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# Day Pitney New York News

## *Sexy Startup Seeks Accredited Investor for Potential Long-Term Relationship*

Article by Eliza Sporn Fromberg

*About me: the new kid on the block. Mysterious, exciting and risky. I could be the best thing that ever happened to you, or you may rue the day we met. I'm warning you?-- once I've got you in my clutches, you may have a hard time extricating yourself.*

*About you: You're looking for a unique opportunity and you have a net worth of more than $1 million (excluding the value of your primary residence) or an annual income exceeding $200,000 for each of the past two years -- and the documents to prove it. Don't be surprised if I ask for your tax returns or brokerage statements or a letter from your investment adviser. And no, I won't take your word for it!*

Now that the Securities and Exchange Commission (SEC) has lifted an 80-year-old ban on general solicitation and advertising of private securities offerings, are we going to witness the proliferation of "matchmaking" websites designed to introduce companies seeking capital to Mr./Ms. Moneybags? Will "accredited investors" be able to gorge themselves on a smorgasbord of previously inaccessible private offerings? Will startup companies be able to raise money simply by creating flashy websites and inundating potential investors with tweets? One thing is certain: The much-anticipated amendments to Rule 506 of Regulation D of the Securities Act of 1933 will fundamentally change the market for private offerings.

To understand the potential magnitude of these new rules, a little background on how private sales of securities have been conducted to date is helpful. Companies seeking to sell their securities in the United States are generally required to either register the securities with the SEC or rely on an exemption from registration. Because registration is both expensive and time-consuming, many securities offerings are structured as "private placements," which are exempted from registration. The most commonly used private placement exemption is Rule 506 of Regulation D. Before the new rules went into effect on September 23, companies seeking to employ the Rule 506 exemption were prohibited from offering or selling securities through any form of "general solicitation or general advertising." Private offerings could not be publicized through newspapers or magazine advertisements, on the television or radio, via the Internet or social media, or even at seminars or meetings whose attendees had been invited by a general solicitation or general advertising.

In order to ensure that offerings fell within the safe harbor provisions of Rule 506, companies raised money quietly, by marketing only to investors with whom the company or its representative (such as an investment bank or placement agent) had a pre-existing relationship. This practice significantly limited the pool of potential investors and made private offerings truly "private."

The prohibition on general solicitation has long been perceived as an obstacle to capital raising and in the age of the Internet seems somewhat antiquated. The SEC's new rule, 506(c), permits an issuer to engage in general solicitation or general advertising in connection with an offer and sale of securities under Rule 506 if all purchasers qualify as "accredited investors" under SEC rules. (For a definition of "accredited investor," see the description in italics above.) The issuer must take "reasonable steps to verify" that all purchasers of the offered securities are accredited investors. The rule does not specify uniform verification methods to determine whether a potential investor is an accredited investor, but the adopting release included a nonexclusive list of methods that will be deemed to constitute reasonable steps. Having an investor check a box on a questionnaire is not a sufficient verification method. Even if all purchasers are, in fact, accredited investors, if the issuer has not taken steps to verify the investors' status, the issuer cannot claim the exemption. This purchaser verification process may be difficult for certain issuers, as it requires a time-consuming and costly facts and circumstances analysis and some investors may balk at providing the types of personal financial information (IRS forms, bank statements, credit agency reports) that issuers may need to conduct the analysis.

So can we expect to see ads for private placements on late-night infomercials? Will we receive e-mails describing private investment opportunities that are the "perfect match" for us? Not so fast. We're unlikely to see a flurry of solicitations any time soon, because at the same time the SEC voted to repeal the general solicitation ban, it proposed new disclosure rules pertaining to general solicitation offerings. The proposed rules require issuers availing themselves of the general solicitation rules to file a form with the SEC (Form D) 15 days prior to the first general solicitation and to file a second Form D with the SEC within 30 days after the completion of the offering. The Form D would disclose additional information about the issuer and the offering. The proposed rules would also require issuers to include certain legends and disclosures on all written general solicitation materials and to submit copies of written general solicitation materials to the SEC for a period of two years. Failure to make a Form D filing could result in a loss of the company's ability to conduct a private placement for one year. If implemented in their proposed form, these rules would impose significant new compliance burdens on issuers and may dampen companies' enthusiasm for general solicitation.

