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ANTITRUST POPULISM

BARAK ORBACH*

In antitrust literature, "populism" is associated with sympathy for small local businesses and fears of large firms. In other areas and everyday language, "populism" means a confrontational approach that is used to attack institutions and influential elites. With the rise of populism in the United States and around the world, this Article questions the antitrust tradition of equating populism with ideas that shaped antitrust law a century ago. The tradition shields contemporary antitrust populists from the criticism and stigma that they deserve and, thus, empowers populist ideas that courts and scholars frequently endorse.

The Article makes three contributions to antitrust literature and the understanding of antitrust law. First, the Article clarifies the general characteristics of populism, contrasting the alleged cause of serving "the people" with the phenomenon's costly dogmatic, anti-intellectual, and destructive methods. It then defines "antitrust populism" as an expression of the populist style in antitrust law and literature—the use of thin ideas, exaggerations, and anxieties to advance antitrust theories. Properly understood, certain forms of antitrust populism rely on dogmatic beliefs that reject nuanced policies and the need for analysis. Second, the Article identifies anti-bigness and anti-enforcement sentiments as the two primary populist strains in antitrust law and literature. Each strain is related to a populist political movement, guided by distrust in institutions, decorated with various theories, and critical of the other strain. Third, the Article explores the relationship between technological progress and antitrust populism. It explains why rapid technological change tends to inspire antitrust populists. The Article argues that courts, the agencies, and scholars should make an effort to reject populist arguments for their anti-intellectual nature and other flaws.

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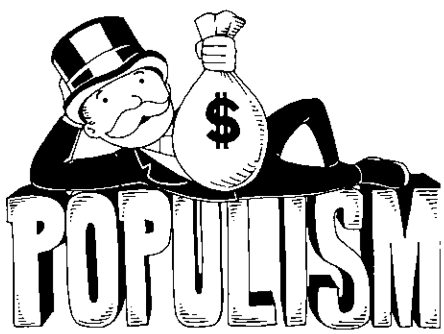
INTRODUCTION



In antitrust literature, "populism" is associated with "an old native Populist strain in American thought, which identifies virtue with the small local businessman and evil with the banks, the railroads, and big corporations."[1] This strain is marginalized in modern antitrust

1. Robert H. Bork & Ward S. Bowman Jr., *The Crisis in Antitrust*, FORTUNE, Dec. 1963, at 138, 201. For expressions of this interpretation in the literature, *see, e.g.*, Oliver Grawe, *Populism, Economists, and the FTC*, ANTITRUST SOURCE, Apr. 2017, at 1 ("Populists appear to share a fear or concern about concentrations of power."); Steven C. Salop & Carl Shapiro, *Whither Antitrust Enforcement in the Trump Administration*, ANTITRUST SOURCE, Feb. 2017, at 2 (arguing that the term "populism" has been used to describe an approach seeking to reduce "the power of large corporations in the American economy."); James C. Cooper, *A Return to Antitrust Populism?*, ANTITRUST SOURCE, Feb. 2017, at 1 (arguing that antitrust populism refers to the approach that "big is bad"); *What Is Trump Antitrust?*, 4 CONCURRENCES: COMPETITION L. REV. (2016) (a collection of essays referring to populism as aggressive antitrust enforcement that targets concentrated markets and large corporations); Sandeep Vaheesan, *The Evolving Populisms of Antitrust*, 93 NEB. L. REV. 370, 373 (2014) (arguing that courts should "strengthen the historic commitment of antitrust law to consumer populism"); Harry First & Spencer Weber Waller, *Antitrust's Democracy Deficit*, 81 FORDHAM L. REV. 2543, 2553–58 (2013) (identifying populism with aggressive enforcement); Alan J. Meese, *Debunking the Purchaser Welfare Account of Section 2 of the Sherman Act: How Harvard Brought Us a Total Welfare Standard and Why We Should Keep It*, 85 N.Y.U. L. REV. 659, 668 (2010) (identifying a "populist school" that arguably claims that "the Sherman Act . . . bans any conduct that restrains the auton-

law.[2] Thus, some have argued that "antitrust populism is long dead."[3] The tradition of equating populism with certain outdated ideas reflects neither the common meaning of populism nor the broad understanding of antitrust law. For more than fifty years, this tradition has been shielding contemporary antitrust populists from the criticism and stigma they deserve, by using the stigma of populism against past ideas and implying that other ideas are not populist. Stated differently, the common meaning of "populism" in antitrust literature reflects a successful demonization of certain ideas that overshadows

omy of traders or results in a concentrated marketplace."); Daniel A. Crane, *Technocracy and Antitrust*, 86 TEX. L. REV. 1159 (2008) (criticizing the populist approach to antitrust and arguing that it vanished with the adoption of economic standards); Michael S. Jacobs, *An Essay on the Normative Foundations of Antitrust Economics*, 74 N.C. L. REV. 219, 220 (1995) (arguing that the "Modern Populist School" included antitrust scholars who argued that antitrust analysis should not exclusively rely on economic principles); Michael E. DeBow, *The Social Costs of Populist Antitrust: A Public Choice Perspective*, 14 HARV. J. L. & PUB. POL'Y 205, 206 (1991) (describing antitrust populist goals as "fair distribution of business opportunities and income and the dispersal of political and economic power."); Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 12 n. 23 (1984) (describing "antipathy to business" as "populist"); Eleanor M. Fox, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140 (1981) (defending the need to limit the power of large corporations); Robert Pitofsky, *The Political Content of Antitrust*, 127 U. PA. L. REV. 1051 (1979) (same); Louis B. Schwartz, *On the Uses of Economics: A Review of the Antitrust Treatises*, 128 U. PA. L. REV. 244 (1978) (same); Thomas E. Kauper, *The "Warren Court" and the Antitrust Laws: Of Economics, Populism, and Cynicism*, 67 MICH. L. REV. 325 (1968) (studying the fear of concentration of the Warren Court); Harold Fleming, *The Supreme Court and Big Business*, HARPER'S MAG., June 1950, at 89 (equating populism with the fear of bigness).

2. *See, e.g.*, Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc., 546 U.S. 164, 181 (2006) ("[W]e would resist interpretation [of the antitrust laws] geared more to the protection of existing *competitors* than to the stimulation of *competition*."). *See generally* Barak Orbach & Grace Campbell Rebling, *The Antitrust Curse of Bigness*, 85 S. CAL. REV. 605 (2012).

3. DANIEL A. CRANE, THE INSTITUTIONAL STRUCTURE OF ANTITRUST ENFORCEMENT 113 (2011). *See also* Jonathan B. Baker, *Competition Policy as a Political Bargain*, 73 ANTITRUST L.J. 483, 522 (2006) (arguing that in the mid-twentieth century "consumers and producers reached a political bargain to adopt a regime that protects competition through antitrust enforcement," ending a political debate over competition policy); Frank H. Easterbrook, *Workable Antitrust Policy*, 84 MICH. L. REV. 1696, 1705 (1986) ("Twenty years ago, . . . the antitrust decisions of the Supreme Court ran to populism . . . to protect 'small dealers and worthy men' in small markets.").

other forms of populism that are pervasive in antitrust law and policy.

