 2020)

Judge Christine M. Arguello entered judgment in favor of defendants Great-West Capital Management, LLC and Great-West Life & Annuity Insurance Co. following an 11-day bench trial held in January 2020, finding that the plaintiffs had failed to meet their burden of proof under Section 36(b) of the Investment Company Act (ICA).

Great-West, a mutual fund complex that includes approximately 60 mutual funds, was principally distributed through retirement plans under the brand Empower

Retirement. Each fund had a total expense ratio (TER), which is the total of all fees charged to shareholders in exchange for the services provided to that fund. The TER included advisory and administrative fees charged by Great-West. The plaintiffs were individuals who acquired shares of certain funds as participants of retirement plans offered by their respective employers. They claimed that both the advisory and administrative services fees charged to the funds at issue were excessive under Section 36(b) of the ICA, “which prohibits fees that are ‘so disproportionately large that [they] bear[] no reasonable relationship to the services rendered and could not have been the product of arm’s length bargaining.’”

The court found that the plaintiffs had failed to meet their burden of proof with respect to all of the factors from *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). Specifically, the court found that (i) the defendants’ board was independent, qualified and engaged in a robust process in approving the defendants’ fees; (ii) the fees were within the range of fees of comparable funds; (iii) the plaintiffs had failed to quantify any alleged economies of scale or show that those economies were not adequately shared with shareholders; (iv) the defendants’ profits were within the range of their competitors’; (v) the defendants had provided extensive, high-quality services in exchange for their fees; and (vi) the plaintiffs failed to identify any significant fall-out benefits that the defendants acquired. As an independent dispositive ground, the court determined that the plaintiffs had failed to meet their burden to prove that they suffered actual damages due to the defendants’ conduct. The court found the plaintiffs’ sole witness on this point to be noncredible and his theories regarding the plaintiffs’ alleged damages to be legally flawed.

An appeal of this decision has been docketed in the Tenth Circuit as *Obeslo v. Great-Western Life & Annuity Insurance Co.*, No. 20-1310 (10th Cir. appeal docketed Sept. 2, 2020).

Loss Causation

Ninth Circuit Reverses Dismissal, Holds Allegations in Whistleblower Complaint Constitute Corrective Disclosure but Short Seller Report Does Not

In re Bofl Holding, Inc. Sec. Litig., No. 18-55415 (9th Cir. Oct. 8, 2020)

On October 8, 2020, the Ninth Circuit reversed the dismissal of a putative securities fraud class action in a decision that provides additional guidance concerning the standard for pleading loss causation in the Ninth Circuit.

The plaintiffs, purported Bofl shareholders, alleged that Bofl and certain of its executives made false or misleading statements touting the bank’s conservative loan underwriting standards, its effective system of internal controls and its robust compliance infrastructure. The

plaintiffs claimed that the truth was revealed in two supposed corrective disclosures: (i) a whistleblower lawsuit filed by a former midlevel auditor at the company, and (ii) a series of eight blog posts authored by anonymous short-sellers of Bofl stock.

The district court dismissed the complaint, holding that neither alleged corrective disclosure could satisfy the loss causation element of the plaintiffs' claim. With respect to the whistleblower complaint, the court held that the allegations were merely "unconfirmed accusations of fraud" and therefore could not have disclosed to the market that Bofl's alleged misstatements were actually false. To adequately plead loss causation, the district court explained, the lawsuit had to be followed by "a subsequent confirmation" of the fraud. With respect to the blog posts, the district court held that they could not constitute a corrective disclosure because each of them relied on information already publicly available. As such, they could not have revealed anything new to the market.

On appeal, the Ninth Circuit reversed. With respect to the whistleblower complaint, the court rejected a categorical rule that allegations in a lawsuit, standing alone, can never qualify as a corrective disclosure. The court stated that allegations can constitute a corrective disclosure when the complaint alleges that "the market treat[ed] [the allegations] as sufficiently credible to be acted upon as truth." In reaching this conclusion, the court distinguished two prior Ninth Circuit decisions. First, the court distinguished *Loos v. Immersion Corp.*, 762 F.3d 880 (9th Cir. 2014), where the Ninth Circuit held that the announcement of an internal investigation into purported wrongdoing, without more, cannot satisfy the loss causation element. That decision was premised on the rationale that instituting an investigation can only indicate a risk of fraud and "'speculation' about 'what the investigation will ultimately reveal.'" Here, in contrast, according to the court, the whistleblower alleged facts that, if true, plausibly revealed the falsity of Bofl's prior statements.

Second, the court distinguished *Curry v. Yelp Inc.*, 875 F.3d 1219 (9th Cir. 2017), which held that the FTC's disclosure of 2,000 complaints from businesses claiming that their Yelp reviews had been manipulated did not reveal the falsity of Yelp's prior statements that its reviews were authentic. The court reasoned that the complaints in *Curry* came from "outsiders who lacked any firsthand knowledge of Yelp's practices." In contrast, the whistleblower was "a former insider of the company who had personal knowledge of the facts he alleged."

With respect to the short-seller blog posts, the court also rejected a categorical rule that a disclosure based on publicly available information can never constitute a corrective disclosure. Rather, as the court stated: "The ultimate question is again one of plausibility: Based on plaintiffs' particularized allegations, can we plausibly infer that the alleged corrective disclosure provided new information to the market that was not yet reflected in

the company's stock price?" The court went on to reaffirm that whether an alleged disclosure is based only on already public information remains a key factor in this analysis.

Here, the court concluded that the short-seller blog posts could not constitute a corrective disclosure as a matter of law. The court reasoned that, even if the posts disclosed new information, "it is not plausible that the market reasonably perceived these posts as revealing the falsity of Bofl's prior misstatements." That is because the "posts were authored by anonymous short-sellers who had a financial incentive to convince others to sell, and the posts included disclaimers from the authors stating that they made 'no representation as to the accuracy or completeness of the information set forth in this article.'" Under those circumstances, a "reasonable investor reading these posts would likely have taken their contents with a healthy grain of salt."

PSLRA — Safe Harbor Provision

Fifth Circuit Holds That Revenue and EBITDA Projections in Proxy Statement Are Protected Under PSLRA's Safe Harbor Provision

Heinze v. Tesco Corp., 971 F.3d 475 (5th Cir. Aug. 19, 2020)

The Fifth Circuit held that revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) projections in a proxy statement are protected by the PSLRA safe harbor provision for forward-looking statements.

Norman Heinze brought a class action on behalf of himself and other shareholders of Tesco Corporation against Tesco, former Tesco board members and Nabors Industries, Ltd. On July 6, 2017, Tesco received an all-stock acquisition offer from Nabors. Tesco's shareholders later approved the transaction. Mr. Heinze alleged that certain omissions in the proxy statement led Tesco shareholders to approve the acquisition, and he filed suit under Sections 14(a) and 20(a) of the Securities Exchange Act and SEC Rule 14a-9. The district court granted the defendants' motion to dismiss as to all claims. Mr. Heinze appealed, and the Fifth Circuit affirmed.

Mr. Heinze alleged that several parts of the proxy statement were misleading, including: (i) a statement that Tesco shareholders would receive a "significant" 19% premium over Tesco's closing price on the last day of trading before the transaction's announcement; (ii) Tesco management's 2017 and 2018 projections for revenue and EBITDA; and (iii) a summary of a fairness opinion written by the investment bank engaged to analyze the offer. The Fifth Circuit rejected all of Mr. Heinze's claims, concluding that Mr. Heinze failed to state a claim upon which relief can be granted under the heightened pleading requirements of the PSLRA.

In rejecting the allegations regarding the first category of statements at issue, the Fifth Circuit concluded that the use of the word “significant” in describing the premium that Tesco shareholders would receive was not material so as to be actionable under SEC Rule 14a-9. The court determined that a reasonable shareholder would have relied on the actual quantity of the premium to assess its significance, rather than the adjective “significant.” Thus, the Fifth Circuit held that Mr. Heinze failed to allege a plausible claim with respect to this portion of the proxy statement.

“In rejecting the allegations regarding the first category of statements at issue, the Fifth Circuit concluded that the use of the word ‘significant’ in describing the premium that Tesco shareholders would receive was not material”

The Fifth Circuit also rejected the allegations relating to the revenue and EBITDA projections. Heinze contended that the projections were rendered misleading because they omitted (i) projections of unlevered free cash flows for the years 2017-22, which allegedly would have reflected an increase in oil prices; (ii) projections for revenue, EBITDA, and other metrics for the years 2019 and beyond, which also allegedly would have reflected an increase in oil prices; (iii) certain “Growth Case” ranges, which allegedly left Tesco shareholders with a pessimistic view of Tesco’s future growth potential; and (iv) details of the investment bank’s analysis comparing the Nabors-Tesco transaction with similar transactions, which allegedly prevented shareholders from realizing how much more compensation they could have been offered.

The Fifth Circuit rejected Heinze’s arguments. The court held that Heinze failed to allege that the projections were misleading, noting that projections need not be based on “rank speculation.” Heinze’s only affirmative allegation in support of his claim was his “prophecy of oil prices increasing,” which the court found not to be viable. Without this allegation, Heinze was left with a “pure-omission” theory “untethered to any specific false or misleading representation in the proxy statement.” The court ultimately held that the company did not have an obligation to include “additional *projections* based on potentially inaccurate assumptions about *future price trends*.”

