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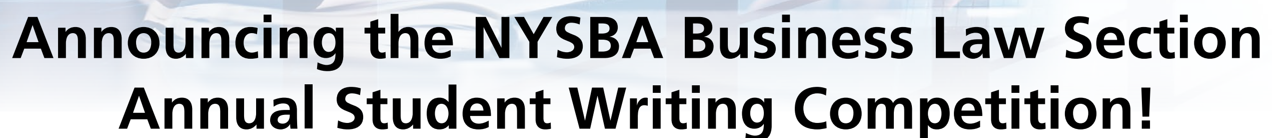
NY Business Law Journal

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

Lawyers as Rats, Part Deux

The Paradox of New York's Commercial Financial Disclosure Law

What To Know About the Bankruptcy Code's New Subchapter V



Announcing the NYSBA Business Law Section Annual Student Writing Competition!

The Business Law Section sponsors an annual Student Writing Competition, open to all students who are candidates for the JD or LLM degree at an accredited law school during the year in which the article is submitted. The student articles submitted in a given year that are judged first, second, and third best, provided they are of publishable quality and otherwise meet the criteria of the Competition, will receive cash prizes of $2,000, $1,500, and $1,000, respectively. At the discretion of the editors, they also will be published in the NYSBA *NY Business Law Journal*, which is sponsored by the Section in cooperation with Albany Law School and is published in the spring and fall. Additional cash prizes may be awarded in the discretion of the Section, and the Section reserves the right to award some, all, or none of the prizes, depending on its determination of quality of submissions. Entries that do not qualify for cash prizes may also be considered for publication in the *Journal*.

Articles submitted will be judged on the following criteria:

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

The manuscript should follow Blue Book cite format (using endnotes rather than footnotes) and be a minimum of 3,000 words (there is no maximum). Submissions should be made by **November 1, 2022** to be included in the next issue of the *Journal*. All submissions become the property of NYSBA and the *Business Law Journal*. By submitting an article, the student is deemed to consent to its publication, whether or not a cash prize is awarded.

To enter, the student should submit an original, unpublished manuscript in Word format to David L. Glass, editor in chief, NYSBA *New York Business Law Journal* (david.glass@macquarie.com).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

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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

I am honored to serve as the Chair of NYSBA's Business Law Section. I thank my three immediate predecessors, Anastasia Rockas, Anthony Fletcher and Drew Jaglom, for their excellent leadership and guidance.

During my one-year term, a high priority for me will be to work toward improving state and federal laws in ways that will make New York more appealing as a company headquarters state and a top state selection for entity formation. Viewed another way, I would like the Section to do everything possible to remove unnecessary impediments to business that continue to exist in New York laws. I am pleased that Michael de Freitas, the Section's Treasurer, will also continue his excellent work this year as the Chair of the Legislative Affairs Committee.

The most universally supported legislative proposal among New York business lawyers is the elimination of the limited liability company publication requirement. This requirement unnecessarily increases the cost of business entity formation or qualification in the state and is simply outdated in an age in which business entity searches are commonly done on state websites.

A second proposal is to change the provisions of the New York franchise law that discourage franchisors from locating their offices in New York State. See my articles, "The Terrifying New York Definition of a Franchise" in the spring 2021 issue of this *Journal*, and "How New York Can Be a Center for International Franchising" in the summer 2020 issue.

I would like the Section's committees to serve as incubators of other legislative proposals. Our Section's substantive committees are these: Banking; Bankruptcy; Business Organizations; Derivatives and Structured Products; Energy and Climate Law; ESG; Franchise Distribution and Licensing; Insurance; Mergers and Acquisitions; Not-For-Profit Corporations; Private Funds; Securities Regulation; Technology and Venture; and Wine, Beer and Spirits.

The committees also offer CLE programs to their members and to other interested lawyers. The Section's many CLE programs take place not just during NYSBA's Annual Meeting and the Section's spring and fall meetings, but also throughout the year. This year's program chair for our Section is Jessica Parker, who is also the vice chair of the Section and the past chair of the Section's Membership Committee. For a list of upcoming programs as well as past programs that are available on demand, see https://nysba.org/committees/business-law-section/.

Our Section's committees also serve to draw members with common professional interests. Decades ago, I joined a newly formed Franchise Law Committee of the Section as my first step into more active participation in the Section and NYSBA as a whole. I look forward to working this year with the Membership Committee's co-chairs, Sarah Gold and Nandy Millette.

I also thank Taa Grays for her continuing and untiring work as chair of the Special Subcommittee on Diversity and her spearheading of the mentoring program and the fellowship program.

Each year, we donate Section funds to the New York Bar Foundation. The Section designates specific organizations that will receive specific amounts of the Section's donation because of the benefit they provide to the growth of business in the state. Each year we try to include in that group organizations that support military veterans in business. I thank Stuart Newman for spearheading this important annual contribution to the Bar Foundation.

Finally, the *N.Y. Business Law Journal* continues to serve as both a voice of the Section and a magnet for Section participation. As Stuart Newman wrote in last year's 25th anniversary issue, the *Journal* is widely recognized as one of the most important tangible benefits of Section membership. We are thankful to the law professors, law students and business law practitioners who continue to write for the *Journal*. I also thank Stuart Newman for founding the *Journal* and serving as its first editor-in-chief, and for his continuing authorship of articles published each year. I also thank Prof. James D. Redwood for his years of service as the *Journal*'s managing editor, and David L. Glass, for his valuable contributions as the editor-in-chief.

As the COVID-19 pandemic and virtual meetings recede and in-person programs hopefully resume and continue, I look forward to an energized and active year for our Section.

Thomas M. Pitegoff

HeadNotes

As this issue was going to press, Governor Hochul was considering whether to sign or veto legislation that would overturn the Court of Appeals' 2021 ruling in *Freedom Mortgage Corporation v. Engel*. The case effectively reopened hundreds of foreclosure cases that the homeowners thought they had won because the lender missed a key deadline. Under pre-*Engel* law, when a lender filed for foreclosure, it had to commence legal proceedings within six years, or notify the borrower that it was discontinuing the action. While it would seem that six years is adequate time to act, because many or most mortgages wind up packaged in securitization transactions, it was not unusual for individual cases to slip through the cracks. In those cases, homeowners generally assumed that the foreclosure action was over and they could keep their homes. In *Engel*, however, the state's highest court held that if the lender ends a foreclosure suit, even if it never so notified the borrower, the statute of limitations automatically stopped running. As a result, lenders have been able to revive hundreds of foreclosure actions around the state that apparently were time-barred.

Representatives of banks and mortgage companies have been lobbying strenuously against the bill. They argue, in effect, that the legislation could make it harder for lenders to work with mortgagors to prevent a foreclosure; it would simply be too risky for the lender, since they would not be able to reset the clock. Foreclosure defense lawyers, on the other hand, assert that this contention is overblown. The bill was intended to restore the status quo before *Engel*; but in at least one way, the law would actually put the lender in a worse position than before *Engel*. Currently—and even prior to *Engel*—lenders could reset the clock unilaterally by withdrawing the lawsuit and then re-filing. But the legislation allows the lender to stop the clock only if it enters into a loan modification agreement—i.e., in consideration of allowing the lender to stop the clock, the borrower could negotiate a lower rate or other modification. Industry representatives read this to mean that if the modified loan then went into default, the lender would be barred from pursuing foreclosure, if the borrower defaults more than six years after the action on the initial loan. This would, they assert, have a chilling effect on their ability and willingness to negotiate a loan modification, and thus could be counterproductive.

While the governor has not said whether she will sign the bill, it passed the state Senate by a margin of 52-20, apparently a veto-proof majority. However it turns out, the new law is another indication that the state, like the federal government, is moving more aggressively to protect consumers in business transactions. Another example is the state's newly enacted Commercial Finance Disclosure Law, discussed below. At the least, there will be new and different challenges for business practitioners down the road.

David L. Glass

In the Winter 2018 edition of the *Journal* appeared "Lawyers as Rats: An Evolving Paradigm," in which Evan Stewart explored the rules governing lawyers who "rat out" their clients for personal gain. In "Lawyers as Rats: Part Deux," Mr. Stewart turns his attention to a different kind of "rat" —a lawyer who rats out other lawyers. ABA Model Rule 8.3, as adopted in 47 states and the District of Columbia, mandates that a lawyer who "knows" that another lawyer has violated the Rules of Professional Conduct in a way that implicates that lawyer's honesty or fitness to practice "shall" inform the appropriate authority. But, as Mr. Stewart explains in his usual clear and entertaining prose, this seemingly simple rule is not so simple to apply in practice. In particular, what constitutes "knowing"? Noting that there may be as many as seven definitions, he discusses the approach taken to this issue in New York and other states. Another problem area is the evolving law surrounding the obligations of law firm associates to report on partners of the firm. Mr. Stewart is a partner in Cohen Gresser; his distinguished reporting and analysis of ethical issues have graced the pages of the *Journal* for more than a decade.

The COVID-19 pandemic brought into sharp relief the difficulties faced by smaller businesses in seeking recourse to Chapter 11 of the Bankruptcy Code, which allows the debtor to remain in business while reorganizing. For a small business, it could be too complicated and too costly to be feasible. But even prior to the pandemic, in 2019 Congress enacted the Small Business Reorganization Act (SBRA), codified in the Bankruptcy Code as Subchapter V. In "What To Know About the Bankruptcy Code's New Subchapter V," Stuart B. Newman and Steven H. Newman explain why the new subchapter is "a new pathway for small businesses to remain in control of running their businesses," the usual reason for using Chapter 11, espe-

cially since the debt cap for a "small business" was raised to $7.5 million. Along the way, they take us through an enlightening and entertaining review of the history of debtors' prisons. Clear and practical, the article is a valuable resource for any business practitioner who advises small businesses. Stuart Newman is a principal of Offit Kurman P.A., senior advisor to the *Journal* and chair of its Advisory Committee; Steven Newman heads the bankruptcy and creditors' rights practice at Katsky Korins LLP. This article first appeared in the June 11, 2022 issue of the *New York Law Journal*; the editors express their appreciation to the NYLJ for permission to reprint it.

Another of the many issues arising from the COVID pandemic that affect small businesses is the concern that lenders might try to use the borrowers' difficult circumstances to gain leverage in making loans on less favorable terms for borrowers. Responding to this concern, the New York Legislature enacted the Commercial Finance Disclosure Law (CFDC), which took effect January 1, 2022. The CFDC is ostensibly aimed at enhanced disclosure, to enable borrowers to compare terms from lenders, and applies only to non-traditional lenders, excluding banks and other lenders that are already well regulated. But in "The Paradox of New York's Commercial Financial Disclosure Law: Will Increased Regulation of Lenders Actually Benefit Borrowers?," Stephen Grable and James Pizzo explain why the CFDC may actually work against the interests of borrowers, by imposing excessive costs and regulatory risk that could drive lenders from the small business market, or compel them to charge higher rates to cover the increased cost. As of this writing, however, the New York State Department of Financial Services had not yet issued regulations to implement the law, so the resolution of some of these issues remains uncertain. Mr. Grable is a litigation partner and Mr. Pizzo a law clerk in the New York office of Thompson Coburn Hahn & Hessen; Mr. Pizzo is currently enrolled in the J.D. program at St. John's University School of Law.

The United States continues to be an attractive market for nonresident businesses. Yet the ins and outs of U.S. taxation of foreign-based enterprises can be a significant factor for a nonresident business contemplating U.S. expansion. In "Tax Considerations for Nonresident Business Enterprises Commencing United States Activities," Patrick McCormick lays out the basic statutory framework for the taxation of nonresident businesses. Noting that countries generally assess taxes based either on residence or on the source of the income, under IRS rules nonresidents are generally taxed only on income effectively connected with the nonresident's trade or business, and FDAP (fixed or determinable annual or periodic) income—the latter comprising generally passive income. But if a nonresident is engaged in an American trade or business, the scope of taxation expands significantly. The author lays out clearly (to the extent tax law is ever clear!) the various tests that will apply in determining how the nonresident is to be taxed. Mr. McCormick is a principal of Offit Kurman P.A. based in Philadelphia.

In March, the Securities & Exchange Commission (SEC) published a massive, 510-page release setting forth proposed new climate-related disclosure rules for public companies. Although the proposed rules are not industry-specific, it appears that they may have a particularly significant impact on companies in the financial sector. In "SEC Proposes Expansive Climate-Related Disclosure Rules," the attorneys of Sullivan & Cromwell explain in detail how these proposed rules will affect financial companies. In particular, they note that "scope 3 emission disclosures" relating to greenhouse gases, and included financed emissions, will almost certainly apply to banks and other lenders, and will result in substantial complexity and compliance cost. The comment period on the proposed rules will have expired in June; final rules are not expected to take effect earlier than 2023 and 2024. As always, we are grateful to the attorneys of Sullivan & Cromwell for sharing their knowledge and expertise with our readers.

Special purpose acquisition companies (SPACs) have become the method of choice for issuers seeking to go public; in both 2020 and 2021, they accounted for more than half of all initial public offerings (IPOs). This has led to concerns being expressed that SPACs do not provide the same degree of shareholder protection as a traditional IPO. To address these concerns, the SEC has now proposed extensive new disclosure rules, pertaining to such matters as the SPAC sponsor, potential conflicts of interest and potential shareholder dilution. The proposal also would require extensive new disclosures in a de-SPAC transaction—i.e., one in which the SPAC acquires and merges into a privately held target company. In "SEC Proposes Significant Changes to Rules Affecting SPACs and De-SPACs," the attorneys of Skadden Arps provide a comprehensive, and comprehensible, overview and analysis of the proposed new rules.

Because Delaware is often the jurisdiction of choice for formation of business entities, New York business lawyers often need to keep abreast of changes in Delaware law. In April, the Delaware State Bar Association approved proposed changes to the Delaware General Corporation Law (DGCL). In "Proposed 2022 DGCL Amendments Include Significant Changes Addressing Exculpation of Officers, Appraisal Rights and Domestic-Related Transactions," Allison Land and Edward Micheletti discuss the significance of the proposed changes in such areas as extending exculpation clauses that protect directors to cover senior officers as well, in light of increasing fiduciary duty claims against officers; addressing uncertainties surrounding domestication transactions, whereby a foreign corporation becomes a Delaware corporation (i.e., through a SPAC transaction); simplifying the conversion of a Delaware corporation into another entity, and other key provisions aimed at maintaining Delaware's unique status as the go-to jurisdiction for business formations. Ms. Land and Mr. Micheletti are

partners of Skadden Arps, based in its Wilmington, Delaware office.

As it has for more than 10 years, Skadden Arps' incomparable "Inside the Courts" provides our readers with an invaluable guide to substantially all significant litigation pending in the federal courts that relates to securities law, or to business law more generally. "Inside the Courts" is must reading not just for litigators, but for all business lawyers who want to keep abreast of potentially significant cases that could affect their clients and their practice. We remain indebted to the lawyers of Skadden Arps for so generously sharing their knowledge and insights.

Since it was first published in 1995, Robert Haig's remarkable treatise, *Commercial Litigation in New York State Courts,* has become a resource valued by business lawyers for its discussion of substantive law as well as its guidance for the litigator. We are pleased to conclude this issue with a review of the fifth edition, published in 2020. The original treatise had three volumes; the latest edition now has 10 volumes, representing the work of 256 principal authors. The review, by Samuel Abernethy and Ted. G Semaya, notes that while the core of the treatise remains focused on case preparation, the rules of procedure, and practical advice on the conduct of commercial litigation generally, in addition there is a "gold mine" for the business lawyer, covering substantive commercial law areas, including industry-specific focus on areas such as sports, energy, not-for-profit, and numerous others. Mr. Haig is a litigation partner with Kelley, Drye & Warren; Mr. Semaya is a principal focusing on commercial litigation with Offit Kurman P.A.; Mr. Abernethy is retired counsel with Offit Kurman and a past chair of the Business Law Section.

David L. Glass

NEW YORK STATE BAR ASSOCIATION

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REQUEST FOR ARTICLES

Lawyers as Rats: Part Deux

By C. Evan Stewart

This author was somewhat surprised to learn that there are approximately 30 rats in animated cartoon history. Undoubtedly, the nicest and most charming (and thus, I suppose, the most popular) is Remy from the movie *Ratatouille*.[1] In a prior article for this distinguished journal, less charming rats were explored: lawyers who rat out their clients and seek to profit thereby.[2] This article will explore lawyers as rats in a different context: ratting out other lawyers.

There's a Rat Rule!

Forty-seven states (and the District of Columbia) have adopted ABA Model Rule 8.3 ("Maintaining the Integrity of the Profession"). Subsection (a) sets forth: "A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, *shall* inform the appropriate professional authority"[3] (emphasis added). Two states—Georgia and Washington—have replaced that mandatory obligation with a discretionary one ("should"). And one state—California—has expressly rejected adopting *any* ethical provision like Rule 8.3.[4]

While this reporting obligation looks simple on its face, its application in real life tells a different story. Most importantly, what constitutes "knowing"? According to one ethics guru, there are least seven definitions that can fill the bill.[5] One frequently cited standard can be found in *Riehlman*.[6] There, the court opined that a lawyer must report another lawyer's misconduct "when the supporting evidence is such that a reasonable lawyer under the circumstances would form a firm belief that the conduct in question had more likely than not occurred." That standard, of course, is an objective one.[7]

New York State takes a different approach. In Opinion 854,[8] the New York State Bar Association Committee on Professional Ethics opined that "knowing" meant the reporting lawyer has actual knowledge or clearly believes another lawyer has engaged in misconduct.[9] The committee also addressed the sticky wicket of whether the ratting lawyer can report the other lawyer's misconduct to that lawyer's client(s). Good faith disclosure to the clients is permitted (but not required) *if* the lawyer has actual knowledge of the misconduct *and* does not reveal any client confidences.[10] This latter condition is consistent with Rule 8.3 (c) and other jurisdictions' views that the obligation of confidentiality takes precedence over the duty to report.[11] The committee went on to urge caution before rushing off to make a discretionary report of misconduct to another lawyer's client(s), citing a host of countervailing considerations (especially damage to that lawyer's attorney-client relationship(s)).

Not *every* violation of the ethics rules is reportable;[12] the test is whether the violation "raises a *substantial* question as to the lawyer's honesty, trustworthiness or fitness" (emphasis added). The most obvious examples of reportable conduct are lying and stealing.[13] Other situations requiring reporting include: inaccurate advertising;[14] unreasonable fees;[15] an improper settlement offer;[16] violation of the duty of confidentiality;[17] failure to correct a defective court order;[18] and the unauthorized practice of law.[19]

Most jurisdictions do not require self-reporting, given that Rule 8.3(a) talks of "another lawyer."[20] But a few jurisdictions do not construe the reporting obligation that way (e.g., Ohio, Alabama, and Kansas), and they *do* require self-reporting.[21]

In one area there is general uniformity: lawyers may *never* use the threat of reporting to attempt to gain an advantage in litigation.[22]

A Seminal Decision

One case seems to stand out—above all others—in the circumstance of a lawyer ratting out another lawyer: *Himmel*.[23] In 1983, Illinois licensed attorney Himmel was hired to help an 18-year-old motorcycle accident victim recover $23,000 in settlement monies that her first attorney pocketed. Himmel was told by his client *not* to report the first lawyer's misconduct to the Illinois Attorney Registration and Disciplinary Commission (IARDC); unbeknownst to Himmel, the client reported the first attorney to the IARDC. Himmel proceeded to get a very favorable settlement of $75,000 with the first lawyer in exchange for an agreement not to prosecute him. When the first lawyer welched on that agreement, Himmel went into court and secured a $100,000 judgment. Ultimately, the client received $10,000 and Himmel received nothing monetarily for his troubles.

In 1986, the IARDC brought charges against Himmel for violating Rule 8.3.[24] And in 1988, the Illinois Supreme Court affirmed the one-year suspension sanction imposed

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by the IARDC. The court ruled that it is the lawyer's *unwaivable* duty to report misconduct; thus, it was simply irrelevant that the client had instructed Himmel not to report on the first lawyer. As a secondary ruling, the court found that Rule 8.3(c)'s bar against using confidential/privilege information to report did not save Himmel from being sanctioned because the privileged information was conveyed to Himmel in the presence of third parties and related to the first lawyer's conversion of client funds (i.e., illegal conduct).[25]

Perhaps it is because of the *Himmel* decision that Illinois leads the nation in misconduct complaints being filed by lawyers against other lawyers.[26] And while actual prosecutions are a far fewer number from initial complaints, many prominent Illinois law firms have felt the sting of Rule 8.3(a).[27]

The Associate's Dilemma

Over the years, a number of commentators have raised concerns regarding the pressures on associates at law firms not to report partner misconduct.[28] In fact, there is a body of law that has developed in this area that is instructive.[29]

The starting point is *Weider v. Skala*.[30] In *Weider*, a former associate at a small New York City law firm brought a breach of contract and wrongful discharge action against his former firm. The ex-associate alleged that he was a star performer ("in charge of handling the most important litigation in the [f]irm"), but when he reported the improper conduct of a fellow associate to two senior partners (both of whom—allegedly—confirmed that the fellow associate was a "pathological liar") and persisted in having the fellow associate be reported to the bar authorities, the ratting lawyer was fired. His complaint was dismissed at the trial court level,[31] and that ruling was affirmed by the intermediate appeals court.[32]

The New York Court of Appeals, however, reversed in part, allowing the ratting lawyer a breach of contract claim, but not a wrongful discharge claim. Theretofore, New York State had been a strict at-will employment state.[33] But because the ethical reporting requirement "is nothing less than essential to the survival of the profession,"[34] and given the "unique characteristics of the legal profession" (especially the dynamics facing associates in law firms), the state's highest court created an exception to the at-will doctrine and ruled the ratting lawyer could proceed with a breach of contract claim (if he could prove the existence of one).[35] As far as giving the ratting lawyer a wrongful discharge claim (where the potential for a real monetary recovery lay), however, that was a bridge too far for the Court of Appeals: "any additional protection must come from the Legislature."[36]

Other jurisdictions that follow the *Weider* precedent include Connecticut, South Carolina, and Illinois.[37] The latest *Weider* case is *Joffe v. King & Spaulding LLP*.[38] In 2017, a former associate of King & Spaulding sued his old firm, claiming that his demotion from senior associate to associate, pay freeze, denial of year-end bonus, and subsequent firing were the result of his attempt to report "ethical concerns about the conduct of two King & Spaulding partners, which arose during their representation" of a Chinese telecommunications company.

The trial court rejected the law firm's motion to throw out the case; King & Spaulding argued that the law firm's ex-associate had not adequately demonstrated "actual knowledge" or "clear belief" of ethical misconduct. The court found the firm's argument "extremely narrow" because it would have required a "mini-trial" as to whether there were in fact actual ethical violations. Instead, the court found sufficient, but "not overwhelming," evidence to support the former associate's position, and allowed the dispute to be resolved by a jury.[39] In December of 2021, after a week-long trial, a jury rejected the ratting lawyer's claim.[40]

Conclusion

In California, it would appear that no one likes a "snitch," and the organized bar firmly believes that "[a]ttorneys will not become their brother's keepers."[41] One ethics professor believes that the reporting rule in all the other states often "goes unenforced, and part of it is kind of a cultural norm against being, you know, the squealer, the snitch, right?"[42] But as the foregoing case law and ethics opinions make clear, the ethical obligation to report another lawyer's misconduct is a real one. A rat may not be what we signed up for in law school, but rules are rules.

Endnotes

1. Disney (2007).
2. C. Stewart, *Lawyers as Rats: An Evolving Paradigm*, NY Business Law Journal (Winter 2018).
3. There is a corresponding duty to report on a judge's misconduct (Rule 8.3 (b)). Ratting does not require disclosure of information otherwise protected by Rule 1.6 ("Confidentiality of Information") (*see supra* 8.3(c).
4. It is somewhat ironic that recent transgressions by two high-profile California attorneys (Thomas Girardi and Michael Avenetti) have brought renewed interest in Rule 8.3—but not in California. *See B. Lowrey Girardi Saga Shows Why Calif. Attys Don't 'Snitch'*, Law360 (Sept. 8, 2021).
5. *Conference Panelists Call for Clarification of Obligation to Report Peer Misconduct*, ABN/BNA Lawyers' Manual on Professional Conduct, 297 (6/13/07). (Patricia Saller, ethics counsel for the Arizona State Bar).
6. 891 So. 2d 1239 (La. 2005).
7. *See also* Louisiana Ethics Op. 06-RPCC-010 (2006) ("reasonable lawyer"); Texas Ethics Op. 520 (1997) (knowledge based on objective facts). For very different standards see Connecticut Informal Ethics Op. 2004-13 (2004) (a "visceral reaction to conduct that produces a 'feeling'…is a reasonable starting point"); *In re Brigandi*,

843 So. 2d 1083 (La. 2003) (knowledge based upon activities which "permeated [the] office").

8. Opinion 854 (3/11/11).

9. *See also* Philadelphia Ethics Op. 2005-7 (2005) (belief is not tantamount to knowledge of misconduct); Vermont Ethics Op. 2004-0 ("good faith or substantial belief").

10. Somewhat seemingly at odds with its actual knowledge standard, the committee went on to opine that if a lawyer "merely suspects" misconduct, she *may* report to authorities. In such a circumstance, the ratting lawyer may *not* notify the attorney's clients and may *not* reveal confidential information.

