Legal Update GDB

PROVIDING CURRENT INFORMATION ABOUT LEGAL DEVELOPMENTS FOR OUR CLIENTS AND FRIENDS SUMMER 2015

The Changing Face of Insider Trading

By: Adam M. Felsenstein, Esq.

For the past six years, the U.S. Attorney's Office for the Southern District of New York has been prosecuting and convicting financial professionals for insider trading with increasing frequency and great success. Many of the more recent prosecutions involved recipients of insider information who were far removed, and knew little about, the original source of the information.

Preet Bharara, the U.S. Attorney for the Southern District, has been the target of substantial criticism for his zeal and ardor in pursuing charges against these remote information recipients. On December 10, 2014, the Court of Appeals for the Second Circuit, perhaps in reaction to Mr. Bharara's overzealousness, released its decision in *United States v. Newman,* which imposed substantial limits on his ability to prosecute such remote recipients going forward.

The *Newman* decision deals primarily with a defendant's intent to commit a crime by using inside information. Prior to *Newman,* the government merely had to prove that the recipient of inside information knew that the source breached a duty of confidentiality by divulging inside information. This was a fairly low standard for the government to meet in order to successfully prosecute a defendant for insider trading. This knowledge of the breach of confidentiality supplies the requisite intent to willfully capitalize on inside information.

The facts of *Newman* involved defendants three or four steps removed from the source of the inside information. At trial, the prosecutors introduced no evidence establishing that the defendants were

Continued on page 5

The Importance of Correct Valuation of Goods Imported Into the U.S.

By: Tobias F. Ziegler, Esq

U.S. companies importing goods from other countries must pay close attention to the valuation of the goods determined by U.S. Customs. As a general rule, any products imported into or exported from the U.S. have to be properly valued and declared to U.S. Customs.

The correct valuation of merchandise is crucial because it will determine the amount of duty to be paid. If imported or exported merchandise is found to be undervalued, it may lead to delays in shipment and even civil or criminal penalties. If, on the other hand, the merchandise is overvalued, it may result in lost revenue to the company and there is a risk that the overvaluation will be interpreted as money laundering or capital flight by government agencies.

In view of these potentially serious legal consequences, it is important for U.S. companies to confirm the correct appraisal of the merchandise. U.S. Customs will perform a proper appraisal of the merchandise even in the event that it is "duty free."

As a member of the WTO (World Trade Organization), the U.S. has enacted into law the GATT (General Agreement on Tariffs and Trade) Valuation Agreement

Continued on page 6

In this issue

THE CHANGING FACE OF INSIDER TRADING — 1
BY ADAM M. FELSENSTEIN

CORRECT VALUATION OF GOODS IMPORTED INTO THE U.S. — 1
BY TOBIAS F. ZIEGLER

UPDATING FRANCHISE DISCLOSURE DOCUMENTS — 2
BY DAVID T. AZRIN

WHEN IS A DECISION OF A COOP BOARD OF DIRECTORS REASONABLE — 3
BY MARC J. LUXEMBURG

CAN A SURETY COMPLETE WORK WITH SAME CONTRACTOR TERMINATED FOR DEFAULT? — 4
BY RANDY J. HELLER

FIRM NEWS AND HONORS — 7

CONTACT INFORMATION — 5

Gallet Dreyer & Berkey, LLP

ATTORNEYS AT LAW

Updating Franchise Disclosure Documents

By: David T. Azrin, Esq.

Franchisors which do not update their disclosure documents in a timely manner risk being required to suspend franchise sales temporarily until the updated disclosure document is completed, or until the state agency approves the updated disclosure document.

Federal regulations require that, each year, franchisors must amend their disclosure documents within 120 days after the end of the franchisor's fiscal year (April 30 if the franchisor uses a calendar fiscal year) to include updated annual information, including updated audited annual financial statements and updated annual information on current and former franchisees.

In addition to the required annual update, federal regulations require franchisors to update their disclosure documents more frequently than each year, if a franchisor undergoes a significant change in ownership or management, or is faced with some significant material adverse financial event or change in circumstances during the course of the year. In such event, a franchisor must amend its disclosure document within a reasonable time after the end of the quarter in which it occurred. If a material change relates to a financial performance representation in Item 19, a franchisor must notify the prospective franchise of the material change as soon as the franchisor becomes aware of the information.