In addition, the court rejected Heinze’s argument that the PSLRA’s safe harbor provision was “intended to

encourage companies to fully disclose their projections.” The court determined that Heinze’s argument based on legislative history was “irrelevant” in the face of the statute’s unambiguous text. Importantly, the court found that the PSLRA’s safe harbor provision applies not only to forward looking “statements” accompanied by cautionary language, but also projections where the company includes cautionary language around the projections.

The court affirmed the dismissal of Heinze’s claims and held that the district court did not abuse its discretion in denying leave to amend.

SEC Enforcement Actions

Fourth Circuit Holds That Disgorgement in an SEC Proceeding Is Not a Criminal Penalty for Purposes of the Double Jeopardy Clause

United States v. Bank, 965 F.3d 287 (4th Cir. July 14, 2020)

The Fourth Circuit held that disgorgement ordered in a prior SEC proceeding would not bar subsequent criminal prosecution for the same underlying conduct under the Double Jeopardy Clause of the Constitution. In so ruling, the Fourth Circuit joined the seven other circuits that have ruled on the issue previously.

In April 2015, the SEC initiated enforcement proceedings in Arizona against Daryl Bank for illegal investment activities. According to the complaint, Mr. Bank and others misled investors by assuring them their investment would yield high returns when they sold Federal Communications Commission licenses to major cellular wireless carriers such as Sprint while knowing the licenses could never be sold or leased to any major wireless carriers.

In 2017, Mr. Bank entered into a consent agreement with the SEC, and a federal district court in Arizona ultimately held Mr. Bank liable for disgorgement of over \$4.4 million. A grand jury in the Eastern District of Virginia later indicted Mr. Bank on charges of securities fraud and unlawful sale of securities based on the same underlying conduct. Mr. Bank filed a motion to dismiss the indictment, arguing that the Double Jeopardy Clause prohibited the indictment because he could not be prosecuted twice for the same conduct. Mr. Bank argued that the U.S. Supreme Court’s recent decision in *Kokesh v. SEC*, 137 S. Ct. 1635, 1639 (2017), which held that disgorgement is a “penalty” for purposes of the applicable statute of limitations, rendered his disgorgement a “criminal sanction” for purposes of the Double Jeopardy Clause.

The Eastern District of Virginia denied the motion to dismiss the indictment, and Mr. Bank appealed to the Fourth Circuit. The Fourth Circuit affirmed. It first considered whether Mr. Bank’s waiver of his right to contest future prosecution on double jeopardy grounds in his consent agreement with the SEC was valid. The

court noted that a defendant is ordinarily permitted to waive the constitutional right to assert a double jeopardy defense. However, like the district court below, the Fourth Circuit declined to rely on the waiver in the consent agreement in disposing of the appeal. The court reasoned that the waiver did not specifically bar double jeopardy claims in future proceedings or in criminal proceedings. In addition, though the waiver clause waived challenges to the imposition of a remedy or civil penalty, the Supreme Court had not ruled that disgorgement could be considered a penalty at the time Mr. Bank signed the consent agreement.

Instead, the Fourth Circuit turned to the issue of whether Mr. Bank's disgorgement qualified as a civil penalty, which would not implicate the Double Jeopardy Clause, as opposed to a criminal penalty, which would implicate the clause. Noting that Kokesh held that disgorgement qualified as a "penalty," the Fourth Circuit then turned to the multifactor analysis developed in *Hudson v. United States*, 522 U.S. 93 (1997), to determine whether such a sanction constitutes a criminal penalty for purposes of the Double Jeopardy Clause. Under *Hudson*, a court must first look to the construction of the statute from which the penalty stems and ask whether the legislature intended the penalty to be civil or criminal in nature. Next, if the penalty is intended to be civil in nature, the court queries whether the statutory scheme is sufficiently punitive to effectively transform what was intended to be a civil remedy into a criminal one. With respect to this second inquiry, *Hudson* provides seven factors as "useful guideposts."

The Fourth Circuit first determined that there was "strong evidence" in various provisions of the securities laws and the Federal Rules of Civil Procedure that the penalty at issue was intended to be civil in nature. Next, under the second step of the *Hudson* inquiry, the court ruled that five of the seven factors weighed in favor of treating disgorgement as a civil penalty. In particular, the court determined that disgorgement did not impose an affirmative disability or restraint, was not historically regarded as a punishment, did not require scienter, had a clear rational purpose other than punishment, and was not excessive in relation to Congress' nonpunitive goals. Thus, the court concluded that disgorgement was not a criminal penalty for purposes of the Double Jeopardy Clause, and Mr. Bank's motion to dismiss the indictment had been properly denied.

Securities Fraud Pleading Standards

Misrepresentations

Second Circuit Affirms Dismissal of Claims Alleging Material Misstatements and Omissions Against Tax Preparation Company

In re Liberty Tax, Inc. Sec. Litig., No. 20-652 (2d Cir. Sept. 30, 2020)

The Second Circuit affirmed the dismissal of claims brought under Sections 10(b) and 20(a) of the Securities Exchange Act alleging that a tax preparation company made false and misleading statements and omissions regarding purported sexual and other misconduct by the company's founder and former CEO.

The court held that a challenged statement regarding the company's compliance task force and ethical standards was too general and lacked "the specificity required to elevate it beyond mere puffery to an actionable, material misrepresentation." The court also concluded that an alleged omission in a press release about the reason why the company had terminated its CEO was not actionable because the law "does not require investors to be given a reason for terminating corporate officers." The press release disclosing the termination did not falsely mislead investors to believe that the CEO's departure "was pursuant to a 'deliberate succession planning process'" because the company had explained that it had engaged in succession planning in hiring a new CEO, not in firing the former one. The press release had also disclosed the extent of the former CEO's ongoing control of the company, including through his ownership of Class B shares, and therefore was not materially misleading with respect to the extent to which the former CEO would retain control over the company after his termination.

District Court Dismisses Securities Fraud Complaint, Finding Statements About Marketing Spend and User Growth Were Not Misleading

In re Stitch Fix, Inc. Sec. Litig., No. 18-cv-06208-JD (N.D. Cal. Sept. 30, 2020)

The Northern District of California dismissed a putative securities fraud class action brought against Stitch Fix, Inc. and certain of its officers, holding that the plaintiff failed to adequately plead a false or misleading statement in violation of Section 10(b) of the Securities Exchange Act.

Stitch Fix is an online retail fashion subscription service. The company's business model starts with clothing, shoes and accessories that it buys from other manufacturers or makes itself. Stitch Fix then curates these items into personalized shipments, called a "Fix," to customers. Customers can try on the items in their Fix, buy what they like and return the rest. Customers are incentivized

to buy all the items in their shipment because they receive a 25% discount if they purchase the entire Fix.

In this case, the plaintiff—a purported shareholder of Stitch Fix—alleged that the company made misleading statements regarding its television advertising and its active client growth.

First, the plaintiff challenged Stitch Fix’s statement in the fourth quarter of 2018 (4Q 2018) that “We continue to make strategic and measured marketing investments designed to achieve near-term payback.” The plaintiff claimed that this statement was misleading because it failed to disclose that Stitch Fix halted national television advertising for 10 of 13 weeks in 4Q 2018 as a way to measure the efficacy of national TV advertising. The court held that the plaintiff failed to allege that this statement was misleading. The court determined that Stitch Fix’s “more general” statements about marketing did not become misleading simply because Stitch Fix had paused one aspect of its marketing campaign—national television advertising—for a period of 10 weeks.

Second, the plaintiff challenged Stitch Fix’s statement from the middle of 4Q 2018 that it had “continued positive momentum” in its “active client growth.” The plaintiff alleged that this statement was misleading because Stitch Fix later revealed that active client growth grew only 2% in that quarter. The court held that the plaintiff failed to plead the falsity of the challenged statement with particularity. While the plaintiff certainly pleaded that overall client growth in the quarter was slow, Stitch Fix made the alleged misstatement not even halfway through the quarter, and the complaint “contain[s] no direct allegations about what active client growth was as of” the date of the alleged misstatement.

S.D.N.Y. Dismisses Complaint Against Bank Alleging Material Misrepresentations in Financial Statements

Plumbers & Steamfitters Local 773 Pension Fund v. Danske Bank A/S, No. 19-CV-235 (VEC) (S.D.N.Y. Aug. 24, 2020)

Judge Valerie E. Caproni dismissed claims brought by the plaintiffs, a putative class of investors, against the defendants, a bank and certain of its former officers and directors, alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act by making misleading statements about the bank’s financial condition that ignored deficiencies in the bank’s anti-money laundering controls at its branch in Estonia. The court determined that the complaint failed to plead scienter with the particularity required by Federal Rule of Civil Procedure 9(b) and the PSLRA and failed to plead any material misrepresentation or omission.

The court rejected the plaintiffs’ argument that certain of the bank’s financial statements improperly reported revenues from its nonresident portfolio (NRP) accounts that included revenue from deposit contracts that had

been derived from money laundering transactions. The court held that the plaintiffs did not allege with particularity that at the time the financial statements were published, the defendants knew that those contracts were unenforceable and that the NRP account funds could not be recognized. The court similarly rejected the plaintiffs’ argument that the defendants misled investors by stating in their 2015 corporate responsibility report that all whistleblower cases reported in 2014 were concluded. The court determined that there was no plausible allegation that the defendants had not concluded the whistleblower cases, even though a subsequent 2018 internal investigative report published by the defendants noted that the whistleblower allegations concerning money laundering were insufficiently investigated. The court found that while the internal investigation report suggested “mismanagement” of the whistleblower complaints, it did not suggest fraud.