In every context but antitrust law, "populism" means a confrontational approach that is not defined by any coherent philosophy and may be expressed in many ways. Populism's primary characteristic is the vilification of institutions—the "establishment" and the "elites"—to gain influence, not necessarily antipathy to large businesses.[4]

This Article questions the antitrust tradition of associating populism with sympathy for small businesses and fears of large businesses. It seeks to correct the misguided approach to populism in antitrust thinking that results in accommodation and even endorsement of populism. The Article makes three contributions to the literature. First, the Article summarizes the general characteristics of "populism" and the "populist style." It defines "antitrust populism" as an expression of the populist style in antitrust law and literature. Second, the Article identifies and compares two primary populist strains in antitrust law and literature. One strain is the anti-bigness approach. Another strain is an anti-enforcement approach. Both strains rely on strong beliefs that rationalize their uncompromising positions. Since the late 1970s,[5] the anti-enforcement strain has been dominating the development of antitrust law.[6] It is the signature mark of the antitrust jurisprudence of the Roberts Court and certain antitrust commentators.[7] Third, the Article

4. *See infra* Part I.A.

5. *See* Cont'l T.V. v. GTE Sylvania, 433 U.S. 36 (1977) (holding that non-price vertical restraints should be reviewed under the rule of reason); Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477 (1977) (creating the "antitrust injury" doctrine); Ill. Brick Co. v. Illinois, 431 U.S. 720 (1977) (creating the "direct purchaser" doctrine). *See also* Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007) (reshaping the standards for motion to dismiss); Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574 (1986) (reshaping the standards for motion for summary judgment). *See also* George L. Priest, *The Limits of Antitrust and the Chicago School Tradition*, 6 J. COMP. L. & ECON. 1 (2010) (summarizing the spirit of the Chicago School antitrust tradition)."

6. *See, e.g.*, U.S. DEP'T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (2008); Easterbrook, *supra* note 1.

7. For the Roberts Court see Lee Epstein et al., *How Business Fares in the Supreme Court*, 97 MINN. L. REV. 1431 (2013); Noam Scheiber, *As Americans Take Up Populism, the Supreme Court Embraces Business*, N.Y. TIMES (Mar. 11, 2016), at B1. For criticism of conservative antitrust commentators see

discusses the relationships between technological progress and antitrust populism.

I.
WHAT IS POPULISM?

A. *Common Characteristics*

During the past three decades, populism has been on the rise in the United States and around the world.[8] In 2016, the Republican Party, led by Donald Trump, seized control of the White House and the two houses of Congress.[9] Trump won the Presidency with radical populism and grandiose promises to serve all people,[10] empower the American worker,[11] act against large businesses,[12] appoint conservative judges,[13] and implement radical nationalism.[14] Trump's populism exhibited disregard of the rule of law, an open distaste for science and economics, as well as use of divisive rhetoric, hyperbolic

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Jonathan B. Baker, *Taking the Error Out of "Error Cost" Analysis: What's Wrong With Antitrust's Right*, 80 ANTITRUST L.J. 1 (2015); Jonathan B. Baker, *Exclusion as a Core Competition Concern*, 78 ANTITRUST L.J. 527 (2013).

8. *See, e.g.*, JOHN B. JUDIS, THE POPULIST EXPLOSION: HOW THE GREAT RECESSION TRANSFORMED AMERICAN AND EUROPEAN POLITICS (2016).

9. *See* Janet Hook et al., *President Trump: Populist Surge Lifts Republican to Upset*, WALL ST. J., Nov. 9, 2016, at A1; Mark Landler, *A Broadside for Washington*, N.Y. TIMES, Jan. 21, 2017, at A1 (describing President Trump's Inaugural Address as "a scalding repudiation of the Washington establishment").

10. *See, e.g.*, Julie Hirschfeld Davis & Michael M. Grynbaum, *Trump Intensifies His Attacks on Journalists and Condemns F.B.I. 'Leakers'*, N.Y. TIMES (Feb. 24, 2017), at A1; *'This Moment Is Yours*, N.Y. TIMES, Jan. 21, 2017, at A16 (annotating President Trump's Inaugural Address); Jim Dwyer, *Drawing a Line From Theories to Untruths*, N.Y. TIMES, Feb. 8, 2017, at A21 (describing Donald Trump's use of conspiracy theories, false claims, and attacks on the press); Michael M. Grynbaum, *Trump Calls Media the 'Enemy of the American People'*, N.Y. TIMES, Feb. 18, 2017, at A15.

11. Michael Scherer, *The Person of the Year*, TIME, Dec. 19, 2016, at 46, 49, 58.

12. *See, e.g.*, Bret Stephens, *The Plot Against America*, WALL ST. J., Oct. 18, 2016, at A9 (commenting on Donald Trump's campaign against the "global power structure"); Holman W. Jenkins, Jr., *Donald Trump's Amazon Adventure*, WALL ST. J., May 14, 2016, at A11 (describing Donald Trump's threats to act against Amazon on antitrust grounds).

13. *See, e.g.*, Kyle Peterson, *Trump's Supreme Court Whisperer*, WALL ST. J., Feb. 4, 2017, at A11 (quoting President Trump proclaiming: "We're going to have great judges, conservative, all picked by the Federalist Society.").

14. *See, e.g.*, *An Insurgent in the White House*, ECONOMIST, Feb. 4, 2017, at 7; *America First and Last*, ECONOMIST, Feb. 4, 2017, at 17.

claims, lies, conspiracy theories, and attacks on the press.[15] The contradictions and contrasts left antitrust experts uncertain about the direction of antitrust law,[16] yet many experts continued to warn that antitrust may return to populism, referring to voices hostile to large businesses.[17] The mismatch between the present tide of populism and experts' depictions of populism calls for clarification.

Studies of "populism" identify the phenomenon as a confrontational approach that may be expressed in many ways, ranging from a reasoning technique to a political strategy to a political movement. The essence of populism is an effort to disrupt the existing social order by solidifying and mobilizing the animosity of "the people" against the "corrupt elites" and the "establishment."[18] The approach is typically used by outsid-