The thirteen states which require registration to sell franchises have differing requirements concerning the deadline for filing an amended disclosure document for approval. For example, California, Maryland, Michigan, New York, North Dakota, and Rhode Island require amendment applications reflecting a material change to be filed "promptly." Other states including Minnesota, Virginia, and Wisconsin, require the amended application to be filed within thirty days after the material event occurs. Illinois requires the amendment application to be filed within thirty days after the end of the quarter in which the material event occurred. Washington requires an amendment application to be filed as soon as reasonably possible and before any further sale occurs.

Registration states also have differing requirements concerning a franchisor's right to continue sales in the state while an amendment application is pending. For example, in some registration states, such as Illinois, Indiana, South Dakota, Virginia, and Wisconsin, an amendment is considered effective upon filing, and the franchisor is allowed to continue selling franchises while the application to amend is pending. In other registration states, the amendment is considered effective a specified time after filing, such as Hawaii (seven days after filing); Maryland (fifteen business days after filing); Rhode Island (thirty business days after filing), and Washington (fifteen business days after filing). In other registration states, such as California, Minnesota, North Dakota, and Washington, the amendment is not considered effective until it is approved, and the franchisor must suspend sales until the new disclosure document is approved. In California, a

Federal regulations require franchisors to update their disclosure documents more frequently than each year, if a franchisor undergoes a significant change in ownership or management, or is faced with some significant material adverse financial event or change in circumstances during the course of the year.

franchisor can continue selling franchises while the application is pending, but the franchisor cannot close the sale, and must provide the prospective franchisee with the approved amended disclosure document before closing the sale.

In New York, the franchisor can continue selling franchises while the application is pending, and can even close sales, but only if the franchisor holds the franchisee's money in escrow and gives the franchisee the opportunity to rescind after giving the franchisee the approved amended disclosure document. The process is cumbersome and, as a result, most franchisors elect to wait until the amended

Continued on page 3

About the author: *David T. Azrin, a partner at Gallet Dreyer & Berkey LLP, represents a range of business clients and individuals on employment, trademark, and franchise law matters. Mr. Azrin is the sponsor of the International Franchise Association's franchise business network program in the New York City area, and has been named one of the top franchise attorneys ("Legal Eagle") in the United States by the editorial board of Franchise Times magazine. Mr. Azrin can be reached at dta@gdblaw.com.*

When is a Decision of a Cooperative or Condominuim Board of Directors Reasonable

By: Marc J. Luxemburg, Esq.

In a recent case the Appellate Division First Department provided a standard for judging the reasonableness of the conduct of a Board of Directors, specifically that actions of the Board are reasonable if they are "legitimately related to the welfare of the cooperative."

The standard was set forth in the case of *Silver v. Murray House Owners Corp.* decided this March. The issue in the case was whether the Board had unreasonably withheld consent to an alteration. In this case, the proprietary lease stated that consent to an alteration "shall not be unreasonably withheld or delayed." Because this language was contained in the lease, the Board's actions were not protected from scrutiny by the traditional doctrine known as the "Business Judgment Rule" and instead the Board was required to demonstrate reasons why it withheld consent to the alteration. The plaintiff claimed that all he desired to do was to replace previously approved HVAC units. The coop's motion for summary judgment dismissing the complaint was denied because there were issues of fact as to whether defendant's rejection was in fact reasonable.

We note that even in the case where the Business Judgment Rule applies, the Board must show that its determination was reasonably related to the welfare of the cooperative. Thus, it seems that in practice the distinction between the application of a reasonableness standard and the application of the Business Judgment Rule is of diminishing significance.

Notwithstanding, we have been recommending that if the proprietary lease contains a "not unreasonably withheld" standard for Board approvals, the Board should propose to the shareholders to amend the lease to provide the more relaxed business judgment standard – namely that the Board may reject for any reason or no reason – instead of the reasonableness standard.

There was an additional issue in the *Silver* case, specifically, that the shareholder had sought to add a cause of action against the coop for "selective enforcement" of the rules. The Appellate Division held that selective enforcement only applies to the conduct of law enforcement officers who selectively enforce laws, and does not lie against a private party such as a coop. Accordingly, the plaintiff could not add a claim to sue the coop for selective enforcement.