The court declined “to make the inferential leap that because [the bank] failed adequately to investigate and resolve extensive [anti-money laundering] lapses at the Estonian branch, defendants must have acted with scienter when they made the various statements touching on Estonia.”

An appeal of this decision was docketed in the Second Circuit (No. 20-3231) on September 23, 2020.

Northern District of California Denies Motion To Dismiss, Finds That Vague, Optimistic Statements in Company’s Registration Statements Are Actionable ‘in Context’

Boston Ret. Sys. v. Uber Techs., Inc., No. 19-cv-06361-RS (N.D. Cal. Aug. 7, 2020)

The Northern District of California denied Uber Technologies’ motion to dismiss claims brought under Sections 11, 12(a)(2) and 15 of the Securities Act, finding that the complaint brought by a purported shareholder of Uber adequately alleged that certain statements in Uber’s April 11, 2019, registration statement were false and misleading.

Notable in the court’s decision was its treatment of certain vague, optimistic statements that might otherwise be considered corporate puffery. “In the Ninth Circuit, vague, generalized assertions of corporate optimism or statements of mere puffing are not actionable material misrepresentations under federal securities laws because no reasonable investor would rely on such statements.” *In re Restoration Robotics, Inc. Sec. Litig.*, 417 F. Supp. 3d 1242, 1255 (N.D. Cal. 2019). However, “[s]tatements by a company that are capable of objective verification are not ‘puffery’ and can constitute material misrepresentations.” *Or. Pub. Emps. Ret. Fund v. Apollo Grp. Inc.*, 774 F.3d 598, 606 (9th Cir. 2014).

In this case, the court found that the statement “it’s a new day Uber” was capable of objective verification

and, therefore, not puffery. The court explained that the registration statement elsewhere admitted that Uber had, in the past, failed to comply with local laws and tolerated sexual harassment, and even abuse, of its passengers and employees. Taking that predicate, the court reasoned that the statement “it’s a new day Uber” “implied the company had turned a corner” and that “these problems were in the past.” Therefore, “[i]t’s a new day is not mere puffery when the speaker knows significant remnants of the ‘old day’—for example, continuing to launch in markets where Uber was clearly illegal, and paying fines or bribes as a cost of doing business—remain.”

The court also found that statements that Uber was “committed to enhancing safety” and “work[ing] tirelessly to earn [its] customers’ trust” were not puffery and, therefore, actionable. (alteration in original). The court reasoned that, “when presented in the context of Uber’s troubled history and the ‘new day’ theme,” those statements “imply that something has changed.” In light of the plaintiff’s allegations that Uber was continuing to perform poorly in terms of passenger safety, those statements implying that “something had changed” were misleading.

S.D.N.Y. Declines To Dismiss Claims That Wrestling Corporation Misled Investors About Negotiations of Material Media Contracts

City of Warren Police & Fire Ret. Sys. v. World Wrestling Entm’t, Inc., No. 20-cv-2031 (JSR) (S.D.N.Y. Aug. 6, 2020)

Judge Jed S. Rakoff denied a motion to dismiss claims brought by a putative class of investors alleging that the defendants, a wrestling corporation and certain of its officers, had violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by misleadingly representing that a key agreement with a Saudi state-controlled television network would be renewed when it had already been terminated, and that there were agreements in principle for an additional media rights deal when negotiations had, in fact, stalled.

The court found that statements made variously during an earnings call, in press releases and in public presentations were misleading because the term “renewal,” as applied to the media contracts, was understood to have its common meaning and was not—as argued by the defendants—a specialized “term[] of art in the broadcasting industry.” The court similarly determined that statements during the earnings call regarding an “agreement in principle” for an additional contract were misleading in light of confidential witness testimony confirming that “the parties had not agreed on fundamental terms of a contract.” The defendants argued that hedging language that the “understanding [wa]s nonbinding” and that it was “possible” that the agreement would “not occur on expected terms” prevented the statements from misleading investors. However, the court found that these statements did not “warn of the misrepresentation that

plaintiff complains of: that there was never an agreement in principle between the parties to begin with.” The court determined that the statements were either not opinions but factual statements, or that the opinions contained particular and material facts that rendered the opinions themselves misleading. Finally, the court determined that the complaint sufficiently pleaded scienter, as evidenced by, for example, the company’s CEO’s sale of millions of shares of stock, for hundreds of millions of dollars, during the class period, which was “unusual in light of [the CEO’s] past trading practices.”

Omissions

Sixth Circuit Upholds Dismissal of Securities Fraud Case for Lack of Particularity

Iafrate v. Angelo Iafrate, Inc., No. 19-1631 (6th Cir. Sept. 21, 2020)

The Sixth Circuit affirmed dismissal of a securities fraud claim brought by the sellers of a construction company. The company, the Angelo Iafrate Construction Company, was owned by Angelo Iafrate Sr. and his children. In 2012, the plaintiffs decided to sell their interests in the company to its employees. To do so, the plaintiffs formed Angelo Iafrate Inc. (AIC) and exchanged their shares in the original company for 30,000 shares of AIC. The plaintiffs additionally furnished AIC with a \$36.7 million loan as financing. AIC set up an employee stock ownership plan (ESOP), which used the loan to purchase the 30,000 shares of AIC stock from the plaintiffs. When the sale closed in December 2013, each of the plaintiffs was issued two promissory notes, one senior and one junior, to cover their portion of the loan. Shortly thereafter, the plaintiffs entered into an agreement that if any one of them received payment on a note, they would hold it in trust. The payment would then be applied pro rata to each noteholder.

Each plaintiff also received a warrant, providing the right to purchase a specified amount of AIC shares. Each warrant contained the following limitation: “This Warrant shall terminate on, and may no longer be exercised on or after, the date that is 60 days after the date that the Company has paid in full both the Senior Promissory Note and Junior Promissory [Note] issued by the Company in favor of the Holder.”

In November of 2016, the board approved a \$5.4 million prepayment to Angelo Sr. In February 2017, AIC fully paid off two other notes. In February 2018, AIC fully paid off all outstanding notes. The plaintiffs allege that each payment was held in trust, honoring the terms of their agreement. Once the last note was paid off, the plaintiffs tried to redeem their warrants. All but one request was denied. AIC only honored the request of the last paid noteholder, claiming that all other noteholders’ requests were time-barred by the terms of the warrant. On July 5, 2018, the plaintiffs filed suit against AIC for securities

fraud, under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The plaintiffs alleged that AIC wrongfully represented that each note prepayment triggered the noteholders' warrant term limit. AIC filed a motion to dismiss for failure to state a claim, which the district court granted. This appeal followed.

The plaintiffs claimed that AIC represented that non-pro rata payments on a note would not be construed as a warrant-triggering event. As evidence of their claims, the plaintiffs cited a statement by AIC's president, that any non-pro rata payments would not change the "long agreed automatic redemption of the [w]arrants all at one time." However, the plaintiffs alleged that the president omitted new information, namely, both the president's interpretation of the warrants and his prediction of how AIC would handle them. In other words, the plaintiffs alleged that they were not told that AIC's president believed the warrants would be triggered by non-pro rata payments.

The Sixth Circuit classified this omission as "soft information." This is contrasted with "hard information," typically "historical information or other factual information that is objectively verifiable." One reason that the president's omissions were classified as "soft information" was that they were his subjective interpretation of a contract provision. Further, the Sixth Circuit applied its decision in *Omnicare*, where it previously stated "an omission of 'soft information' is only actionable as securities fraud if 'the new information [is] so concrete that the defendant must have actually known that the new information renders the prior statement misleading or false and still did not disclose it.'" *In re Omnicare, Inc. Securities Litigation*, 769 F.3d 455, 471 (6th Cir. 2014).

Here, the plaintiffs failed to allege with any particularity any statements establishing AIC's commitment to only honor the warrants after all notes were paid. Therefore, the president's alleged omission was not actionable, as there was no prior statement that the omission rendered materially false. Accordingly, the Sixth Circuit affirmed the district court's dismissal of the plaintiffs' suit.

S.D.N.Y. Denies Motion for Reconsideration of Claims Against Tobacco Company Because Alleged Misleading Statements About Electric Cigarettes Were Not Material

In re Philip Morris Int'l Inc. Sec. Litig., No. 18-CV-08049 (RA) (S.D.N.Y. Sept. 21, 2020)

Judge Ronnie Abrams denied a putative class of shareholders' motion for reconsideration challenging the court's dismissal with prejudice of their claims against Philip Morris International Inc. (Philip Morris) and several of its executives alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by making misleading statements about the sales performance of the company's smoke-

free electronic device, which had plateaued in Japan, the only country where the product was widely available. In particular, the plaintiffs asked the court to reconsider its dismissal of their claims that the defendants' SEC filings failed to comply with Item 303 of Regulation S-K, 17 C.F.R. § 229.303(a)(3)(ii), and with Item 503 of Regulation S-K, 17 C.F.R. § 229.503(c).

