HeadNotes

As our Winter 2018 issue went to press, we noted that the markets were being roiled by uncertainty over whether the latest saber-rattling between China and the Trump Administration was, or was not, the precursor to a full-fledged trade war. As this issue goes to press, the chatter on cable news and the press again is heavily focused on the latest retaliation by China for tariffs imposed by the Administration. The more things change . . .

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

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

David L. Glass

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

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

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

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

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

Another welcome change is in the offing in the bank regulatory world. In "Financial Stability Oversight Council Seeks to Change How It Determines Systemic Risk," Kathleen Scott explains how the Council (FSOC) is proposing to take a completely new approach to systemic risk, by focusing on activities that pose risk to the financial system rather than focusing on individual non-bank companies. The FSOC, created as a kind of super-regulator under the Dodd-Frank Act that responded to the global financial crisis, is chaired by the Secretary of the Treasury and includes the heads of all the financial regulatory agencies. Among other things, under Dodd-Frank, it has the power to designate large non-bank financial companies as "systemically important financial companies (SIFIs)" which would then be regulated as bank holding companies by the Federal Reserve. Ms. Scott shows why this approach has failed to achieve the intended result of reducing systemic risk and describes how the proposed new approach would work. Along the way, she provides a very useful primer on the background and genesis of the FSOC itself. A senior counsel with Norton Rose Fulbright in New York, Ms. Scott is a past Chair of the Business Law Section and of its Banking Law Committee.

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

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

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

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

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

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

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

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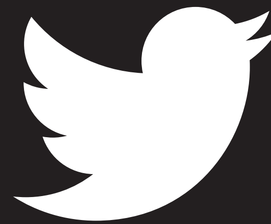

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