11. *See, e.g.*, Connecticut Informal Ethics Op. 2011-06 (2011); Massachusetts Ethics Op. 12-01 (2012); Michigan Informal Ethics Op. RI-314 (1999); North Dakota Ethics Op. 02-05; Oregon Ethics Op. 2005-95 (2005); Pennsylvania Ethics Op. 2014-025 (2014).

12. *See, e.g.,* Rhode Island Ethics Op. 2006-04 (2006) (dilatoriness in filing judgments is "far less contemptible" than "deliberate acts of dishonesty"); Texas Ethics Op. 632 (2013) (use of impermissible trade name did not raise a "substantial" question)' Maryland Ethics Op. 2015-03 (a violation of Rule 1.6 on a listserv will not create a duty to report); Connecticut Informal Ethics Op. 2013-05 (2103) (purported violations involving litigation among heirs of a "highly dysfunctional family" did not raise a "substantial question").

13. *See, e.g., Robison v. Othotic & Prosthetic Lab, Inc.,* 27 N.E. 3d 182 (Ill. App. Ct. 2015); Connecticut Informal Ethics Op. 05-11 (2005); Maryland Ethics Op. 2004-11 (2003); North Dakota Ethics Op. 01-05 (2001); Virginia Ethics Op. 1840 (2007).

14. *See* Missouri Informal Ethics Op. 2006-0074.

15. *See* New Mexico Ethics Op. 2005-2 (2005).

16. *See* North Dakota Ethics Op. 98-02 (1998).

17. *See* South Carolina Ethics Op. 02-15 (2002).

18. *See* Texas Ethics Op. 534.

19. *See* Mich. Bar Ethics Op. No. R1-382 (Dec. 8, 2021) (must report); *but see* Pennsylvania Ethics Op. 2002-11 (2002) ("might be" required to report). In any case, this particular issue has become even more difficult in light of the pandemic's effect on law practice and possible changes in Rule 5.5. *See* Bloomberg Law (*Lawyers Without Borders? The Future of Rule 5.5*) (2002-02).

20. *See, e.g., State v. Ankerman*, 840 A. 2d 1182 (Conn. App. Ct. 2004). That said, in some jurisdictions there is a duty to report on your own or your co-counsel's malpractice. See NY Ethics Op. 1092 (2016).

21. *See* Ohio Supreme Court Ethics Op. 2016-2 (April 8, 2016).

22. *See e.g.,* Wisconsin Formal Ethics Op. E-01-01 (2001); *Pearson v. Linden Lumber Co.,* 2006 BL 135851 (S.D. Ala. April 13, 2006); Iowa Ethics Op. 14-02 (2014). In *Pigs Get Fat, Hogs Get Slaughtered: Keeping Lawyers Out of the Slaughterhouse*, NY Business Law Journal (Summer 2015), the author surveyed the law concerning a related subject: whether lawyers may threaten criminal prosecution to gain a tactical advantage in civil litigation.

23. 533 N.E. 2d 790 (Ill. 1988).

24. Rule 8.3(a)'s equivalent in Illinois at the time was 107 Ill. 2d R. 1-103(a).

25. Thus, one of the 5 Cs (confidentiality) was missing. *See* C. Stewart, *The Attorney-Client Privilege: Misunderestimated or Misunderstood?* New York Law Journal (Oct. 20, 2014). While this might be the correct analysis of confidentiality vis-à-vis the privilege, the *Himmel* court once again confused the privilege (an evidentiary privilege owned by the client) with the ethical obligations attorneys have of protecting client confidentiality. *See supra Stewart*, note 2.

26. *See* D. Van Duch, *Best Snitches: Illinois Lawyers*, National Law Journal A1 (Jan. 28, 1997).

27. *E.g.*, Winston & Strawn; Chapman & Cutler; Mayer Brown; Lord, Bissel & Brook.

28. *See, e.g., supra* note 5 (Hofstra Law Professor Roy Simon).

29. There are other instances, however, where situations have been mislabeled as the "Associate's Dilemma." *See* C. Stewart, *The Associate's Dilemma: Joe Fortenberry, Mahlon Perkins, and the Kodak Antitrust Trial*, Federal Bar Council Quarterly (August 2021); C. Stewart, *The Associate's Dilemma: Regulation U*, Federal Bar Council Quarterly (December 2021).

30. 80 N.Y. 2d 628, 593 N.Y.S. 2d 752 (Ct. Appls. 1992).

31. By moving to dismiss the complaint, the law firm made a critical mistake: all of Weider's allegations had to be accepted as true. King & Spaulding appear not to have repeated this mistake in *Joffe. See infra* notes 38–40 and accompanying text.

32. 544 N.Y.S 2d 971 (Sup. Ct. N.Y.Cty) & 582 N.Y.S. 2d 980 (1st Dep't).

33. *Murphy v. American Home Products Corp.,* 58 N.Y. 2d 293, 461 N.Y.S. 2d 282 (Ct. Appls. 1983).

34. Rule 8.3(a)'s predecessor in New York State was DR 1-108 (A).

35. 593 N.Y.S. 2d at 756. The dilemma that the ratting lawyer had to face (reporting vs. losing his job) did not move the highest court of Illinois in *Balls v. Gambro*, 584 N.E 2d 104 (Ill. 1991). *See supra* note 2.

36. 593 N.Y.S. 2d at 757. Why one fundamental alteration of the state's public policy can be within the Court of Appeals' purview, but another is not, continues to baffle this author.

37. *Matzkin v. Delany, Zemetis, Donahue, Durham & Noonan P.C.*, No. CV-04-4000288-S (Conn. Super. Ct. July 29, 2005) (unpublished); South Carolina Ethics Op. 05-21 (2005); *Skolnick v. Altheimer & Gray*, 730 N.E. 2d 4 (Ill. 2000) [*Skolnick* appears to be at odds with *Balls – see supra* note 35; *see also supra* note 2].

38. 2018 BL 204273, No. 17-CV-3392 (VEC) (S.D. N.Y. June 8, 2018).

39. *King & Spaulding Case Spotlights Response to Ethics Report*, ABA/BNA Lawyers' Manual on Professional Conduct (June 13, 2018).

40. *King & Spaulding Off Hook for Defamation Claim in Ethics Case*, Bloomberg Law News (2021-12-07).

41. *See supra* note 4.

42. *Id.* (Professor Dmitry Bam, University of Maine School of Law).

What To Know About the Bankruptcy Code's New Subchapter V

By Stuart B. Newman and Steven H. Newman

Our country's protection for debtors has come a long way over time. Some of the earliest settlers came to America, not on the Mayflower, but as indentured servants. Did you know that one of the early Revolutionary War heroes, Henry ("Light Horse Harry") Lee, who went on to become governor of the Commonwealth of Virginia (and yes, also the father of General Robert E. Lee), spent his last days in debtor's prison? The same dubious distinction of time spent in debtor's prison also befell two signers of the Declaration of Independence.

While Congress began passing legislation regarding bankruptcy relief early in the 19th century, it took a decision by the U.S. Supreme Court in 1833 to abolish debtor's prison, and it was not until The Nelson Act of 1898 before the country had its first modern bankruptcy legislation. Our current Bankruptcy Code traces back to the Bankruptcy Reform Act of 1978.

Flash forward almost 50 years to the COVID pandemic, our bankruptcy laws have developed into a well-established mechanism for protection of both individual and business entity protection, but that relief was frequently beyond the reach of debtors who found the process of filing for relief too complicated and, ironically, too expensive. Notwithstanding COVID's almost instantly devastating impact on the economy, the number of bankruptcy filings in this country in 2020 declined more than 30% from the prior two years. While there may have been other reasons for the decline in filings (for example, state emergency debt moratorium legislation; consumer and business stimulus programs; and even Pandemic-related court closures), Congress, as early as 2019, saw the need to increase the ability of small businesses to utilize the reorganization benefits of Chapter 11 in a more efficient and less expensive procedure. It passed the Small Business Reorganization Act of 2019 (the SBRA), which became effective on Feb. 19, 2020, right at the start of the pandemic in this country. (Another attempt at broad, consumer-based legislative relief introduced that year by Sen. Elizabeth Warren, the Consumer Bankruptcy Reform Act of 2020, died in Congress.) The SBRA created a new pathway for small businesses to remain in control of running their busi-nesses, which is the usual reason for choosing to seek relief under Chapter 11, while eliminating many of the reasons that typical Chapter 11 proceedings exhausted the patience, and wallets, of both debtors and creditors.

But first you ask, of course, what is a "small business" under Subchapter V? Well Congress had the "obvious" answer—it was any business that had debt that did not exceed $2,725,625. If your business had a dollar more in debt you were just not small enough. (Though researched, how Congress decided on that very precise number as a cap for defining "small" still eludes the authors.)

As noted above, since bankruptcy filings actually decreased substantially in 2020, Subchapter V was obviously not an immediate success if the goal was to help small businesses obtain a fresh start through bankruptcy. The low and arbitrary cap on the debt limit was an obvious problem, which was fixed by raising the debt limit to a higher, round number, $7,500,000, when President Joe Biden signed into law, as part of the 2020 CARES Act. (Coronavirus Aid, Relief and Economic Security Act of 2020, Pub. L. No. 116-136, 134 Stat. 281 (effective May 17, 2020).) As a consequence, the vast majority of Chapter 11 filings in the last two years were made under Subchapter V.

So what are the features of Subchapter V that differentiate it from a regular Chapter 11 and make it more appealing to small businesses? (It is worth noting that an individual may also qualify to be debtor under Subchapter V in certain situations. §1182(1)(A) of the Bankruptcy Code defines who may be "debtor" under Subchapter V and states in pertinent part that a debtor "means a *person* engaged commercial or business activities …" (emphasis added). Under §101(41) of the Bankruptcy Code, a "person" includes an individual, partnership and a corporation). And are there any other qualifications that must be met for its use and availability?

First of all, Subchapter V can only be used where the majority of the debt arose from the commercial and business activities of the debtor. It is not a filing option, for example, for a business which consists solely of the ownership and operation of single asset real estate. See 11 U.S.C. §1182(1)(A). Note also that in determining eligibility for Subchapter V, §1182(1)(A) of the Bankruptcy Code expressly excludes certain debts from the $7,500,000 debt ceiling: (1) all debt owed to affiliates and insiders, (2) contingent debts and (3) unliquidated debts.

Some of the benefits of using the Subchapter V filing option are immediate. For example, the requirements to assemble and file (1) the schedules of assets and liabilities and (2) monthly operating reports are eliminated. Instead, the debtor must write up a brief history of its business operations, a liquidation analysis and projections of its ability to make payments under a proposed plan. The debtor also needs to file a plan within 90 days of the petition date. (The court can extend the 90-day period for cause under §1189(b) of the Bankruptcy Code.

It is noteworthy that the Bankruptcy Code does not expressly state what is the consequence if the debtor fails to file a plan in 90 days. Thus this area will need to be developed by the courts.) Not only is less disclosure

required to start the Subchapter V case, but Subchapter V also eliminates the requirement of a disclosure statement in connection with the filing and solicitation of approval of the plan, unless the court orders otherwise for cause. 11 U.S.C. §1181(b). A very important distinguishing feature from a regular Chapter 11 is the fact that, subject to certain limitations, the absolute priority rule, wherein a dissenting class of unsecured creditors can block any plan to pay a junior class of debt unless the unsecured are paid in full, is eliminated in Subchapter V. In fact, under Subchapter V, unsecured creditors' committees have been eliminated. See 11 U.S.C. §§1102(a)(3) and 1181(b). Such sections provide that there will not be a creditors' committee in a Subchapter V case unless the court orders otherwise for cause. In and of itself, that is a major streamlining of the entire bankruptcy proceeding.

Of critical importance are several features that make it easier for a debtor to confirm a cramdown plan under Subchapter V than under the traditional Chapter 11. (A cramdown plan is a plan in which not all classes of creditors have voted to accept the plan. Often under a cramdown plan the debtor will retain its assets without paying its creditors in full.) First, only the debtor can file a plan. 11 U.S.C. §1189(a). Thus, the debtor has an unlimited exclusive period, whereas the traditional Chapter 11 debtor has only 120 days of exclusivity (subject to the debtor's right to ask the court for an extension up to 18 months from the petition date). 11 U.S.C. §1121. This gives significant control of the case to the debtor, since it is the only party that can submit a plan for confirmation under Subchapter V.

Second, while generally the Chapter 11 plan confirmation requirements under §1129(a) must be met in order to confirm a Subchapter V plan, there are a number of key exceptions. The requirement under §1129(a)(10) that at least one impaired class of creditors accept the plan is eliminated. 11 U.S.C. §1191(b).

Also eliminated is the absolute priority rule for a cramdown of unsecured claims under §1129(b). Subchapter V allows a debtor to cramdown a plan if it, among other things, provides that the value of the property to be distributed under the plan in a three-year period (or such longer period as the court determines, not to exceed five years) is not less than the projected disposable income of the debtor. (See 11 U.S.C. §1191(c)(2). Section 1191(d) of the Bankruptcy Code sets forth the calculation of "disposable income.")

In addition, unlike in Chapter 11, plan confirmation under Subchapter V does not require payment of all administrative claims on confirmation. Section 1191(e) allows administrative claims to be paid over time if the Subchapter V plan is confirmed as a cramdown plan under §1191(b).

Moreover, post-confirmation, the Subchapter V debtor is also the only party that can seek to modify a plan. Thus, if the business prospers beyond projections in the following years (as many businesses did in 2021), neither the trustee nor any unsecured creditors can seek to modify the plan to increase payments under the plan.

Yes, there is a trustee in a Subchapter V proceedings, but the trustee's rule is more limited and advisory than Chapter 7 or Chapter 11 trustees, and the debtor is not required to pay the trustee's fees. 28 U.S.C. §1930(a)(6)(A).

Also, in Subchapter V a debtor (unlike a chapter 11 debtor) is not required to pay quarterly fees to the U.S. Trustee. See 11 U.S.C. §1930(a)(6). This can be a savings of thousands of dollars over the life of an extended proceeding.

There is another important feature of Subchapter V which business lawyers should be aware of. Whereas typically the Bankruptcy Code requires that all accrued legal fees to be paid by the debtor to the attorney prior to filing a petition in order to avoid conflicts, this requirement has been modified under Subchapter V in order to provide a lower hurdle for the small business debtor and its counsel. (Under §1195 of the Bankruptcy Code an attorney holding a prepetition claim that is less than $10,000 is not disqualified from representing the debtor in the Subchapter V case. Accordingly, counsel needs to be aware of this claim limit when counseling a client prior to filing under Subchapter V). When the 2020 CARES Act increased the debt cap for small businesses to $7.5 million, the increase was only intended to be temporary, and Congress set the increase to expire on May 27, 2021. As the COVID pandemic lingered, however, Biden extended the expiration date another ten months to March 27, 2022. As this article is being written, that date had already expired without further extension by Congress. However, on March 14, 2022, Sen. Chuck Grassley (R-Iowa) introduced a bill—the Bankruptcy Threshold Adjustment and Technical Corrections Act, S.3823, 117th Congress (20212022)—to make the higher limit permanent, and Bloomberg News reported widespread bipartisan support for the bill.

To be clear, Subchapter V was designed to aid small businesses, typically owned by a sole proprietor or family, such as a restaurant or local retail store that could be viable long term if it had assistance in handling its current debt. Even with the increased debt cap, it is not a replacement for reorganization of most larger businesses under the traditional Chapter 11 proceeding.

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The Paradox of New York's Commercial Finance Disclosure Law: Will Increased Regulation of Lenders Actually Benefit Borrowers?

By Stephen J. Grable and James G. Pizzo

The COVID-19 pandemic's impact on New York businesses included mandatory shutdowns, disruptions to employment needs, and closure of many small businesses. As with prior financial market disruptions, one resulting perception is that lenders may leverage market conditions to lend on terms less favorable to borrowers. New York is seeking to address this perceived harm through increased regulations on certain commercial lenders.

New York's Commercial Finance Disclosure Law (CFDL), enacted into law as of Jan. 1, 2022, requires certain commercial lenders to provide consumer-like disclosures to borrowers of loans of less than $2.5 million.[1]

While well intended, the law may not benefit the very borrowers that it seeks to help. Uncertainties remain as implementation has been delayed pending release of final regulations, but the CFDL in all events will impose costs on impacted lenders to conform their disclosure and underwriting practices, and also will increase regulatory risk. As the resulting costs of implementation and compensating for risk will likely be passed through to borrowers, the CFDL may have the unintended consequence of increasing borrowing costs for small businesses.

Impact of Market Disruptions on Small Businesses

The principal justification for the CFDL is that, during the most recent financial crisis, "bank loans to small businesses declined, exacerbating the credit crunch felt by small businesses."[2] Alternative lenders—included those providing merchant cash advances and factoring—leveraged developments in technology to fill the gap and serve the small business market."[3] Some lenders were alleged to have overcharged and engaged in predatory lending practices."[4]

With small businesses making up 99.8% of all New York businesses and employing more than 50% of the private workforce,[5] the impact from financial market disruptions can be devastating. For example, at the outset of the pandemic in the spring of 2020, the fate of many small businesses was unknown. Nearly 40% of small businesses closed.[6] 77% of small businesses experienced a decline in revenue,[7] decreasing the total revenue of small businesses by 64%.[8] And 35% of small businesses experienced reduced employment.[9]

Spurred by the pandemic's impact on small businesses, the CFDL advanced through the legislative process and became effective as of Jan. 1, 2022.

Legislation

New York's legislators passed the CFDL to create standardized disclosure requirements for lenders, to enable borrowers to more easily compare competing loan terms. The principal goal is to ensure that small businesses have the ability to obtain clear and detailed information to make informed financial decisions.[10]

The CFDL applies to non-traditional lenders such as factors and merchant cash advancers. Traditional financial institutions are exempt from the CFDL, including: (i) banks, trust companies, and industrial loan companies; (ii) federally chartered savings and loan associations, federal savings banks, and federal credit unions; and (iii) savings and loan associations, savings banks, and credit unions.[11]

The CFDL applies broadly to a wide range of commercial financing transactions:

- "Sales-based financing"—defined as a "transaction that is repaid by the recipient to the provider, over time, as a percentage of sales or revenue, in which the payment amount may increase or decrease according to the volume of sales made or revenue received by the recipient."[12]
- "Closed-end financing"—defined as a "closed-end extension of credit, secured or unsecured, including [some] equipment financing . . . the proceeds of which the recipient does not intend to use for personal, family or household purposes."[13] This "includes financing with an established principal amount and duration."[14]
- "Open-end financing"—defined as an "agreement for one or more extensions of open-end credit, secured or unsecured, the proceeds of which the recipient does not intend to use primarily for personal, family or household purposes."[15] This includes credit extended where the "provider reasonably contemplates repeated transactions," the "provider may impose a charge from time to time on an outstanding unpaid balance," and the "amount of credit that may be extended . . . is generally made available to the extent that any outstanding balance is repaid."[16]
- "Factoring transactions" —defined as an "accounts receivable purchase transaction that includes an agreement to purchase, transfer, or sell a legally enforceable claim for payment held by a recipient for goods the recipient has supplied or services the recipient has rendered that have been ordered but for which payment has not yet been made."[17]
- "Other forms of financing"—reflecting a catch-all category, comprised of transactions that otherwise fall under the CFDL's definition of "commercial financing."

"Commercial financing" includes any "form of financing, the proceeds of which the recipient does not intend to use primarily for personal, family or household purposes."[18] To determine whether a transaction constitutes commercial financing under the CFDL, the "provider may rely on any statement of intended purposes by the recipient."[19] The provider, however, is not "required to ascertain that the proceeds of a commercial financing are used in accordance with the recipient's statement of intended purposes."[20]

There are a few notable exceptions to the types of transactions that the CFDL applies to. The CFDL does not apply to transactions over $2,500,000, transactions secured by real property, or lenders that make five or fewer transactions within New York in a 12-month period.[21]

Critically, while the CFDL became effective on Jan. 1, 2022, lenders currently do not have any obligations under the law because there are no regulatory guidelines in place to implement and enforce the CFDL. The Department of Financial Services (DFS) has announced that a lender's obligations under the CFDL will not arise until DFS issues final regulations and those regulations take effect.[22] DFS previously published a pre-proposal draft regulation, but received extensive and significant comments from interested parties.[23] In light of this, DFS expects to publish a revised proposed regulation for notice-and-comment later this year.[24]

Unintended Consequences

Implementation of the CFDL will require impacted lenders to conform their lending practices. Regulatory compliance risks will also increase, with penalties including a $2,000 fine for each violation and a $10,000 fine for each willful violation.[25] Additionally, a lender that knowingly violates the CFDL may be liable for restitution or be subject to a permanent or preliminary injunction on behalf of a recipient affected by the violation.[26]

While disclosure is the principal purpose of the CFDL, presumably an equally important purpose is to ensure fair and competitive lending terms for small businesses. That

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additional purpose will likely be frustrated by the uncertainties, risks, and associated costs resulting from the CFDL.

For example, from a borrower's perspective, financing could become more expensive and take longer to secure. Additionally, lenders who find it too onerous or even impossible to comply with the CFDL could choose to forgo providing lending services in New York, narrowing the market available to borrowers for competitive loan terms.

These concerns were voiced during the legislative process. During the Senate committee hearing on the bill, Senator George Borrello, a small-business owner himself, expressed that while he did "appreciate the intent" of the bill, he was "fundamentally opposed" for several reasons. Senator Borrello believed that the CFDL would "reduce the number of credit opportunities" and "impede [the] ability to get credit as small-businesses."[27] He also foresaw that "more state-chartered institutions [would be] forced out of New York because of . . . a different standard than those that are federally chartered or chartered in other states."[28] Senator Daphne Jordan concurred with all of Senator Borrello's concerns during the committee hearing.[29] Nonetheless, the committee pushed the legislation forward and it was signed into law.

Conclusion

During the pandemic, New York faced an unprecedented period of economic turbulence and struggle. But small businesses are now surging back, with many in a better position than before the pandemic. Since the spring of 2020, the number of small businesses has increased nearly 50%,[30] total small business revenue is up over 80%,[31] and employment has increased by 25%.[32]

As uncertainties remain pending the forthcoming regulations, concerns are growing deeper as to the impact on costs, risks, and competitive financing opportunities for small business.

The CFDL, while designed to provide benefits for small businesses, may have the opposite result.

Endnotes

1. N.Y. Fin. Serv. Art. 8 (McKinney 2022).
2. N.Y. State Senate, S5470B Sponsor Memo, 2019-2020 Leg. Sess. (N.Y. 2020).
3. *Id.*
4. *Id.*
5. *Id.*
6. *Percent Change in Number of Small Businesses Open*, Opportunity Insights, tracktherecovery.org (last updated Mar. 4, 2022).
7. *Small Businesses and the Economic Recovery: Work in Progress*, Office of the New York State Comptroller (Nov. 23, 2021), osc.state.ny/reports/small-businesses-and-economic-recovery-work-progress.
8. *Percent Change in Small Business Revenue*, Opportunity Insights, tracktherecovery.org (last updated Mar. 4, 2022).
9. *Id.*
10. Press Release, Adrienne A. Harris, Acting Superintendent, Department of Financial Services, *Proposed Regulation Ensures Small Businesses Have Adequate Information to Make Informed Decisions about Credit Offers, Proposed Rule Implements New York State's Commercial Finance Disclosure Law* (Sept. 21, 2021), dfs.ny.gov/reports_and_publications/press_releases/pr202109211.
11. N.Y. Fin. Serv. §§ 801(f), 802(a) (McKinney 2022). Also exempted are (i) persons acting in a capacity as a technology service provider to exempt entities; (ii) lenders regulated under the federal Farm Credit Act; (iii) leases defined by UCC 2-A-103; and (iv) commercial financing transactions where the recipient is a car dealer, an affiliate of a car dealer, or rental car company, or an affiliate of a rental car company. *Id.* § 801(b), (c), (e), (h).
12. *Id.* § 801(j).
13. *Id.* § 801(d).
14. *Id.*
15. *Id.* § 801(c).
16. N.Y. Fin. Serv. § 801(c) (McKinney 2022).
17. *Id.* § 801(a).
18. *Id.* § 801(b).
19. *Id.*
20. *Id.*
21. *Id.* § 802(d), (f), (g).
22. Letter from Serwat Farooq, Deputy Superintendent, Consumer Examinations, Consumer Protection and Financial Enforcement Division (Dec. 31, 2021), dfs.ny.gov/system/files/documents/2021/12/rp_23n ycrr600 _ guidance_effective_date_article8_2021_12_31.pdf.
23. *Id.*
24. *Id.*
25. N.Y. Fin. Serv. § 812(a) (McKinney 2022).
26. *Id.* § 812(b).
27. *Hearing on S.B. S5470B before the S. Comm. on Banks*, 2019-2020 Leg. Sess. (N.Y. 2020) (statement of Sen. George Borrello, member, S. Comm. on Banks).
28. *Id.*
29. *Hearing on S.B. S5470B before the S. Comm. on Banks*, 2019-2020 Leg. Sess. (N.Y. 2020) (statement of Sen. Daphne Jordan, member, S. Comm. on Banks).
30. *Percent Change in Number of Small Businesses Open*, Opportunity Insights, tracktherecovery.org (last updated Mar. 4, 2022).
31. *Percent Change in Small Business Revenue*, Opportunity Insights, tracktherecovery.org (last updated Mar. 4, 2022).
32. *Percent Change in Employment*, Opportunity Insights, tracktherecovery.org (last updated Sept. 21, 2021).