The court noted that Item 303 requires a corporation to affirmatively disclose "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations," and that Item 503 "requires a corporation to 'provide under the caption "Risk Factors" a discussion of the most significant factors that make an investment' in a security 'speculative or risky,' and requires each risk factor to 'adequately describe[] the risk.'" The court held that the alleged omissions about the performance of Philip Morris' smoke-free product in Japan were forward-looking statements and were not material, and the Risk Factors provided in the company's public filings were not "boilerplate," as the plaintiffs alleged, but sufficiently specific. The court noted, for example, that the Risk Factors cautioned investors that the company's success "increasingly" depended on "adult smoker willingness to convert to our [smokeless cigarettes]." The court held that the plaintiffs "failed to establish circumstances warranting the use of the 'extraordinary remedy' of reconsideration with respect to the Court's prior holding that [the defendants] satisfied their disclosure obligations under Items 303 and 503."

Scienter

District of Massachusetts Dismisses Allegations That Data Protection Company Defrauded Investors About New Software Product

Luna v. Carbonite, Inc., No. 19-cv-11662-LTS (D. Mass. Oct. 22, 2020)

Judge Leo T. Sorokin dismissed with prejudice claims brought by a putative class of investors against a data protection company and certain of its former executives alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by making misleadingly positive statements about a new software product that the company withdrew from the market after nine months. Specifically, the plaintiff alleged that the company launched the product and made statements during the class period touting the product, even though it "never worked, from the time before it was officially launched until it was withdrawn." The plaintiff further alleged that the defendants concealed from investors that the company had dedicated teams of engineers working to fix the product and issued to its customers software patches to address the product's programming bugs. The plaintiff alleged that the individual defendants

sold millions of dollars of company stock during the class period and argued that the sales supported a strong inference of scienter.

The court held that the complaint failed to plead scienter with the particularity required by the PSLRA and Rule 9(b). The court found that all of the challenged statements alleged about the new product were made during the product's launch or shortly thereafter, and there was no factual allegation that the statements were not genuinely believed when made. The court discredited the allegation that the individual defendants' class period stock sales were suspicious, noting that (i) they were pursuant to Rule 10b5-1 trading plans or to satisfy tax obligations, and (ii) the overall holdings of company stock by the individual defendants either were approximately the same at the beginning and end of the class period or increased during the class period. The court found that "while [the new product] may not have" worked "before or after release, the totality of allegations fails to support a strong inference of scienter," especially "in light of the substantial efforts to develop or repair [the new product], the disappearance of [product]-specific statements shortly after the launch, the absence of specific operational factual misrepresentations, and the stock sales taken in context." The court also held that the defendants' statements were not alleged to be sufficiently reckless to support scienter because "there is no factual allegation that [defendants] were on notice at any point prior to [the product's] withdrawal from the market that [the product] had no hope of working."

E.D.N.Y. Dismisses Complaint Against Cosmetics Company Alleging Material Misstatements and Omissions Concerning the Company's Failed Operational Management Software Platform

Lachman v. Revlon, Inc., No. 19-cv-2859 (RPK) (RER) (E.D.N.Y. Sept. 17, 2020)

Judge Rachel P. Kovner dismissed claims brought by the plaintiffs, a putative class of investors, against the defendants, an international beauty cosmetics company and certain of its officers, alleging that they violated Sections 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5 thereunder by making statements downplaying the risks of moving to a new software platform before the transition and the severity of the impact on the company after the transition had occurred. The court held that, although the failure of the software (which was used for managing different areas of the company's operations) created a material weakness in the company's internal controls over financial reporting, the plaintiffs failed to plead scienter with the particularity required by the Private Securities Litigation Reform Act (PSLRA) and Federal Rule of Civil Procedure 9(b).

The court rejected the argument that statements made in the company's 2016 Form 10-K, prior to the transition to the new software platform, were actionable because

they did not sufficiently warn about unspecified risks related to the launch of the software platform. The court determined that the plaintiffs did not plead facts supporting the inference that the defendants knew of undisclosed material risks at the time the 2016 Form 10-K was filed. The court noted that when the 2016 Form 10-K was filed, the defendants were still designing and planning the new software platform, and therefore, it was not a risk that "had already materialized." The court also rejected the argument that statements made in the company's 2017 Form 10-K, after the launch of the new software platform, were actionable because they "mis[ed] investors about the severity of the implementation problems and the Company's remediation efforts." The court found that the defendants "detailed service level disruptions" related to the launch "and the negative consequences flowing from those disruptions." The court noted that the defendants made no statements that their remediation efforts were successful but simply made statements that they immediately took action to address problems caused by the launch. Finally, the court held that the company's Sarbanes-Oxley Act certifications stating that the company's internal controls were effective were not misleading, finding that the certifications were statements of opinion, and it was not adequately pleaded that the opinion was not genuinely believed.

District of Massachusetts Dismisses Securities Fraud Claims Against Online Home Goods Retailer

In re Wayfair, Inc. Sec. Litig., No. 19-10062 (DPW) (D. Mass. July 8, 2020)

Judge Douglas P. Woodlock dismissed claims brought by a putative class of investors against an online home goods retailer under Sections 10(b) and 20(a) of the Securities Exchange Act, alleging that the company and certain of its executives made false and misleading statements about the company's financial position. The investors alleged that during the putative class period, the company's advertising revenue leverage was worse than in previous years, and that the company and the company's CEO concealed this problem from investors. The investors further alleged that the company's stock price fell on the day that the company made an announcement revealing negative advertising leverage.

The court dismissed the claims, examining three categories of statements the investors alleged were false and determining that the first set of statements alleged to be false by the investors were classic puffery (e.g., "[w]e remain incredibly bullish about our business") and thus not actionable. The court similarly determined that the second set of statements were not actionable because they were forward-looking statements concerning the company's projections and forecasts about what was expected in the company's future. The court noted that these types of forward-looking statements are covered by the safe harbor provision of the PSLRA.

For the third set of statements, which concerned the company's advertising strategies, the court determined that the investors failed to adequately allege they were false when made. The court concluded that the investors failed to allege scienter with particularity as required by Rule 9(b) and the PSLRA, and rejected the investors' argument that "because Defendants said that they paid close attention to their financial position and their financial position ended up being different than Defendants said it was, Defendants must have been lying." The court likewise found that the investors' allegations that the defendants' company stock sales were suspiciously timed and supported scienter was contradicted by the public record, as the defendants' sales were spaced throughout the class period and their stock holdings at the end of the class period were comparable to their holdings at the beginning of it.

Standing

First Circuit Affirms Dismissal of Claims Against Medical Device Company

Yan v. ReWalk Robotics Ltd., No. 19-1614 (1st Cir. Aug. 25, 2020)

The First Circuit affirmed the dismissal of claims brought by a putative class of investors against a medical device company, its officers and directors, and the initial public offering (IPO) underwriters, alleging that the defendants concealed material information in the company's IPO registration statement about its failure to comply with the Food and Drug Administration's regulations, in violation of the Securities Act. The plaintiff also alleged that after the IPO, the company continued to make material false statements in violation of the Securities Exchange Act.

The plaintiff alleged that the company issued a registration statement in September 2014 that touted the clinical success of the company's medical device, which was intended for long-term use by individuals with

spinal cord injuries but did not disclose that the company was still waiting to receive FDA approval on its proposed study plan. The plaintiff further alleged that the company failed to disclose a September 2015 FDA warning letter that stated that the device was "currently misbranded under [the Food, Drug and Cosmetic Act]" and threatened sanctions absent corrective action by the company.

As to the Securities Act claims, the First Circuit determined that the registration statement's allegedly misleading statements were true and there were no actionable omissions. For example, the First Circuit found that statements about the safety risks associated with the device were adequate, given that the company disclosed that a "user could experience death or serious injury" were the device to malfunction. The court also determined that the company had adequately disclosed the claimed risk or uncertainty as required under Regulation S-K. The registration statement explained that "[t]here is no long-term clinical data with respect to the safety or physical effects of [the device]" and that approval for use "beyond the institutional/rehabilitational setting" required performance of the relevant postmarket study" (alteration in original).

The district court had determined that the lead plaintiff did not have standing to assert claims under the Securities Exchange Act, since he purchased his shares in September 2014 and the relevant alleged omissions were not made until the company's quarterly earnings calls in 2015 and 2016. The First Circuit affirmed, finding that the plaintiff had failed to tie anything misleading in the registration statement to later alleged fraudulent omissions made by the company, and thus the statements made by the company after the plaintiff's share purchase were not made in furtherance of "a common scheme to defraud." The First Circuit also determined that the plaintiff could not cure this deficiency by adding another named plaintiff who would have had standing to prosecute the Securities Exchange Act claims because the complaint's failure to adequately allege scienter was independently dispositive of those claims.



The Terrifying New York Definition of a Franchise

By Thomas M. Pitegoff

Licensing is big business. Brand owners may license selected product lines, create brand extensions, enter new markets, or simply enhance their brands through licensing. But few brand owners know that the New York Franchise Sales Act (NYFSA), by its terms, regulates licensors who provide no marketing assistance and impose no requirements other than quality control.

The definition of a “franchise” under the NYFSA is extremely broad.¹ It covers far more business arrangements than anyone would reasonably consider to be a franchise. This anomaly puts New York franchise law in “left field,” as the late Rupert Barkoff noted in his excellent article published in the *New York Law Journal* on May 1, 2012.² This is an understatement. The NYFSA, which has not been revised since it went into effect in 1981, is not even in the same ballpark as similar legislation in other jurisdictions. Barkoff called this anomalous New York definition of a franchise “terrifying.”