***About the author:** Marc J. Luxemburg is a partner at Gallet Dreyer & Berkey LLP. His practice focuses on real estate transactions, cooperative and condominium law, and real estate litigation. Mr. Luxemburg represents numerous buildings and sponsors in the New York City area. He is the President of the Council of New York Cooperatives and Condominiums, a non-profit membership organization with more than 2300 cooperative and condominium members, which provides educational activities and monitors legislation which affect its members. He has taught numerous seminars on the legal aspects of operating cooperatives and on the role of the Board of Directors. Mr. Luxemburg can be reached at mjlh@gdblaw.com.*

Franchise Disclosure Documents (continued from page 2)

disclosure is approved. In recent years, New York has made a concerted effort to expedite the processing of pending applications, so that franchisors' applications will be approved before early June, when an annual national franchise expo takes place in New York City.

In light of these varying requirements, the decision whether and when to issue and file an amended disclosure document requires an evaluation of various factors, including the significance of the event or change, the requirements of the states in which the franchisor is registered, and the potential for liability. Depending on these factors, franchisors may be required to suspend sales in all or some states while awaiting approval of an amendment application.

Can a Surety Complete the Work with the Same Subcontractor that Was Terminated for Default?

By: Randy J. Heller, Esq.

Private developers often require contractors to obtain performance bonds, to make sure that the work will be completed. But developers should be aware that, under recent court precedent, if a developer terminates a contractor for its incompetence, the surety company may have the right to bring back the very same contractor to complete the job.

Not every private construction owner requires that its contractor obtain a performance bond. The cost of a bond is not insignificant and is inevitably passed along to the owner in the contractor's bid price. Requiring a subcontractor to obtain a performance bond is even more rare. But it is often viewed as a small price to pay to ensure that if something goes wrong, and the subcontractor is terminated for cause, there will be a surety company to arrange for (or at least pay for) the completion of the subcontractor's work.

But can the surety company step in and bring back the very same subcontractor which was terminated for its incompetence? That is the situation which provided the fact pattern for a recent case in the Supreme Court of New York County involving demolition work at the ill-fated Deutsche Bank Building in the aftermath of the September 11, 2001 terrorist attack in Lower Manhattan.

Following a fire in 2007, the contractor, Bovis, terminated the subcontractor, The John Galt Co. (Galt), for failing to maintain a fire standpipe, which left two firefighters dead. Following the "termination for cause," Bovis made demand upon the surety, Arch, to complete the work under its $25 million performance bond. Arch came forward and advised Bovis that it would be completing the work with the very same subcontractor, Galt, that Bovis had just thrown off the job!

Bovis advised Arch "in no uncertain terms" that it would not permit Galt back on the job. Bovis then retained a different subcontractor to complete the work and sued Arch for the costs. Arch argued that this constituted a breach under the bond, and rendered it no longer liable for any costs due to Bovis's refusal to let Arch use the replacement subcontractor of its choosing.

Bovis made two main arguments to justify its refusal to let Galt back on the job. First, it argued that Galt was not a "responsible" contractor. However, the Court stated that "when a surety elects to complete its principal's contract, the surety is primarily responsible for completion, and the contractor chosen by the surety to do the work becomes the surety's agent, not its subcontractor."

Next, Bovis argued that the subcontract gave it the right to approve or disapprove any subcontractors in its discretion. Again, the Court held that Galt would not have been acting as a subcontractor in working to complete the work; it would merely be acting as the surety's agent.

The Court concluded that unless the bond provides otherwise, a surety is free to choose its completion contractor, and the owner's or general contractor's interference with the surety's choice is a material breach rendering the bond null and void.

While we might all sympathize with Bovis's refusal to allow the defaulted subcontractor back onto the project site as a matter of principle, asserting that principle, without first analyzing the language of the bond, proved very costly indeed.

Unless the bond provides otherwise, a surety is free to choose its completion contractor, and the owner's or general contractor's interference with the surety's choice is a material breach rendering the bond null and void.

About the author: *Randy J. Heller is a partner at Gallet Dreyer & Berkey LLP. His practice focuses on construction law and litigation, representing contractors and owners in construction related matters. Mr. Heller has been named a Super Lawyer by the New York Times magazine as one of the top attorneys in construction law in the New York metropolitan area, and by New York Magazine as one of the Best Lawyers of New York. Mr. Heller can be reached at rjh@gdblaw.com.*

Insider Trading (continued from page 1)

Prior to *Newman,* the government merely had to prove that the recipient of inside information knew that the source breached a duty of confidentiality by divulging inside information.

aware of the original source of the information. The intent to trade illegally was to be inferred from the fact such confidential information could only have been obtained by a breach of the original source's duty of confidentiality.