Tax Considerations for Nonresident Business Enterprises Commencing United States Activities

By Patrick McCormick

Nonresident businesses increasingly seek to commence or expand United States activities based on a multitude of factors—entering the lucrative United States market is a common factor. Associated with U.S. market penetration, however, is exposure to U.S. tax ramifications. The United States imposes significant tax ramifications under statutory provisions; these ramifications can be altered, however, through application of income tax treaties. The below provides an overview of United States tax considerations for nonresident businesses with American activities.

Statutory Provisions

For income tax purposes, the United States classifies taxpayers either as United States taxpayers—primarily by virtue of residence, though for individuals also based on citizenship—or as nonresidents. The former are subject to tax on worldwide income, with tax credits available to offset foreign taxes paid (where income is foreign-sourced). Business entities—whether corporations or partnerships—are classified as domestic entities if created or organized under laws of the United States or any individual state; business entities which are not domestic are foreign.[1]

In the multinational context, countries normally assess income tax based on either (1) the source of the income item or (2) the residence of the income recipient. In most cases, nonresidents are subject to United States tax only on United States-sourced income (with narrow exceptions, such as those noted below). Under statutory American rules, the former includes (1) income effectively connected with a nonresident's trade or business and (2) fixed or determinable annual or periodic income ("FDAP income").

Both trade or business income and FDAP income focus on American sourcing; where a nonresident is engaged in an American trade or business, however, the scope of American tax is more expansive. Nonresidents are taxed on income effectively connected with a United States trade or business at graduated rates, with deductions associated with generating the income item permitted.[2] Determinations as to whether income is effectively connected to an American trade or business focus on (1) whether a "United States trade or business" is found and whether (2) an income item is "effectively connected" to the trade or business. For the former, case law provides that a U.S. trade or business exists where profit oriented activities are carried on in the United States which are regular, substantial, and continuous.[3] Certain income—such as income resulting from the disposition of United States real property interests—is statutorily classified as effectively connected (and automatically subject to American tax).[4]

Whether gains of a nonresident are "effectively connected" to the United States—and thus subject to a greater scope of tax—is dictated by whether the gain meets either an "asset use" test or a "material factor" test. More specifically, in determining either whether an FDAP income item or gain or loss from American sources from the sale or exchange of a capital asset is effectively connected with the conduct of a United States trade or business, two factors are considered: (1) whether the income, gain, or loss is derived from assets used in (or held for use in) the conduct of the trade or business, or (2) whether the activities of a trade or business were a material factor in the realization of the income, gain, or loss.[5]

In addition to the general corporate tax imposed on nonresident corporations, the branch profits tax levies a second tax on foreign corporations directly engaged in a United States trade or business; this tax is equal to 30% of the foreign corporation's "dividend equivalent amount" for the taxable year.[6] A foreign corporation's "dividend equivalent amount" is its effectively connected earnings and profits for the taxable year adjusted based on United States net equity.[7] The term "effectively connected earnings and profits" means earnings and profits attributable to income effectively connected to the United States, without reduction for distributions made by the foreign corporation during any taxable year or by the amount of branch profits tax or tax on excess interest paid by the foreign corporation.[8]

FDAP income functionally is a "catch all" category for U.S. sourced ordinary income of a nonresident that is not connected to an American trade or business and is not American-sourced capital gains. Included within the FDAP income category are interest (subject to expansive exceptions), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic gains, profits and income.[9] Where income fits into both the "effectively connected to a United States trade or business" category and the FDAP category, tax rules for the former apply.[10] This distinction is important: while effectively connected income is taxed on a net basis (at graduated rates) with deductions and credits permissible, FDAP income is taxed at a flat 30% rate, with no deductions permitted and tax primarily collected through payor withholding.[11]

Where a United States trade or business exists, the scope of American tax expands significantly. In most cases, nonresidents not engaged in a United States trade or business are subject to American tax only on FDAP income, leaving significant gaps in American-sourced income items (most notably non-real property capital gains).[12] If a nonresident is engaged in an American trade or business, the nonresident is taxed on all income effectively connected to that trade or business—not just FDAP income, but capital gains, inventory sales and certain limited foreign-sourced income items.[13]

Tax Treaties

Income tax treaties permit qualified residents to alter the statutory United States trade or business standard referenced above, replacing it with a (somewhat) heightened standard focused on whether business profits are attributable to a United States "permanent establishment." Income tax treaties primarily provide benefit where a taxpayer resides in one country (the "residence country") and has income taxable by another country under that country's sourcing rules (the "source country"). Where (1) the residence country and the source country have an income tax treaty in place between them and (2) the applicable taxpayer can meet qualification requirements in the residence country, the source country's tax rules can (usually by election) be overridden by treaty terms. While each income tax treaty has its own distinct provisions (e.g., the Canada-United States Income Tax Convention is not identical to the India-United States Income Tax Convention), most share general concepts and terminologies.

Generally, income tax treaty benefits are available to a recipient of an income item only where the income item's beneficial owner is qualified for benefits. For treaty purposes, the term "person" includes individuals, estates, trusts, partnerships, companies, and any other bodies of persons.[14] A "company" is any corporate body or any entity taxed as a corporation.[15]

A resident under typical income tax treaty provisions is any person who, under the laws of the residence country, is liable for tax by reason of domicile or residence (not when subject to tax only on income sourced to that country). The term "beneficial owner" is not defined within tax

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treaties. However, technical explanations (which accompany tax treaties to give added clarity to treaty provisions) often provide that the beneficial owner "is the person to [whom] . . . income is attributable for tax purposes under the laws of the source [country]."[16]

Nonresidents eligible for treaty benefits alter the American business tax scope from income effectively connected with the conduct of a United States trade or business to (generally) profits attributable to the carrying on of a business through a United States permanent establishment.[17] Existence of a permanent establishment enables a source country to tax the nonresident as if she functionally had separately incorporated within the country—further replicating the trade or business statutory standard.[18]

A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on.[19] Offices, places of managements, and branches all are included within the scope of a permanent establishment.[20] Maintenance of a fixed place of business solely for auxiliary or preparatory activities, however, does not cause a permanent establishment to be created.[21] Where a nonresident business incorporates in the United States (i.e., forms a United States subsidiary), the subsidiary's activities are not attributed to the parent for permanent establishment purposes (as the subsidiary is taxed separately on its own activities).[22]

Whether a "fixed place of business" exists for a nonresident business is ultimately determined under United States standards for the same. To constitute a "fixed place of business", an establishment does not need to be immovable or perpetual.[23] A facility does not need to be attached to the ground, as long as it remains at a given site for the requisite period.[24]

Like with the "U.S. trade or business" prong of the statutory "income effectively connected to a United States trade or business" standard, existence of a permanent establishment does not by itself create United States tax consequences. Business profits must be attributable to the permanent establishment for American tax scope to expand. "Business profits" are not specifically defined under tax treaties; treaty technical explanations provide that business profits include any income generated by a trade or business, thereby incorporating capital gains and other income which would be treated as "effectively connected" to a United States statutory trade or business.[25]

FDAP income is also altered by treaty provisions; while not subject to overarching redefinition like with the permanent establishment standard, treaties provide significant reduction to the 30% tax rate statutorily applicable. Certain income items—like royalties and interest—can be fully exempt from taxation.[26] For items like dividends, rather than provide an exclusion from source-country tax, typical treaties provide a reduced rate of tax to the general 5-15% range.[27]

Endnotes

1. I.R.C. § 7701(a)(4).
2. I.R.C. § 871(b).
3. *See U.S. v. Balanovski*, 236 F.2d 298 (2d Cir. 1956); *U.S. v. Northumberland Insurance Company*, 521 F. Supp. 70 (DNJ 1981).
4. I.R.C. § 897.
5. Regs § 1.864-4(c)(2)(i).
6. I.R.C. § 884(a).
7. I.R.C. § 884(b).
8. Regs § 1.884-1(f)(1).
9. *See* I.R.C. § 1441(b).
10. *See* I.R.C. § 871(b).
11. *See* 26 U.S.C. § 871(a). Persons having control, receipt, custody, disposal or payment of FDAP income items of a nonresident are required to deduct and withold a tax equal to 30% thereof. 26 U.S.C. § 1441(a). Witholding is required on the gross amount of the payment made. 26 C.F.R. § 1.1441-3(a)(1). A witholding agent is personally liable for any amount required to be withheld, whether or not tax is actually withheld. 26 U.S.C. § 1461.
12. *See* I.R.C § 881 (a).
13. I.R.C. § 864(c).
14. *See* Mexico-United States Income Tax Convention, Art 3(1).
15. *Id.*
16. See United States-United Kingdom Income Tax Convention Technical Explanation, Art. 10.
17. *See* United States-Canada Income Tax Convention, Art. 7(1).
18. *See* United States-Canada Income Tax Convention, Art. 7(3).
19. *See* United States Model Income Tax Convention, Art. 5(1).
20. United States Model Income Tax Convention, Art. 5(2).
21. United States Model Income Tax Convention, Art. 5(4).
22. United States Model Income Tax Convention, Art. 5(7).
23. *See* Revenue Ruling 67-322.
24. *See* OECD Model Treaty Commentaries, Art. 5 (2014).
25. *See* United States-United Kingdom Income Tax Treaty Technical Explanation, Art. 7.
26. *See* Spain-United States Income Tax Convention, Art. 11(1).
27. *See* Australia-United States Income Tax Convention, Art. 10(2).

SEC Proposes Expansive Climate-Related Disclosure Rules

By the Attorneys of Sullivan & Cromwell

The rules would require public companies to disclose detailed greenhouse gas emissions, climate transition plans, targets and progress against targets, long-term climate risks and business impacts, and climate-related corporate governance, including new information in notes to audited financial statements

Summary

On March 21, 2022, the Securities and Exchange Commission proposed climate-related disclosure requirements (the "Proposed Rules") that would require U.S. public companies and foreign private issuers to dramatically expand the breadth, specificity and rigor of climate-related disclosures in their SEC periodic reports and registration statements. The Proposed Rules, set out in a 510-page proposing release, mark a significant departure from the SEC's traditional principles-based and materiality-based reporting framework and move toward a prescriptive climate-related disclosure regime that mandates reporting of detailed information regardless of its materiality. The Proposed Rules, if adopted, will meaningfully increase the cost and complexity of public reporting. To enable compliance, companies will need to expend significant advance effort to enhance, among other things, data collection procedures (including from third parties in their value chain), and internal processes and controls, which will require substantial internal and external resources (including audit oversight of novel financial statement requirements).

Key provisions of the Proposed Rules include:

- Disclosure of greenhouse gas (GHG) emissions (both in absolute terms, not including offsets, and in terms of intensity in relation to business scale) that cover Scope 1, Scope 2 and—if material or if the company has set targets or goals that include Scope 3 emissions—Scope 3 GHG emissions, and third-party attestation (eventually at a "reasonable assurance" level) for Scope 1 and Scope 2 GHG emissions disclosures,
- Disclosure of any climate transition plan, internal carbon price, climate-related targets or goals adopted by the company, and progress against such plan, targets and goals,
- Disclosure of climate-related risks over the short, medium and long term and their impacts on business activities,
- Disclosure of qualitative and quantitative climate risk and historical impact in the notes to a company's audited financial statements, with information required to be presented on a disaggregated basis if the aggregated impact is 1% or more of the total line item; and
- Disclosure of corporate governance of climate-related risks and risk management processes.

The disclosure requirements would apply to all SEC reporting companies (other than Canadian issuers using Form 40-F), even those with no publicly listed equity securities. The proposed disclosure requirements are based closely on the Task Force on Climate-Related Financial Disclosure (TCFD) disclosure framework (see Appendix A for a comparison between the TCFD framework and the Proposed Rules), and the GHG emissions disclosure requirements generally adhere to the GHG Protocol. Compliance would be phased in, with reporting for large accelerated filers beginning in 2024 with respect to fiscal year 2023 if the Proposed Rules become effective at the end of this year (see Appendix B for disclosure compliance dates).

The SEC voted 3 to 1 (Commissioner Pierce dissenting) to issue the Proposed Rules. The public comment period was initially open until May 20, 2022, but on May 9, 2022, the SEC extended the end of the public comment period to June 17, 2022.[1] The Proposed Rules are already generating intense debate and are widely expected to attract vigorous comments and legal challenges.

Key implications and takeaways of the Proposed Rules for companies, including those outlined below, were further discussed during Sullivan & Cromwell's webinar entitled "Scope and Implications of the SEC's Proposed Climate-Related Disclosure Rules" on Tuesday, March 29, 2022.

Background and Potential Future Challenges

According to the SEC, over the last decade, investors and other stakeholders have increasingly requested climate-related disclosures that are comparable, consistent and decision-useful.[2] In the absence of a regulatory framework in the United States, many investors, including some of the largest U.S. institutional investors, have urged companies to provide standardized disclosures on climate-related risks, impact, oversight and metrics based on frameworks developed by TCFD and other standard setters. In response, more U.S. public companies have begun to voluntarily disclose climate-related information, although to varying degrees of scope and specificity. Many U.S.-listed foreign private issuers, meanwhile, are already reporting

under home country frameworks. These disclosures are generally made in sustainability or ESG reports rather than filed or furnished in SEC filings, which is consistent with the SEC's 2010 guidance on climate-related disclosures. Under the SEC's existing disclosure framework as set forth in the 2010 guidance, disclosure of specific climate-related metrics is not mandatory. Rather, a company is required to disclose information about potential or actual impacts of climate change to the extent material to investors. Investors and other stakeholders have argued some level of regulatory involvement is required to bring consistency, comparability and reliability to these disclosures and therefore make them decision-useful, and to align with the global momentum towards mandatory climate disclosures.

Under the Biden administration, climate change disclosure has been at the forefront of the SEC's agenda. Following then-Acting Chair Allison Herren Lee's announcements in March 2021 that the SEC will be "working toward a comprehensive ESG disclosure framework," the SEC solicited public input on climate disclosure from a broad range of stakeholders. Although some commenters criticized current disclosure practice for not producing consistent, comparable and reliable information, others argued that climate-related disclosures should only be required if the information in those disclosures is material to a company's business and would alter a reasonable investor's investment decision. Starting in September 2021, the SEC also selectively began sending comment letters to public companies regarding their climate-related disclosures (both within and outside of their SEC filings). Notably, based on publicly available responses, nearly all public companies that responded to the SEC's comment letters asking for additional disclosure on the basis of the 2021 guidance reported that they do not find climate change-related physical or transition risks to be material to their businesses.[3]

In proposing the new disclosure requirements, the SEC concluded based on feedback from stakeholders and the staff's own experiences that the existing disclosure system is not eliciting information that enables investors to assess accurately the potential impacts of climate-related risks on a company's business or to gauge how a company's board and management are assessing and addressing those impacts, particularly as compared to similarly situated companies. The staff also considered recent developments in other jurisdictions, which have been developing or revising their mandatory climate-related disclosure regimes. For example, the European Union has proposed a new Corporate Sustainability Reporting Directive[4] and the United Kingdom is currently implementing mandatory TCFD-aligned reporting,[5] each of which will apply to large companies and financial institutions, whether public or privately held. The United Kingdom has also mandated Scope 1 and 2 GHG emissions reporting for large companies.[6] According to the SEC, the Proposed Rules would help address an increasing global recognition of the need to improve companies' climate-related disclosures. Unlike the approach taken by the EU and other jurisdictions, which includes substantive requirements to align with the Paris Accord and voluntarily comply with initatives such as the Glasgow Financial Alliance for Net Zero, the Proposed Rules do not require companies to reduce GHG emissions or make substantive changes to their business strategies.

The Proposed Rules represent one of the most far-reaching steps in the Biden administration's "whole-of-government" approach for addressing climate change and achieving net zero emissions across the U.S. economy by 2050.[7] The administration has faced significant political headwinds on its climate agenda and has been advancing its initiatives through funding allocated under the Bipartisan Infrastructure Law, federal procurement policies and federal regulatory agencies, which have promulgated new policies and focused on various aspects of climate change impact across different sectors of the U.S. economy. For example, the Commodities Futures Trading Commission,[8] the Federal Reserve Board[9] and the Financial Stability Oversight Council[10] have each recently warned that climate change threatens U.S. financial stability and have recommended increased disclosure of climate risks. In December 2021, the Office of the Comptroller of the Currency released draft principles designed to provide large banks with a high-level framework for managing climate-related financial risks and indicated that more detailed guidance will be issued in 2022.[11] The Department of Labor released rules in October 2021 that removed barriers to fiduciaries' ability to consider climate and other ESG-related disclosures when selecting investments.[12]

It is unclear whether the Proposed Rules will be adopted in the form currently proposed. The Proposed Rules will likely elicit vigorous comments and are widely expected to be subject to legal challenges, including on the basis that they exceed the SEC's statutory authority and violate First Amendment rights. A similar challenge was made in connection with the SEC's conflict minerals rules, which were partially struck down.[13] Notwithstanding this uncertainty, in light of the breadth, specificity and implications of the disclosures contemplated by the Proposed Rules, the speed with which they are proposed to be adopted, and the potentially lengthy time required to establish the con-

trols and procedures necessary to enable such disclosures, companies should assess their compliance readiness soon. Companies should also monitor the Proposed Rules' potential impact on market practices regarding voluntary climate-related disclosures going forward, even if adoption of the Proposed Rules is delayed.

Summary of the Proposed Rules

The Proposed Rules comprise new items in Regulation S-K and a new article in Regulation S-X. New Items 1500-1507 of Regulation S-K, modeled in part on the TCFD disclosure framework,[14] would require a company to disclose information about (i) its governance of climate-related risks; (ii) climate-related impacts on its strategy, business model and outlook; (iii) climate-related risk management; (iv) GHG emissions metrics; and (v) any internal carbon price or climate-related targets and goals. According to the SEC, the widespread adoption of, and alignment with, the TCFD framework could potentially facilitate more comparable disclosures globally while reducing the compliance burden for public companies, many of which have experience reporting under this framework. In addition, accelerated and large accelerated filers would be required to obtain attestation by an independent third party of their GHG emissions metrics

Proposed Article 14 of Regulation S-X would require companies to include climate-related financial statement metrics (which would consist of disaggregated climate-related impacts on existing financial statement line items) and related disclosures in a note to their audited financial statements. These metrics would then be subject to audit by an independent registered public accounting firm and come within the scope of the company's internal control over financial reporting.

A. Disclosure of Climate-Related Risks and Their Impact

The Proposed Rules include detailed requirements for companies to disclose the actual and potential climate-related risks that are reasonably likely to have a material impact on the company's business or consolidated financial statements. These requirements include disclosure of both physical and transition risks over the short, medium and long term. Under the Proposed Rules, companies will have the ability to determine the most appropriate time periods for disclosure, although the SEC has requested comment on whether it should define these periods (e.g., whether long term should be defined "as 10-20 years, 20-30 years, or 30-50 years").

In addition, the Proposed Rules would require companies to describe any actual and potential impacts of those risks on their business, strategy and outlook, with specific financial statement disclosures regarding the impact of those risks. Although the proposed disclosures are based on the TCFD framework, the SEC acknowledged that only a minority of public companies that voluntarily report under TCFD actually disclosed the impact of climate-related risks and opportunities on their business in alignment with TCFD, and even companies that make such disclosures do not include the granular details proposed by the SEC.[15]

Physical Risks: Companies would be required to provide detailed disclosures of material physical risks faced, including classification of the risk as acute (e.g., hurricanes) or chronic (e.g., sea level rise or the decreased availability of fresh water). Companies would also need to disclose the ZIP code or equivalent postal-type code for properties subject to physical risks, if material, as well as granular information about exposure to risks of flooding or water stress, if material.

Transition Risks: Companies would be required to disclose how they are impacted by material transition risks, which are the risks associated with the impact of regulatory, technological and market changes related to mitigation of, or adaptation to, climate change. Companies would be required to identify whether these risks relate to regulatory, technological, market (including changing consumer, business counterparty and investor preferences), liability, reputational or other transition-related factors and how those factors impact the company.

Impact of Risks: Companies also would be required to describe the actual and potential impact of these risks on their strategy, business model and outlook, and how such impacts are considered as part of their strategy, financial planning and capital allocation, on a current and forward-looking basis. The SEC —noting that many companies currently include only boilerplate discussions about the impact of climate-related risks—has proposed a specific list of the types of impacts a company would be required to discuss, including impacts on the types and locations of its operations, impacts on suppliers and impacts of any activities to mitigate climate-related risks. Although the risks themselves are qualified by materiality, the required discussion of the impact of those risks on a company's business strategy is not currently so qualified.

B. Disclosure and Attestation of GHG Emissions Metrics

The Proposed Rules would require disclosure of Scope 1 GHG emissions (direct GHG emissions from operations that are owned or controlled by the company) and Scope 2 GHG emissions (indirect emissions from the generation of purchased or acquired electricity, steam, heat or cooling that are consumed by the operations owned or controlled by the company, such as indirect emissions created by use of the company's sold products or emissions created by products and services bought by the company) without regard to materiality. In addition, companies would be required to disclose Scope 3 GHG emissions (all other indirect emissions not covered by Scope 2),[16] if such emissions are material or if a company has already set a GHG target or goal that includes Scope 3 emissions.[17] This new Scope 3 disclosure requirement is among the most con-

troversial provisions of the Proposed Rules because, for many companies, Scope 3 emissions are both the largest source of emissions and the most difficult to reliably estimate. Smaller reporting companies would not be required to disclose Scope 3 emissions. For seasoned reporting companies, GHG emissions disclosure would be subject to a graduated framework of third-party attestation requirements (see Appendix B for attestation compliance levels and dates). The SEC notes that such disclosure could help mitigate instances of "greenwashing."

Definitions: The definitions used in the Proposed Rules for GHG emissions are substantially similar to those provided by the GHG Protocol.[18] However, unlike the GHG Protocol, the Proposed Rules do not permit companies to elect an equity share approach or a control approach but instead would require reporting based on financial consolidation accounting principles and would require companies to report proportionate emissions from equity investees.

Required Scope 1 and Scope 2 Emissions: The Proposed Rules would require a company to disclose their Scope 1 and Scope 2 GHG emissions for its most recent fiscal year and, where reasonably available, for the historical fiscal year(s) included in its consolidated financial statements. GHG emissions must be expressed both on a carbon dioxide-equivalent basis and disaggregated among seven separate GHGs (even those that are individually quantitatively immaterial) and must exclude any purchased or generated offsets. GHG intensity (per unit of revenue and per relevant unit of production) must also be reported, as well as detailed disclosures of the methodology, inputs and assumptions used to calculate the GHG metrics.[19] In addition, companies must disclose any material change to the methodology or assumptions underlying its GHG emissions disclosure from the previous fiscal year.

Potential Scope 3 Emissions Disclosures; Phase-In and Liability Safe Harbor: Companies required to report Scope 3 emissions would be subject to similar disclosure requirements as discussed above, although companies could report Scope 3 emissions as a range if they disclose the reason for doing so and the underlying assumptions.[20] In response to widespread concerns from many commenters regarding the current lack of methodological consensus and data regarding Scope 3 emissions, the SEC proposed a longer phase-in period for Scope 3 emissions. The Proposed Rules also include a modified liability safe harbor under which disclosure of Scope 3 emissions would not be deemed a fraudulent statement unless it is shown that the disclosure was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.

Reasonable Estimates and Gaps in Data: In recognition of the challenges of reporting Scope 3 and other GHG data, the Proposed Rules would allow companies to use reasonable estimates when disclosing all GHG emissions, so long as they also describe the assumptions underlying the estimates and the reasons for using them. If there are gaps in data required to calculate GHG emissions, a company must disclose the method used to address the gaps, and how accuracy or completeness of disclosure may be impacted.

Reliance on Third-Party Data: Because of the inherent difficulties associated with gathering GHG data—particularly Scope 3 emissions data—companies will need to rely on data compiled and created by third parties, which may potentially expose companies to liability for disclosures beyond their ability to verify and control. Notably, the Proposed Rules would require companies to disclose, to the extent material, the use of any such third-party data and the process used to assess such data.

Attestation Requirement: Under the Proposed Rules, accelerated filers and large accelerated filers (including foreign private issuers) would need to include in relevant SEC filings an attestation report that covers the disclosure of their Scope 1 and Scope 2 emissions.[21] Attestation would be on a limited assurance basis for the first two years the requirement is effective and on a reasonable assurance basis thereafter (which is the standard applied to financial statements). The Proposed Rules would require that attestation reports be provided using standards that are publicly available at no cost and established by a body or group that has followed due process procedures, although the SEC declined to adopt a particular standard because of the evolving nature of the GHG emissions reporting and attestation landscape. Thus, companies and investors may be required to assess and compare multiple attestation standards.[22]

C. Climate-Related Metrics in Financial Statements

Perhaps the most unexpected and unprecedented element of the Proposed Rules is the mandated qualitative and quantitative climate risk disclosures in the notes to a company's audited financial statements.