Companies seeking capital will need to weigh the burdens of the verification requirement and the proposed rules against the advantages of accessing a larger pool of potential investors. Some issuers may decide to continue to rely on the "old" rule, which is now 506(b). Undoubtedly we'll see the development of web-based platforms that match issuers and accredited investors and provide verification of investors' accredited status. Startups will be able to tweet about investment opportunities -- so long as the legends and disclosures that may be required by the SEC fit within the 140-character limit! Some entrepreneurs may decide that engaging in general solicitation will have a negative effect on their company's image or credibility and decline to take advantage of Rule 506(c). Others may determine that they can raise funds more effectively through targeting pre-existing networks of accredited investors and that competing for investor attention through a general solicitation is a waste of energy. Depending on the outcome of their individual cost-benefit analyses, different issuers will take different approaches. Accredited investors trolling for sexy startups will have more investment opportunities but will be left to wonder whether the "best" prospects are still being offered through private channels. Ultimately, it's the investor who must decide: Are general solicitation offerings lightning in a bottle or only losers desperately seeking a little love?

## *FATCA: The Wave of the Future*

Article by G. Warren Whitaker

FATCA, or the Foreign Account Tax Compliance Act, represents the culmination of several years of U.S. initiatives aimed at uncovering unreported offshore accounts owned by U.S. taxpayers. It was signed into law on March 18, 2010, as part of the HIRE (Hiring Incentives to Restore Employment) Act. FATCA imposes a 30 percent withholding regime on all payments of income from and proceeds of sale of any U.S. security payable to any foreign financial institution that has not entered into an agreement with the IRS to report all worldwide income of its U.S. clients. Non-financial foreign entities are also required to disclose U.S. persons with more than 10 percent beneficial ownership of the entity or face withholding.

When this law was initially enacted, an informed survey of non-U.S. people in the financial industry found that most of them adhered to one of two very different schools of thought regarding FATCA. Many talked about the great incentive foreigners would now have to invest in totally non-U.S. portfolios and thought FATCA would discourage foreign investment in the United States. They envisioned the emergence of institutions that would invest only outside the United States and would not comply with any U.S. requirements and believed foreign investors would flock to these institutions. In fact, the now-defunct Wegelin Bank in Switzerland announced it would become the first such institution. In addition, these people believed foreign governments would resent the high-handed imposition of FATCA on the rest of the world and would jointly create an alternative market comprising only non-U.S. securities. Ultimately, it was thought, the United States would admit defeat and the imposition of FATCA would be repeatedly deferred until it was finally repealed.

The second point of view, not as widely held at the outset, was that FATCA represented the wave of the future. Instead of imposing its will on the rest of the world by fiat backed by economic might, the United States was merely leading the charge in an action that most other developed countries supported and within a few years they would happily clamber on board by cooperating with the United States and enacting similar legislation to cover their own securities and taxpayers. The end result would be an interlocking series of automatic exchange-of-information agreements resulting in a worldwide reporting system.

Three years later, it is clear the adherents of the second viewpoint were correct. FATCA has not gone away. Western European countries did voice some initial concerns about FATCA, but they did not band together to offer an alternative for global investment. Instead, they asked the United States to make certain modest changes so that the FATCA regime could fit within their national regulatory systems. The United States complied by proposing a series of intergovernmental agreements that modify the operation of FATCA while maintaining its basic thrust: the reporting by non-U.S. institutions to the United States of all U.S. owners of foreign accounts.

Meanwhile, within the United States, FATCA did not cause major ripples, because the whole intent of the law was to push the burden of U.S. tax enforcement onto non-U.S. institutions. Today, FATCA is finally receiving attention in the United States as U.S. institutions address the complex withholding rules they must follow whenever they make payment to a foreign institution or entity.

In the most recent development, as stories of undisclosed foreign accounts have made headlines across Europe, the United Kingdom and other EU countries have praised FATCA and proposed "mini-FATCAs" for their countries that would provide for automatic sharing of information.