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15. *See, e.g.*, Matt Taibibi, *The Madness of Donald Trump*, ROLLING STONE, Oct. 5, 2017, at 32; Charles Sykes, *Insane Clown Posse*, NEWSWEEK, Sept. 29, 2017, at 17; David Leonhardt & Stuart A. Thompson, *Trump's Lies*, N.Y. TIMES, June 25, 2017, at SR10; James Risen & Tom Risen, *Donald Trump Does His Best Joe McCarthy*, N.Y. TIMES, June 22, 2017, at SR2; *The War on Journalism*, L.A. TIMES, Apr. 5, 2017, at A12; *Why the President Lies*, L.A. TIMES, Apr. 4, 2017, at A10; *Conspiracy Theorist in Chief*, L.A. TIMES, Apr. 3, 2017, at A11; *Our Dishonest President*, L.A. TIMES, Apr. 2, 2017, at A17; Jim Dwyer, *Drawing a Line from Theories to Untruths*, N.Y. TIMES, Feb. 8, 2017, at A21; Sendhil Mullainathan, *The Disappearing Economist*, N.Y. TIMES, Feb. 26, 2017, at BU6; Michael M. Grynbaum, *Trump Calls Media the "Enemy of the American People"*, N.Y. TIMES, Feb. 18, 2017, at A15; Quinta Jurecic, *Trumpelstiltskin*, WASH. POST, Jan. 29, 2017, at B4; Nancy Gibbs, *The Choice*, TIME, Dec. 19, 2016, at 44; Michael Scherer, *The Person of the Year*, TIME, Dec. 19, 2016, at 46; *Art of the Lie*, ECONOMIST, Sept. 10, 2016, at 9; *Yes, I'd Lie to You*, ECONOMIST, Sept. 10, 2016, at 17; Dan P. McAdams, *The Mind of Donald Trump*, ATLANTIC, June 2016, at 76. *See also* David Von Drehle, *The Second Most Powerful Man in the World?*, TIME, Feb. 13, 2017, at 24 (profiling Steve Bannon, the White House's Chief Strategist in the Trump Administration).

16. *See, e.g.*, *What Is Trump Antitrust?*, CONCURRENCES NO. 4-2016, Nov. 2016.

17. *See, e.g.*, *id.* (a collection of essays); Grawe, *supra* note 1; Salop & Shapiro, *supra* note 1; A.B.A. SECTION OF ANTITRUST LAW, PRESIDENTIAL TRANSITION REPORT: THE STATE OF ANTITRUST ENFORCEMENT 2–3, 34–35 (2017).

18. *See* Bart Bonikowski & Noam Gidron, *The Populist Style in American Politics: Presidential Campaign Discourse, 1952–1996*, 94 SOC. FORCES 1593, 1593–94 (2016) (defining "populism" as "a form of politics predicated on a moral vilification of elites and a concomitant veneration of the common people" and finding that "populism is primarily a strategic tool of political challengers, and particularly those who have legitimate claims to outsider status"); Robert R. Barr, *Populists, Outsiders and Anti-Establishment Politics*, 15 PARTY POL. 29, 44 (2009) (defining populism as "a mass movement led by an

ers, mavericks, and ideologues when institutions appear to cause or neglect social and economic problems of "the people."[19] Historically, rapid technological advancements, economic crises, and changes in the composition of the population were conducive to populism.[20] Otherwise, populism often serves as a persuasion technique and inspires ideological beliefs. Populism can be found throughout the political spectrum, but is concentrated at the poles.[21] It does not have contextual characteristics—the phenomenon defies political classifications and tends to include inconsistent and even contradicting elements.[22]

Two common characteristics of populism are nationalism and anti-intellectualism. Populist nationalism is a product of commitments to "the people," as opposed to "others." Like populism itself, populist nationalism is an evasive concept that may mean anything from national pride and efforts to main-

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outsider or maverick seeking to gain or maintain power by using anti-establishment appeals and plebiscitarian linkages"); Cas Mudde, *The Populist Zeitgeist*, 39 GOV'T & OPPOSITION 541, 543 (2004) (defining populism as "an ideology that considers society to be ultimately separated into two homogeneous and antagonistic groups, 'the pure people' versus 'the corrupt elite', and which argues that politics should be an expression of the . . . general will of the people"); Margaret Canovan, *Trust the People! Populism and the Two Faces of Democracy*, 47 POL. STUD. 2, 3 (1999) (defining populism as "an appeal to 'the people' against both the established structure of power and the dominant ideas and values of the society"); MICHAEL KAZIN, THE POPULIST PERSUASION: AN AMERICAN HISTORY 1 (rev. ed. 1998) (defining populism as "a language whose speakers conceive of ordinary people as a noble assemblage not bounded narrowly by class, view their elite opponents as self-serving and undemocratic, and seek to mobilize the former against the latter"). *See also Playing With Fear*, ECONOMIST, Dec. 12, 2015, at 15 ("Populists differ, but the bedrock for them all is economic and cultural insecurity."); George Packer, *The Populists*, NEW YORKER, Sept. 7, 2015, at 23 ("That's the volatile nature of populism: it can ignite reform or reaction, idealism or scapegoating. It flourishes in periods . . . when large numbers of citizens who see themselves as the backbone of America . . . feel that the game is rigged against them.").

19. *See, e.g.*, Bonikowski & Gidron, *supra* note 18, at 1594 ; Barr, *supra* note 18, at 44.

20. *See* KAZIN, *supra* note 18; ERNESTO LACLAU, ON POPULIST REASON (2005).

21. *See* Mudde, *supra* note 18 at 542.

22. LACLAU, *supra* note 20.

tain national identity to isolationism and anti-globalism.[23] Populist anti-intellectualism refers to the willingness of populists to seek endorsement of low-information audiences, rejection of facts and criticism, common use of conspiracy theories, and targeting of intellectuals as "corrupt elites."[24] Populist thinkers sometimes include intellectuals, such as those of the Progressive movement in the early 20th century and the conservative movement in the late 20th century.[25] But the participation of intellectual thinkers in populist movements does not cure their anti-intellectual nature. Historian Richard Hofstadter famously identified in populism a "paranoid style," which he described as a crusading mentality of "angry minds" that use thin ideas with "heated exaggeration, suspiciousness, and conspiratorial fantasy."[26] Hofstadter's characterization captures the spirit of the populist style: a persuasion technique that utilizes exaggerations and anxieties to promote certain ideas supposedly to serve the public.[27] Political populism periodically gains power, but the populist style has always been common and is here to stay.[28] It is this style that defines populists, not their commitments to particular ideas.

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23. Barr, *supra* note 18; Canovan, *supra* note 18; Mudde, *supra* note 18; KAZIN, *supra* note 18. *See generally Why They're Wrong*, ECONOMIST, Oct. 1, 2016, at 11; John O'Sullivan, *Special Report: The World Economy*, ECONOMIST, Oct. 1, 2016; *The New Nationalism*, ECONOMIST, Nov. 19, 2016, at 11; *League of Nationalists*, ECONOMIST, Nov. 19, 2016, at 63; *Drawbridges Up*, ECONOMIST, July 30, 2016, at 16 (explaining that "[t]he divide in rich countries is not between left and right but between open and closed").

24. *See,* e.g., RICHARD HOFSTADTER, ANTI-INTELLECTUALISM IN AMERICAN LIFE (1962); Richard Hofstadter, *The Paranoid Style in American Politics*, HARPER'S, Nov. 1964, at 77; MATT K. LEWIS, TOO DUMB TO FAIL xxx (2016) ("The word [intellectuals] has a negative connotation on the Right."); James Surowiecki, *The Populism Problem*, NEW YORKER, Feb. 15, 2010, at 50 ("[The] new populism has stitched together incompatible concerns and goals into one 'I'm mad as hell' quilt.").

25. *See* KAZIN, *supra* note 18.