Financial Impact Metrics: The Proposed Rules would require a company to describe the impact—whether positive or negative—of climate-related risks, such as severe weather events and transition activities, on financial statement line items on a line-by-line basis. The required disclosures are **not** limited by materiality. Instead, the narrative disclosure is triggered if the impacted amount is 1% or more of the related line item.[23] For example, a company would have to describe changes to general and administrative expenses due to new emissions pricing, if such changes equal 1% or more of the general and administrative expenses line item.

Expenditure Metrics: The Proposed Rules also would require a company to disclose expenditures related to mitigating the risk of severe weather events and transition activities. Companies would be required to separately aggregate amounts of expenditure expensed and capitalized costs incurred. The expenditure metrics would be subject to the same 1% threshold as the financial impact metrics.

Financial Estimates and Assumptions: Companies would be required to disclose how severe weather events and transition activities affected estimates and assumptions (e.g., estimates made in connection with an asset impairment analysis) related to the financial statements.

D. Governance of Climate-Related Risks and Risk Management Processes

The Proposed Rules would mandate governance disclosures that go beyond the information currently required in proxy statements and the level of detail set forth under the TCFD framework.

Among other disclosures required with respect to directors' and management's roles in climate-related risk oversight and governance, companies would have to specify:

- any board members or board committees responsible for the oversight of climate risk;
- the processes and frequency by which the board or board committee discusses climate-related risks;
- how the board is informed about climate-related risks;
- whether and how the board or board committees consider climate risk as part of a company's business strategy, risk management and financial oversight;
- whether and how the board sets climate-related targets and goals and how it oversees progress against those targets or goals, including the establishment of any interim targets or goals;
- whether certain management positions or committees are responsible for assessing and managing climate-related risks and the process by which such positions or committees are informed about and monitor climate-related risks;
- procedures for internal reporting and monitoring of climate risk;
- the extent to which management relies on in-house staff and/or third-party consultants with relevant expertise to evaluate climate-related risks and implement related plans of action; and
- whether the responsible positions or committees report to the board or board committee on climate-related risks and how frequently this occurs.

Companies are separately required to describe any processes in place for identifying, assessing and managing climate-related risks, and to provide granular details that include how the company:

- determines the relative significance of climate-related risks compared to other risks;
- considers existing or likely regulatory requirements or policies, such as GHG emissions limits, when identifying climate-related risks;
- considers shifts in customer or counterparty preferences, technological changes or changes in market prices in assessing potential transition risks;
- determines the materiality of climate-related risks, including how it assesses the potential size and scope of any identified climate-related risk;
- decides whether to mitigate, accept or adapt to a particular risk, as well as the process for prioritizing risks and determining how to mitigate a high priority risk; and
- whether and how climate-related risks are integrated into the company's overall risk management system or processes.

In addition, companies would be required to identify any board member with expertise in climate-related risks, with disclosure in such detail as necessary to fully describe the nature of the expertise. However, unlike board members with audit committee financial expertise or the proposed cyber expertise governance framework under the SEC's recently proposed cyber rules,[24] the Proposed Rules do not provide a safe harbor insulating a director identified as having climate risk expertise from liability. As a result, directors with such expertise may be viewed as having greater responsibility with respect to climate-related oversight and be exposed to greater scrutiny due to their expertise, and, compared to directors with other identified expertise, face greater liability.

The lack of a safe harbor is not the only way in which these new requirements deviate from the SEC's practice elsewhere regarding risk disclosure and management. Notably, the requirement to disclose information on risk mitigation deviates from the SEC's long-standing position that companies should not downplay material risks they may face by describing how such risks are being mitigated.

The Proposed Rules do not require disclosure of whether executive compensation is connected to climate-related targets, but, given the proposed inclusion of financial statement disclosures, the Proposed Rules may nevertheless impact executive compensation if the SEC adopts changes to existing clawback rules. In 2021, the SEC reopened the comment period on potential new rules that would prohibit the listing of companies that do not develop and implement policies to recapture excess incentive compensation paid to an executive officer based on erroneous financial statements.[25]

E. Transition Plan/Targets and Goals

Many companies have voluntarily disclosed their adoption of transition plans in sustainability reports or other public disclosures. The EU has recently proposed mandating adoption of a climate transition plan (consis-

tent with a 1.5°C warming scenario) by all large EU companies and by non-EU companies with significant EU revenues.[26] Under the Proposed Rules, if a company has adopted a transition plan, then (whether or not they have publicly disclosed the plan) they are subject to prescriptive disclosure requirements with respect to metrics and targets used to identify and manage physical and transition risks. Companies would be required to update their transition plan disclosures annually and to include narrative descriptions of the actions taken during the previous year to achieve the plan's targets or goals.

Similarly, the Proposed Rules would require disclosure of detailed qualitative and quantitative information if a company has set any climate-related targets or goals as many companies have voluntarily done, including pursuant to initiatives such as the Glasgow Financial Alliance for Net Zero. This includes not only targets and goals related to GHG emissions (e.g., net zero pledges), but also any related to energy or water usage, conservation or ecosystem restoration, as well as goals with regard to revenues from low-carbon products in line with anticipated regulatory requirements, market constraints or other goals established by a climate-related treaty, law, regulation, policy or organization. The Proposed Rules would require disclosure of the scope of activities and emissions included in the target, unit of measurement (e.g., absolute versus intensity-based targets), time horizon for achieving the target, baseline time period and baseline emissions against which progress will be tracked, as well as any interim targets.

Neither the transition plan nor the targets and goals disclosure requirements are conditioned on materiality.

F. Offsets/Internal Carbon Pricing/Scenario Analysis

If, as part of its net emissions reduction strategy, a company uses carbon offsets or renewable energy credits or certificates (RECs), the Proposed Rules would require disclosure of the role that carbon offsets or RECs play in the company's climate-related business strategy. Additionally, if a company uses an internal carbon price when assessing climate-related factors, the Proposed Rules would require disclosures of (1) the price in units of the company's reporting currency per metric ton of carbon dioxide equivalent, (2) the total price and the boundaries for measurement on which the total price is based and (3) the rationale for selecting the internal carbon price applied. These disclosures also are not conditioned on materiality.

Although companies are not required to conduct scenario analyses, if they do,[27] then they must disclose detailed information about such analyses, including the scenarios considered (e.g., an increase of no greater than 3º, 2º or 1.5ºC above pre-industrial levels), as well as the parameters, assumptions and analytical choices, and the projected principal financial impacts on the company's business strategy under each scenario. This requirement to disclose the outcome of scenario analysis also is not conditioned on materiality. This would require companies that conduct scenario analysis to provide qualitative and quantitative information on not only the financial impacts of climate change on their business, but also the steps they are taking—or considering—to respond to hypothetical future climate scenarios.

G. Mechanics

The Proposed Rules would require companies to include the climate-related disclosures in SEC periodic reports and registration statements, including for initial public offerings, in a separately captioned "Climate-Related Disclosure" section and in the financial statements. The new disclosures would be on a "filed" (not "furnished") liability basis, consistent with other required SEC disclosures (except any climate disclosures by foreign private issuers included on Form 6-K would be on a "furnished" basis, consistent with other 6-K disclosures). Companies would be able to continue to incorporate by reference certain disclosures from other parts of their registration statements or annual reports (e.g., Risk Factors, MD&A or the financial statements), or in some cases from their other filed or submitted reports.

The Proposed Rules include phase-in periods for companies as set forth in Appendix B. The disclosure compliance date begins in 2024 with respect to fiscal year 2023 for large accelerated filers, in 2025 with respect to fiscal year 2024 for accelerated filer and non-accelerated filers, and in 2026 with respect to fiscal year 2025 for smaller reporting companies. All filers would have an additional year to comply with applicable Scope 3 disclosure requirements and smaller reporting companies would not be required to disclose Scope 3 emissions.

The Proposed Rules would require companies to tag climate-related disclosures in Inline eXtensible Business Reporting Language ("Inline XBRL"). The proposed requirement would include block text tagging and detail tagging of the new narrative and quantitative climate-related disclosures. The new financial statement disclosure requirements apply to all years included in the financials (i.e., fiscal years 2021, 2022 and 2023 in the 2023 annual report of a large accelerated filer), unless such information is not available without unreasonable effort or expense. GHG emissions data must be presented for historical periods if reasonably available.

Implications

The Proposed Rules, if adopted, will have immediate and significant ramifications on how companies collect, disclose and verify climate-related data and plans, and will meaningfully increase the cost and complexity of SEC compliance.

Compliance Timeline/Readiness Assessment. Public companies will need to devote substantial human and financial resources to develop (or enhance the quality of) climate-related information required under the Proposed Rules. Given the limited comment and phase-in periods

and the scope and complexity of the Proposed Rules, companies will need to assess their readiness now. Although these assessments will necessarily be individualized since companies are at different maturity levels in their climate reporting, some general areas of focus may include:

- Have cross-functional teams been organized to establish accountability for climate-related reporting?
- Are there knowledge gaps or staffing challenges that need to be addressed?
- Where does climate-related information come from within the organization, and who are the owners within the company? Has data aggregation been standardized and automated within the company? Does the company need to integrate or combine systems in order to generate certain types of data?
- What information does the company need to collect from third parties? Are there any gaps in the company's ability to obtain and assess such third-party data? What procedures does the company have for assessing the quality of that information, and does the company have assurance that it will receive the required information on a timely basis (or at all)?
- Does the company subject its climate disclosures to disclosure controls and procedures?
- Has the company identified a qualified independent third-party attestation service provider? What does the company need to do to prepare for third-party auditing of its disclosures, and how long will it take the company to become prepared?
- Has climate risk been integrated into existing risk management or compliance frameworks?
- Does the company need to add individuals with climate-related expertise to its board of directors and management team?

Even if a company already has a robust climate disclosure framework in place, the board and management team will need to reassess their current disclosure timeline and processes in light of the Proposed Rules.

Accelerated Climate Reporting. Currently, many companies publish their sustainability or ESG reports several months after they have completed the year-end audit process and filed their annual report, which gives them more time to collect data (including waiting for year-end data to be published by third parties such as power utilities/interconnections) and complete climate-related internal disclosure review and any third-party verification processes. Because the Proposed Rules require that the new climate-related disclosures be included in a company's annual report, U.S. domestic reporting companies will need to accelerate the timeline for preparing these disclosures, which could pose substantial challenges if there are constraints on the availability of information and internal and external resources. Some of the most significant aspects of the Proposed Rules (for example, Scope 2 and 3 emissions disclosure) require reliance on information outside of a company's control. The accelerated timeline will be impacted further by the attestation requirement for GHG emissions disclosures as well as the new audit procedures that will be required to be performed on climate disclosures included in the notes to the audited financial statements. Because all audit and assurance activities will have to be performed at the same time as the year-end financial statements, companies will need to evaluate, and potentially remedy, systems and resource constraints, which may be particularly acute for small and mid-sized companies. Although the SEC has proposed that companies be permitted to estimate their fourth quarter emissions for this purpose, the Proposed Rules would still represent a significant acceleration of reporting under current practices.

Novel Approach to "Materiality." In the Proposed Rules, a limited number of disclosures are required only when material, which the SEC has indicated would adhere to the traditional definition of materiality established by the Supreme Court in *TSC Industries, Inc.* v. *Northway, Inc*.[28] The remaining disclosures required by the Proposed Rules, however, are not conditioned on materiality, or refer to a specific threshold well below any standard materiality determinations, marking a significant departure from the SEC's long-standing principles-based disclosure regime. A few notable examples include:

- The proposed amendments to Regulation S-X require disclosure of certain climate-related impacts on existing financial statement line items to the extent the aggregate impact is 1% or more of the particular line item for a given year, which is significantly below the typical quantitative benchmark of 5% under SAB 99.[29]
- The Proposed Rules require detailed information (in some instances, both qualitative and quantitative without reference to materiality) regarding a company's scenario analysis (at a far more granular level than called for under the TCFD framework), internal carbon pricing and transition plans, in each case, if used by the company.
- The Proposed Rules require disclosure of Scope 1 and Scope 2 emissions for each of seven GHGs separately (without any materiality threshold), as well as a description of the company's methodology, including its organizational and operational boundaries, calculation approach (including any emissions factors used and the source of the emissions factors), and any calculation tools and third-party data used to calculate GHG emissions.
- The Proposed Rules in this respect align more with the EU's prescriptive requirements under the EU Taxonomy and Sustainable Finance Disclosure Regulations (and proposed Corporate Sustainability

Reporting Directive).[30] Additional SEC rulemakings are expected on other ESG issues, including with respect to workforce issues, such as wage quality and equity and diversity. It is likely these rule proposals will similarly involve prescriptive disclosure obligations not qualified by materiality.

Climate-Related Actions or Statements Can Trigger Ongoing Disclosure Requirements. Some of the proposed disclosure requirements apply only if a company decides to take certain actions with respect to climate change. To avoid triggering an inadvertent or premature disclosure obligation, companies should be mindful of the Proposed Rules when making public statements on climate change or considering the implementation or expansion of climate-related plans. Examples include:

- If a company uses an internal carbon price, or if it uses analytical tools (such as scenario analysis) to assess the impact of climate-related risks on the business and financial statements, then the company would need to include the comprehensive information described above under "Offsets/ Internal Carbon Pricing/Scenario Analysis."

- If a company has adopted a transition plan, it must describe the plan, including the relevant metrics and targets used to identify and manage physical and transition risks, as further discussed above under "Transition Plan/Targets and Goals."

- If a company has set any targets or goals (even if these targets and goals have not been publicly disclosed), it is required to provide certain disclosures regarding those targets and goals as further discussed above under "Transition Plan/Targets and Goals."

- If a company has already taken these climate-related actions, the company would be required to make disclosures with respect to these actions if the Proposed Rules are adopted in their current form. Furthermore, certain foreign private issuers may be required by regulation in their home country to adopt transition plans or use scenario analysis, which would effectively make these disclosures mandatory for them. Similarly, if other U.S. regulators start to require companies subject to their jurisdiction to take climate-related actions subject to these disclosure requirements (e.g., scenario analysis by U.S. financial institutions), the disclosure requirements would effectively commence in connection with those regulatory requirements.

Scope 3 Emissions. The Proposed Rules would require disclosure of Scope 3 emissions only if material or if targets have been set. However, all companies will need to calculate (or at least estimate) Scope 3 emissions to determine materiality in the first instance, resulting in significant costs to a company even if the company ultimately determines that no Scope 3 disclosure is required. Moreover, companies may be concerned that their materiality determinations may be second-guessed by the SEC. As Commissioner Pierce notes in her dissenting statement, the SEC suggests that such emissions generally are material and admonishes companies that "materiality doubts" should be resolved in favor of disclosure, noting that the proposing release suggests a possible mandatory reporting of Scope 3 emissions if they represent more than 40% of total GHG emissions.

Much controversy surrounds the disclosure of Scope 3 emissions, which are generated within a company's value chain, including its upstream suppliers and downstream customers. Considerable uncertainty surrounds the reliability of data and methodologies used to delineate and measure Scope 3 emissions compared to more straightforward metrics for calculating Scope 1 (or even Scope 2) emissions. It can be challenging to delineate what constitutes a company's value chain, and Scope 3 emissions inherently include a level of "double-counting" as one company's Scope 1, 2 and/or 3 emissions may be another company's Scope 3 emissions.

Third-party data is necessary to calculate upstream and downstream Scope 3 emissions. Such third-party data, as well as the processes a company uses to obtain and assess the data, must be disclosed under the Proposed Rules if material. Companies may wish to begin examining the source of their emissions calculations, if applicable, with a view to disclosing the diligence they undertake around the quality of the sources, as well as identifying any limitations on their ability to publicly disclose the source. In addition, companies may consider modifying existing contractual arrangements to allow for effective capture of third-party data required for reporting purposes. To the extent data is not available, the SEC acknowledged that it may also be necessary for companies to rely heavily on estimates and assumptions to generate Scope 3 emissions data. For example, companies may need to rely on assumptions about how customers will use their products in order to calculate Scope 3 emissions from the use of sold products.

Many companies in the United States in the energy, chemicals, steel and other industrial sectors with significant emission sources are required to report some GHG emissions to the U.S. Environmental Protection Agency (USEPA) under the Clean Air Act or state analogues.[31] However, because USEPA's reporting requirements are often facility-specific, rather than focused on the consolidated entity, and do not comprehensively cover Scope 1, 2 and 3 emissions, even these companies will need to develop and produce additional emissions-related information to comply with the Proposed Rules.

Attestation of Disclosure. Scope 1 and 2 emissions data will be subject to attestation requirements by an independent and experienced third party. The Proposed Rules are extensive in their independence tests (similar to those for auditors), and also contain specific requirements for

qualification. Companies should begin assessing potential attestation service providers, including with a view towards the independence requirements, particularly as they consider the use of consultants (who would not be independent) to assist them with the climate-related rules in general. Although the attestation provisions are subject to an additional one-year phase-in period, the assurance obligation will apply to all data presented, including data for historical periods. As such, companies should establish controls and procedures designed to ensure any emissions data disclosed prior to the effectiveness of the attestation obligation will also satisfy the standards for assurance.

For companies that already obtain third-party assurance over their voluntary GHG disclosures, the Proposed Rules may require them to reassess the qualifications of their attestation service providers. The cost of obtaining third-party assurance from highly-regarded providers may increase. Moreover, many companies that have obtained third-party assurances in the past have only done so with a limited subset of their GHG emissions data, and the attestation required by the Proposed Rules would therefore increase the time and cost associated with attestation.

Financial Statement Metrics. One of the more significant changes in the Proposed Rules is the disclosure in the notes to the audited financial statements of quantitative, line-item disclosure (both revenue and expense) of the financial impact of certain severe weather events and other natural conditions, financial impacts related to transition activities, expenditures to mitigate climate-related risks, financial estimates and assumptions impacted by climate-related risks.

A company's auditors will need to audit these new disclosures, some of which are quantitative but a large portion of which are qualitative. These additional audit procedures, particularly in the early years of the rules' effectiveness, could add both significant time and expense to the annual financial reporting process.

Certain of the disclosures require significant levels of judgment and subjectivity and may not be conducive to audits. For line items such as revenue, it may be difficult to determine whether a climate-related event, particularly a transition risk, had an impact on the line item. For example, if a company experiences a decline in sales due in part to consumers moving away from the product in favor of a more environmentally-friendly competing product, it may be hard to quantify the extent of the decrease in revenues attributable to the shift in consumer preference, as opposed to other effects (e.g., decline in economy or change in consumer preference for other reasons).

ICFR, DCP and Oversight. The Proposed Rules will necessitate the creation of additional oversight functions, both at the board and management levels. As new disclosures will be required in audited financial statements, audit committees will find themselves with added responsibilities.

Internal control over financial reporting (ICFR) and DCP will need to be expanded to cover the new disclosures, and companies may need to add additional qualified personnel and integrate them into their ICFR and DCP procedures.

Companies also will need to assess their existing disclosures and the climate information that has already been collected, much of which may have been done without third-party assurance. As companies begin to provide information on a go-forward basis under a mandatory reporting regime, one in which certain emissions disclosures require third-party attestation and certain other disclosures or calculations may be subject to audit, companies may identify deficiencies in their existing disclosures that require correction.

Governance. The Proposed Rules do not prescribe governance but rather require disclosure regarding both board and management oversight regarding climate-related risks. A number of the disclosure requirements are quite detailed, and we expect that many companies will implement processes to align with the disclosure requirements. For example, companies would be required to include a description of the process and frequency by which the board (or board committee) discusses climate-related risks, how the board is informed of climate-related risks, and how frequently the board considers climate-related risks.

In addition, the Proposed Rules require disclosure as to whether any member of the board has expertise in climate-related risks, with disclosure required "in sufficient detail to fully describe the nature of the expertise." Boards may wish to begin considering whether they have members who may have such expertise and if not, whether additional board members may be warranted. As noted above under "Governance of Climate-Related Risks and Risk Management Processes," unlike directors who are identified as having financial statement expertise or, under the proposed new cyber rules, cyber expertise, the Proposed Rules lack any safe harbor for directors identified as having climate expertise.

Impact on Private Companies, Mergers & Acquisitions, Equity Investees and Foreign Private Issuers

Private Companies. The Proposed Rules do not provide a phase-in for newly public companies (beyond that which applies to the effectiveness of the Proposed Rules generally). The requirement to include climate-related disclosure with respect to future public offerings could delay, or even impede, private company access to U.S. public capital markets.

The Proposed Rules would apply to a company with reporting obligations pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), and companies filing a registration statement under

the Exchange Act or the Securities Act of 1933. Because private companies that issue registered debt securities may become subject to the reporting requirements under the Exchange Act, they would be obligated to comply with the proposed climate-related disclosures. The Proposed Rules may shift market practice for Rule 144A and other private securities offering disclosures as well.

Mergers & Acquisitions. The Proposed Rules would have the effect of requiring public company acquirers registering the issuance of securities on Form S-4 to disclose some climate-related information regarding the target company (without regard to whether the target company is public or private). Because the Proposed Rules do not provide accommodations for these companies, they may have meaningful implications for the timing and complexity of M&A transactions.

The Proposed Rules also do not contain any accommodations for newly acquired entities, meaning that a public company acquirer would be required to include climate-related disclosures regarding an entity even if it has not had sufficient time to review that entity's climate profile, emissions information and other data. This is in contrast, for example, to the rules on internal control over financial reporting, which permit companies and auditors to exclude from the ICFR assessment certain newly acquired entities.

Even if there are accommodations included in the final rules, companies should assess relevant climate-related matters when pursuing acquisition opportunities. By extension, private companies seeking to make themselves attractive acquisition targets for public companies should be cognizant of the new rules and disclosure standards.

Equity Investees. In presenting emissions data, the Proposed Rules would require companies to include in their calculation emissions data from equity method investees, calculated on a proportionate basis. As part of their disclosure controls and procedures, companies will need to assess what contractual and other rights they have to obtain the information necessary to comply with this requirement. As part of the planning process, companies will also need to assess the ability of their existing non-wholly owned consolidated entities and equity method investees to provide the required information. With respect to new joint venture and other equity investments, companies should consider including covenants requiring that this information be provided, similar to covenants that may be included around financial reporting.

Foreign Private Issuers. The Proposed Rules subject foreign private issuers (other than Canadian issuers filing on Form 40-F) to the obligations that apply to U.S. domestic companies, which include the novel financial statement requirements for issuers whose financials are prepared under IFRS-IASB. Although the SEC has partly based its proposals on TCFD and the GHG Protocol (under which many foreign private issuers already report on a voluntary or "comply or explain" basis), as detailed above and in Appendix A, the SEC's proposed implementation goes far beyond the present scope of disclosure of many such issuers. Furthermore, home country regulation may require foreign private issuers to undertake scenario analysis, or specify climate-related plans, goals or targets, which effectively would make certain optional aspects of the Proposed Rules mandatory. The SEC has asked for feedback on whether it should permit foreign private issuers subject to an alternative reporting regime that the SEC deems substantially similar to the Proposed Rules to satisfy their obligations under the SEC's rules by complying instead with the requirements of the alternative reporting regime.

Liability. The Proposed Rules significantly expand the scope of both historical and forward-looking disclosures that companies will be required to include, on a "filed" basis, in their periodic reports and registration statements. However, the Proposed Rules provide only narrowly targeted safe harbors that are in many respects more limited than the safe harbors that currently exist with respect to information that can be calculated on a much more reliable basis.[32] As one of many examples, the SEC notes that the proposed transition periods for assurance over GHG emission disclosures are intended to provide companies with time to familiarize themselves with the GHG emissions disclosure requirements and develop the relevant DCP, but the Proposed Rules do not provide a safe harbor for corrections that may result over time as a result of this transition. Furthermore, any adoption of the Proposed Rules would be against the backdrop of the SEC's creation of the Climate and ESG Task Force in the Division of Enforcement in March 2021, which the SEC announced will play a role in "[p]roactively addressing emerging disclosure gaps that threaten investors and the market."

Timing, Legal Challenges and Comment. The Proposed Rules include an aggressive implementation schedule, with reporting for large accelerated filers (with a December 31 fiscal year-end) applying with respect to fiscal year 2023 if the Proposed Rules become effective before the end of this year. However, it is unclear whether the Proposed Rules will be adopted in the form currently proposed. The Proposed Rules will likely elicit vigorous comments and are widely expected to be subject to legal challenges, including on the basis that they exceed the SEC's statutory authority and violate First Amendment rights. Parties that anticipate being affected by the Proposed Rules are encouraged to submit comments as part of the public comment processes. Sullivan & Cromwell intends to comment and is actively consulting with clients and other interested stakeholders about the potential effects of the Proposed Rules.