While we are not yet at the point whereby a client who opens a financial account anywhere in the world must provide a global identification number so the data can be automatically shared with every relevant taxing jurisdiction, we are clearly headed in that direction.

The new era in financial regulation ushered in by FATCA (perhaps to be known to future historians as "the Age of FATCA") will lead to a number of changes in the international private banking world. These include:

- **Compliance:** There will be a greater need for accountants around the world who can prepare accurate tax returns disclosing worldwide income, and for lawyers who can interpret the myriad international rules about taxation and disclosure. There will also be a need for technicians within institutions who can set up systems to provide compliant disclosure to their account holders.
- **Tax Planning:** There remain many opportunities for legitimate, sophisticated multinational tax planning. Those engaged in fully transparent planning for decades used to face shadowy competition in the form of nondisclosure. This will no longer be an option. Of course, legitimate planning requires a high level of expertise, research and keeping up with the latest developments, which will entail professional costs and complex structures.
- **Investment Performance and Fees:** Institutions can no longer charge a substantial fee to offer confidentiality alone. They will have to provide respectable investment performance and will be under pressure to offer competitive fees as well. This may push some to seek very aggressive investment performance, as was seen by the move of certain institutions to Bernard Madoff shortly before his fall. The wiser institutions will focus on consistent, diversified, reliable performance rather than spectacular gains at the cost of high risk.

- **Client Service:** Clients seeking confidentiality did not frequently communicate with their institutions or ask them for services beyond secrecy. Now they will demand more attention and will be less hesitant to change institutions if they do not get it. While investment performance and sophisticated technical advice will be prized, it is often excellent service that keeps clients from moving to another institution. Those institutions that want to retain their clients will seek to offer clients the best service possible.

In the Age of FATCA, new rules will apply. Those who recognize and adhere to them will survive; those who cling to the past will not.

## *Be Prepared for Disaster*

Article by Frank E. Lawatsch, Jr.

An important consideration for companies is the establishment and implementation of corporate preparedness strategies that address emergency events, including natural disasters, terrorist activities and outbreaks of pandemics. For instance, there have been several epidemics across the globe with the potential to become pandemics, such as the bird flu epidemic in China and the respiratory syndrome coronavirus (MERS-CoV) in the Middle Eastern countries that have or potentially could have affected U.S. companies with offices or suppliers in those regions. Experts from the United Nations have calculated that the bird flu outbreak in China, which began in February 2013, has caused about $6.5 billion in losses to the global economy. Such disastrous events raise complex issues for affected companies.

In one particular case in which Day Pitney attorneys assisted a client whose New York office buildings sustained extensive water damage from flooding, the following conditions were present:

1. Slow responses from government agencies
2. Confusion regarding building owners' v. building occupiers' responsibilities
3. Loss of power for months
4. Mold and contamination
5. No coordinated game plan for reaction
6. Absence of drawings
7. Inadequate insurance to cover the post-emergency recovery or clarity on existing insurance coverage
8. No records of pre-existing conditions on impacted buildings

In another New York case, Day Pitney attorneys were tasked with assessing the impact of contamination on a client's building from hazardous substances in the air resulting from building debris, combustion byproducts and emissions from fires. Issues included lack of health-based benchmarks for assessing the risk to human health from exposure to the air pollutants, lack of decision-making tools, and less than adequate or untimely guidance from the governmental or scientific communities on human health risks, background or contamination levels, and remediation standards.

When these types of difficult issues arise, it is extremely helpful to have a well-organized corporate preparedness plan in place.

A company should have in place an emergency preparedness plan and a business continuity plan, as typical emergency plans do not work for many disaster situations. Companies might consider preventive measures, if possible, as well as reactive capabilities.

Each company has substantially different needs that determine how it must prepare for and manage potential terrorist acts and other disasters. A company's industry, infrastructure, concentration of business processes, geographic locations, number and type of facilities, number of employees, and regulatory compliance requirements are important determinants of corporate need. Larger, more complex entities will need to implement more extensive and complex preparedness strategies and capabilities. For example, financial service companies should have more extensive business continuity plans in place, while companies dependent on complex supply chains should be more concerned with the security of suppliers than are the companies less dependent on them. Additionally, companies with critical facilities located in major cities should be more prepared for terrorist activities than those located in more remote areas.