26. Hofstadter, *The Paranoid Style in American Politics*, *supra* note 24.

27. For the use of reasoning to advance arguments *see* Hugo Mercier & Dan Sperber, *Why Do Humans Reason? Arguments for an Argumentative Theory*, 34 BEHAV. & BRAIN SCI. 57 (2011) (discussing empirical literature showing that people tend to use reasoning to persuade others, not to evaluate their own ideas, and often fail to recognize that they do so).

28. *See* KAZIN, *supra* note 18.

B. *Defining Antitrust Populism*

The populist style—used as a reasoning instrument—often appears in antitrust law and policy, as well as in antitrust literature. "Antitrust populism," thus, may be defined as an expression of the populist style in antitrust law and literature—the use of thin ideas, exaggerations, and anxieties to advance antitrust theories. Two vocal strains in antitrust law have these characteristics and are closely related to populist political movements. For their affiliations to political movements, these strains are casually known as "liberal" and "conservative," but may be better described as "anti-bigness" and "anti-enforcement" populist strains. Anti-bigness populism is the old strain that has been traditionally known in antitrust literature as "populism." This strain seeks to protect the local control of industries by small businesses and identifies business size as evil.[29] Justices Brandeis and Douglas greatly contributed to this line of antitrust populism. Brandeis was often described with titles that bespeak the aura of populism: "the people's lawyer"[30] and the "principal champion of small business."[31] Before his appointment to the Supreme Court, Brandeis wrote a highly influential series of articles for *Harper's Weekly,* which discussed the "Money Trust" problem and advocated for using the antitrust laws against large industrial companies and the financial industry.[32] The most famous article in this series was

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29. *See, e.g.*, Brown Shoe Co. v. U.S., 370 U.S. 294 (1962) (relying on anti-bigness sentiments to block a merger).

30. *See* MELVIN I. UROFSKY, LOUIS D. BRANDEIS: A LIFE 227 (2009); John Braeman, *"The People's Lawyer" Revisited: Louis D. Brandeis versus the United Shoe Machinery Company*, 50 AM. J. L. HIST. 284 (2010). *See also* LOUIS D. BRANDEIS, BUSINESS – A PROFESSION 321 (1914) ("We hear much of the 'corporation lawyer,' and far too little of the 'people's lawyer.' The great opportunity of the American Bar is and will be to stand again as it did in the past, ready to protect also the interests of the people.").

31. Milton Handler, *Introductory – The Brandeis Conception of the Relationship of Small Business to Antitrust*, 16 A.B.A. SEC. ANTITRUST L. 13, 14 (1960). *See also* Richard P. Adelstein, *"Islands of Conscious Power": Louis D. Brandeis and the Modern Corporation*, 63 BUS. HIST. REV. 614, 615 (1989) (describing Justice Brandeis as the "indefatigable champion of small enterprise"); ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 41 (1978) ("It is well known that a strong underlying policy orientation of Brandeis' approach was sympathy for small, perhaps inefficient traders who might go under in fully competitive markets.").

32. *Banker-Management*, HARPER'S WKLY., Aug. 16, 1913, at 14; *The Solution of the Trust Problem*, HARPER'S WKLY., Nov. 8, 1913, at 18; *Cutthroat Prices,*

A Curse of Bigness, which iconized the condemnation of business size. Brandeis's writing has inspired many anti-bigness advocates. Justice William Douglas, who succeeded Justice Brandeis on the Court, pressed the pro-enforcement line far further than Brandeis.[33]

By contrast, the anti-enforcement strain emphasizes criticism of enforcement institutions and identities reasons to avoid antitrust enforcement. It builds on exaggerated beliefs that markets are competitive and tend to correct themselves relatively quickly, whereas erroneous antitrust enforcement is common and impairs market functioning. Robert Bork is the most influential thinker behind this strain of populism. Bork's famous antitrust paradox is largely a critique of Brandeis's anti-bigness populism and the Supreme Court that supposedly endorsed Brandeis's ideas.[34] Bork believed that antitrust law had "so decayed" that it was "no longer intellectually respecta-

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HARPER'S WKLY., Nov. 15, 1913, at 10; *Breaking the Money Trust*, HARPER'S WKLY., Nov. 22, 1913, at 10; *How the Combiners Combine*, HARPER'S WKLY., Nov. 29, 1913, at 9; *The Endless Chain*, HARPER'S WKLY., Dec. 6, 1913, at 13; *Serve One Master Only!*, HARPER'S WKLY., Dec. 13, 1913, at 10; *What Publicity Can Do*, HARPER'S WKLY., Dec. 20, 1913, at 10; *Where the Banker Is Superfluous*, HARPER'S WKLY., Dec. 27, 1913, at 18; *Big Men and Little Business*, HARPER'S WKLY., Jan. 3, 1914, at 11; *A Curse of Bigness*, HARPER'S WKLY., Jan. 10, 1914, at 18; *The Inefficiency of the Oligarchs*, HARPER'S WKLY., Jan. 17, 1914, at 18. Brandeis later published some of the articles in a book that focused on the financial sector. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914).

33. C. Paul Rogers III, *The Antitrust Legacy of Justice William O. Douglas*, 56 CLEV. ST. L. REV. 895 (2008). *See also* United States v. Columbia Steel Co., 334 U.S. 495, 535–36 (1948) (Douglas, J., dissent):

> We have here the problem of bigness. Its lesson should by now have been burned into our memory by Brandeis. The Curse of Bigness shows how size can become a menace—both industrial and social. It can be an industrial menace because it creates gross inequalities against existing or putative competitors. It can be a social menace—because of its control of prices . . . [S]ize . . . the measure of the power of a handful of men over our economy. That power can be utilized with lightning speed. It can be benign or it can be dangerous. The philosophy of the Sherman Act is that it should not exist.

34. *See, e.g.*, ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 408 (1978) ("The paths [of] . . . antitrust law . . . [exhibit] the paradox of great popularity and vigorous enforcement coupled with internal contradiction and intellectual decadence."); Robert H. Bork & Ward S. Bowman Jr., *The Crisis in Antitrust*, FORTUNE, Dec. 1963, at 138 (warning about a crisis caused by "'protectionist' trends in antitrust").

ble."[35] Yet, in his pursuit of a more logical version of antitrust law, Bork went as far as offering and promoting a study of the legislative intent of the Sherman Act that is completely divorced from the record.[36] Bork's attack on institutions, chiefly the Supreme Court, and aversion of liberal elites epitomize populism.

As populist voices, the anti-bigness and anti-enforcement strains have a few common characteristics. Both are expressions of political populism and are guided by criticism of institutions—big corporations and their enablers, antitrust enforcement, politicians, and weak courts. The antitrust philosophy of each strain builds on relentless critique of the other strain and intellectuals associated with that strain. Of course, proponents of each strain take pride in its intellect, while emphasizing the incoherency of the other strain. Explicitly or implicitly, proponents of each strain see populism only in the other strain.