Appendix A

Comparison with TCFD

TCFD Recommendation	SEC Proposed Rules
Governance: Describe the board's oversight of climate-related risks and opportunities.	Describe the board of directors' oversight of climate-related risks, including, as applicable, the identity of any board member with climate-related expertise and other details summarized in "Summary of the Proposed Rules" above. If applicable, discuss the board's oversight of climate-related opportunities, but such discussion is not required.
Governance: Describe management's role in assessing and managing climate-related risks and opportunities.	Describe management's role in assessing and managing climate-related risks, including, as applicable, the identity of any members of management with climate-related expertise and other details summarized in "Summary of the Proposed Rules" above. If applicable, discuss management's oversight of climate-related opportunities, but such discussion is not required.
Strategy: Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.	Describe any climate-related risks reasonably likely to have a material impact on the company, including on its business or consolidated financial statements, over the short, medium and long term. This discussion should specify whether such risks are physical or transition risks and the nature of the risks presented (including the location of properties subject to material physical risk by ZIP or similar postal code). In addition, the company must describe how it defines short, medium and long term horizons. If applicable, disclose the actual and potential impact of any climate-related opportunities, but such discussion is not required.
Strategy: Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.	Describe the actual and potential impact of any climate-related risks identified on the company's strategy, business model and outlook. In addition, discuss whether and how any impacts are considered as part of the company's business strategy, financial planning and capital allocation, as well as whether and how any such risks have affected or are reasonably likely to affect the company's consolidated financial statements. Discuss how any of the new climate-related financial statement metrics or any of the company's own climate-related goals and targets are used in the company's strategy and analysis, and whether it maintains an internal carbon price.
Strategy: Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	Describe the resilience of the company's business strategy in light of potential future change in climate-related risks. Describe any analytical tools, such as scenario analysis, that the company uses to assess the impact of climate-related risks on its business and consolidated financial statements. While the Proposed Rules do not require scenario analysis, if the company uses scenario analysis to assess the resilience of its business strategy, it must disclose the scenarios considered, including parameters, assumptions and analytical choices, as well as the projected principal financial impacts on the company's business strategy under each scenario.

TCFD Recommendation	SEC Proposed Rules
Risk Management: Describe the organization's processes for identifying and assessing climate-related risks.	Describe any processes the company has for identifying, assessing and managing climate-related risks. If applicable, describe any processes for identifying, assessing and managing climate-related opportunities, but such description is not required.
Risk Management: Describe the organization's processes for managing climate-related risks.	Same as above.
Risk Management: Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	Describe how any climate-related risk identification and management processes are integrated into the company's overall risk management system or process. If a separate board or management committee is responsible for managing climate-related risks, disclose how such committee interacts with the committee governing general risks. If the company has adopted a transition plan as part of its climate-related risk management strategy, describe the plan, including relevant metrics and targets.
Metrics and Targets: Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.	Financial statement disclosure under three categories of financial statement metrics: (i) financial impact metrics, (ii) expenditure metrics and (iii) financial estimates and assumptions. For each type of financial statement metric used, provide contextual information, describing how each specified metric was derived, including a description of significant inputs and assumptions used, and if applicable, policy decisions made by the company to calculate such metrics.
Metrics and Targets: Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks.	Disclose total Scope 1 emissions and total Scope 2 emissions separately after calculating them from all sources that are included in the company's organizational and operational boundaries. Accelerated filers and larger accelerated filers must provide an attestation report covering their Scope 1 and 2 emissions disclosure in the relevant filing. The Proposed Rules would phase in the requirements for such attestation over the second, third and fourth years after the rule's compliance date. Disclose Scope 3 emissions if (i) such emissions are material or (ii) the company has set a GHG emissions reduction target or goal that includes its Scope 3 emissions. If required, such disclosure should identify the categories of upstream and downstream activities included in the calculation, and if a category of Scope 3 emissions is significant to the company, it must identify such category and separately provide emissions data for such category. In addition, describe the data sources used to calculate its Scope 3 emissions. Smaller reporting companies are exempt from reporting Scope 3 emissions.

TCFD Recommendation	SEC Proposed Rules
Metrics and Targets: Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.	Disclose any targets or goals related to the reduction of GHG emissions, or any other climate-related target or goal, including, as applicable, a description of the scope of activities and emissions included in the target, the unit of measurement, the defined time horizon by which the target is intended to be achieved, the defined baseline period and emissions against how progress will be tracked, any interim targets and how the company intends to meet its target goals. In addition, if the company sets targets or goals, disclose the relevant data to indicate whether the company is making progress toward meeting its targets or goals and how such progress has been achieved. Companies must report if they used carbon offsets to achieve their climate-related targets or goals.

Appendix B[1]

1. Disclosure Compliance Dates

Filer Type	Disclosure Compliance Date		Statement Metrics Audit Compliance Date
	All proposed disclosures, other than Scope 3 GHG emissions metrics	Scope 3 GHG emissions metrics	
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Same as Disclosure Compliance Date
Accelerated Filer and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	
Smaller Reporting Company	Fiscal year 2025 (filed in 2026)	Exempted	

1. Assumes a fiscal year end of December 31. The SEC indicated a company with a different fiscal year-end date that results in its fiscal year 2023 commencing before the effective date of the rules would not be required to comply until the following fiscal year.

2. Attestation Compliance Dates

Filer Type	Disclosure Compliance Date (No Assurance)	Limited Assurance[1]	Reasonable Assurance[2]
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)
Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)

1.Reasonable assurance is equivalent to the level of assurance provided in an audit of a company's consolidated financial statements included in a Form 10-K or Form 20-F annual report.
2. Limited assurance is equivalent to the level of assurance (commonly referred to as a "review") provided over a company's interim financial statements included in a Form 10-Q.

Endnotes

1. See Press Release, SEC, SEC Extends Comment Period for Proposed Rules on Climate-Related Disclosures, Reopens Comment Periods for Proposed Rules Regarding Private Fund Advisers and Regulation ATS (May 9, 2022), https://www.sec.gov/news/press-release/2022-82.
2. *See* the proposing release at pp. 16-29, https://www.sec.gov/rules/proposed/2022/33-11042.pdf.
3. *See* Audit Analytics, The SEC Focuses on Climate Change in Latest Round of Comment Letters (Feb. 24, 2022), https://blog.auditanalytics.com/the-sec-focuses-on-climate-change-in-latest-round-of-comment-letters/.
4. European Commission Press Release IP/21/1804, *Sustainable Finance and EU Taxonomy: Commission Takes Further Steps To Channel Money Towards Sustainable Activities* (April 21, 2021), https://ec.europa.eu/commission/presscorner/detail/en/ip_21_1804.
5. Press Release, UK Dept. for Business, Energy & Industrial Strategy, *UK to Enshrine Mandatory Climate Disclosures for Largest Companies in Law* (Oct. 29, 2021), https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law.
6. The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 No. 1155 (UK), https://www.legislation.gov.uk/ukdsi/2018/9780111171356/contents.
7. *See* Sullivan & Cromwell, *Biden Administration Announces New Climate Change Initiatives* (Feb. 28, 2022), https://www.sullcrom.com/files/upload/sc-publication-biden-administration-announces-new-climate-change-initiatives.pdf.
8. CFTC, Climate-Related Market Risk Subcommittee, *Managing Climate Risk in the U.S. Financial System* (Oct. 2020), https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf.
9. Board of Governors of the Federal Reserve System, Financial Stability Report (Nov. 2020) at 59, available at https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf.
10. *See* Sullivan & Cromwell, *Financial Stability Oversight Council Report on Climate-Related Financial Risk* (Nov. 2, 2021), https://www.sullcrom.com/sc-publication-financial-stability-oversight-council-report-on-climate-related-financial-risk.
11. *See* Sullivan & Cromwell, *OCC Seeks Public Feedback on Principles for Climate-Related Financial Risk Management for Large Banks* (Dec. 21, 2021) https://www.sullcrom.com/files/upload/sc-publication-occ-release-and-seeks-feedback-on-principles-for-climate-related-financial-risks-management-for-large-banks.pdf.
12. *See* News Release, Department of Labor, *U.S. Department of Labor Proposes Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Management* (Oct. 13, 2021), https://www.dol.gov/newsroom/releases/ebsa/ebsa20211013.
13. *See* Sullivan & Cromwell, *SEC Adopts Final Rules to Implement the "Conflicts Minerals" Disclosure Requirements of the Dodd-Frank Act* (Aug. 31, 2012), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Adopts_Final_Rules_to_Implement_the_Conflict_Minerals_Disclosure_Requirements_of_t.pdf; Sullivan & Cromwell, *Court Vacates SEC Resource Payment Disclosure Rule* (July 2, 2013), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Court_Vacates_SEC_Resource_Payments_Disclosure_Rule.pdf.
14. The TCFD Framework is organized around four core pillars: governance, strategy, risk management, and metrics and targets.
15. Similarly, based on a TCFD study in 2021 (available at https://www.fsb.org/wp-content/uploads/P141021-1.pdf), companies that are reporting under the framework are not implementing fully all of the TCFD recommendations, including recommended board and management disclosures.
16. "Scope 3 emissions" are defined as "all indirect GHG emissions not otherwise included in a registrant's Scope 2 emissions, which occur in the upstream and downstream

activities of a registrant's value chain." Upstream emissions include emissions attributable to goods and services that the company acquires, the transportation of goods (for example, to the company), and employee business travel and commuting. Downstream emissions include the use of the company's products, transportation of products (for example, to the company's customers), end of life treatment of sold products, and investments made by the company.

17. The Proposed Rules would require inclusion of GHG emissions from outsourced activities that previously were conducted as part of a company's own operations when determining whether its Scope 3 emissions are material and when disclosing those emissions.

18. Some U.S. public (and private) companies are required to report certain GHG emissions data to the U.S. Environmental Protection Agency (USEPA), which also refers to the GHG Protocol in its reporting program. Companies that provide GHG emissions data under the USEPA's program may be able to leverage some of their reported data to partially satisfy the disclosures contemplated by the Proposed Rules.

19. For companies that use carbon offsets or renewable energy credits as part of their plans to achieve climate-related targets or goals, the Proposed Rules would require disclosure of the amount of carbon reduction, description and location of projects, any authentication and cost.

20. The Proposed Rules noted that a financial institution's Scope 3 emissions disclosures would likely include the so-called "financed emissions" (i.e., emissions from companies to which the financial institution provides debt or equity financing). Although the Proposed Rules would permit financial institutions to use any appropriate methodology to calculate its Scope 3 emissions, the SEC notes that the Partnership for Carbon Accounting Financials' Global GHG Accounting & Reporting Standard provides one methodology that complements the GHG Protocol and could assist financial institutions in calculating their financed emissions.

21. Although the Proposed Rules generally would apply to foreign private issuers, they are not proposed to extend to Canadian issuers reporting under the Multijurisdictional Disclosure System.

22. The proposed EU Corporate Sustainability Reporting Directive also includes an attestation requirement that contemplates limited assurance pursuant to standards to be adopted by the European Commission, with the potential for the European Commission to require reasonable assurance in the future.

23. Examples of such line items include revenue, cost of revenue, selling, general and administrative expenses, sale of property, plant and equipment (in statement of cash flows), inventories, intangible assets, long-term debt and contingent liabilities.

24. *See* Sullivan & Cromwell, *SEC Proposes New Cybersecurity Disclosure Rules for Public Companies* (Mar. 11, 2022), https://www.sullcrom.com/files/upload/sc-publication-sec-proposes-new-cybersecurity-disclosure-rules-for-public-companies.pdf.

25. *See* Press Release, *SEC Reopens Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation* (Oct. 2021), https://www.sec.gov/news/press-release/2021-210.

26. *See* Sullivan & Cromwell, *European Commission Proposes Mandatory Corporate Sustainability Due Diligence and Climate Change Plans* (Mar. 7, 2022), https://www.sullcrom.com/sc-publication-eu-proposes-mandatory-corporate-sustainability-due-diligence-and-climate-change-plans?msclkid=d65da294ad2f11ecb38a03a5e185fde3.

27. Financial regulators have identified scenario analysis as a key emerging tool in the study of climate-related financial risks. In particular, in the Principles for Climate-Related Financial Risk Management for Large Banks, the OCC noted that management should develop and implement climate-related scenario analysis frameworks in a manner commensurate to the bank's size, complexity, business activity and risk profile. *See supra* note 11.

28. *See TSC Indus., Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1976).

29. *See* SEC Staff Accounting Bulletin No. 99, 17 Fed. Reg. 211 (Aug. 12, 1999).

30. *See* European Commission Press Release, *supra* note 4.

31. In December 2009, the USEPA issued an "endangerment and cause or contribute finding" for GHG emissions under the Clean Air Act, which enabled the USEPA to craft rules to directly regulate GHG emissions, and, on January 1, 2010, the USEPA began requiring large emitters of GHG to collect and report data with respect to their GHG emissions. *West Virginia v. Environmental Protection Agency*, currently pending in the United States Supreme Court, challenges the ability of USEPA to regulate carbon dioxide emissions related to climate change and could significantly impact the agency's future ability to regulate GHG emissions.

32. Although certain climate-related information will be protected by the forward-looking statement safe harbors under the Private Securities Litigation Reform Act (PSLRA), these safe harbors are not available for registration statements. Moreover, the SEC specifically notes in the proposing release that the PSLRA also does not limit the SEC's ability to bring enforcement actions.

SEC Proposes Significant Changes to Rules Affecting SPACs and De-SPACs

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

On March 30, 2022, the Securities and Exchange Commission (SEC or Commission) proposed new rules that would impose additional disclosure requirements on initial public offerings (IPOs) by special purpose acquisition companies (SPACs) and in business combination transactions involving SPACs (de-SPACs).

The proposed rules would significantly impact SPACs in a number of ways, including by:

- Mandating new disclosure requirements in SPAC IPOs and de-SPAC business combinations regarding the sponsor of the SPAC, potential conflicts of interest and dilution of shareholder interests.
- Imposing specialized disclosure and procedural requirements in de-SPAC transactions, including:
    - mandating a fairness determination from the SPAC as to the de-SPAC transaction and any related financing transactions, and
    - requiring disclosure regarding any outside report, opinion or appraisal received by the SPAC or its sponsor.
- Aligning de-SPAC transactions with traditional IPOs for purposes of non-financial statement disclosures and liability protections, including:
    - deeming the private operating company a co-registrant when a SPAC files a Securities Act registration statement for a de-SPAC transaction;
    - rendering unavailable to SPACs the liability safe harbor in the Private Securities Litigation Reform Act of 1995 (PSLRA) for forward-looking statements, and
    - deeming any underwriter in a SPAC IPO to be an underwriter in a subsequent de-SPAC transaction if such person takes steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction.
- Requiring that disclosure documents in de-SPAC transactions generally be disseminated to investors at least 20 calendar days in advance of a shareholder meeting or the earliest date of action by consent.
- Deeming a business combination involving a SPAC and another entity that is not a shell company to constitute a sale of securities to the SPAC shareholders for purposes of the Securities Act.
- Aligning more closely the financial statement requirements in a business combination transaction involving a SPAC and a private operating company with those in a traditional IPO.
- Updating and expanding guidance regarding the general use of projections in SEC filings, as well as when projections are disclosed in connection with a de-SPAC transaction.
- Creating a safe harbor that would be available to qualifying SPACs under the Investment Company Act of 1940 (Investment Company Act).

Comments should be received by May 31, 2022, or within 30 days after publication in the Federal Register, whichever is later.

Background

Though SPACs have existed as an alternative to blank check companies since the early 1990s, they recently have become the predominant choice for issuers to go public, due to certain perceived advantages over a traditional IPO, including pricing certainty and streamlined disclosure requirements. SPACs raised more than $83 billion in 2020 and $160 billion in 2021, and in both of those years, SPACs constituted more than half of all IPOs. As SPACs have gained in prominence, certain commentators have expressed concern that there are insufficient shareholder protections as compared to traditional IPOs.

To address these concerns, the SEC has proposed a series of new rules and rule amendments, which can be divided into five different categories, each of which is summarized below.

Proposed New Subpart 1600 of Regulation S-K

Proposed Subpart 1600 to Regulation S-K sets forth specialized disclosure requirements applicable to SPACs regarding the sponsor, potential conflicts of interest and dilution, and requires certain disclosures on the prospectus cover page and in the prospectus summary. It also would require enhanced disclosure for de-SPAC transactions, including a fairness determination requirement.

SPAC Sponsor

Proposed Item 1603 would require additional disclosure about the sponsor, its affiliates and any promoters of the SPAC in registration statements and schedules filed in connection with SPAC registered offerings and de-SPAC transactions. The disclosures would address:

- The experience, material roles and responsibilities of these parties, as well as any agreement, arrangement or understanding between the sponsor and the SPAC, its executive officers, directors or affiliates, in determining whether to proceed with a de-SPAC transaction and regarding the redemption of outstanding securities;
- The controlling persons of the sponsor and any persons who have direct and indirect material interests in the sponsor, as well as an organizational chart that shows the relationship between the SPAC, the sponsor and the sponsor's affiliates;
- Tabular disclosure of the material terms of any lock-up agreements with the sponsor and its affiliates, and
- The nature and amounts of all compensation that has or will be awarded to, earned by or paid to the sponsor, its affiliates and any promoters for all services rendered in all capacities to the SPAC and its affiliates, as well as the nature and amounts of any reimbursements to be paid to the sponsor, its affiliates and any promoters upon the completion of a de-SPAC transaction.

Conflicts of Interest

Proposed Item 1603 also would require that a SPAC disclose any actual or potential material conflict of interest between (1) the sponsor or its affiliates or the SPAC's officers, directors or promoters, and (2) unaffiliated security holders.

Actual or potential conflicts would include the contingent nature of sponsor compensation that may induce the sponsor and affiliates to pursue a business combination transaction that would not necessarily benefit the shareholders, the time pressure the sponsor is under to enter into a business combination, whether the sponsor is involved in multiple SPACs, and when a sponsor and/or its affiliates hold financial interests or have contractual obligations to other entities, including entities with which the SPAC is exploring entering into a business combination. These potential conflicts of interest may be especially relevant to shareholders at the time the SPAC and sponsor are considering entering into a business combination, especially as the SPAC nears the end of the period to complete such a transaction.

Dilution

Proposed Items 1602 and 1604 would require additional disclosure about the potential for dilution in (1) registration statements filed by SPACs, including those for IPOs, and (2) de-SPAC transactions. Sources of dilution may include sponsor compensation, underwriting fees, shareholder dilution, outstanding warrants, convertible securities and PIPE financings.

A simplified tabular dilution disclosure would be required on the prospectus cover page in SPAC IPOs on Form S-1 or F-1. The SPAC also should disclose that dilution may be disproportionately borne by shareholders of a SPAC that do not redeem their shares prior to consummation of the business transaction.

For a de-SPAC transaction, SPACs would use a sensitivity analysis to disclose the amount of potential dilution under a range of reasonably likely redemption levels and quantify the increasing impact of dilution on non-redeeming shareholders as redemptions increase.

Prospectus Cover Page

Proposed Item 1602 would require that certain fundamental disclosures be made in plain English on the SPAC's IPO prospectus cover page, including the time a SPAC has to consummate a de-SPAC transaction, redemptions, sponsor compensation, dilution (including the simplified tabular disclosure described above) and conflicts of interest.

On the de-SPAC cover page, the SPAC would be required to include information on the fairness of the de-SPAC transaction, material financing transactions, sponsor compensation, dilution and conflicts of interest.

Prospectus Summary Disclosures

Proposed Item 1602 also would require certain key disclosures to be included in a prospectus summary. For SPAC IPOs, a range of information related to the prospective business combination would be required, including how a target will be identified, whether the business combination requires shareholder approval, the length of time to consummate the transaction (including any possible extensions), plans and consequences of seeking additional financing for the business combination and any material conflicts of interest. The prospectus summary also would include information on the securities offered, including the terms, redemption rights and whether they are of the same or a different class than those held by the sponsor and its affiliates.

For de-SPAC transactions, information more specifically related to the business combination must be included, including the background and material terms of the transaction, whether the transaction is fair to investors, investor redemption rights, material conflicts of interest, financing transactions in connection with the de-SPAC and a tabular disclosure of sponsor compensation and dilution.

Background of and Reasons for the De-SPAC Transaction; Terms and Effects

Proposed Item 1605 would require disclosure of the background, material terms and effects of the de-SPAC transaction to better assist investors in understanding the merits of the transaction. The disclosures are modeled on certain line-item requirements found in Regulation M-A but tailored to address issues more specific to de-SPAC transactions. The disclosures include:

- A summary of the background of the de-SPAC transaction, including, but not limited to, a description of any contacts, negotiations or transactions that have occurred concerning the de-SPAC transaction;
- A brief description of any related financing transaction, including any payments from the sponsor to investors in connection with the financing transaction;
- The reasons for engaging in the particular de-SPAC transaction and for the structure and timing of the de-SPAC transaction and any related financing transaction;
- An explanation of any material differences in the rights of security holders of the post-business-combination company as a result of the de-SPAC transaction, and
- Disclosure regarding the accounting treatment and the federal income tax consequences of the de-SPAC transaction, if material.

De-SPAC Fairness Opinion

To address concerns regarding perceived potential conflicts of interest and misaligned incentives, proposed Item 1606(a) would require the SPAC to disclose whether it reasonably believes the proposed business combination and any related financing transactions are fair or unfair to unaffiliated security holders, as well as including a discussion of the basis for this statement. The SPAC would be required to discuss in reasonable detail the material factors upon which a reasonable belief regarding the fairness of a de-SPAC transaction and any related financing transaction is based and, to the extent practicable, the weight assigned to each factor.

To provide additional context for evaluating the SPAC's decision to proceed with a de-SPAC transaction, proposed Item 1606 separately would require disclosure on whether:

- The business combination or any related financing transaction is structured so that approval of at least a majority of unaffiliated security holders is required;
- A majority of directors who are not employees of the SPAC has retained an unaffiliated representative to act solely on behalf of unaffiliated security holders for purposes of negotiating the terms of the de-SPAC transaction or any related financing transaction and/or preparing a report concerning the fairness of the de-SPAC transaction or any related financing transaction, and

- The de-SPAC transaction or any related financing transaction was approved by a majority of the directors of the SPAC who are not employees of the SPAC.

Reports, Opinions and Appraisals

Proposed Item 1607 would require disclosure about whether or not the SPAC or its sponsor has received any report, opinion or appraisal obtained from an outside party relating to the consideration or the fairness of the consideration to be offered to security holders or the fairness of the de-SPAC transaction or any related financing transaction to the SPAC, the sponsor or security holders who are not affiliates. To assist investors in evaluating such report, opinion or appraisal, the proposed item further would require disclosure of:

- The identity, qualifications and method of selection of the outside party and/or unaffiliated representative;
- Any material relationship between (1) the outside party, its affiliates, and/or unaffiliated representative, and (2) the SPAC, its sponsor and/or their affiliates, that existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of the relationship;
- Whether the SPAC or the sponsor determined the amount of consideration to be paid to the private operating company or its security holders, or the valuation of the private operating company, or whether the outside party recommended the amount of consideration to be paid or the valuation of the private operating company, and
- A summary concerning the negotiation, report, opinion or appraisal, which would be required to include a description of the procedures followed; the findings and recommendations; the bases for and methods of arriving at such findings and recommendations; instructions received from the SPAC or its sponsor; and any limitation imposed by the SPAC or its sponsor on the scope of the investigation

Any report, opinion or appraisal would need to be filed as an exhibit to the Form S-4, Form F-4 and Schedule TO for the de-SPAC transaction or included in the Schedule 14A or 14C for the transaction, as applicable.

Aligning De-SPAC Transactions With IPOs

Co-Registrant Status of Private Operating Company

Arguing the de-SPAC transaction effectively is an IPO of the target private operating company and that a private operating company's method of becoming a public company should not negatively impact investor protection, the proposed rules would amend Form S-4 and Form F-4 to require that the SPAC and the target company be treated as co-registrants when these registration statements are filed by the SPAC in connection with a de-SPAC transaction.

This requirement would make the additional signatories to the form, including the principal executive officer, principal financial officer, controller/principal accounting officer and a majority of the board of directors or persons performing similar functions of the target company, potentially liable under § 11 of the Securities Act of 1933 (Securities Act) (subject to a due diligence defense for all parties other than the SPAC and the target company), for any material misstatements or omissions in the Form S-4 or Form F-4 at the time of effectiveness, thereby incentivizing these persons to more carefully review and conduct due diligence on the target company disclosures in the registration statement.

Private Securities Litigation Reform Act Safe Harbor

The PSLRA provides a safe harbor for forward-looking statements under the Securities Act and the Exchange Act of 1934 (the Exchange Act), whereby a company is protected from liability for forward-looking statements in any private right of action under the Securities Act or Exchange Act when, among other things, the forward-looking statement is identified as such and is accompanied by meaningful cautionary statements.

The safe harbor is not available, however, when a forward-looking statement is made in connection with an IPO or an offering by a blank check company. The proposal seeks to amend the definition of "blank check company" to include SPACs for purposes of the PSLRA. By amending the definition of "blank check company" to include SPACs, the proposal would cause "the statutory safe harbor [to not be] available for forward-looking statements, such as projections, made in connection with de-SPAC transactions involving an offering of securities by a SPAC." The unavailability would extend to statements regarding the projections of target private operating companies in these transactions.

Underwriter Status and Liability

The release observes that although the timing of a SPAC IPO and a de-SPAC transaction can be separated by a considerable length of time, "the result of a de-SPAC transaction, however structured, is consistent with that of a traditional initial public offering."

That is, the de-SPAC transaction is the mechanism "by which the target company's securities, as securities of the combined company, are distributed into the hands of public investors." As with a traditional IPO, the SEC believes investors would benefit from the rigor and diligence exercised by SPAC underwriters in connection with the de-SPAC transaction.