Further, more extensive coordination of risk assessment within an enterprise risk management framework may be necessary for improved resource allocation and efficiency. This is because risk assessment often may be fragmented, as multiple accountabilities and organizational models exist in one company, nomenclature is not standardized, and preparedness functions are not well integrated with senior leadership. Researchers have found that companies that evaluate and mitigate enterprise risk from an overall perspective, and integrate their preparedness functions accordingly, likely will improve preparedness overall. Best practices that could be implemented include threat warning systems, access control, air protection, crisis management, risk assessment, surveillance, employee protection, business continuity, perimeter protection, mailroom and delivery security, communications, and training.

Day Pitney provides corporate preparedness as well as crisis management services. Day Pitney attorneys' experiences include assisting clients in resolving a variety of issues and lawsuits resulting from the September 11 attacks, Hurricane Katrina and Superstorm Sandy. Day Pitney's work in the post-crisis management services area includes:

1. Providing advice on the identification, hiring and retaining of contractors, including negotiating, drafting and executing agreements and work plans.
2. Addressing security and regulatory concerns, including interfacing with state and federal regulators and police.
3. Dealing with environmental concerns, including aiding in the development of a health and safety plan and participating in site visits.
4. Securing endorsements to the client's existing insurance policies and obtaining new policies to cover the recovery processes.
5. Providing assistance in the development of a communications plan for diverse audiences -- regulators, investors, lenders, employers and the board of directors.
6. Providing advice on strategies to avoid potential claim litigation arising from the event.

Day Pitney's clients for this service have included a major international bank headquartered in New York City and one of the largest securities clearing companies in the world, located in New York City. Our attorneys have counseled both commercial building owners and tenants.

## *Why Lenders Obtain (or Don't) Real Estate Appraisals in Lending Transactions*

Article by Jeffrey S. Held

In the wake of the subprime mortgage crisis, real estate lending practices of U.S. financial institutions have continued to come under intense scrutiny. As a result, many financial institutions have reassessed their business practices to ensure they are in full compliance with applicable law. This has led many lenders to require real property appraisals in connection with secured loans, whereby the borrower grants the lender a security interest in its assets, including real property. Many lenders now take the position that the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires such appraisals even when the primary basis for the underwriting decision is the business's cash flow and not the value of the real estate itself.

Congress passed FIRREA in the aftermath of the savings and loan crisis of the 1980s, when there was a dramatic increase in loan defaults and the value of the real property collateralizing such loans was below the value of the defaulted loans. FIRREA applies to lending transactions with real property collateral that, among other things, involve the FDIC, National Credit Union Administration, Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, or financial institutions regulated by these agencies.

Through regulations promulgated under FIRREA, the government has sought to protect lenders when a real property lien is granted, in order to counterbalance the risk of a borrower defaulting on a loan. Without an accurate valuation of the real property, a lender cannot accurately assess the risk of a loan. If the lender overvalues the real property and a default occurs, the lender bears the burden of the differential in value. When this happens, there is concern that a federal agency insuring such an institution would be called on to meet its insurance requirement, doing so at taxpayer expense. FIRREA was enacted to protect the federal government and the public's financial interests in these types of situations.

It should be noted that FIRREA requires real estate appraisals to be obtained by the lender; the borrower must not be involved in the process of obtaining an appraisal. Therefore, from the lender's perspective, one of the most important issues is the cost associated with obtaining appraisals -- this could potentially create disincentives for lenders to take security in real property when the decision to extend a loan is not primarily related to the value of real property. The most obvious cost is the actual expense associated with hiring an appraiser to evaluate the real property. However, the time it would take to obtain such an appraisal is a potentially more important cost; appraisals can often delay a deal by several months, which may impact the eventual availability (or prudence) of the loan. These costs often weigh heavily in a lender's decision as to whether to take a lien on real estate in a secured lending transaction -- if the lender determines these costs to be too high, it may very well decide not to take a security interest in the real property, in order not to run afoul of FIRREA.