The contrast between the Warren and Roberts Courts illustrates the point. The Warren Court's pro-small business approach is often used to exemplify anti-bigness populism.[37] The Roberts Court's antitrust jurisprudence approach is, in many ways, a mirror image of the Warren Court. It reflects chronic skepticism of the efficacy of antitrust enforcement and hostility toward antitrust plaintiffs.[38] Thus, when the Warren and Roberts Courts are compared in their antitrust jurisprudence, it is difficult to argue that one is populist and the other is not.

II.
Technological Progress and Antitrust Populism

The relationship between antitrust and technological change provides some context for the sources of antitrust populism. The term "technological change" refers to improved ef-

35. Bork, *supra* note 34, at 418.

36. Barak Orbach, *Was the Crisis in Antitrust a Trojan Horse?*, 79 Antitrust L.J. 881, 891 (2014).

37. *See, e.g.*, Kauper, *supra* note 1. The Chicago School developed literature ridiculing the antitrust jurisprudence of the Warren Court. *See* Herbert Hovenkamp, *Antitrust Policy After Chicago*, 84 Mich. L. Rev. 213, 218 (1985) ("The Chicago School has been particularly relentless in its criticism of the antitrust policy of the Warren Era, which has been presented as the antithesis of sound economic thinking in antitrust policy.").

38. *See* Epstein et al., *supra* note 7; Scheiber, *supra* note 7.

ficiencies gained through innovation. The process disrupts markets and may be unfavorable to older technologies and small economic units. A market disruption, especially one with negative effects on small firms, is a prescription for antitrust populism.

A. *Guiding Principles for National Policies*

Modern national economic policies are guided by the premise that productivity growth, which is an increased efficiency measured by gross domestic product (GDP) per capita per hour, defines a country's ability to improve the standard of living over time.[39] The primary source of productivity growth, in turn, is the "total factor productivity" (TFP), which is the portion of national output not explained by the amount of inputs used; namely, the gap between input and output of resources in production. TFP is generally attributed to innovation and efficiencies.[40] Accordingly, national economic policies, including antitrust law, seek to promote efficiency and innovation. These widely accepted economic principles, which emphasize the virtues of technological progress, were developed during the twentieth century. In the context of antitrust policies, competition is one of the factors that may affect innovation intensity, but the relationship between competition and innovation is complex.[41] Market competition may influence the degree of

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39. *See, e.g.*, COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT 207 (2016) ("Productivity growth is critical to the well-being of the American economy, its workers, and its households. Growth in labor productivity means American workers generate more output for a given amount of work, which can lead to higher living standards via higher wages, lower prices, and a greater variety of products."); PAUL KRUGMAN, THE AGE OF DIMINISHED EXPECTATIONS 11 (3d ed. 1997) ("Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."). The reliance on GDP to measure prosperity has been under criticism. *See How to Measure Prosperity*, ECONOMIST, Apr. 30, 2016, at 7; *The Trouble with GDP*, ECONOMIST, Apr. 30, 2016, at 23.

40. *See* Jason Furman, Chairman, Council of Economic Advisors, Productivity Growth in the Advanced Economies: The Past, the Present, and Lessons for the Future, Remarks at the Peterson Institute for International Economics (July 9, 2015).

41. *See, e.g.*, Carl Shapiro, *Competition and Innovation: Did Arrow Hit the Bull's Eye?*, *in* THE RATE AND DIRECTION OF ECONOMIC ACTIVITY REVISITED 361 (Josh Lerner & Scott Stern eds., 2012); Jonathan B. Baker, *Beyond Schumpeter vs. Arrow: How Antitrust Fosters Innovation*, 74 ANTITRUST L.J. 575, 577 (2007);

inventive activities, but not always in the same direction and it is not entirely clear how.[42] There is, however, a broad consensus that antitrust law should facilitate and promote innovation.[43]

B. *The Social Costs of Progress*

One of the assumptions underlying economic policies that seek to enhance productivity growth is that negative welfare effects, associated with increased efficiencies and innovation, dissipate effectively in the economy. When this condition does not hold, efficiencies and innovation may not produce the expected productivity growth and improvements in the standard of living. This phenomenon is known as the "productivity paradox."[44]

To illustrate the productivity paradox, consider the present time. The transition from the "old economy" to the "new economy" produced considerable efficiencies, but is unfavorable to large segments of society.[45] Big data, artificial intelligence, and robotics permit greater automation and improved optimization, leading to dramatic changes in the demand for skills, the elimination of many jobs, and the retirement of

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Michael L. Katz & Howard A. Shelanski, *Mergers and Innovation*, 74 ANTITRUST L.J. 1, 2 (2007).

42. *See, e.g.*, Shapiro, *supra* note 41, at 362; Ilya Segal & Michael D. Whinston, *Antitrust in Innovative Industries*, 97 AM. ECON. REV. 1703, 1703 (2007) ("[T]he effects of antitrust policy on innovation are poorly understood."); Katz & Shelanski, *supra* note 41, at 2 (analyzing challenges for merger policy when sometimes concentration is conducive to innovation); Baker, *supra* note 41, at 577.

43. *See* HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 1 (2005) ("Few people dispute that antitrust's core mission is protecting consumers' right to the low prices, innovation, and diverse production that competition promises."); U.S. DEP'T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT vii (2008) ("The U.S. antitrust laws reflect a national commitment to the use of free markets to allocate resources efficiently and to spur the innovation that is the principal source of economic growth.").

44. Nobel laureate Robert Solow is credited for identifying the phenomenon, when in the late 1980s he observed that "[y]ou can see the computer age everywhere but in the productivity statistics." Robert M. Solow, *We'd Better Watch Out*, N.Y. TIMES BOOK REV., July 12, 1987, at 36.

45. For early discussions of the transition to the new economy *see The New Economy: Work in Progress*, ECONOMIST, July 24, 1999, at 21; *The New Economy*, TIME, May 30, 1983, at 62.

many technologies.[46] In numerous industries, the demand for labor has already dramatically declined or changed, and in others the decline and transformation of the demand is imminent. Technology and innovation change labor markets in other ways as well. Over 20% of the workforce is already employed in the "gig economy" and this sector is expected to grow.[47] In these markets, gig workers enter into formal agreements with on-demand companies (*e.g.*, Uber, Airbnb) to provide services to the company's customers. The contractual arrangements of gig workers are flexible, giving workers fewer benefits than those provided to traditional employees and less control over their tasks than a typical independent contractor would have.[48] These contractual arrangements produce considerable efficiencies, leading to the decline of traditional business models in various industries.[49] The productivity gains tend to be unfavorable to the workforce and small companies.[50] The productivity paradox, thus, is created because of the negative welfare effects on large segments in the economy.

Long term-trends underscore negative welfare effects experienced during the transition to the new economy. Since the mid-1970s, income inequality has been on the rise, business dynamism (the rate of entry of entrepreneurial firms) has been declining, mobility between jobs and across occupations

46. *See, e.g.*, ERIK BRYNJOLFSSON & ANDREW MCAFEE, THE SECOND MACHINE AGE (2014); Tom Standage, *Special Report: Artificial Intelligence*, ECONOMIST, June 25, 2016; *The Onrushing Wave*, ECONOMIST, Jan. 18, 2014, at 24; Carl Benedikt Frey & Michael A. Osborne, The Future of Employment: How Susceptible Are Jobs to Computerisation? (Sept. 17, 2013) (working paper) (on file with the Oxford Martin Programme on Technology and Employment); *Special Report: Data, Data Everywhere*, ECONOMIST, Feb. 27, 2010.