Proposed Rule 140a would clarify that a person who has acted as an underwriter in a SPAC initial public offering (SPAC IPO Underwriter) and participates in the distri-

bution by taking steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction will be deemed engaged in the distribution of the securities of the surviving public entity in a de-SPAC transaction, i.e., that person will be an underwriter within the meaning of § 2(a)(11) of the Securities Act. The release argues that attaching underwriter status to SPAC IPO Underwriters in connection with de-SPAC transactions should incentivize them to help ensure under § 11 of the Securities Act the accuracy of the disclosures in de-SPAC transactions, given the attendant liability for registered de-SPAC transactions.

While not an exhaustive list, the commission observed that acting as a financial advisor to the SPAC, assisting in identifying potential target companies, negotiating merger terms, finding and negotiating PIPE or other financing, or receiving compensation in connection with a de-SPAC could all constitute underwriter participation in the transaction.

Minimum Dissemination Period

In order to give investors and the market adequate time to assess a proposed de-SPAC transaction, the proposed amendments would require that the prospectuses and proxy and information statements filed in connection with de-SPAC transactions be distributed to shareholders at least 20 calendar days in advance of a shareholder meeting or the earliest date of action by consent, or the maximum period for disseminating such disclosure documents permitted under the applicable laws of the SPAC's jurisdiction of incorporation or organization if such period is less than 20 calendar days.

Business Combinations Involving Shell Companies

Shell Company Business Combinations as Sales to Shell Company Investors

The proposing release posits that when a reporting shell company conducts a business combination with a company that is not a shell company the substantive reality of the transaction is that reporting shell company investors effectively have exchanged their security representing an interest in the reporting shell company for a new security representing an interest in the combined operating company.

With a view to providing disclosure and liability protections to investors in reporting shell companies under these circumstances, proposed Rule 145a would deem any business combination of a reporting shell company involving another entity that is not a shell company to involve a sale of securities to the reporting shell company's securityholders. Nothing in proposed Rule 145a would prevent the use of a valid exemption, if available, to cover the sale transaction.[1]

The release emphasizes that proposed Rule 145a is narrowly drawn and business combinations between two bona fide non-shell entities would not be impacted. Further, recognizing the special role of so-called business combination related shell companies in merger and acquisitions activity, proposed Rule 145a would not apply to reporting shell companies that are definitional business combination related shell companies.

De-SPAC Financial Statement Requirements

Currently, the manner by which a private operating company chooses to become a public company may impact its financial statement disclosures due to differing requirements found in applicable SEC forms. The proposal seeks to end this transactional asymmetry by amending relevant forms, schedules and rules to more closely align the financial statement reporting requirements in business combinations involving a shell company and a private operating company with those in traditional initial public offerings.

This harmonization would extend to the number of years of financial statements that are required, the audit requirements of a predecessor target business, and the age of the financial statements of a predecessor target business, among others. The release also addresses whether and when the historical financial statements of a shell company are required in filings made after the consummation of a business combination.

One prominent change would expand the circumstances in which a target company may report only two years of historical financial statements: The proposed amendments would permit a shell company registrant to include in its Form S-4/F-4/proxy or information statement two years of statements of comprehensive income, changes in stockholders' equity and cash flows for the private operating company for all transactions involving an emerging growth company (EGC) shell company and a private operating company that would qualify as an EGC without regard to whether the shell company has filed or was already required to file its annual report.

Outside of this welcome change, the proposed amendments generally codify existing practices, so issuers would not see any significant changes to their obligations.

Enhanced Projections Disclosure

Financial Projections Generally

The release acknowledges that financial projections may be helpful for investors making an investment decision but expresses concern with the potential for abuse, including financial projections that (1) do not have a reasonable basis, (2) use non-GAAP financial metrics without sufficient explanation or justification, or (3) are displayed with excessive prominence in comparison to historical financial information.

To address these concerns, the SEC proposes to update its views on the projected financial information. The proposed amendments would continue to require that all financial projections have a reasonable basis but it would go further and state that:

- any projected measures that are not based on historical financial results or operational history should be clearly distinguished from projected measures that are based on historical financial results or operational history;
- presenting projections that are based on historical financial results or operational history without presenting such historical measure or operational history with equal or greater prominence generally would be misleading;
- projections that include a non-GAAP financial measure should also clearly define or explain the measure, describe the GAAP financial measure to which it is most closely related, and explain why the non-GAAP financial measure was used instead of a GAAP measure, and
- the guidance also applies to projections of future economic performance of persons other than the registrant that are included in the registrant's SEC filings.

SPAC Financial Projections

The SEC believes that financial projections used in de-SPAC transactions present increased risks due to the nature of such transactions and the SPAC structure. For example, the compensation of the sponsor of a SPAC may depend largely on whether a de-SPAC transaction is completed, and the financial projections of a private target company may influence how investors evaluate a proposed de-SPAC transaction. The SEC has proposed additional disclosure requirements for financial projections used in a de-SPAC transaction, including requiring a registrant to disclose:

- the purpose of the projections and the party that prepared them;
- all material bases and assumptions underlying the projections, and any factors that may materially impact such assumptions;
- any material growth rates or discount multiples used in preparing the projections, and the reasons for selecting such growth rates or discount multiples;
- whether the disclosed projections reflect the view of the SPAC's board or management as of the date of the filing, and if not, the purpose of disclosing the projections and the reasons for the board's or management's continued reliance on the projections, and
- where the projections relate to the target company, whether the target company has affirmed that its projections reflect the view of its management or board as of the date of the filing, and if not, the purpose of disclosing the projections and the reasons for the continued reliance on the projections by the SPAC's management or board.

Investment Company Act Safe Harbor

Proposed Rule 3a-10 would provide a safe harbor from the definition of "investment company" under § 3(a)(1)(A) of the Investment Company Act for SPACs that meet the following conditions, among others:

- **Asset Composition**. The SPAC's assets must consist solely of government securities, government money market funds and cash items prior to the completion of the de-SPAC transaction. In addition, these assets may not be acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.
- **Activities**. The SPAC must seek to complete a single de-SPAC transaction after which the surviving company will be primarily engaged in the business of the target company, and the surviving company must have at least one class of securities listed for trading on a national securities exchange. A SPAC relying on the safe harbor is limited to only one de-SPAC transaction, which can involve the combination of multiple target companies as long as they are treated as part of a single de-SPAC transaction.
- **Business Purpose**. The activities of the SPAC's officers, directors and employees, its public representations of policies and its historical development must be primarily focused on activities related to seeking a target company. The board would need to adopt an appropriate resolution as evidence of this business purpose. In addition, the SPAC could not hold itself out, or otherwise suggest, that it is primarily engaged in the business of investing, reinvesting or trading securities.
- **Duration**. The SPAC must file a report on Form 8-K announcing that it has entered into an agreement with a target company (or companies) to engage in a de-SPAC within 18 months after its IPO and complete its de-SPAC transaction within 24 months of such offering. Any assets that are not used in connection with the de-SPAC transaction must be distributed in cash to investors as soon as reasonably practicable thereafter. If a SPAC fails to meet either the 18-month or the 24-month deadline, it also would be required to distribute the SPAC's assets in cash as soon as reasonably practicable.

Endnote

1. The release, however, notes that exemption under § 3(a)(9) of the Securities Act generally would not be available.

Proposed 2022 DGCL Amendments Include Significant Changes Addressing Exculpation of Officers, Appraisal Rights and Domestication-Related Transactions

By Allison Land and Edward Micheletti

On April 12, 2022, the Corporation Law Section of the Delaware State Bar Association (DSBA) approved proposed amendments to the Delaware General Corporation Law (DGCL) that include provisions that, if enacted, would authorize exculpation clauses limiting or eliminating the monetary liability of certain officers, make appraisal rights available to beneficial owners of stock, and facilitate domestications of non-U.S. entities and consummations of other corporate transactions related to domestications.

Exculpation of Senior Officers

Since its adoption in 1986, § 102(b)(7) has authorized a corporation's certificate of incorporation to contain an exculpation clause that limits or eliminates the personal liability of its directors for monetary damages arising out of breaches of the fiduciary duty of care. The protection from monetary liability afforded by § 102(b)(7) historically has been expressly limited to directors, and not available for officers. In recent years, the prevalence of fiduciary duty claims against officers has increased significantly, particularly in the context of class action M&A litigation seeking monetary damages.

In many instances, the same breach of fiduciary duty claims are brought against both directors and officers, and while directors are able to have such claims dismissed based on § 102(b)(7) exculpation clauses, officers are not. In some circumstances, individuals that serve a dual role as both director and officer will have such claims dismissed in their capacity as a director based on a § 102(b)(7) exculpation clause, but they will remain in the case and subject to liability in their capacity as an officer with respect to the very same underlying allegations.

The proposed amendments to § 102(b)(7) seek to reduce (but do not eliminate) this imbalance in the treatment of directors and officers. Notably, the proposed amendments would authorize exculpation of officers only in connection with direct claims brought by stockholders, including class actions, but would not eliminate monetary liability of officers for breach of fiduciary duty arising out of claims brought by the corporation itself or for derivative claims brought by stockholders in the name of the corporation.

In addition, not all officers would be entitled to the protection of an exculpation clause. Rather, only the following senior officers may be entitled to the benefit of an exculpation clause: the CEO, president, CFO, COO, chief legal officer, controller, treasurer and chief accounting officer, as well as any other persons identified as "named executive officers" in the corporation's most recent SEC filings. Moreover, the same exclusions from exculpation applicable to directors (i.e., liability arising out of a breach of the duty of loyalty, acts or omissions not in good faith, or involving intentional misconduct or knowing violation of law or transactions from which the director derives an improper personal benefit) also would apply to officers under the proposed amendments, other than the exclusion for liability for unlawful dividends, since only directors are authorized to declare and cause the corporation to pay dividends.

If the proposed amendments are enacted, corporations should consider whether to amend their certificate of incorporation to provide for exculpation of their senior officers.

Domestications

Delaware has experienced an increase in the number of non-U.S. entities domesticating to Delaware in recent years, due in part to the prevalence of domestications in connection with de-SPAC transactions. Upon effectiveness of a domestication, a non-U.S. entity becomes a Delaware corporation, subject to all provisions of the DGCL. Promptly following a domestication, related corporate transactions (such as mergers, stock issuances or charter amendments) often occur.

There is some uncertainty as to whether approval by the pre-domestication board and stockholders satisfies the DGCL's requirements for board and/or stockholder approval of such corporate transactions for the Delaware corporation. Given timing constraints, however, it is often impracticable to hold a board or stockholders' meetings to approve such matters following the domestication. Moreover, given that such matters are authorized in accordance with applicable non-U.S. laws prior to effectiveness of the domestication, there does not appear to be a strong public policy rationale for delaying or impeding such transactions to obtain board and stockholder approvals already obtained, albeit under another jurisdiction's laws.

The proposed amendments to § 388 address this uncertainty and facilitate consummation of such other corporate actions swiftly following the domestication, without the requirement for additional board or stockholder approvals of the post-domestication Delaware corporation. The amendments would permit a domesticating non-U.S. entity to adopt a plan of domestication setting forth the terms and conditions of the domestication. A plan of domestica-

tion also may set forth any corporate actions to be taken by the domesticated Delaware corporation "in connection with" the domestication, including mergers, stock issuances and amendments to the Delaware certificate of incorporation. A plan of domestication, and any corporate actions set forth therein, must be approved prior to effectiveness of the domestication in accordance with the requirements of all applicable non-U.S. laws. The proposed amendments to § 388 provide that, once such approvals have been obtained, any corporate action set forth in the plan of domestication that is within the power of a Delaware corporation under the DGCL shall be "deemed authorized, adopted and approved by the domesticated corporation and its board of directors, stockholders or members," and no further action of the board, stockholders or members of the domesticated corporation is required under the DGCL.

Appraisal Rights for Beneficial Owners

The proposed amendments to § 262 would entitle beneficial owners of stock to exercise appraisal rights directly, rather than requiring them to cause the record holder of their shares to demand appraisal on their behalf. In order to assert appraisal rights with respect to any shares, a beneficial owner must maintain continuous beneficial ownership of such shares from the date of the demand through the effective date of merger, consolidation or conversion, as applicable, and provide documentary evidence of such ownership.

Conversions of Delaware Corporations

The conversion of a Delaware corporation into another entity presently requires unanimous approval of stockholders. Where it is impracticable to obtain such approval, however, the corporation may be merged with and into another entity, with such other entity surviving the merger, thus achieving the same result as in a conversion by way of merger, which generally requires approval of a majority of the corporation's outstanding shares entitled to vote thereon. The proposed amendments would harmonize these divergent voting requirements by reducing the required stockholder vote to approve a conversion from a unanimous vote to a majority of the outstanding shares entitled to vote on such conversion, *provided* that if the corporation is converting to a partnership with one or more general partners, approval of each stockholder who will become a general partner also is required to authorize such conversion.

In connection with such reduction in the required vote to approve a conversion, § 262 also would be amended to provide appraisal rights in connection with any conversion of a corporation for stockholders who do not vote in favor of such conversion, unless appraisal rights are denied pursuant to the "market out" exception applicable to publicly traded shares.

For a corporation first organized prior to August 1, 2022, if its certificate of incorporation, or any voting trust agreement or other written agreement between the corporation and one or more stockholders, contains any provision that restricts, conditions or prohibits consummation of a merger or consolidation, such provision is also deemed to apply to a conversion, unless the certificate of incorporation or such agreement expressly provides otherwise.

Delegation of Authority To Issue Stock or Options

The proposed amendments would provide flexibility by permitting the board of directors to delegate to a person or body the authority to issue stock under § 152, sell treasury shares under § 153 and issue rights or options to acquire stock under § 157. Under the proposed amendments, the board of directors may delegate such authority by adopting a resolution fixing (i) the maximum number of shares of stock, rights or options that the delegate may issue or sell, (ii) a time period during which the issuances or sales may occur, and (iii) the minimum amount of consideration to be received for the issuances or sales. Any person or entity to whom such authority is delegated would not have the power to issues shares, options or rights to themselves.

Access to Stockholder List

Finally, the proposed amendments eliminate the requirement that a corporation make a stocklist available, during any stockholders' meeting, for inspection by all stockholders present at such meeting. The stocklist must still be made available, however, for inspection by stockholders during the 10-day period immediately preceding the meeting date.

The proposed amendments will be introduced in the General Assembly for consideration and, if adopted and signed into law by the governor, the amendments would become effective on August 1, 2022, except for (i) the amendments relating to appraisal rights, which would become effective for mergers, consolidations and conversions, for which the agreement or plan is entered into on or after August 1, 2022, or the required authorizations thereof are adopted on or after August 1, 2022, as applicable, and (ii) the amendments relating to domestication, which would become effective for domestications if a plan of domestication is entered into on or after August 1, 2022, or, if there is no such plan, if the required authorizations thereof are adopted on or after August 1, 2022.

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Inside the Courts

An Update From Skadden Securities Litigators

Class Certification

Central District of California Denies Class Certification in Securities Fraud Action Concerning Company's Purchase of ADRs

Stoyas v. Toshiba Corp., No. 2:15-cv-04194 (C.D. Cal. Jan. 7, 2022)

Judge Dean D. Pregerson denied class certification in a securities fraud case alleging that Toshiba Corp. committed accounting fraud and made material misrepresentations.

The plaintiffs were pension funds that utilized the services of professional investment managers to purchase and sell Toshiba American depositary receipts (ADRs)—securities listed on U.S. exchanges that represent ownership of shares in foreign companies—between May 8, 2012, and November 12, 2015. Typically, financial institutions hold the common stock of foreign companies and issue ADRs. The ADRs can then be bought and sold by the investing public in the same manner that other domestic securities trade. In this case, however, brokers in New York purchased Toshiba common stock on the Tokyo Stock Exchange for the purposes of ADR conversion on behalf of the plaintiffs' investment managers. After the brokers purchased the common stock, the shares were converted to Toshiba ADRs for the plaintiffs to purchase at a previously contracted price.

The plaintiffs alleged that Toshiba deliberately used improper accounting practices in an attempt to inflate its pre-tax profits and conceal financial impairment. Based on these alleged misrepresentations, the plaintiffs brought a putative class action against Toshiba under § 12(a)(1) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder and Article 21-2 of the Financial Instruments and Exchange Act of Japan. Because the plaintiffs were pursuing monetary relief, they moved for class certification under Federal Rule of Civil Procedure 23(b)(3).

The district court denied the plaintiffs' motion for class certification for failure to satisfy the typicality requirement. In reaching this decision, the court found that the plaintiffs incurred irrevocable liability to take and pay for the ADRs in Japan, unlike members of the proposed class who acquired "Toshiba securities" in the United States. The court found that the moment the broker completed the transaction for Toshiba common stock on the Tokyo Stock Exchange, the plaintiffs became legally bound to perform their contractual obligations to pay for the ADRs once the brokers converted the stock into ADRs. The court held that under the U.S. Supreme Court's 2010 decision in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010), and its progeny, because the most significant aspects of the plaintiffs' ADR purchases occurred outside of the U.S., they lacked standing to seek relief under U.S. securities laws and therefore could not represent an investor class.

The court rejected the plaintiffs' argument that the broker was not acting on the investment manager's behalf, but instead as a "riskless principal." A broker-dealer acts in a "riskless principal" capacity when he or she purchases securities in the marketplace for purposes of selling them back to another purchaser at the same price. The plaintiffs argued that liability could not have attached until the ADRs were sold in the separate transaction, post-conversion. The court rejected this argument, reasoning that if the broker acted as a "riskless principal," that fact would undermine the plaintiffs' argument because it would further support the notion that the investment manager (and by extension, the plaintiffs) was bound to complete the trade as soon as the broker purchased the underlying common stock.

District of Utah Grants Class Certification to Biotechnology Company Investors

In re Myriad Genetics Sec. Litig., No. 2:19-cv-00707-DBB (D. Utah Dec. 13, 2021)

Judge David Barlow certified a class of biotechnology company investors in a suit alleging that the company and certain of its officers violated § § 10(b) and 20(a) of the Exchange Act, and Rule 10b-5 thereunder, by misrepresenting developments of certain biotechnology.

In opposing the lead plaintiff's motion for class certification, the defendants disputed only the adequacy element of Rule 23(b), which requires that "the representative parties will fairly and adequately protect the interests of the class." In principle, the defendants argued that the proposed plaintiff lacked "sufficient knowledge about the class action" and abdicated its duties to counsel. The defendants also argued that the plaintiff's deposition testimony showed that duties such as reviewing the complaint and analyzing potential legal claims were actually conducted by the plaintiff's counsel. The court rejected these arguments because (i) the plaintiff's board had a solicitation process in place in the event of litigation; (ii) the plaintiff made the ultimate decision of whether to initiate legal action; and (iii) the plaintiff chose the firm to represent it in the class action. Cutting in favor of the lead plaintiff's adequacy, the court also noted that the plaintiff reviewed the complaint before it was filed, collected documents for pro-

duction in the litigation and had ultimate authority over the law firms in the litigation.

Similarly, the court rejected the defendants' argument that the plaintiff would not adequately represent the interests of the class because it lacked sufficient knowledge about the class action. The court found that the plaintiff's testimony showed a knowledge of the alleged misstatements that gave rise to the action, discussed the nature of the claims against the defendants and demonstrated the ability to explain specifically which statements in the defendants' press release were false or misleading.

Derivative Litigation

Court of Chancery Dismisses Derivative Suit for Failure To Plead Demand Futility

Equity-League Pension Trust Fund v. Great Hill Partners L.P., C.A. No. 2020-0992-SG (Del. Ch. Nov. 23, 2021)

Vice Chancellor Sam Glasscock III dismissed all claims, including breach of fiduciary duty claims, against Wayfair's directors in connection with the company's issuance of $535 million in convertible debt (the Transaction) to The Spruce House Partnership and subsidiaries of Charlesbank Capital Partners, LLC and Great Hill Partners, L.P.

Amid the "economic maelstrom" in the early stages of the global pandemic, Wayfair negotiated a private investment in public equity (PIPE) transaction to raise $500 million through the issuance and sale of convertible notes, culminating in the Transaction. The audit committee charged with reviewing conflicted deals approved the Transaction, with the full board's approval shortly thereafter. The plaintiff, a Wayfair stockholder, filed suit, alleging that the Transaction was conflicted because certain board members purportedly "participated on the buy-side."

The defendants moved to dismiss pursuant to Court of Chancery Rule 23.1, arguing that the plaintiff failed to make a demand or adequately plead with particularity that demand would have been futile. The court granted the motion to dismiss. Rejecting the plaintiff's allegation that the audit committee members faced a substantial likelihood of potential liability in connection with their approval of the transaction, the court explained that, in light of the § 102(b)(7) exculpatory provision in Wayfair's certificate of incorporation, the plaintiff would have to plead facts showing bad faith. The court emphasized this high pleading standard, noting "where (as here) there is no adequate pleading of conflicted interests or lack of independence on the part of the [members of the Audit Committee], the scienter requirement compels that a finding of bad faith should be reserved for situations where the nature of [the Audit Committee members'] action[s] can in no way be understood as in the corporate interest." Rejecting the plaintiff's argument that the audit committee's actions supported an inference of bad faith, the court noted that the audit committee considered the Transaction with potential conflicts in mind and was aware of the terms offered by other arm's length bidders.

Court of Chancery Dismisses Derivative Suit Challenging Stock Repurchases and Dividends for Failure To Plead Demand Futility

In re Chemours Co. Derivative Litig., C.A. No. 2020-0786-SG (Del. Ch. Nov. 1, 2021)

Vice Chancellor Sam Glasscock III dismissed derivative claims arising from stock repurchases and corporate dividend payments allegedly made in violation of certain provisions of the Delaware General Corporation Law (DGCL) that generally require such payments to be made out of a corporation's surplus.

The Chemours Company was born from a corporate spin-off in 2015. As part of the spin-off, Chemours' former corporate parent transferred certain liabilities, including environmental liabilities, to Chemours. Chemours later sued its former parent, alleging that the size of the liabilities had been understated, and therefore Chemours would have been insolvent at its creation. Before and during that dispute, however, Chemours made stock repurchases and issued dividends. Chemours' board justified these payments based on a calculation of corporate surplus using generally accepted accounting principles (GAAP), as explained to it by external advisers and corporate officers. The plaintiff contended that the expenditures resulted from negligence or willful wrongdoing by the directors—exposing the directors to liability—because Chemours' own allegations in its lawsuit against its former parent demonstrated that the directors were aware that Chemours had no surplus, and that to rely on GAAP was improper because it failed to take into account the contingent environmental liabilities.

On the statutory claims, the court held that a majority of the director defendants did not face a substantial likelihood of liability for the stock repurchases and dividend payments. Section 174 of the DGCL states that "[i]n case of any wilful or negligent violation of § 160 or § 173 of this title, the directors under whose administration the same may happen shall be jointly and severally liable . . . to the full amount of the dividend unlawfully paid, or to the full amount unlawfully paid for the purchase or redemption of the corporation's stock . . . . " Therefore, in the event of a willful or negligent violation of § 160 or § 173, which respectively set out the requirements for approving a stock repurchase and dividend payment, § 174 imposes liability upon the directors serving at the time of the violation. The court noted, however, that § 174 is "tempered" by § 172, which provides that in the event of a violation, directors are "fully protected" if they rely "in good faith" upon the corporation's records, officers and employees; committees of the board; or experts in determining that the corporation has adequate funds to repurchase stock or pay dividends.

The court concluded that the plaintiff did not allege with particularity that the stock repurchases and dividend

payments violated § § 160, 170 or 173, or that the director defendants were negligent under § 174. With respect to the standard to be applied to the Chemours board's determination of Chemours' surplus, the court held that it will defer to a board's surplus calculation "so long as [the directors] evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination of the surplus that is not so far off the mark as to constitute actual or constructive fraud." Having determined that the plaintiff failed to adequately plead that the Chemours directors' surplus determinations failed to meet that standard, the court held that the plaintiff failed to plead noncompliance with § § 160, 170 and 173, and therefore there was no "willful or negligent" violation to hold the directors liable for under § 174. Furthermore, the court held that beyond the failure to allege a statutory violation, the directors were also "fully protected" from liability under § 172, a defense that could be considered at the pleadings stage similar to § 141(e) because they relied "'in good faith upon the records of the [Company] and upon' the Company's officers and financial advisors."

The court also dismissed the breach of fiduciary duty claim against the Chemours directors after noting that, pursuant to a Section 102(b)(7) provision, the directors were exculpated for breaches of the duty of care, which the plaintiffs failed to plead. Because a majority of the Chemours board did not face a substantial likelihood of liability as to any of the claims, the court also dismissed the breach of fiduciary duty claims against the Chemours officers, as demand was not excused.

Forum Selection Bylaws

Seventh Circuit Declines To Enforce Forum Selection Bylaw

Seafarers Pension Plan v. Bradway, No. 20-2244 (7th Cir. Jan. 7, 2022)

This Exchange Act Section 14(a) derivative suit arose out of the Federal Aviation Administration's grounding of the Boeing 737 MAX airliner in 2019 and 2020 in response to 737 MAX airliner crashes. A Boeing shareholder filed suit on behalf of Boeing under § 14(a) in the Northern District of Illinois, where Boeing is headquartered. Boeing moved to dismiss on the grounds of forum non conveniens, pointing to a corporate bylaw stating that all derivative suits must be brought in the Delaware Court of Chancery unless the company consents to a different forum. Boeing conceded that enforcement of the bylaw would foreclose the suit entirely because the Exchange Act gives federal courts exclusive jurisdiction over actions under it, but it argued that Delaware law offered a sufficient substitute. The district court agreed and dismissed the suit.