In its decision, the Court of Appeals vastly expanded the quantum of proof required to secure an insider trading conviction. Not only must the individual being prosecuted know that the original source broke a duty of confidentiality, but they must also be aware that that the source received a personal benefit for divulging such information. This ruling represents a substantial obstacle to the prosecution of remote recipients of insider information as it requires the recipient to have a much greater level of knowledge about the source of the inside information before that recipient can be subject to criminal prosecution. The Court of Appeals has, in essence, provided a level of protection for individuals down the chain who are unaware of the source of the information, and may be unaware of the fact it was taken inappropriately.

In a broader sense, the U.S. Attorney's Office for the Southern District has received a stinging rebuke from the Court of Appeals for its overzealousness in prosecuting remote insider trading defendants. The Court of Appeals sent a clear message that insider trading laws were never meant to impose criminal liability on such remote recipients. This censure has shaken the government's pursuit of insider traders to the core. For example, Judge Andrew Carter of the Southern District has already gone so far as to vacate guilty pleas of defendants where the pleas did not outline that the defendants knew that the source had received a personal benefit. Judge Jed Rakoff has called for a wholesale redrafting of insider trading laws to more closely conform with the conduct Congress intended to criminalize. For its part, the Securities and Exchange Commission has announced its intent to seek civil enforcement penalties, which require a lower quantum of proof, with greater frequency rather than lobbying the U.S. Attorney's Office to bring criminal charges.

Going forward, the *Newman* decision represents an important new tool for defense attorneys representing clients accused of insider trading. *Newman* allows defense counsel to explore the source of insider information, and argue that a defendant lacked the intent to criminally trade on inside information given their distance from the source. Individuals who are notified that they may be the target of an insider trading investigation should work with counsel to promptly investigate the source of the information in order to preserve and develop this important defense.

About the author: *Adam M. Felsenstein is an associate at Gallet Dreyer & Berkey, LLP. His practice focuses on civil and criminal litigation matters, including trial work in the state and federal courts. Mr. Felsenstein can be reached at amf@gdblaw.com.*

This newsletter is intended to keep our clients and friends generally informed on legal developments. It is not a substitute for personal legal advice.
This material is Attorney Advertising. Prior results do not guarantee a similar outcome.
For more information or advice on any legal matters, please contact any of our attorneys at 212.935.3131 or by visiting our website at www.gdblaw.com.

VALUATIONS OF IMPORTED GOODS (CONTINUED FROM PAGE 1)

Unless certain requirements are met, U.S. Customs will be reluctant to accept "transaction value" between a related seller and buyer.

(19 U.S.C. § 1401a). Under this law, commissions and fees paid to the foreign seller must be included in the value declared to U.S. Customs. Accordingly, it is important for U.S. companies to be aware that the value for Customs purposes isn't always equal to the purchase order price or contract price.

Specifically, in most import transactions, U.S. Customs appraises the value of imported merchandise by determining its "transaction value," which is defined under the GATT Valuation Agreement (19 U.S.C. § 1401a(b)(1)) to mean the price actually paid or payable for the merchandise when sold for exportation to the U.S., plus amounts equal to:

A. the packing costs incurred by the buyer with respect to the imported merchandise;

B. any selling commission incurred by the buyer with respect to the imported merchandise;

C. the value, apportioned as appropriate, of any assist;

D. any royalty or license fee related to the imported merchandise that the buyer is required to pay, directly or indirectly, as a condition of the sale of the imported merchandise for exportation to the United States; and

E. the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller.

Thus, if a U.S. company pays a commission to a foreign supplier based on sales in the U.S. or if a customer of a U.S. company pays a license fee or royalties to the U.S. company of which a part is paid back to the foreign supplier, these commissions must be included in the value declared to U.S. Customs. If the U.S. company uses the actual purchase price without taking these commissions or fees into account, then the value of the merchandise might not be properly declared in the import documents.

It should also be noted that U.S. Customs law contains specific provisions concerning transactions between "related parties," meaning, for example, a U.S. company and its foreign affiliate. Unless certain requirements are met, U.S. Customs will be reluctant to accept "transaction value" between a related seller and buyer. The importer of record will either have to show that the price charged by the related party was the product of arm's length negotiations or that it satisfies certain test values described in the regulations. If the parties fail to meet these conditions, U.S. Customs may use an alternative method of appraisal that likely results in a higher value and increased duties reducing the profit margin.