47. *See* Cynthia A. Montgomery et al., *The On-Demand Economy*, Harvard Business School Technical Note 716-405, Sept. 2015; SARAH A. DONOVAN ET AL., CONG. RESEARCH SERV., WHAT DOES THE GIG ECONOMY MEAN FOR WORKERS? (2016); *There's an App for That*, ECONOMIST, Jan. 3, 2015, at 17.

48. Mark J. Loewenstein, *Agency and the New Economy*, 72 BUS. LAWYER 1 (2017).

49. Anna Louie Sussman & Josh Zumbrun, *'Gig' Economy Spreads Broadly*, WORLD STOCK MARKET NEWS (Mar. 25, 2016), http://stockmarketnewsworld.com/gig-economy-spreads-broadly/; DONOVAN ET AL., *supra* note 47. *See also There's an App for That*, ECONOMIST, Jan. 3, 2015, at 17.

50. *See, e.g.*, Eric Morath, *Top Earners Gain in Gig Economy*, WALL ST. J., May 4, 2016, at A2; *Part-time Palaver*, ECONOMIST, Sept 19, 2015, at 74; Lauren Weber, *Some Bosses Reclassify Employees to Cut Costs*, WALL ST. J., July 1, 2015, at B1.

has diminished, market concentration in many key industries has increased, and national productivity growth has been relatively disappointing.[51] The trends are not fully understood. There is, however, a consensus that social discontent caused by the transition to the new economy is among the primary causes of the present rise of populism in the United States.[52] Stated simply, during the past decades, dramatic changes in markets produced significant efficiencies, yet various trends related to these changes also generated negative welfare effects and social discontent.

Thus, although technological progress is celebrated as the principal engine of prosperity, theory and history show that rapid technological change may result in significant negative welfare effects that could give rise to populism. Such populism, in turn, tends to result in policy distortions that have additional and even greater negative effects.

C. *Industrial Revolutions and Their Significance*

The United States produced two industrial revolutions that generated prolonged periods of social discontent. The Second Industrial Revolution led to the emergence of the first large businesses and prompted Congress and the states to begin developing modern business laws. The present industrial revolution is still ongoing and is often described as the transition from the "old economy" to the "new economy."[53] Both industrial revolutions generated massive waves of populism.

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51. *See* Jason Furman, Beyond Antitrust: The Role of Competition Policy in Promoting Inclusive Growth, Remarks delivered at Searle Center Conference on Antitrust Economics and Competition Policy (Sept. 16, 2016); Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States*, 1913–1998, 118 Q. J. Econ. 1 (2003); Thomas Piketty & Emmanuel Saez, *Inequality in the Long Run*, 344 SCIENCE 838 (2014); *Forgotten Men*, ECONOMIST, Feb. 18, 2017, at 22 (describing the growing gap between white working-class men and other men in the United States); Adrian Wooldridge, *Special Report: The Rise of the Superstars*, ECONOMIST, Sept. 17, 2016 (describing the rise of companies with market power); *Too Much of a Good Thing*, ECONOMIST, March 26, 2016, at 23 (describing the increase in concentration in the US economy); *Jobs Are Not Enough*, ECONOMIST, July 19, 2014, at 23 (describing the decline in productivity growth).

52. *See* Barack Obama, *The Way Ahead*, ECONOMIST, Oct. 8, 2016, at 22.

53. The "First Industrial Revolution," mostly known as the "Industrial Revolution," took place in Great Britain between 1760 and 1830. It gave birth to factories in Great Britain and later in other countries. *See* THE BRIT-

An "industrial revolution" is a rapid transformation of the economy through significant technological advancements, bringing about automation and enhanced efficiencies. The concept intends to convey the idea of a radical change in the set of technological possibilities.[54] At least in the short run, industrial revolutions have considerable negative welfare effects, such as elimination of jobs, and losses to businesses that are invested in older technologies.[55] These negative welfare effects are conducive to populism.

The "Second Industrial Revolution" was a spike of innovation in the United States between 1870 and 1914, which contributed to productivity growth in the US economy that lasted into the 1970s.[56] The technological advancements of the era contributed to the development of mass production and mass distribution and, thus, to a transformation of the economy. New forms of businesses emerged—multiunit companies. These business enterprises utilized economies of scale and scope, integrated several lines of operations, and relied on professional managements.[57] The rise of multiunit firms marked the decline of traditional businesses that were owned by "an individual or a small number of owners," who operated "a shop, factory, bank, or transportation line, out of a single office."[58] The Second Industrial Revolution formed what was known during much of the twentieth century as the "modern

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ISH INDUSTRIAL REVOLUTION: AN ECONOMIC PERSPECTIVE (Joel Mokyr ed., 2d ed. 1999).

54. *See* DAVID S. LANDES, THE UNBOUND PROMETHEUS (2d ed. 2003).

55. David H. Autor, *Why Are There Still So Many Jobs? The History and Future of Workplace Automation*, 29 J. ECON. PERSP. 3 (2015); Joel Mokyr et al., *The History of Technological Anxiety and the Future of Economic Growth: Is This Time Different?*, 29 J. ECON. PERSP. 31 (2015). *See also* Thurman Arnold, *Depression—Not in Your Lifetime*, COLLIER'S, Apr. 25, 1953, at 24, 26 (noting that "[s]udden industrial advances always shake existing economic institutions to their foundations.").

56. *See* Andrew Atkeson & Patrick J. Kehoe, *Modeling the Transition to a New Economy: Lessons from Two Technological Revolutions*, 97 AM. ECON. REV. 64 (2007); Alfred D. Chandler, Jr., *Industrial Revolutions and Institutional Arrangements*, 33 BULL. AM. ACAD. ARTS & SCI. 33 (1980); Robert J. Gordon, *U.S. Economic Growth since 1870: One Big Wave?*, 89 AM. ECON. REV. 123 (1999).

57. ALFRED D. CHANDLER JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 1–5 (1977).

58. *Id.* at 3. Alfred Chandler observed that the "modern business enterprise" of the twentieth century was "the organizational response to fundamental changes in processes of production and distribution made possible

economy," which relied on relatively local manufacturing with vertical distribution chains and depended on fossil fuels. Today, the twentieth century economy is known as the "old economy."