In order to sell franchises anywhere in the U.S., a franchisor must prepare a detailed franchise disclosure document that includes audited financial statements. A franchisor located in New York, or a franchisor that intends to sell franchises to buyers in New York, must register the offering with the state Attorney General’s Office before the franchisor may lawfully sell franchises from or in the state. The franchisor must then make the required disclosures to each prospective franchisee and wait 10 business days (or 14 calendar days in the other dozen or so states that regulate franchise sales) before entering into the agreement or accepting any payment.

Failure to comply with the NYFSA can result in enforcement action by the New York State Attorney General’s Office and private actions by franchisees for rescission, damages, injunctive or declaratory relief, attorneys’ fees, and costs. Willful violation of the NYFSA can lead to punitive damages and criminal liability.

Not only can a simple trademark license agreement be a franchise in New York, but a marketing consulting agreement can also be a franchise. So can a distribution arrangement where the distributor must pay an initial fee to the supplier to gain the right to distribute in a specific market or territory. To put this another way, outside of the business arrangement that we all know as a franchise is a large “gray” area in which the arrangement is at risk of being a franchise under New York law.

In short, the NYFSA is a trap for the unwary. Most people would not think of consulting with a franchise lawyer before entering into a trademark license agreement or a marketing agreement. Yet failure to comply with the NYFSA can give ammunition to an aggrieved

licensee in a dispute with its licensor or result in prosecution of the licensor by the New York State Attorney General’s office.

The broad definition of a franchise cries out for change in the law.

A Two-Prong Definition Impedes Business in New York

The definition of a franchise under most franchise sales laws contains three elements: a fee, a trademark and a marketing plan prescribed in substantial part by the franchisor. The franchise sales laws of Maryland and Virginia are typical examples.³ These definitions, unlike the New York definition, are also similar to the definition of a franchise under the Federal Trade Commission’s trade regulation rule on franchising (the “FTC Rule”), which also contains three elements.⁴

The New York definition of a franchise has just two elements.⁵ One element is either a trademark or a marketing plan prescribed in substantial part by the franchisor. The second element is a fee.

Each of the franchise sales laws, of course, has various exemptions and exclusions from the definition of a franchise.⁶

Both prongs of the NYFSA’s definition of a franchise raise issues. Starting with the first prong, what does it mean to grant “the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor” without a trademark? A marketing consultant may provide a marketing plan to a client to enable that client to launch a business. Certainly, the client will pay a fee. Is this a franchise? When does such an arrangement constitute a “grant” of the “right” to engage in a business? The statute is not at all clear on what type of arrangement this prong of the definition is intended to cover.

The second prong is easier to understand but is extremely broad. The plain language of the statute covers many license and distribution arrangements that would not be considered franchises in other states. Any trademark license granting someone a right to engage in a business in consideration for a royalty would fall within the definition of a franchise under the NYFSA. So would a distribution arrangement with no grant of trademark

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rights in which the distributor pays a one-time fee to the supplier to purchase the distribution rights. These are not the types of business arrangements that anyone unfamiliar with New York law would expect to be franchises.

For licensors who receive proper legal advice, this broad definition is an impediment to doing business in the state of New York or with a person located in New York. The proper advice in many of these cases is that the broad scope of the New York law creates risk and imposes a degree of uncertainty. This advice would discourage some from locating their business in the state. Why would a licensor choose to be subject to the extensive franchise registration and disclosure requirements in New York when the company can avoid these requirements by locating in or licensing into any other state? Why would a consultant based in New York or working with a New York client provide a marketing plan to enable the client to launch a business?

“The sparse enforcement of the NYFSA does not change the fact that the threat is always there.”

For Traditional Franchisors, New York’s Broad Definition of a Franchise Is a Non-Issue

Companies that offer traditional franchises have no issue with the broad definition of a franchise under the NYFSA. Franchisors know that they must prepare franchise disclosure documents in accordance with the FTC Rule and, when necessary, also in accordance with the requirements of the NYFSA and the franchise laws of other states. Franchisors register their franchise offerings in New York as they do in other states and they make the required disclosures to prospective franchisees.

The broad definition of a franchise under the NYFSA also does not adversely affect franchisees or prospective franchisees in traditional franchise arrangements. They receive the required disclosures from their franchisors regardless of the law’s overly broad definition of a franchise.

The “terrifying” aspects of the New York definition apply only to those who would not be considered franchisors under the FTC Rule or the franchise sales laws of any other state.

Narrowing New York’s broad definition of a “franchise” to conform to the definition in other states would have no effect on franchisors or franchisees as those terms are commonly understood.

Does the Broad Definition Serve a Useful Purpose?

In practice, relatively few litigants raise the issue of noncompliance with the NYFSA against trademark licensors or marketing consultants. The Attorney General’s Office seldom prosecutes business arrangements that are not commonly understood to be franchises. The reason may be that these business arrangements do not require the protections that the NYFSA affords to prospective franchisees.

Maybe we should view trademark licensors and certain marketing consultants in New York as we do drivers who speed on a highway. Drivers often speed. Only a small number are prosecuted. But speeding is dangerous. A simple trademark license agreement or marketing consulting agreement is not.

The sparse enforcement of the NYFSA does not change the fact that the threat is always there. An enforcer can arbitrarily decide at any time to enforce it. Why should a licensor or consultant have to run this risk?

The fact that the Attorney General’s Office does not apply the law to arrangements that are not commonly understood to be franchises also indicates that the Attorney General’s Office may not view the broad definition as a necessity. Cutting back the definition so that it conforms to the laws of other states would not significantly change the enforcement activity at the Attorney General’s Office. Nor would it change the way private litigants behave.

A revised NYFSA could eliminate the registration and disclosure requirement for businesses that lie in the “gray” area of the New York definition today while retaining the Attorney General’s broad anti-fraud jurisdiction for these businesses. If necessary, the state might even consider enacting a “business opportunity” law, as roughly half of the states have done, which would regulate some business arrangements in the “gray” area but have far less onerous registration and disclosure requirements than a franchise law.

The broad definition of a franchise has been a part of the NYFSA since it became effective in 1981. New York was the last state to enact a franchise sales law, and that law has never been amended.

One commentator noted in 2012 that the NYFSA “was crafted to attack a vast criminal invasion of the franchise arena which transpired in the 1960s and 70s (including significant organized crime involvement) and to safeguard New York’s reputation as the financial capital of the world.”⁷ In other words, the NYFSA was written expansively in order to give the Attorney General broad latitude to prosecute bad actors who might run off with initial franchise investments of would-be franchise buyers. The same author noted in 2020 that on its 40th anniversary, the NYFSA “achieved its intended purpose—

the eradication of massive fraud and criminality that had permeated the then-nascent franchise arena.”⁸

Even if there was a need for a franchise law with such broad application in 1981, there is no such need today. Undoubtedly, the FTC Rule, which went into effect in 1979, also played an important role in cleaning up an industry that was riddled with fraud, as did the franchise laws of other states, which were all enacted in the 1970s before the FTC Rule became effective.

Time for Change

Most business owners want to comply with applicable laws. If by chance or good fortune a business owner based in New York or planning to do business in New York happens to consult with a franchise lawyer before entering into a trademark license agreement or a market consulting agreement, that business owner might be advised either to seek a discretionary exemption or to locate the business outside the state of New York and to consider not entering into the contract with anyone who is located in New York. This sounds extreme because it is.

Franchising is a respected way of doing business. Franchising is also an important part of the U.S. economy.⁹ With some careful revising, the NYFSA can make franchising a far more important part of the New York economy than it is today. The broad definition of a franchise under the NYFSA today is the single most important reason to change this law. It is high time for New York State to change its definition of a “franchise” to conform more closely with the franchise sales laws of other states.

Endnotes

1. N.Y. General Business Law (GBL) Article 33, Section 681.3 defines a franchise as follows:

“Franchise” means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

(a) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or

(b) A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee.

2. Rupert M. Barkoff, *New York Franchise Act: Out in Left Field*, NYLJ 5/1/2012.

3. Section 14-201(e)(1) of the Maryland Business Regulation Code provides as follows:

“Franchise” means an expressed or implied, oral or written agreement in which:

(i) a purchaser is granted the right to engage in the business of offering, selling, or distributing goods or services under a

marketing plan or system prescribed in substantial part by the franchisor;

(ii) the operation of the business under the marketing plan or system is associated substantially with the trademark, service mark, trade name, logotype, advertising, or other commercial symbol that designates the franchisor or its affiliate; and

(iii) the purchaser must pay, directly or indirectly, a franchise fee.

4. Section 13.1-559(A) of the Code of Virginia (the Retail Franchising Act) defines a “franchise” as follows:

“Franchise” means a written contract or agreement between two or more persons, by which:

1. A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services at retail under a marketing plan or system prescribed in substantial part by a franchisor;

2. The operation of the franchisee’s business pursuant to such plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and

3. The franchisee is required to pay, directly or indirectly, a franchise fee of \$500 or more.

16 CFR Section 436.1(h) provides as follows:

Franchise means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

(1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark;

(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and

(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

5. *Supra* note 1.
6. See Leslie D. Curran and Beata Krakus, eds. *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws* (ABA Forum on Franchising, 2017).
7. David Kaufman, *In Defense of the New York Franchise Act*, N.Y.L.J. June 26, 2012.
8. David Kaufman, *New York Franchise Act Turns 40—A Look Back*, N.Y.L.J. June 25, 2020.
9. See, e.g., <https://www.franchise.org/franchise-information/franchise-business-outlook/franchise-business-economic-outlook-2020>.