On appeal, the Seventh Circuit reversed in a 2-1 decision. The court held that the bylaw was not authorized by § 115 of the DGCL, which provides that "bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State." Specifically, the majority held that the Boeing bylaw was not "consistent with applicable jurisdictional requirements" because the Exchange Act limits jurisdiction to federal courts. It further found that the bylaw's restriction to the Court of Chancery went further than § 115 allows. According to the majority opinion, § 115 permits suits to be limited to courts "in" Delaware— including federal courts in Delaware—whereas the Boeing bylaw excluded all federal courts. The Seventh Circuit supported its argument by looking at the legislative history of the DGCL.

The Seventh Circuit then reviewed related Delaware case law and found that Delaware courts have not authorized forum bylaws that regulate whether, rather than where, shareholders may file suit. In fact, it found that the Court of Chancery had suggested that bylaws such as Boeing's would be invalid in *Boilermakers Local 154 Retirement Fund v. Chevron Corp*., 73 A.3d 934 (Del. Ch. 2013). The court also distinguished certain Supreme Court and Seventh Circuit precedent cited by Boeing to support the enforceability of forum-selection clauses. It explained that the decisions in those cases hinged on "the international character" of the disputes, a factor not present in this case. Accordingly, the Seventh Circuit reversed the district court's judgment and remanded the case for further proceedings.

Judge Frank Easterbrook dissented, noting that nothing in Boeing's bylaws prevents the shareholders from bringing a direct suit under § 14(a) in federal court. He explained that derivative suits—even those based on alleged violation of federal securities laws—arise under state law, and that § 14(a) ensures only the right to a direct claim, not a derivative one. Thus, the bylaw did not prevent the plaintiff from exercising its federal rights. Judge Easterbrook also disagreed with the majority's reading of § 115 of the DGCL. Under his reading, the provision's phrasing "any or all of the courts in this state" forbids bylaws that block litigation in Delaware but allows those that limit the courts "in" Delaware in which a suit may be brought.

Loss Causation

District of Colorado Denies Summary Judgment Against Cryptosecurity Firm for Failure To Plead Loss Causation

Arslani v. UMF Grp., Inc., Civil Action No. 19-cv-1117-WJM-KLM (D. Colo. Jan. 7, 2022)

Judge William J. Martinez denied a plaintiff's motion for summary judgment in a suit alleging violations of § § 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder against a cryptocurrency firm and its attorney. Specifically, the plaintiff alleged that between January 2017 and September 2017, the defendants falsely announced that the company would be transitioning from the oil and gas business into the medical marijuana business, and then into the cryptosecurity business. The plaintiff alleged that those fraudulent representations by defendants induced him to purchase securities. After the company failed to respond to the complaint, the plaintiff obtained default judgment against the company and moved for summary judgment against the attorney.

Although the attorney did not respond to the plaintiff's motion for summary judgment, the court found that the plaintiff failed to meet its burden as to loss causation under Rule 10b-5 sufficient to support summary judgment. The plaintiff failed to present evidence that "information correcting [the] alleged misrepresentations was revealed before the stock price dropped." Without such evidence, the court noted that concluding that the misrepresentation caused the price drop would be "entirely speculative," and the court denied the motion.

SEC Enforcement Actions

Ninth Circuit Affirms Disgorgement Order, Holds That Liu Does Not Apply to Relief Defendants

SEC v. Berkeley Healthcare Dynamics, LLC, No. 20-16754 (9th Cir. Jan. 5, 2022)

The Ninth Circuit affirmed the denial of a motion for relief from a judgment ordering disgorgement as a remedy for securities law violations, concluding that the Supreme Court's 2020 decision in *Liu v. SEC*, 140 S. Ct. 1936 (2020) did not require deduction from the disgorgement order of a relief defendant's legitimate expenses.

The case arose out of an action initiated by the Securities and Exchange Commission (SEC) against a defendant alleged to have operated a wide-ranging scheme to defraud investors. The original complaint also named Berkeley Healthcare Dynamics, LLC, a company that owned a warehouse leased to the defendant, as a "relief defendant"—an entity not accused of having directly committed any legal violations but alleged to be holding the proceeds from the alleged fraud. In late 2018, the Northern District of California granted summary judgment to the SEC, finding that the relief defendant, together with the primary defendant, were liable for disgorgement of $23.9 million. The relief defendant objected to the disgorgement order and argued that some of the funds were appropriately paid by the defendant as a tenant for expenses required under the lease. However, the district court overruled this objection on the grounds that the relief defendant failed to show that there was any factual dispute that those funds were commingled with the ill-gotten funds. The relief defendant did not appeal.

Subsequently, on June 22, 2020, the Supreme Court decided *Liu*, which held that a disgorgement award cannot "exceed a wrongdoer's net profits," and therefore, "courts must deduct legitimate expenses before ordering disgorgement[s]." After the *Liu* decision, the relief defendant moved for relief from judgment, arguing that, after *Liu*, it could not be required to disgorge its "legitimate business expenses." The district court denied the relief defendant's motion, concluding that *Liu* did not change the governing law.

The Ninth Circuit affirmed on the basis that *Liu* applied only to disgorgements ordered against primary wrongdoers. The panel determined that, in contrast to a primary wrongdoer, a relief defendant is not subject to disgorgement of "profits," but only ill-gotten funds that they lack a legitimate claim to receive (as opposed to, for example, compensation for rendered services). Because *Liu* provides that primary wrongdoers must disgorge all profits less legitimate expenses, it cannot apply to relief defendants. The court emphasized that this approach is consistent with *Liu*'s reasoning that an equitable remedy "should be designed to restore the status quo and avoid being transformed into a penalty." The panel affirmed that the relief defendant's failure to appeal the district court's summary judgment order is not excusable under *Liu*.

Securities Fraud Pleading Standards

Materiality

Second Circuit Reverses Dismissal of Proposed Class Action Claiming Internet Company Misled Shareholders About Relisting Plan

Altimeo Asset Mgmt. v. Qihoo 360 Tech. Co., No. 20-3074(2d Cir. Nov. 24, 2021)

The Second Circuit reversed the dismissal of a class action lawsuit brought by a putative class of investors against a Beijing-headquartered internet company incorporated under the laws of the Cayman Islands and its controlling officers. The complaint alleged that the defendants violated § § 10(b), 20(a) and 20A of the Exchange Act and Rule 10b-5 thereunder by, among other things, concealing from investors their plan to relist the company in the Chinese public market when they had 16 months earlier represented in certain proxy materials that the company was being taken private. These proxy materials allegedly contained misleading statements that indicated there were no "current plans, proposals or negotiations" for an "extraordinary corporate transaction," and that in the future

the company "may propose or develop plans and proposals" to relist on another internationally recognized stock exchange. The district court dismissed the complaint in its entirety, finding that it did not plausibly allege a misstatement or omission of material fact sufficient to state a claim for securities fraud.

On appeal, the Second Circuit disagreed with the district court's findings. Specifically, the Second Circuit focused on the plaintiffs' allegation that, at the time the proxy materials were sent to the shareholders, the company's officers had "already planned to relist Qihoo at a far-higher valuation in China post-transaction." In support, the Second Circuit credited several allegations in the complaint, including (i) that according to "[a]n expert in Chinese and United States M&A and capitals market transactions," it "typically takes companies at least a full year on the quickest possible timeline and usually longer, from the time they first start to consider a backdoor listing until they reach agreement with a shell company to conduct a reverse merger"; and (ii) two recent news articles reporting that the privatization plan provided to investors involved in taking the company private included the option of relisting the company on the Chinese stock market.

The Second Circuit inferred from these allegations, taken together, that the statements in the proxy materials that there were "no current plans" to relist the company, as well as its omission of any such plan, were materially misleading. The panel determined that because the relisting was announced 16 months after the proxy materials were issued, it is likely that negotiations for relisting were already underway at that time, a fact that would have been material to a reasonable investor.

EDNY Grants Motion To Amend Complaint To Resolve Inadequate Pleadings

Gordon v. Tencent Music Entm't Grp., 19-cv-5465 (LDH) (TAM) (E.D.N.Y. Dec. 27, 2021)

Judge Taryn A. Merkl granted a motion for leave to amend brought by a putative class of investors alleging violations of § § 11 and 15 of the Securities Act, § § 10(b) and 20(a) of the Exchange Act, and Rule 10b-5 thereunder against the "largest online music entertainment platform in China"—which had an initial public offering (IPO) in 2018—certain of the company's officers and directors, and certain financial firms and advisers that assisted with the IPO. The first complaint alleged that, in SEC filings related to the IPO, the company failed to disclose that it was the subject of an "anti-monopoly investigation" being conducted by the Chinese government. The court dismissed that complaint, agreeing with the defendants that the complaint failed to plead that any misrepresentations were made at the time of the SEC disclosures since no investigation had been confirmed at that point. The plaintiffs moved to amend.

The court granted the motion for leave to amend because the proposed amendments addressed the issues with the original complaint raised in the motion to dismiss. In particular, the court determined that the proposed amendments were not futile because they provided "facts and additional context," including about a meeting that the defendants had with Chinese authorities before the Chinese government commenced its investigation, sufficient to give rise to a reasonable inference that the SEC filings were misleading. The court also noted that the misleading filings were not "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance," and therefore could serve as the basis of the plaintiffs' claims.

Southern District of Ohio Dismisses Securities Fraud Claim Against Power Company Connected to Lobbying Scandal

Nickerson v. Am. Elec. Power Co., No. 2:20-cv-4243 (S.D. Ohio Dec. 20, 2021)

Judge Sarah D. Morrison dismissed a putative class action for securities fraud against public utility holding company American Electric Power Company, Inc. (AEP) for failing to plead any actionable misrepresentations or omissions.

The plaintiffs alleged AEP made material misrepresentations and omissions concerning its involvement in passing a piece of Ohio legislation, House Bill 6. While AEP initially opposed the bill, it lobbied for the inclusion of a provision that would benefit it. The final version of the bill ultimately included the provision. AEP also gave financially to an organization that in turn contributed to other entities involved with passing the bill. An alleged large-scale bribery scheme behind the bill's passage later came to light. AEP's shares fell after its alleged connection with the scheme through which political contributions became known. The plaintiffs sued, alleging, in relevant part, one count of securities fraud under the Exchange Act.

The plaintiffs alleged that several statements made in AEP earnings calls, responses to analyst questions, corporate accountability reports, public filings and AEP's regulatory newsletter were materially false or misleading. In broad strokes, the plaintiffs alleged AEP was not transparent about its lobbying efforts related to the bill and the company's political contributions. The plaintiffs alleged AEP's statements gave the false impression the bill was legitimately passed and that AEP was not actively involved in lobbying for the bill. AEP argued the alleged misrepresentations or omissions were not actionable, and the court agreed.

Applying the heightened pleading standards for fraud under Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 (PSLRA), the court noted deficiencies under each category of statements the plaintiffs identified. In part, the court found that comments made on earnings calls regarding AEP's failure to

state why it initially withheld support for the bill were not material. It noted AEP's intentions were apparent from its public actions and statements, and the comments would not have significantly altered the total mix of information available to investors. The court further found AEP's statements discussing the bill in its initial form and the positive elements from the bill as passed too generic and innocuous to have misled any reasonable investor.

With respect to a statement that the company was still analyzing the impact of the bill on AEP, the court found no reasonable investor would draw from this statement the misleading impression that AEP did not back the provision that benefited it, as the plaintiffs contended. As to the statements in the regulatory newsletter, which the plaintiffs did not allege were factually inaccurate, the court found them merely descriptive and neither false nor misleading. Finally, the court agreed with AEP that the language in the corporate accountability reports concerning AEP's commitment to transparency and public disclosure of lobbying activities and political contributions were inactionable puffery—corporate aspirations upon which no reasonable investor would rely. Because none of the identified statements could form the basis for a claim under the PSLRA, the court dismissed the plaintiffs' claim for securities fraud with prejudice.

Misrepresentations

Eighth Circuit Affirms Dismissal of Securities Fraud Class Action

City of Plantation Police Officers Pension Fund v. Meredith Corp., No. 20-3510 (8th Cir. Oct. 18, 2021)

The Eighth Circuit affirmed the dismissal of a putative class action alleging securities fraud against Meredith Corp. and several of its executives. The plaintiff's claims arose from Meredith's acquisition of Time, Inc. Meredith's share price dropped three times in 2019 after information emerged indicating difficulties integrating the companies following the acquisition. The plaintiff's complaint identified 138 allegedly false or misleading statements made by Meredith executives regarding the acquisition and integration. Meredith moved to dismiss the complaint for failure to state a claim. The district court granted the motion to dismiss and denied the plaintiff's request for leave to amend. The plaintiff appealed to the Eighth Circuit.

On appeal, the Eighth Circuit summarily concluded that 137 of the 138 statements alleged in the complaint were not actionable as either (i) forward-looking statements accompanied by meaningful cautionary statements; (ii) corporate puffery; or (iii) forward-looking statements, for which the allegations did not raise a strong inference of being made with actual knowledge of their falsity.

The court then considered the one remaining alleged misstatement from Meredith's then-CEO in February 2019. The CEO stated that the company had fully integrated its human resources, finance and legal departments. The complaint alleged that this statement was false on the basis of a confidential statement from a former Meredith employee, who stated that the legacy Meredith employees and legacy Time employees used different finance software systems until August 2019.

Although the court found that this statement came closer to stating a securities fraud claim than the other 137, it concluded this allegation still fell short of giving rise to an inference of scienter. The Eighth Circuit noted the former employee's confidential statement provided no insight into what the CEO knew about the finance software systems. The court also indicated the complaint failed to state with particularity facts supporting the claim that the use of two software systems was so obvious that the CEO would have been negligent to turn a blind eye. Instead, it found more plausible the inference that the CEO lacked insight into the inner workings of the finance department consolidation at the time of his statement.

Having determined that the complaint failed to allege any actionable misstatements, the Eighth Circuit affirmed the district court's dismissal of the complaint. The court also affirmed the denial of leave to amend because the plaintiff's proposed new allegation of securities fraud, raised for the first time in opposition to the motion to dismiss, also would not have survived a motion to dismiss.

Northern District of California Denies in Part Dismissal of Securities Fraud Action, Clarifying That the Context of Statement Could Mislead Reasonable Investor

In re Vaxart Inc. Sec. Litig., Case No. 20-cv-05949-VC (N.D. Cal. Dec. 22, 2021)

Judge Vince Chhabria denied in part a motion to dismiss securities fraud claims brought against a vaccine development company, its officers and the hedge fund with a majority stake in the company based on allegedly misleading statements regarding the company's ability to mass-produce a successful coronavirus vaccine.

In June 2020, the company published the first in a series of eight press releases about its efforts to develop a coronavirus vaccine, each of which sent the company's shares higher. Within a span of 10 days, the company announced it had initiated a program to develop an oral vaccine, reached an agreement with another company to develop and manufacture 1 billion doses of an oral vaccine and been selected for the U.S. government's Operation Warp Speed. The Department of Health and Human Services (HHS) later confirmed the federal government had not chosen Vaxart as one of its leading vaccine developers; instead, the company had been selected to participate only in a nonhuman primate challenge study organized and funded by Operation Warp Speed. While Vaxart had disclosed that information, it did so only in small print in the press release in question. The clarifying statement by HHS allegedly caused Vaxart's stock price to decline. The plaintiffs, purported investors, brought securities fraud

claims under § 10(b) of the Exchange Act and Rule 10b-5 thereunder against Vaxart, its officers and the hedge fund, alleging that the defendants made misleading statements to the investing public regarding the company's progress in developing a coronavirus vaccine.

The district court denied the defendants' motion to dismiss in part. The court concluded that the complaint failed to sufficiently plead that the hedge fund that sold shares in the wake of the misleading statements was liable for the alleged misstatements, and it determined that the hedge fund did not "make" the statement under *Janus*, nor did it disseminate any of Vaxart's press releases. However, with respect to the company and its officers, the court concluded that the plaintiffs had adequately alleged the defendants knowingly misled the investing public about the company's progress in developing a vaccine.

First, the court concluded that the plaintiffs' complaint adequately alleged that the statements in the press releases would have misled a reasonable investor. The information Vaxart made available to the market in its press releases, within the broader context of the government steadily announcing recipients of Operation Warp Speed, materially misled the investing public that it was pioneering a successful coronavirus vaccine. The court found that the complaint plausibly alleged Vaxart designed its press release with truthful statements that would take advantage of the health care environment in order to mislead investors.

Second, the court found that the complaint had adequately alleged scienter by pleading facts permitting a strong inference that defendants were acting with intent to mislead and elicit an unduly favorable reaction by the market. Specifically, the plaintiffs plausibly alleged that the defendants knew the company had not been selected to receive federal funding through Operation Warp Speed and that its manufacturing company did not have the regulatory capacity nor personnel to produce 1 billion doses of the vaccine.

Particularity

District of Colorado Denies Motion for Reconsideration, Dismissing Alleged Price-Fixing Conspiracy Claims Brought by Putative Class of Investors

Hogan v. Pilgrim's Pride Corp., Civil Action No. 16-cv-02611-RBJ (D. Colo. Nov. 29, 2021)

Judge R. Brooke Jackson denied a motion for reconsideration of the court's order and judgment dismissing a second amended complaint filed by a putative class of investors against a leading broiler chicken producer and certain of its executives. The second amended complaint (SAC) alleged that the defendants violated § § 10(b) and 20(a) of the Exchange Act and Rule 10b-5(a) and (c) thereunder by concealing the company's participation in a price-fixing conspiracy that began as early as 2007 and continued through at least November 2016. The SAC alleged that the defendants instead falsely attributed the company's success to operational improvements, artificially inflating the company's share price.

In March 2018, the court granted the defendants' motion to dismiss the plaintiffs' first amended complaint for failure to "plead the underlying antitrust conspiracy with sufficient particularity." The plaintiffs moved for reconsideration of that order based in part on a Northern District of Illinois case that they characterized as an "intervening change in the law." The court denied the motion but granted the plaintiffs leave to amend their complaint. In June 2020, more than a year and a half after leave to amend was granted, the plaintiffs filed the SAC. They argued that the amended complaint was justified by the "genuinely new fact" of a recent federal grand jury indictment in Colorado of certain broiler chicken-producing company executives for their role in a price-fixing and bid-rigging conspiracy between 2012 through 2017. The court dismissed the SAC, agreeing with the defendants that the § 10(b) claims were time-barred by the five-year statute of repose for securities fraud actions and that the lead plaintiff lacked standing to bring any remaining claims. The court rejected the plaintiffs' argument that the "continuing fraud exception" or "relation back" claims under Rule 15(c) rendered the complaint timely. The plaintiffs moved for reconsideration.

The court denied the motion, again rejecting the plaintiffs' argument regarding "relation back" because the plaintiffs had failed to raise any new issues that they did not or could not have made in their opposition to the motion to dismiss. The court found that it did not commit "clear error" by ignoring the plaintiffs' second claim, which asserted "scheme liability" under Rules 10b-5(a) and (c), because (i) it was an entirely new argument that was not made in response to the defendants' motion to dismiss; and (ii) "scheme liability"—which generally applies to "deceptive conduct rather than deceptive statements"—was inapposite to the facts of this case.

Scienter

Second Circuit Vacates and Remands Dismissal for Reconsideration of Scienter Pleading

In re Hain Celestial Grp., Inc. Sec. Litig., Docket No. 20-1517 (2d Cir. Dec. 17, 2021)

The Second Circuit vacated and remanded a lower court's dismissal of a securities fraud claim against a health food company and four former or present officers. The complaint alleged violations of § § 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder arising from public statements that the company's growth was attributable to increased demand for the company's products, when demand was actually shrinking and sales were maintained through "channel stuffing" ("offering large and unsustainable incentives such as price reductions and an absolute right to return unsold products"). The complaint alleged that the defendants failed to disclose the channel stuffing and how it artificially inflated sales figures, such that when

the practice was finally revealed through a series of disclosures—including the company's announcement of an internal investigation into its historical financial results and an SEC investigation—the company's stock price fell. The complaint also alleged that the channel stuffing amounted to a scheme to defraud investors. The lower court dismissed the complaint for failure to allege scheme liability for a violation of Rule 10b-5(a) and (c) and to adequately allege scienter for a violation of Rule 10b-5(b).

The Second Circuit reversed the dismissal because the lower court failed to consider whether the complaint adequately alleged that Rule 10b-5(b) had been violated. The lower court had reasoned that because the channel stuffing practices were not wrongful, there could be no violation of clause (b), as "it would be incongruous for the court to have concluded that it was done with a wrongful state of mind." The Second Circuit found that the lower court erred by failing to assess the "total weight of the circumstantial allegations together with the allegations of motive and opportunity" in considering whether scienter had been adequately pled. The Second Circuit therefore remanded the case for the lower court to consider whether scienter had been adequately pled.

Second Circuit Upholds Dismissal of Securities Fraud Claim for Failure To Plead Scienter

Lehmann v. Ohr Pharm., Inc., No. 20-4185-cv (2d Cir. Dec. 16, 2021)

In a summary order, the Second Circuit affirmed the dismissal of claims brought by a putative class of investors against a pharmaceutical company and certain of its officers under § § 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder, alleging that the defendants made misleading statements about clinical trial results involving the company's experimental drug Squalamine. The clinical trial evaluated whether Squalamine, combined with another drug already approved by the Food and Drug Administration (FDA), Lucentis, would treat "wet" age-related muscular degeneration better than Lucentis alone. These claims had been previously dismissed by the district court in *Lehmann v. Ohr Pharm. Inc.*, 18 Civ. 1284 (LAP), 2019 WL 4572765 (S.D.N.Y., Sep. 20, 2019). The Second Circuit had then affirmed that dismissal and remanded the case to the district court to determine whether to grant leave to file a second amended complaint in *Lehmann v. Ohr Pharm., Inc.*, 830 F. App'x 349 (2d Cir. 2020). On remand, the plaintiffs filed a series of letters, which the district court judge construed collectively as a motion for leave to amend and denied, dismissing the claims for a second time. The plaintiffs appealed, raising procedural and substantive arguments.

The Second Circuit rejected the plaintiffs' procedural argument that the district court had improperly construed its pre-motion letters as a motion for leave to amend. The Second Circuit held that as long as a plaintiff's letters are "sufficiently detailed" and the plaintiff is given the opportunity to respond to a defendant's counterarguments, a district court does not abuse its discretion for construing the letters as a motion. The Second Circuit also rejected the plaintiffs' argument that the district court had improperly determined that any amendment would be futile, ruling that the plaintiffs failed to allege that the defendants "were at least as likely as not" to have acted with scienter. The Second Circuit rejected the plaintiffs' argument that the defendants were reckless in touting the efficacy of Squalamine when they knew that the reliability of the study's control variable (i.e., with Lucentis alone) was uncertain and inconsistent with previous Lucentis-only studies. The Second Circuit determined that, while the plaintiffs interpreted prior studies of Lucentis as inconsistent with the control study, they did not allege any facts suggesting that the defendants "reached or should have reached" the same conclusion. The Second Circuit noted that the plaintiffs failed to point to any reports concluding that previous Lucentis studies had results "inconsistent with or better" than those provided in the defendants' clinical trial and determined that the plaintiffs had failed to adequately allege scienter.

Second Circuit Affirms Dismissal of Proposed Class Action Claiming Pharmaceutical Company Misrepresented FDA Feedback on New Drug

In re Alkermes Pub. Ltd. Sec. Litig., 21-801-cv (2d Cir. Dec. 7, 2021)

A Second Circuit panel affirmed the dismissal of a class action lawsuit brought by a putative class of investors against a pharmaceutical company and several of its officers. The complaint alleged that the defendants violated § § 10(b) and 20(a) of the Exchange Act by misrepresenting feedback that the company had received from the FDA on the company's new drug and its clinical trial protocols. The complaint alleged that because of those misrepresentations, investors were surprised when the FDA publicly disclosed its concerns and the FDA advisory committee voted against approving the drug. The district court dismissed the complaint for failing to sufficiently plead scienter.

On appeal, the Second Circuit agreed with the district court's finding that the allegations in the amended complaint did not give rise to a strong inference of recklessness, and thus the amended complaint had failed to plead scienter. Specifically, the Second Circuit determined that the defendants' public disclosures did not mischaracterize the FDA's rejection of the company's novel approach to providing evidence of efficacy for a new drug in its Phase 3 clinical trial design. The panel credited several correspondences between the company and the FDA and other public disclosures regarding the company's novel approach, and the risk of FDA inflexibility in accepting the new design. The panel held that this evidence, far from raising a strong inference of scienter, instead supported the more cogent nonfraudulent inference that the defendants were optimistic about the FDA's review.

The Second Circuit also rejected the plaintiffs' argument that the defendants' omission of the FDA's comments that it "did not agree" with the use of "averaging" to prove the drug's efficacy gave rise to a strong inference of recklessness. Instead, the panel held that the company had appropriately disclosed it would give the FDA "all the data available for . . . review" so the FDA could "analyze the data however they choose." Finally, the Second Circuit rejected the plaintiffs' argument that the company had mischaracterized the FDA's objection to the company's use of post hoc data to show efficacy. The panel determined that because the FDA has publicly declared post hoc analysis to be merely "exploratory," and since the company's public disclosures concerning post hoc analyses were consistent with that, investors understood that those results were less significant.