The present industrial revolution began in the 1970s.[59] Developments in information and communications technologies (ICT) have been radically transforming the organization of production and distribution. Big data, artificial intelligence, and robotics considerably enhance automation and optimization of resources.[60] Additionally, we are witnessing a transition to efficient energy sources and advanced materials, while reducing reliance on fossil fuels and organic materials. This industrial revolution has been expanding globalization, enhancing efficiencies, and reshaping the demand for skills and capital in markets. The new economy is global and builds on technologies that permit automation of a wide range of complex routine and non-routine cognitive tasks (mostly known as "high-tech"). There are also dramatic developments in the structure of business organizations. The new business enterprise that emerges in this industrial revolution is often described as "platform." It utilizes network externalities to connect suppliers and consumers through an online platform. Amazon, Apple, Google, and Facebook, the titans of the era, illustrate the model.[61]

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by the availability of new sources of energy and by the increasing application of scientific knowledge to industrial technology." *Id.* at 376.

59. *See* Ryan Avent, *The Third Great Wave; To Come*, ECONOMIST, Oct. 4, 2014, at 3; *The New Economy: Work in Progress*, ECONOMIST, July 24, 1999, at 21. *See also* Chandler, *Industrial Revolutions and Institutional Arrangements*, *supra* note 56 (describing the First and Second Industrial Revolution and depicting the likely characteristics of the Third Industrial Revolution).

60. *See, e.g.*, ERIK BRYNJOLFSSON & ANDREW MCAFEE, THE SECOND MACHINE AGE: WORK, PROGRESS, AND PROSPERITY IN A TIME OF BRILLIANT TECHNOLOGIES (2014); Tom Standage, *The Return of the Machinery Question*, ECONOMIST, June 25, 2016, at 4; Oliver Morton, *Immigrants from the Future*, ECONOMIST, March, 29, 2014, at 3; *The Onrushing Wave; The Future of Jobs*, ECONOMIST, Jan. 18, 2014, at 26; Carl Benedikt Frey & Michael A. Osborne, *The Future of Employment: How Susceptible Are Jobs to Computerisation?*, Oxford Martin Programme on the Impacts of Future Technology (Sept. 2013); Kenneth Cukier, *Data, Data Everywhere*, ECONOMIST, Feb. 27, 2010, at 3.

61. *See generally Robber Barons and Silicon Sultans; Self-Made Wealth in America*, ECONOMIST, Jan. 3, 2015, at 54; *Everybody Wants to Rule the World; Internet Monopolies*, ECONOMIST, Nov. 29, 2014, at 19; *Another Game of Thrones; Technology Giants at War*, ECONOMIST, Dec. 1, 2012, at 24.

D. *Antitrust Reflections*

Antitrust law was born in a populist reaction to the developments during the Second Industrial Revolution. Congress enacted the Sherman Act in response to a populist agrarian movement whose leaders proudly identified themselves as populists.[62] This movement resented intellectualism and perceived technology as a threat.[63] The so-called "antitrust movement," which led to the early development of antitrust laws related to "trustbusting," emerged after the enactment of the Sherman Act as a thread of the Progressive movement.[64] The four-way presidential race among Woodrow Wilson, William Howard Taft, Theodore Roosevelt, and Eugene Debs in 1912 is often used to illustrate this form of populism.[65] Until 2016, the 1912 presidential race was the last election in which antitrust featured in major presidential campaigns.

Old antitrust cases sometimes refer to the need to respond to public anxieties in the era of the Second Industrial Revolution. For example, *Trans-Missouri* speaks of "small dealers and worthy men. . .who might be unable to readjust themselves to their altered surroundings."[66] In *Alcoa*, Judge Learned Hand observed that "among the purposes of Congress in 1890 was a desire to put an end to great aggregations of capital because of the helplessness of the individual before them."[67] *Brown Shoe* talks about the "desirability of retaining

62. *See* Thomas W. Hazlett, *The Legislative History of the Sherman Act Re-Examined*, 30 ECON. INQ. 263 (1992) ; Thomas J. DiLorenzo, *The Origins of Antitrust: An Interest-Group Perspective*, 5 INT'L. REV. L. & ECON. 73, 74 (1985); George J. Stigler, *The Origin of the Sherman Act*, 14 J. L. STUD. 1 (1985). *See also* JOHN D. HICKS, THE POPULIST REVOLT: A HISTORY OF THE FARMERS' ALLIANCE AND THE PEOPLE'S PARTY (Minn. Arch. ed., 1931).

63. HICKS, s*upra* note 62.

64. *See* Richard Hofstadter, *What Happened to the Antitrust Movement?*, *in* THE BUSINESS ESTABLISHMENT 113 (Earl. F. Cheit ed., 1964); Marc Winerman, *The Origins of the FTC: Concentration, Cooperation, Control, and Competition*, 71 ANTITRUST L.J. 1 (2003).

65. *See* JAMES CHACE, 1912: WILSON, ROOSEVELT, TAFT & DEBS (2005); Daniel A. Crane, *All I Really Need to Know About Antitrust I Learned in 1912*, 100 IOWA L. REV. 2025 (2015); William Kolasky, *The Election of 1912: A Pivotal Moment in Antitrust History*, 3 ANTITRUST 25 (2011).

66. United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 323 (1897).

67. United States v. Aluminum Co. of Am., 148 F.2d 416, 428 (2d Cir. 1945).

local control over industry and the protection of small businesses."[68] The adoption of the "rule of reason" standard in the 1911 *Standard Oil* case was perceived as an interpretation empowering large businesses.[69] Criticism of the interpretation and concerns regarding the rise of large business entities contributed to the enactment of the Clayton and Federal Trade Commission Acts of 1914.[70]

By the 1960s, memories of the anxieties and displacement caused by the Second Industrial Revolution had faded. Confidence in government regulation began to erode.[71] Courts became influenced by a new "populist mood" expressing doubts of agency expertise and concerns that agencies were "captured" by the industries that they regulated.[72] Conservative populism emerged as a movement that criticized the perceived ineffectiveness of the establishment (the government and the Supreme Court), ridiculed liberal intellectuals, and made exaggerated claims about market efficiency and economic logic.[73]

In economics and antitrust, conservative populism is associated with the Chicago School.[74] Four emblematic examples of this populism in antitrust law are (1) the argument that in antitrust consumer welfare means allocative efficiency; (2) the "false positive" (or "error costs") framework; (3) skepticism of

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68. *Brown Shoe*, 370 U.S. at 315–316.

69. Standard Oil Co. v. United States, 221 U.S. 1 (1911). *See Views of Financial Leaders on the Standard Oil Decision*, WALL ST. J., May 17, 1911, at 1. *See also Business Likes Oil Decision*, N.Y. TIMES, May 17, 1911, at 1; *An Improvement Looked for By Leading Industrial Interests*, WALL ST. J., May 20, 1911, at 1; Edward G. Lowry, *The Supreme Court Speaks*, HARPER'S WKLY., June 3, 1911, at 8.

70. *See May Amend Sherman Law*, N.Y. TIMES, May 16, 1911, at 4; *Business Likes Oil Decision*, *supra* note 69, at 1; *Amended Trust Law to Be Issue*, WASH. POST, May 17, 1911, at 4; *Senators in Haste to Amend Trust Act*, N.Y. TIMES, May 18, 1911, at 3; *To Tighten Trust Law*, WASH. POST, May 18, 1911, at 1. *See generally* Winerman, *supra* note 64.