I Meant What I Wrote, And I Wrote What I Meant¹

By Robert Kantowitz

The words in a contract matter, or at least they should matter. In *Prendergast v. Swiencicky*,² the Appellate Division, Third Department did something that courts are not supposed to do: it disregarded the plain words of a contract. I write this article both to register an objection to what the court did and to warn of the mischief that can attend such actions and to remind lawyers to be careful, very careful, about how they draft contracts and to think about what the words actually say and mean.

I. Facts

Without cluttering up a recitation of facts with details that are not important to my point, here is what happened.

Prendergast (Seller) agreed to sell her house to Swiencicky (Buyer). They used a standard form contract, supplied by and in use in the local real estate industry. The contract specified that time was of the essence.

Buyer decided that she wanted the price lowered by \$30,000. Accordingly, Buyer arrived for the scheduled closing with the usual checks, in this case made out to the banks holding the two mortgages in the amounts needed to pay off the mortgages and a check to Seller, but the check to Seller was \$30,000 less than what was due net to Seller under the contract.

That is when things got interesting. Buyer pointed out that the standard form contract that they had executed obligated Seller to deliver unencumbered title to the property. Since Seller intended to use the bank checks to pay the banks to release the mortgages—but only after the closing—Buyer correctly noted that Seller was in default because the title would still be encumbered until the mortgages were paid off and the liens were released. Buyer offered to waive that default and close, but only if Seller would reduce the price. Seller refused. No closing.

Seller, having subsequently sold the property to a different purchaser for what apparently was a lower price, sued Buyer for damages.³ The court awarded Seller damages for loss in value relative to the agreed-upon contract price and for mortgage interest in the interim.

II. The Court Failed To Respect the Contract to Which the Parties Had Agreed

The Appellate Division affirmed, holding for Seller apparently on the basis of the dubious doctrine of “C’mon, this is the way everyone does it,” disregarding the plain words of the contract.

The court further observed that “[Buyer] had documented assurance that the marketable title was being provided.”

The dissent pointed out that the majority was wrong on both counts.

A. The wrong timing sequence shifted risks to Buyer

1. How the court disadvantaged Buyer

By holding that Seller had been entitled to close first and then later use the checks to pay off the mortgages, the court shifted from Seller to Buyer the risks that the checks made out to the mortgagees would not actually get to the mortgagees or Seller or the mortgagees would fail to record a satisfaction of the liens, and in either case the liens would remain.

These were risks that the contract plainly did not obligate Buyer to bear.

2. The decision was not compelled by logic or necessity

The common practice as imposed by the court was not something that the contract had not addressed nor was it something that could be grafted onto the contract consistently with the rest of the contract. Rather, this practice contradicted the contract.

Giving effect to the contract as written would not have created an absurd or unheard-of result. Parties are certainly free to contract for delivery of unencumbered title, and a seller who agrees to that is taking on the responsibility to do whatever is necessary to get to that point by the closing.

In any event, this was not a case where resort to common practice, even if not quite in accord with the contract, is the *only* way to keep the wheels of commerce turning. In this case, there were several alternatives, none of which would have thrown a wrench, or even much grit, into the gears of the real estate industry:⁴

- First and foremost, the parties could have written the contract to provide for a different kind of deed or for a closing and post-closing procedure that suited Seller’s needs, rather than unambiguously and explicitly requiring delivery of unencumbered title.

Robert Kantowitz has been a tax lawyer, investment banker and consultant for 40 years. He is a long-time member of NYSBA’s Committee on Attorney Professionalism.

- The parties could have entered into a contract providing for an escrow of the funds pending receipt by the banks of what was due them and their release of the liens.
- The mortgagees (the banks) could have been present to process a payoff contemporaneously. The dissent pointed out that under the contract as written a contemporaneous payoff might not have worked, since the banks would not have been entitled to their payoff proceeds until after the closing of the property transfer and would not likely release liens before getting paid, while the property transfer could not take place before the liens were extinguished. But in my experience, practitioners faced with such chicken-and-egg closings and interdependent cash transfers—sometimes even with extremely large sums of money running into the hundreds of millions of dollars—have found ways to make things work out acceptably in practice. More broadly, had the banks been present and prepared to cooperate, the risk to Buyer might have been made far lower as a practical matter, perhaps below the threshold objectively necessary to justify Seller’s refusal to close.
- Seller could have agreed to Buyer’s *ad hoc* proposal that the price be reduced by \$30,000 and the funds be escrowed for the few days it would have taken to get the banks paid and the liens cleared. Obviously, a discount would have cost the Seller considerable money, and I have not found anything in the record to indicate whether Buyer attempted to get Seller to agree to a lesser price reduction in order to reach agreement on a closing. More subtly, as in the previous point, had Seller explicitly agreed to an escrow, even with no reduction in price, the dispute would have become one of technicalities rather than one involving a substantive risk.

B. The court misread the contractual title requirement

As noted above, the majority focused on a paragraph in the contract that referred to “marketable title” and concluded that what was proffered satisfied that definition. But as the dissent points out, even if Buyer might have been able to procure title insurance in respect to the “marketable title,” the contract did not place this burden on Buyer.

More critically and fundamentally, the very next paragraph of the contract “required [Seller] to transfer the property ‘by means of a [w]arranty [d]eed, with [l]ien [c]ovenant.’” For those who do not remember the first-year property course from law school,⁵ that means a deed completely free of encumbrances—which of course Seller could not deliver. The majority appears to have missed this or ignored this rather important provision.

III. The Correct Resolution

The dissent’s position, which in my view is the correct interpretation of the contract, is as follows:

While I do not seek to disturb the typical course of real estate closings, and do not wish to upend the often-necessary practice of paying off mortgage liens with closing proceeds, I believe that it is more important to hold parties to the terms of their contracts. Buyers and sellers — assisted by their real estate brokers and attorneys, who regularly handle such matters — may alter the terms of the form contracts to reflect the nature of their individual circumstances. I cannot agree with the majority that the use of a standard form real estate contract necessarily incorporates the common practices in the real estate industry such that those practices are given more weight than the language of the contract itself. In contract law, the unambiguous language of the contract must prevail.

“It is hard to see this case as broadly precedential. . . . But it does provide yet another illustration of what can go wrong when one assumes that doing things the way that everyone does things cannot lead to problems.”

To get beyond the technical differences, any number of analogies could be provided. Perhaps the simplest is as follows. Suppose that the seller showed up at the closing and said, “I cannot deliver unencumbered title because a worker just slapped a \$20,000 mechanic’s lien on it late yesterday; I could not pay him off and get the lien removed before the closing this morning, and he’s out of town for a few days anyway, but I promise you that I will take care of the lien as soon as he returns and then within a week or two the lien will be removed.” Would the purchaser have to close? Of course not. The fact that many if not most purchasers might well close and trust the seller to make things right soon enough is irrelevant.

Likewise in this case. Many, if not most, home sellers cannot and will not pay off mortgages without the funds provided by the purchaser at closing, so in the interest of facilitating closings, most home purchasers in the area apparently ignore the risk that checks might not reach their intended destinations. The court took it as given by

all parties that many real property closings in that area use that form of contract and those procedures. But the happenstance that others do not generally enforce their rights does not overcome the pesky fact that Seller promised an unencumbered title and could not deliver it. Similarly, Seller's finding a subsequent purchaser is also irrelevant, regardless of whether the second purchaser was willing to accept the same contract and procedures (about which I found no information in the record in any event). The point of the dissent, with which I agree (though the dissent phrased it less indelicately), is that mass stupidity, ignorance or laxity does not justify a result contrary to law.

IV. Conclusion and Recommendation for Lawyers

The Court of Appeals has refused to hear an appeal,⁶ thereby missing an opportunity to clarify that contracts should be enforced as written. The combination of a standard form contract, a reflexive way of doing things, relatively unsophisticated clients and a setting in which transactions are mostly (one would hope) uneventful led to a real error. This is especially unfortunate under New York law and in the New York courts, given the position of the state as an exemplar of well-functioning and well-developed commercial law and its status as a center of court practice, all of which make it of paramount importance that parties be able to rely on the contracts that they write without worrying about any "this is the way it's done in Schenectady" surprises.

It is hard to see this case as broadly precedential from a jurisprudential perspective, and that is fortunate. But it does provide yet another illustration of what can go wrong when one assumes that doing things the way that everyone does things cannot lead to problems. I would

like to believe that if, instead of the jargon that requires recourse to a legal dictionary and paragraphs that seem to deal with the same criterion but say different things, the parties had either said "all liens must be cleared before closing," or, more likely, "proceeds to the seller will be in escrow until all liens are cleared," this litigation never would have arisen. So, as unnecessary and inconvenient (and sometimes costly) as it may seem, lawyers should read forms and boilerplate and understand what they mean and are intended to do before blithely using them or dropping them into contracts. That is certainly true when one has never used the language before, and it is even good discipline when some time has elapsed since one last thought about the meaning of the terms, how the clauses work together, the applicable law and all the "what ifs."