Fourth Circuit Affirms Dismissal of Shareholder Suit Against Information Technology Company for Failure To Adequately Plead Scienter

KBC Asset Mgmt. NV v. DXC Tech. Co., 19 F.4th 601 (4th Cir. 2021)

Plaintiffs KBC Asset Management NV, Arbejdsmarkedets Tillaegspension and the City of Warren Police and Fire Retirement System appealed the dismissal of their class action suit against defendants DXC Technology Company (DXC) and two of its executives under § § 10(b) and 20(a) of the Exchange Act and Rule 10b-5 thereunder.

The plaintiffs alleged that they bought DXC shares at an inflated price after the defendants made false and misleading statements concerning DXC's financial health. DXC released a press statement on February 8, 2018, announcing positive financial results. Months later, on November 6, 2018, the company decreased its projected revenue guidance to shareholders by approximately $800 million. The plaintiffs, who bought DXC shares between the February announcement and November revision, alleged that the defendants knew that cost-cutting measures implemented in 2018 undermined the company's ability to generate revenue, but they omitted or mispresented this information. The plaintiffs filed a complaint based on these allegations and the district court dismissed the complaint, holding that the plaintiffs failed to allege the defendants' statements were actionable or that the defendants acted with scienter. The plaintiffs appealed.

The Fourth Circuit affirmed the district court's dismissal, evaluating in turn the different categories of statements challenged by the plaintiffs and ruling that they had failed to allege facts supporting a strong inference of scienter. With respect to allegations a former company executive made in a separate lawsuit that they had warned DXC that cutting costs would harm customer satisfaction, the court found these allegations represented mere business disagreements over an action the former employee was asked to carry out, rather than knowledge amounting to scienter.

With respect to statements of unnamed former company employees who allegedly believed DXC was heading in the wrong direction before and during the class period, the court concluded that the statements were vague and conclusory, and otherwise failed to demonstrate that the witnesses passed their concerns on to the defendants. The court also found that even if the former employees were ultimately correct that the defendants made "unwise business decisions," such mistakes could not support a strong inference of scienter.

The court also concluded that alleged stock sales by the executive defendants during the class period did not sufficiently demonstrate scienter. The court concluded that one executive's stock sales were not large enough to raise a strong inference of scienter, and the other executive's sales were substantially smaller than the amount of stock he sold during a control period where he was not alleged to have engaged in wrongdoing. In light of these mitigating circumstances, the court did not draw a strong inference of scienter.

Regarding the plaintiffs' asserted "core-operations theory," the court ruled that the theory had not been sufficiently presented and lacked specific facts demonstrating the defendants' knowledge of problems within the company. Finally, with respect to the temporal proximity between DXC's positive statements and its ultimate disclosures of revised revenue guidance (allegedly less than three months), the court stated that temporal proximity alone could not support a strong inference of scienter. The court asserted that the plaintiffs, in effect, were improperly attempting to plead fraud by hindsight.

The court also found other mitigating factors existed, effectively weakening the plaintiffs' ability to allege scienter, including (i) the plaintiffs' own allegations offered an innocent and plausible explanation of DXC's financial struggles; and (ii) the defendants previously announced risks and newly discovered weaknesses to investors in a timely manner. After evaluating these factors in conjunction with the plaintiffs' allegations, the court held that the plaintiffs had failed to satisfy the PSLRA's heightened burden for pleading scienter.

SPAC Litigation

Court of Chancery Denies Motion To Dismiss in Novel Application of Fiduciary Duty Principles in SPAC Context

In re MultiPlan Corp. S'holders Litig., C.A. No. 2021-0300-LWW (Del. Ch. Jan. 3, 2022)

Vice Chancellor Lori W. Will denied motions to dismiss claims for breach of fiduciary duty against a special purpose acquisition company's (SPAC) sponsor and its directors, as well as for aiding and abetting breach of fiduciary duty against its financial advisor.

Churchill was a SPAC founded and controlled by Michael Klein through a sponsor entity (the Sponsor). According to the plaintiffs, the SPAC's directors were allegedly hand-picked by Mr. Klein and given economic interests in the Sponsor. Churchill's 2020 IPO was priced at $10 per unit, consisting of one share of Class A stock and a quarter of a warrant. After the IPO, Churchill's equity structure consisted of Class A shares held by public stockholders and Class B "founder" shares purchased by the Sponsor for a nominal capital contribution and convertible to Class A shares if the SPAC closed a transaction. The Class A and Class B shares represented 80% and 20% of the SPAC's outstanding equity, respectively. In the event that a transaction was not accomplished within 24 months, the SPAC would liquidate, and Class A shareholders would receive their pro rata share of the amount from the IPO plus interest, equal to $10.04. In contrast, the Sponsor's Class B shares would expire absent a deal. The warrants held by both Class A and Class B stockholders would also expire without a deal. However, if the SPAC proposed a business combination, Class A stockholders could choose to exercise a redemption right for their Class A shares for $10.04 and would retain their warrants, regardless of whether they voted in favor of the deal.

The SPAC identified MultiPlan as its acquisition target and retained The Klein Group LLC, an entity controlled by Mr. Klein, as its financial advisor. The SPAC did not obtain an independent third-party valuation of MultiPlan or a fairness opinion. The merger proxy statement sought stockholder approval and also informed Class A stockholders about their ability to redeem their shares. Stockholders overwhelmingly approved the deal. After the merger closed, the newly public MultiPlan's stock dropped significantly based on a report from an equity research firm about MultiPlan's largest customer forming a competitor entity, which was not disclosed in the proxy. The complaint followed, asserting class claims for breach of fiduciary duty against the SPAC directors, Mr. Klein, the SPAC's chief financial officer, and The Klein Group.

The court concluded that the entire fairness standard of review applied for two reasons. First, the court held that it was reasonably conceivable that the de-SPAC (a merger of the target company with the SPAC) was a conflicted controller transaction. The parties agreed that Mr. Klein—through the Sponsor—controlled the SPAC, and the court concluded that "[t]he well-pleaded allegations in the Complaint highlight a benefit unique to Klein," emphasizing that on the date the merger closed, the Sponsor's investment was worth $356 million—"representing a 1,219,900% gain on the Sponsor's $25,000 investment." However, "[t]hese figures would have dropped to zero absent a deal." In contrast, Class A stockholders would have received $10.04 per share if the SPAC failed to consummate a transaction and liquidated, or if they had redeemed their shares. Thus, the court concluded that there was a "potential conflict between Klein [and the Sponsor] and public [Class A] stockholders resulting from their different incentives in a bad deal versus no deal" at all.

Second, the court held that there were reasonably conceivable allegations that the SPAC board was conflicted because the SPAC's directors, through their economic interests in the Sponsor, "would benefit from virtually any merger—even one that was value diminishing for Class A stockholders—because a merger would convert their otherwise valueless interests in Class B shares into shares of Public MultiPlan." The court also held that the complaint adequately pled that a majority of the board was conflicted because its members were not independent from Mr. Klein.

The court then held plaintiffs pleaded that the proxy contained false and misleading disclosures with sufficient particularity to survive a motion to dismiss. The proxy allegedly "did not disclose that MultiPlan's largest customer was UHC and that UHC was developing an in-house alternative to MultiPlan that would both eliminate its need for MultiPlan's services and compete with MultiPlan . . . Based on the plaintiffs' allegations, it is reasonably conceivable that a Class A stockholder would have been substantially likely to find this information important when deciding whether to redeem her Churchill shares."

Finally, the court held that the complaint alleged nonexculpated claims for breach of fiduciary duty against the SPAC's directors "because the Complaint alleges that the director defendants failed, disloyally, to disclose information necessary for the plaintiffs to knowledgably exercise their redemption rights." The court also sustained claims against Mr. Klein in his capacity as the SPAC's controlling stockholder and as CEO of the SPAC. However, the court dismissed claims against the SPAC's CFO. The court also sustained an aiding and abetting allegation against The Klein Group.

Standing

Northern District of California Denies Motion To Dismiss, Clarifies Shareholder Standing as Forced Seller

Quinan v. Kleinberg, Case No. 21-cv-05295-JCS (N.D. Cal. Nov. 26, 2021)

Judge Joseph C. Spero denied a motion to dismiss, holding that a shareholder whose shares were forcibly liquidated in a reverse stock split had standing to bring claims under Rule 10b-5, despite not being a bona fide purchaser or seller of securities who based his purchase or sale on alleged fraudulent activity.

This case involved a company with five shareholders, three of whom were directors and the defendants in this case. Two of the directors wanted to buy out the other three shareholders and reached an agreement to purchase the shares owned by one of the nondirector shareholders. Then they engaged in negotiations to buy out the third director. The defendants commissioned Stonebridge Adviso-

ry Inc. to value the company for "partner buyout purposes" and claimed to use this valuation to determine an offer price to buy the shares of the one remaining nondirector shareholder, who is the plaintiff in the case. The plaintiff refused the purchasing defendants' offer to buy his 50,000 shares. When he refused, the defendants allegedly decided to forcibly purchase the plaintiff's shares through a reverse stock split, which would be put to a shareholder vote. Under the terms of the 1:75,000 stock split, shareholders would receive one share of the company's newly issued stock for every 75,000 shares that they owned. Importantly, all fractional shares would be liquidated. Thus, the plaintiff would own only two-thirds of a share of the newly issued stock, and his fractional share would therefore be liquidated. The defendants, who owned a majority of the shares, voted in favor of the reverse stock split.

The plaintiff sued, alleging that the defendants justified the reverse split on the basis of a valuation that they knew to be inaccurate, using much lower estimates of the company's value to negotiate the buyout price. The plaintiff brought securities fraud claims under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, alleging that the defendants made misleading statements in connection with the company's purchase of the plaintiff's shares.

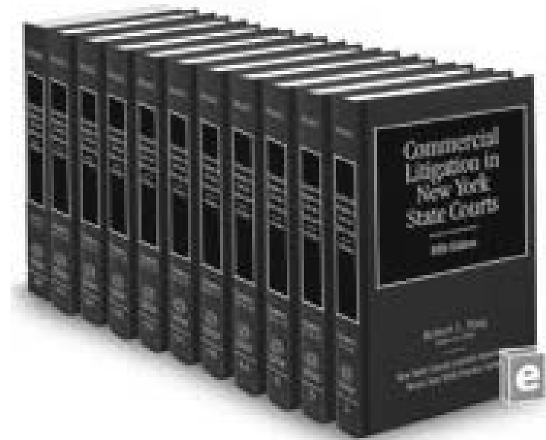
The defendants moved to dismiss, arguing that the plaintiff lacked standing under Rule 10b-5 because he was not a bona fide purchaser or seller of shares who based his purchase or sale on alleged fraudulent activity. The district court rejected that argument, finding that the plaintiff had standing based on the forced seller doctrine.

Under the forced seller doctrine, a shareholder plaintiff has standing if he or she was forced "as a matter of law to sell" their shares, or forced to fundamentally change the nature of their investment as a result of a fraudulent scheme. Here, the court found that the plaintiff had standing under the forced seller doctrine because the defendants' vote on a reverse split meant that the plaintiff could not continue to hold his shares, which were involuntarily liquidated.

The court also rejected the defendants' argument that the forced seller doctrine did not apply because the plaintiff "had plenty of opportunity to make decisions regarding his investment." The court noted that the defendants failed to cite any authority that a rejection of a previous offer to purchase shares made a subsequent liquidation of his shares volitional. The court similarly found unpersuasive the defendants' arguments that the plaintiff's failure to attend the shareholder meeting where the reverse split vote occurred, or his failure to cash the check that was sent to him when his shares were liquidated, prevented the plaintiff from invoking the forced seller doctrine. The court concluded that the doctrine was available because the plaintiff was required, as a matter of law, to sell his shares as a result of the defendants' allegedly fraudulent scheme.

Book Review
Commercial Litigation in New York State Courts 5th Edition, by Robert L. Haig

Reviewed by Samuel F. Abernethy and Ted G. Semaya



Robert L. Haig has done it again with the fifth edition of *Commercial Litigation in New York State Courts*, published in October 2020. Increasing the deeply talented bench of jurists and practitioners to a corps of 256 principal authors, Haig & co. have vastly expanded the work to 10 volumes, including 28 new chapters.

This is a very different animal from its forebears, although its evolution has been consistent and relentless. Haig, a litigation partner at Kelley Drye & Warren, with numerous positions and honors, is the chair of the Commercial Litigation Advisory Council, being one of the architects of the Commercial Division of the New York State Supreme Court. The three-volume 1995 debut edition of the treatise was the first step-by-step "how-to" book for litigators in New York State courts and became indispensable for a generation of litigators.

The fifth edition maintains those distinctions, but it has become much more, and for many more members of the bar than litigators. It remains a uniquely useful guide into areas with which practitioners are not familiar, not least due to its frequent integration of the discussion of substantive law with procedure. Add the yet broader scope of business subjects and analyses of objectives, options, and strategies from different perspectives and you have a tool not only helpful to litigators but equally useful to business law practitioners.

The core of the treatise (the first 66 chapters) remains a description of the rules and procedures and advice on the practice of commercial litigation for the life of a case from pleading preparation, through trial, appeal, settlement, and judgment enforcement. It is a detailed, practical guide for litigators and the lawyers who work with them.

There is much in these chapters for the business lawyer, whose partnership with the litigator in charting litigation strategy cannot be overstated. For example, whether considering a claim or responding to one or to a regulatory inquiry, the client's business lawyer is the first on the scene, and the chapter on the investigation of the case ably covers the basics, such as protecting privilege. Similarly, as to drafting contract dispute resolution clauses and advising clients on where to file suit, the fifth edition adds Delaware and foreign courts to its previous comparison of New York with federal courts. These chapters are sufficiently detailed and annotated for a litigator but provide clear comparisons and strategic considerations for the non-litigator.

The comparison with foreign courts includes England and Wales, Australia, France, Germany, and Russia. It continues the series' recognition that New York courts are in global competition for dispute resolution work with foreign courts and with private dispute resolution services. It thus helps to educate the increasing cadre of consumers of such services in company general counsel and litigation departments and in law firms. In this connection, added to its previous chapters on suing or representing foreign corporations in New York state courts and international arbitration, is the comparison with foreign courts as well as a chapter on cross-border litigation. While no substitute for international litigation and dispute resolution practice materials, the set alerts the reader to important issues and provides references for further study.

Next in the set one finds chapters covering litigation avoidance and alternatives including negotiation, mediation and other nonbinding ADR, arbitration, including international arbitration, and even business matters surrounding litigation decisions such as crisis and public relations management. Then the treatise moves into an expanded treatment of litigation management subjects including techniques for expediting and streamlining litigation, litigation management by judges (new), corporations and law firms and the litigation finance and technology subjects of third-party litigation funding (new), litigation technology and artificial intelligence (new).

Haig adds chapters on subjects acknowledged to be unconventional for a conventional litigation treatise but which he views as important to commercial litigators regarding the "business" of litigation practice and professional growth and development of commercial litigators. These chapters include marketing to potential business clients, teaching litigation skills, career and practice development, and diversity and inclusion. They are filled with

sound advice, some new and some tried and true. These chapters are well written and surprisingly comprehensive (if duplicative from time to time) and include practical advice.

Sixty-four of the 68 next and final chapters housed in more than four volumes cover a wide array of substantive law matters. This is a gold mine for the business lawyer. The subjects include those you would expect, such as contracts, sale of goods, insurance, banking, and M&A, but also such industry-specific titles as sports, energy, not-for-profit institutions, health care institutions, e-commerce and social media. Among the new chapters are those on private equity, gaming, joint ventures, limited liability companies, valuation of a business and valuation of real property.

To take an example, the securities litigation chapter begins with an overview of the types of securities litigation and pleading considerations for plaintiffs and defendants, given the federal statutory scheme strongly favoring federal jurisdiction. In an illustration of the care given to the coordination of related subjects in the treatise, the chapter first advises that two of the four types of securities litigation are treated in the separate chapters on, respectively, shareholder derivative actions and broker-dealer litigation and arbitration. The chapter discusses federal jurisdiction, preemption, and removal of class actions, state statutory claims, and claims by large and sophisticated investors. While a full examination of all the involved issues is beyond the scope of the chapter, it is a good introduction and overview, reasonably annotated and ends with a useful checklist.

Commercial litigators, business lawyers, in-house counsel, and lawyers of nearly every other stripe will continue to learn new areas, find procedural and substantive practical roadmaps and tips and references for further guidance related to all things which touch commercial litigation in New York State courts and beyond. The fifth edition is available hardbound from Thomson Reuters, which publishes it in a unique joint venture with the New York County Lawyers Association, and digitally on the Westlaw online legal research platform.

Samuel F. Abernethy is a retired counsel with the firm of Offit Kurman. He is a past chair of the NYSBA Electronic Communications Committee and of the Business Law Section and a past member of the NYSBA Executive Committee.

Ted G. Semaya is a principal with Offit Kurman, where he focuses on complex and international business litigation. He is a past chair of the International Litigation Committee of the NYSBA Commercial and Federal Litigation Section.

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Committee Reports

Banking Law

No report received.

Scott E. Wortman, Chair

Bankruptcy Law

It is our privilege to announce that George P. Angelich, a partner in the bankruptcy and financial restructuring practice at Arent Fox LLP in New York, NY, has been designated to assume the chair of the Bankruptcy Law Committee of the Business Law Section of the New York State Bar Association.

George represents debtors, committees of unsecured creditors, secured creditors, and lenders in bankruptcy reorganization and liquidation proceedings, and, among his many other accomplishments, is the editor of the American Bankruptcy Institute's textbook entitled *Retail and Office Bankruptcy Landlord/Tenant Rights*. In addition, George has participated as a panelist in a number of CLE programs presented by this committee over the past two years, which are available for viewing on demand on the NYSBA website:

Bankruptcy Practice and Procedure During the Covid-19 Pandemic (05/20/2020)

Defending Preferential Transfer Cases (Webinar) (8/10/2020)

Time Bombs in Bankruptcy (Traps for the Unwary) (10/22/2020)

Forensic Accounting and Valuation Tools (11-17-2020)

Bankruptcy and Virtual Lawyering (12-10-2020)

Saving Small Businesses, Subchapter V – A Lifeline & Toolkit (4/16/2021 and 04/23/2021)

Business Bankruptcy Basics Program, Parts I & II (6/25/2021 and 6/28/2021)

Introduction to Distressed Company M&A – Bankruptcy Code 363 Sales (10/7/2021)

We invite those of you who either are or wish to become NYSBA members and who wish to participate in Bankruptcy Committee meetings and CLE programs to provide us with your current complete contact information so that we can keep you apprised of future committee meetings and events and encourage you to participate in formulating agendas and CLE programs.

Mark B. Brenner, Chair

Business Organizations Law

We have commented upon and issued a statement supporting legislation repealing the publication requirements of the New York Limited Liability Company Law and held three CLEs on business law topics. In the coming year, we will continue to advocate for the repeal of the publication requirement, and apprise the EC of developments, hold CLEs on business law issues and solicit articles on topics of interest to business attorneys, owners and executives.

Stephen L. Brodsky, Chair

Derivatives and Structured Products

No report received.

David Lucking, Chair

Diversity (Special Subcommittee)

No report received.

Taa Grays, Chair

Energy and Climate

No report received.

Paul Ghosh-Roy, Chair

ESG

The ESG Committee participated in the annual fall meeting of the Business Law Section in October 2021 and assisted in organizing a panel on "Corporate Purpose: Stakeholder vs. Shareholder Primacy in Business Law Today." The panel was moderated by Robert Mascola, an ESG committee member and, at the time of the event, a Senior Director of the Program on Corporate Ethics and Compliance at Fordham University School of Law. The ESG Committee also participated in the annual winter meeting of the Business Law Section in January 2022. David Curran, the co-chair of the ESG Committee, moderated a panel entitled "Where Does New York Stand in the Competition Among States and Regions for Business."

The ESG Committee has scheduled two programs for early summer 2022. The first program will focus on the new "SEC Proposed Rule on Climate-Related Disclosures" and the second on the use of "Data Science for Measuring Impact and Conducting Successful Engagements with Portfolio Companies."

Linda K. Smith, Co-Chair

Franchise, Distribution and Licensing Law

No report received.

Breton H. Permesly, Chair

Insurance Law

No report received.

Sanjiv Tata, Chair

Legislative Affairs

The Legislative Affairs Committee works with the NYSBA Governmental Relations Department to monitor legislative activity of interest to the Section, and works with Section leadership and other Section committees in preparing comments on pending legislation and proposals for new legislation. We have also provided testimony to legislative committees. Bills supported by the Section are regularly enacted. The Section is an important voice in business law legislative activity in this state.

Michael A. deFreitas, Chair

Membership

No report received.

Jessica Thaler Parker, Chair

Mergers and Acquisitions

The Mergers and Acquisitions Committee has had a busy and successful start to 2022. On Feb. 25, Chairman David Lallouz, Head of M&A and Chief Legal Officer of Bruderman & Co., moderated a CLE on M&A Trends 2021-22, presented by Dennis O'Rourke and Tina Kassangana of Morritt Hock & Hamroff LLP and Matthew Hull, Managing Director at Bruderman. The presentation focused on legal developments, practice developments and market trends on the heels of COVID's impact on valuations and risk, and other rapidly moving market forces.

On May 12, Mr. Lallouz moderated a mock negotiation of a middle market private equity acquisition, presented by Finn Dixon & Herling LLP partners Neil Ruben and Austin Pendelton, covering the lifespan of a transaction from LOI to closing.

Committee leadership looks forward to providing frequent exciting content for NYSBA members throughout the year.

David Lallouz, Chair

Not-for-Profit Corporations Law

No report received.

David A. Goldstein, Chair

Securities Regulation

The Securities Regulation Committee has maintained an active schedule of meetings, focusing on recent regulatory priorities and other matters of timely interest. Below is a list of the programs held to date in 2022; additional programs are being scheduled for later in the year.

2022 Meetings

- March 2: Securities Enforcement Update https://nysba.org/events/securities-enforcement-update/
- March 24: Cross-Border Regulatory Priorities https://nysba.org/events/cross-border-regulatory-priorities/
- May 11 and 12: Recent SEC Rulemaking Initiatives, Part I and Part II
- May 11 - Part I: Implementation of the Marketing Rule and Cyber-security Proposal
- May 12 - Part II: Form PF Amendment and Private Fund Adviser Proposals

Tram N. Nguyen, Chair

Wine, Beer and Spirits Law

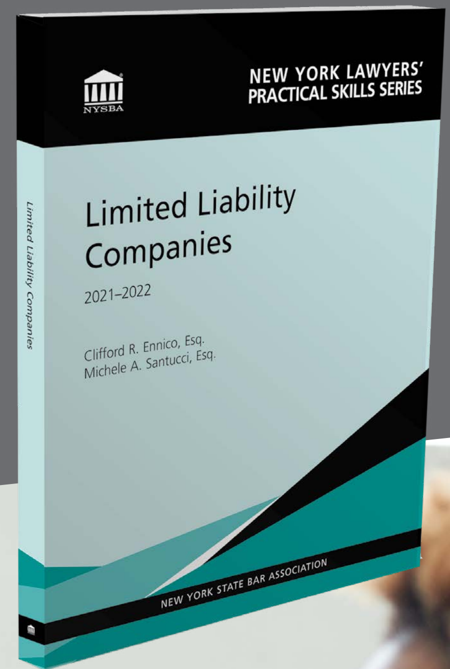
The Wine Beer and Spirits Law Committee had an auspicious beginning in January 2020, when we combined a continuing legal education program on SCOTUS decisions on interstate alcohol shipments with what we refer to as a "product tasting." It was our intention to continue with quarterly meetings that combined a one-hour CLE program with a one-hour social program involving networking and the use of the products that are the subject of our committee. Unfortunately, COVID intervened and although we have had two remote meetings since then, one involving a wine tasting led by a winemaker in California and the other involving a beer tasting led by a brand representative from the Ommegang brewery in Cooperstown, our ability to engage in face-to-face networking has been severely restricted.

We are starting to see the light at the end of the tunnel and we hope to resume active meetings toward the end of this year. We have an open-door membership policy, so any member of the Business Law Section can join. We welcome you even if your practice does not focus on some of the complex or arcane issues raised by 50 states' worth of alcohol regulation and clashes with the federal Commerce Clause, made more complicated by the anti-preemption provision of the 21st Amendment. If you have friends who want to join, but are not members of the Section, they can join the Section for the extremely low Section dues and then join the committee at no additional cost. To join, email me at jlh@gdblaw.com.

Jay L. Hack, Chair

PUBLICATIONS

Limited Liability Companies



Authors:
Clifford R. Ennico, Esq.
Michele A. Santucci, Esq.

This practical title provides guidance on the formation of limited liability companies, including issues specific to the naming of LLCs, the contents of organization and publication, along with coverage of the tax implications, and the differences between the New York and Delaware Limited Liability Company Laws. Also covered are management matters and member interests, the operating agreement, dissolution, mergers and consolidations, and more.

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