About the author: *Tobias F. Ziegler, Esq., head of the firm's international business practice, represents foreign and U.S. companies in all areas of corporate work, including, for example, the formation of corporate entities, product liability, sales agency, joint ventures and cooperation arrangements, corporate structuring, trademarks, licensing requirements and commercial contracts of all types. Mr. Ziegler also has extensive experience in representing business and individual clients in all aspects of real estate work, including transactional work, mortgage financing and real estate development work. In addition to his legal education in the United States, Mr. Ziegler holds law degrees from Germany and France, and he is fluent in the languages of both countries. He is an active member of the Eurojuris international legal organization. Mr. Ziegler can be reached at tfz@gdblaw.com.*

Our Practice Areas Include:

- Banking & Financial Institutions
- Construction Law
- Co-op and Condo Law
- Corporate Finance and Securities
- Corporate Law
- Employment Law
- Franchising, Distribution & Licensing
- International Business Law
- Litigation
- Real Estate Law
- Tax Law
- Trademarks and Copyright
- Trusts & Estates
- White Collar Criminal Defense

Firm News and Honors

MARC J. LUXEMBURG

In January, 2015, partner Marc J. Luxemburg was the speaker at a seminar sponsored by the Association of Riverdale Cooperatives entitled A Review of Current Significant Legal Issues of 2014.

In March, 2015, partner Marc J. Luxemburg presented a seminar for members of cooperative boards on The New Form of Proprietary Lease which has been promulgated by the Council of New York Cooperatives & Condominiums. The seminar explores the deficiencies in existing forms of proprietary leases and how the new form clarifies the authority of a board to manage the cooperative.

DAVID T. AZRIN

In February 2015, partner David T. Azrin was again named a *Franchise Times* Legal Eagle, a designation given to top franchise attorneys in the country, as judged by the *Franchise Times'* editorial board.

MORRELL I. BERKOWITZ

In March 2015, partner Morrell I. Berkowitz secured an important victory for a client when he obtained a permanent injunction in New York Supreme Court against a director of a cooperative corporation who had improperly disclosed confidential attorney-client communications in multiple emails including to a person who was suing the cooperative. That same director was also sanctioned by the court for making a frivolous motion seeking to prevent disclosure to shareholders of the director's misconduct.

JAY L. HACK

In May 2015, partner Jay L. Hack, a past chair of the New York State Bar Association Business Law Section from 2013-2014, was appointed as a member of the New York State Bar Association President's Task Force on the Power of Attorney Law.

TOBIAS F. ZIEGLER

In May 2015, Tobias F. Ziegler gave a presentation on the issue of international branches and subsidiaries at the Eurojuris International Business Group Meeting in Helsinki, Finland.

ADAM M. FELSENSTEIN

In June 2015, associate Adam M. Felsenstein was admitted to the bar of the Supreme Court of the United States.

DAVID N. MILNER

In June 2015, partner David N. Milner was re-elected for a sixth term as a Trustee of the Village of Lake Success, New York.

GDB Partners

David T. Azrin
dta@gdblaw.com
Franchise, Trademark, Employment, Litigation

David L. Berkey
dlb@gdblaw.com
Real Estate, Cooperative/Condo Law, Litigation

Morrell I. Berkowitz
mib@gdblaw.com
Litigation, Real Estate

Mark B. Brenner
mbb@gdblaw.com
Corporate, Bankruptcy, Real Estate

David S. Douglas
dsd@gdblaw.com
Litigation

Jay L. Hack
jlh@gdblaw.com
Banking, Securities, Corporate

Randy J. Heller
rjh@gdblaw.com
Construction, Suretyship and Litigation

Beatrice Lesser
bl@gdblaw.com
Real Estate Litigation, Co-op/Condo, Commercial and Residential Landlord/Tenant

Marc J. Luxemburg
mjl@gdblaw.com
Real Estate, Corporate, Litigation

David N. Milner
dnm@gdblaw.com
Taxation, Trust and Estates, Corporate, Real Estate

Perry L. Mintz
plm@gdblaw.com
Real Estate, Corporate

Seymour D. Reich
sdr@gdblaw.com
Trusts and Estates, Real Estate

Scott M. Smiler
sms@gdblaw.com
Real Estate, Corporate

Roger L. Stavis
rls@gdblaw.com
White Collar Criminal Defense, Investigations

Jerry A. Weiss
jaw@gdblaw.com
Litigation

Gallet Dreyer & Berkey, llp

attorneys at law

845 Third Avenue
New York, NY 10022-6601