Endnotes

1. Paraphrasing Horton the Elephant in Dr. Seuss's *Horton Hatches the Egg*.
2. 2020 NY Slip Op. 02686 (App. Div. 3d Dep't, May 7, 2020), motion for leave to appeal denied, 2020 NY Slip Op 76207 (Dec. 17, 2020).
3. The case was further complicated by Buyer's demand for specific performance, even though Seller had already sold the property to another person. Regardless of how that element should be sorted out, the fundamental issue remains whether or not Buyer should have prevailed in its claim that Seller was not prepared to close under the contract as written.
4. These are all common-sense alternatives, some of which were actually raised by the parties. It is not clear whether one or both of the parties had a lawyer present at the closing to review the contract.
5. Or who are exasperated or exhausted from reading my recent article on the statute of frauds, see *The Statute of Frauds and the Fork in the Road*, NYSBA Journal (Dec. 2020).
6. See note 2 *supra*.



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 <https://nysba.org/committees/business-law-section/>.

Banking Law Committee

CLE Presentations and Committee Events

- **Fair Servicing Risks and How to Maintain Fair and Responsible Servicing Practices:** Presentation and Committee discussion at the NYSBA Annual Meeting on Fair Servicing as it relates to the California Consumer Privacy Act (CCPA) and New York's adoption of Part 500 ("Cybersecurity Requirements for Financial Services Companies"). January 29, 2020.
- **COVID-19 Emergency Preparedness Plans Required by the New York Department of Financial Services:** Discussion and practical guidance on requirements for state-chartered banks, credit unions, branches of foreign banking organizations, broker-dealers, licensed lenders, and money transmitters to submit preparedness plans addressing cybersecurity risks stemming from the COVID-19 pandemic. April 6, 2020.
- **Banking and Fraud Prevention:** Lessons learned from the 2008 financial crisis applied to regulatory and compliance controls to monitor and prevent fraud amid the COVID-19 pandemic. May 11, 2020.
- **Best Practices for Managing Privacy and Security Risks with Vendors and Third Parties:** Panel discussion on the wave of new and changing privacy and security laws in the United States and abroad, and how those developments impact relationships with service providers and third parties. July 28, 2020.
- **True Lender Developments:** Detailed presentation on the Office of the Comptroller of the Currency's True Lender rulemaking and an insider's view on the settlement agreement between the Colorado Attorney General and bank-fintech partnerships. October 30, 2020.

Committee Activities

- State legislative initiatives and regulatory proposals affecting the banking and financial services industry at-large.
- The impact of COVID-19 on community banks.
- COVID-19 and technology in the workplace.
- Interpreting the CARES Act lender agreement and banking requirements connected to the Paycheck Protection Program.

Scott E. Wortman, Chair

Bankruptcy Law Committee

The Bankruptcy Law Committee has maintained an active schedule of CLE programs despite the ongoing pandemic.

- 05-10-2020 Bankruptcy Practice and Procedure During the COVID-19 Emergency
- 08-10-2020 Defending Preferential Transfer Cases
- 10-22-2020 Timebombs in Bankruptcy
- 12-10-2020 Bankruptcy and Virtual Lawyering: A Court Technology Update
- 01-20-2021 What Every State Court Practitioner Should Know About Bankruptcy

Mark B. Brenner, Chair

Business Organizations Law Committee

The Business Organizations Law Committee last summer had a CLE presented by Perry Sofferman on conducting virtual meetings for LLCs.

Regarding the task force for the New York Limited Liability Company Law (NY LLCL), I previously presented my comments to the Business Law Section that the prior draft document/report was procedurally flawed in several respects and did not comport with NYSBA Bylaws. In 2021, I will be constituting a task force on the NY LLCL ("NY LLCL Task Force") which I will Chair, soliciting involvement from the Business Organizations Law Committee members and the Business Law Section, then oversee the leadership structure of the NY LLCL Task Force, a survey to be circulated among Business Law Section members and possibly the entire NYSBA. Based on the results of the survey, plus input from the Task Force members, I will draft a report on NY LLCL for consideration by the Business Law Section. If approved, the report will then, following appropriate Bylaw procedures, be presented to the House of Delegates for its review and approval. I will

draw upon counsel and instruction from Business Section Leadership for proper procedure for the entire process.

Separately, I was appointed to the NYSBA Task Force on COVID-19 Immunity, and I am a member of the Contract Committee thereof, which is being chaired by Jay Hack.

Stephen L. Brodsky, Chair

Diversity Committee

“The New York State Bar Association is committed to diversity in its membership, officers, staff, House of Delegates, Executive Committee, Sections and Committees and their respective leaders,” states the NYSBA Diversity Policy.

NYSBA, under the leadership of its Diversity Committee, has continued its work to enhance diversity within the leadership and membership of NYSBA. In January 2020, the Diversity Committee proposed enhancements to the NYSBA Diversity Plan that were approved by the House of Delegates at the January 2020 House of Delegates meeting. The Plan “is designed to achieve not just diversity—the presence of lawyers and law students from all backgrounds—but inclusion as well—their full and equal participation in the Association.”

The Plan enumerates several activities the sections of the NYSBA must execute to deepen diversity and inclusion. The Business Law Section has developed a plan to align with the NYSBA Diversity Plan. The activities comprising our plan are:

1. **Diversity Committee Liaison:** Have liaisons from various diverse bars external and internal to NYSBA;
2. **Partnership Opportunities:** NYSBA Business Law Section and members could participate as panelists or as a resource;
3. **Job Opportunity:** Circulate to diverse bar listservs;
4. **Heritage Month Events:** Co-hosting Heritage Month Celebrations;
5. **Speaking/Publication Opportunities:** Speaking/writing opportunities at Business Law Section forums/programs/publications;
6. **Mentoring Program:** Targeting law students and young lawyers of colors; subsidizing membership fees for the students/young lawyers; and
7. **Fellowship Program:** Create a work opportunity for diverse students at BLS member firms subsidized by BLS grant funds.

The BLS Diversity Committee is executing our plan in partnership with eight bar associations (Asian American Bar Association of NY, Association of Black Women Attorneys, Bronx Women’s Bar Association, Dominican Bar Association, Korean American Lawyers Association of

Greater NY, Metropolitan Black Bar Association, Muslim Bar Association and Puerto Rican Bar Association) and one NYSBA Section (Women in Law).

We all can advance the BLS Diversity Plan. Do you want to volunteer to be a mentor? Do you have a speaking opportunity on a panel? Can you give a work opportunity to a law student? Can you attend one of our heritage month celebration events? If the answer to just one of these questions is “yes,” please contact me at tgraysbarmail@gmail.com.

Taa Grays, Chair

Environmental Social Governance Committee

The Environmental Social Governance (ESG) Committee was formed in January 2021 as a new Standing Committee of the NYSBA Business Law Section. It is co-chaired by Linda Smith (CCO, Fiera Capital Inc) and David Curran (Chief Sustainability Officer, Paul Weiss).

ESG refers to a set of “E”nvironmental, “S”ocial and “G”overnance standards that are used to assess risks, enhance investment returns and/or to promote environmental or societal goals. ESG factors are increasingly incorporated into investment and credit analysis. Companies are evaluated for their sustainable practices by investors and rating agencies. Environmental issues such as a company’s impact on climate change and social issues such as racial justice, diversity and inclusion, data privacy and the like are increasingly important from business and legal perspectives. Robust governance is critical to ensuring that E and S commitments and obligations are documented so that they can be tracked, measured, monitored and reported on. The goal of the ESG Committee is to:

- Actively monitor developments in the area;
- Provide a forum for discussion among practitioners, both in-house and law firm, and help them benchmark their ESG practices against peers;
- Organize CLE programs;
- Link members of the legal profession to academia and not-for-profits active in sustainability;
- Inform members of publicly available educational resources such as courses in ESG matters offered by UN institutions;
- Engage the student body in law schools around the state and New York City; and
- Educate and engage the student body and faculty in New York State’s law schools as to ESG practices and developments.

On January 15, 2021, soon after its formation, the Committee co-sponsored a two-panel event on “New York’s Changing Energy Industry: Legal and Regulatory Impacts.” The event was co-sponsored with the Energy and

Climate Law Committee and the Securities Regulation Committee. The ESG Committee also intends to participate in the annual spring meeting and collaborate to organize a panel on corporate sustainability.

Linda Smith, Co-Chair

Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee has maintained a full schedule of educational programs despite the pandemic, as follows:

January 29, 2020: “Franchise Government Relations Update, Including New York Assembly Labor Committee’s Hearings on ‘ABC-Test’ Legislative Proposals.” Speaker: Jeff Hanscom (International Franchise Association).

January 29, 2020: “Significant Joint Employer Developments.” Speakers: Renee Silver (Tannenbaum Helporn Syracuse & Hirschtritt); Aaron Van Nostrand (Greenberg Traurig).

September 17, 2020: “COVID-19’s Impact on Franchising.” Speakers: Dale Cohen (Kaufmann Gildin & Robbins); David Kaufmann (Kaufmann Gildin & Robbins).

January 21, 2021: “Business Best Practices in a Post-COVID World.” Speaker: Mark Seibert (The iFranchise Group).

Breton H. Permesly, Chair

Insurance Law Committee

No report submitted.

Giancarlo Stanton, Chair

Legislative Affairs Committee

No report submitted.

Mike de Freitas, Chair

Membership Committee

The Membership Committee is focused on finding ways to make the Business Law Section and NYSBA more relevant to our members, and thus to enhance the attractiveness of membership in the Section. The Section has implemented a mentorship program. We are organizing regular webinars on topics of interest such as alternative careers for lawyers, what to do with your kids during a pandemic, and project management for lawyers. These are not necessarily CLE but are topics of interest for business lawyers and lawyers who are business owners. We are looking to our members to share their stories and experiences about practicing law during the pandemic—

that which we cannot wait to return to as it was and that which we hope is here to stay. We are working to continue to expand what we offer to members in the hope that they will remain members and will encourage others to join the Section as well. We encourage all members to provide suggestions as to benefits, topics for programming, and otherwise let us know how we can help and become more relevant for current and future members. If you have any questions about membership or suggestions for Section leadership, please contact Jessica Parker, secretary and membership chair, at jthalerparker@gmail.com.

Jessica Parker, Chair

Mergers and Acquisitions Committee

No report submitted.

James Rieger, Chair

Not-for-Profit Corporations Law Committee

The Not-for-Profit Corporations Law Committee recently presented two very well-attended and very well-received CLE programs. On January 21, as part of the Business Law Section’s Annual Meeting, our presenter was Karin Kunstler Goldman, deputy bureau chief in the New York State Attorney General’s Charities Bureau. The program was entitled “Update from the Charities Bureau: Non-profit Organizations and the Attorney General Facing the Challenges of the COVID-19 Pandemic.” On September 14, the committee presented a CLE program entitled “The Impact of the Pandemic on Nonprofit Corporate Governance.” Both of these CLE programs were recorded and are available on-demand on NYSBA’s website.

The committee is currently consulting with our partners in the legal community that serve the nonprofit sector in response to recent legislation that impacts the nonprofit sector.

David Goldstein, Chair

Public Utility Law Committee

No report submitted.

George Pond, Chair

Securities Regulation Committee

The Securities Regulation Committee has long maintained a regular schedule of programs to advance the knowledge of its members. Events in the second half of 2020:

- **June 2020:** The Securities and Exchange Commission's Exam Priorities for 2020 for Investment Advisers
- **July 2020:** Legal and Ethical Considerations in Securitized Loan Transactions
- **August 2020:** *Liu v. SEC*: An Overview of the Recent Decision
- **September 2020:** Market Trends for Private Fund Advisors
- **October 2020:** Mandating Gender Diversity: California's Approach to Diversifying Boards Of Public Companies
- **November 2020:** The Interplay Between New York and the SEC's Regulation of Virtual Currencies
- **December 2020:** Leveraging AI and Digitization in the Securities Industry

Events in first half of 2021:

- **January 2021:** New York's Changing Energy Industry: Legal and Regulatory Impacts
- **February 2021:** Accessible Banking for All: How Advances in Technology Can Help the Masses Gain More Control Over Their Financial Well-being
- **March 2021:** Respectful Workplace Training
- **April 2021:** Sanctions and OFAC Issues
- **May 2021:** Cross-Border Bankruptcy Issues Faced by Private Funds
- **June 2021:** Recent Developments in Capital Markets

Tram Nguyen, Chair

Technology and Venture Law Committee

No report submitted.

Clayton A. Prugh, Chair

Wine, Beer and Spirits Law Committee

The Wine, Beer and Spirits Law Committee was formed in late 2019 to take a serious look at a topic that many of us consider to be a hobby (I have a wine cellar in my basement). We have sponsored three CLE sessions since formation. The first session, pre-pandemic, was an in-place meeting in January 2020. We started with a one-hour presentation on SCOTUS decisions holding that the dormant Commerce Clause pre-empted the provision of the 21st Amendment giving control of alcohol legislation to the states. We finished with a "product tasting" that was made lawful by the SCOTUS decisions discussed in the first hour.

The committee then held two virtual CLEs. The first analyzed the laws that regulate the movement of alcohol from Europe to the U.S., then from one state to another, and finally from a producer to a distributor to a retailer in New York. It was followed by a guided wine tasting presented by the owner and principal winemaker of Tercero Winery in California. Finally, as part of the Business Law Section annual meeting, we held a virtual CLE to discuss the outlook for import tariffs on alcohol from the EU under the new administration, which was followed by a guided beer tasting of Ommegang "Game of Thrones" beer, which was held on Inauguration Day as the winner of our own Game of Thrones was sworn in.

In addition to its CLE sessions and Good and Welfare Sessions, the committee has also published a newsletter, dubbed the "Alcohol Law Newsletter." The entirely electronic newsletter is distributed by email at no charge. The inaugural Winter 2020/21 issue contained articles on alcohol tariffs, whether the loosening of distribution laws under the COVID pandemic might have staying power, and the unanswered questions still to be addressed by the U.S. Supreme Court. The last article included a discussion of whether we could glean some insights on how the newest member of the Court might vote on the dormant Commerce Clause from her law review article on originalist interpretations of the Constitution.

If you are interested in subscribing to the newsletter, email the committee at AlcoholLawNewsletter@gmail.com.

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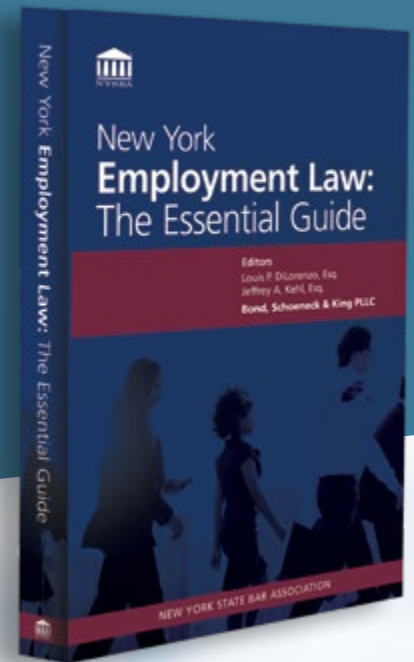
Welcome New Section Members

The following members joined the Section between August 21, 2020 and Feb. 18, 2021.

Safiyya Akoojee	Brian Albert Fink	Joseph J. Maltese	Jeffrey Scott Schultz
Suzanne R. Albin	Allen L. Finkelstein	Anastasia Mantziou	Dani Schwartz
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Melody Emelina Alvarado Latino	Eugene M. Fisher-Haydis	Benjamin Marshak	Vanessa Rae Seidman
Leonard D. Andrew	Matei Foit	Zachary Evan Marshall	Anastasia Marie Semel
Juan Carlos Arce	Alyssa Ann Forslund	Jose Antonio Masini Torres	Aysegul Senoz
Meiying Z. Austin	Donald R. Fox	Michael R. May	Patrice E. Sessa
Michael Joseph Azakie	Erica Maysan Francisco-Lau	Chanel T. McCarthy	Salik W. Shaikh
Khalid M. Azam	Richard Franzblau	Serenna Leona McCloud	Michael C Shearman
Mustafa Backo	Emma Frean	Sean J. McGowan	Jay Shusterhoff
Andres Baena	Toshishige Fujiwara	Henry C. Meier	Shahram Siddiqui
Khama Banda	Kenneth Bay Furry	Joshua M. Miller	Adomas Siudika
Ellen Alexandra Koshie	Rod P. Futerfas	Nandy Adanna Millette	Philip Sivin
Bannerman-Quist	Glinnesa D. Gailliard	Eric Matthew Milner	George Sobek
Danielle Bauer	Sophie Gandler	Faith Mitton	Perry Sofferman
Danielle Stacey Baxter	Zhe Gao	Chinye Monye	Shauna L. Spinosa
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Frank Peter Beninato	Elizabeth A. Genung	Mary Patricia Moore	Stephen R. Stegich
Louis Berger	Constance Oberle Geoghan	Daniela Lao Morrison	Nisha Kamilla Sundra Rajoo
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Maxine Blake	Richard S. Goldstein	Alma Jean Murcia-Mackin	Guan Ling Charlotte Tan
Tracy L. Boak	Diego Gomez Haro	Musonda Mutati	Sinan Haluk Tandogan
Luke Daniel Brindle-Khym	Neil S. Greenbaum	Mark Myers	Sanjiv Jayant Tata
Erin Brown	Jasjit Singh Grewal	Mohamed Louay Nashawi	Kim Taylor
Adam L. Browser	Jared A Grossman	Kimberly R. Nason	Evan Patrick Thomson
Christopher R Bryant	Anna Grover	Joshua Charles Nathan	Aaradhana Tomar
Cristina Buccola	John C. Guilds	Daniel Stuart Newman	Elizabeth Ann Topazio
Monica Laverne Robinson	Zhao Guo	Scott L. Nicholas	James T. Townsend
Bynum	Dennis W. Habel	Gregory G. Nickson	Genevieve Trigg
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Thomas P. Casper	Owen Eric Herne	Leni Nulsen	Sarah Tune
Bartholomew Chacchia	Illonka Javette Hines	Antonio Camacho Núñez	Raysheea Turner
Hin Lam Chan	Robert W. Hollweg	Henrique Olsen	Christi L. Underwood
Ying Cheng	Michael Charles Hughes	Lauran Oneill	Vanessa Van Brunt
Ming CHI	Gwendolyn Elaine Jackson	Melissa H. Orlen	John Vander Neut
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Hakyung Cho	Pamela Y. Jones	Cecelia F. Pelkey	Daniel Walsh
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