71. *See, e.g.*, MARVER H. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION (1955); JAMES M. LANDIS, REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT (1960); MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962).

72. Thomas W. Merrill, *Capture Theory and the Courts: 1967–1983*, 72 CHI.-KENT L. REV. 1039 (1997).

73. For populism in the conservative movement, see KAZIN, *supra* note 18, at 165–94; 245–66.

74. *See* Herbert Hovenkamp, *Antitrust Policy After Chicago*, 84 MICH. L. REV. 213 (1985).

the profitability of exclusionary conduct; and (4) the belief that vertical restraints are unlikely to harm competition. The proposition that the phrase "consumer welfare" means "allocative efficiency" comes from Robert Bork's interpretation of the legislative intent of the Sherman Act, which is understood today as academic deceit or gross exaggeration.[75] Bork's interpretation implies that distributive concerns should not factor into antitrust policies. Its literal meaning (consumer welfare = efficiency) is confusing and there is no good explanation for its broad endorsement.[76] The "false positives" framework was derived from Aaron Director's formulation of laissez faire economics by commentators associated with the Chicago School and was adopted by the Supreme Court as a guiding doctrine for antitrust analysis.[77] The framework states that anticompetitive conduct is largely self-correcting, whereas antitrust enforcement deters beneficial business activities.[78] Stated simply, the false positives framework is a broad statement that anti-

75. Orbach, *supra* note 36.

76. *See* Barak Orbach, *The Antitrust Consumer Welfare Paradox*, 7 J. COMPETITION L. & ECON. 133 (2011).

77. *See* Aaron Director, *The Parity of the Economic Market Place*, 7 J. L. & ECON. 1, 2 (1964) ("Laissez faire has never been more than a slogan in defense of the proposition that every extension of state activity should be examined under a presumption of error."). For criticism of the framework, see Baker, *Taking the Error Out of "Error Cost" Analysis*, *supra* note 7. For the adoption of the framework by the Supreme Court, see for example, Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 282 (2007) ("[A]ntitrust courts are likely to make unusually serious mistakes."); Verizon Communs., Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 414 (2004) ("Against the slight benefits of antitrust intervention here, we must weigh a realistic assessment of its costs."); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986) ("[M]istaken inferences in [antitrust] cases . . . are especially costly, because they chill the very conduct the antitrust laws are designed to protect.").

78. Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 329 (1984):

> [J]udicial errors that tolerate baleful practices are self-correcting while erroneous condemnations are not. . . .The costs of the judicial process—including the costs of errors, which deter beneficial practices—suggest the wisdom of letting the competitive process rather than the courts deal with conduct that does not create profits by reducing competition. If the practice really is anticompetitive and privately unprofitable, it will go away in time. If it persists, the appropriate inference is that it has competitive benefits.

trust enforcement tends to be cost-ineffective.[79] For example, the skepticism of the potential profitability of exclusionary conduct is often articulated with economic lingo, but generally reflects a hostility toward antitrust enforcement that is not supported by economics.[80] Finally, the belief that vertical restraints are unlikely to harm competition emerged when antitrust law condemned many procompetitive vertical restraints. Rather than stating that vertical restraints tend to be procompetitive but may also serve anticompetitive purposes, Chicago School scholars argued that vertical restraints should be legal per se under antitrust law.[81] Today, the rule of reason standard applies to vertical restraints and the application of the rule is very unfavorable for plaintiffs.[82] As noted, this approach may be better described as anti-enforcement populism.

The transition to the new economy prompted two populist reactions to antitrust law: some have fiercely argued that antitrust laws are ill-equipped to regulate innovative firms, while others have strongly argued that antitrust laws ought to address the size of the technological giants and their financiers. For example, in the late 1990s, the *Microsoft* trial sparked the first significant debate about the role of antitrust law in the new economy.[83] In 1998, when the Justice Department and 20 states filed the complaint, Microsoft was the world's largest software maker.[84] The debate over the effectiveness of anti-

79. *See, e.g.*, Geoffrey A. Manne & Joshua D. Wright, *Google and the Limits of Antitrust: The Case Against the Antitrust Case Against Google*, 34 HARV. J. L. & PUB. POL'Y 1, 6 (2011) ("[T]he error cost framework . . . presumes that errors are an inevitable and core feature of the antitrust enterprise.").

80. *See* Baker, *Exclusion as a Core Competition Concern*, *supra* note 7.

81. *See, e.g.*, Robert Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157 (1954); Frank H. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTITRUST L.J. 135 (1984); Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981).

82. *See* Barak Orbach, *Antitrust Stare Decisis*, 15 ANTITRUST SOURCE 1 (2015).

83. United States v. Microsoft Corp., 253 F.3d 34 (D.C. Cir. 2001). *See also* Robert J. Barro, *Why the Antitrust Cops Should Lay Off High Tech*, BUS. WEEK, Aug. 20, 1998, at 20; Robert H. Bork, *The Most Misunderstood Antitrust Case*, WALL ST. J., May 22, 1998, at A16; Robert H. Bork, *What Antitrust Is About*, N.Y. TIMES, May 4, 1998, at A19.

84. *At War With Microsoft*, ECONOMIST, May 23, 1998, at 15.

trust enforcement roughly followed the trial.[85] The *Microsoft* court wrote that it decided the case "against a backdrop of significant debate amongst academics and practitioners over the extent to which 'old economy' . . . doctrines should apply to firms competing in dynamic technological markets."[86] The Antitrust Modernization Commission examined the concerns and concluded that there was "no need to revise the antitrust laws to apply different rules to industries in which innovation, intellectual property, and technological change are central features" and that antitrust enforcers should "carefully consider market dynamics" in all industries.[87] More recently, in the *eBook* case, Apple orchestrated a hub-and-spoke conspiracy and warned the court that "a ruling against Apple would set a dangerous precedent" as it would "punish innovation."[88]

From the opposite direction, fears of size escalated quickly after the Great Recession. Journalists, commentators, and politicians returned to populist ideas from the early days of antitrust law, such as "trust-busting," the protection of small businesses, "fair competition," fears of bigness, concerns that "everything is rigged," and hostility to "robber barons."[89] In

85. *See, e.g.*, George L. Priest, *Flawed Efforts to Apply Modern Antitrust Law to Network Industries*, *in* HIGH-STAKES ANTITRUST 118 (Robert W. Hahn ed., 2003); David S. Evans & Richard Schmalensee, *Some Economic Aspects of Antitrust Analysis in Dynamically Competitive Industries*, *in* 2 INNOVATION POLICY AND THE ECONOMY 1 (Adam B. Jaffe et al. eds., 2002); Jonathan M. Jacobson, *Do We Need a "New Economy" Exception for Antitrust*, 2001 ANTITRUST 89 (Fall 2001); Robert Pitofsky, *Challenges of the New Economy: Challenges at the Intersection of Antitrust and Intellectual Property*, 68 ANTITRUST L.J. 913 (2001); Richard A. Posner, *Antitrust in the New Economy*, 68 ANTITRUST L.J. 925 (2001).

86. *Microsoft*, 253 F.3d at 49.

87. ANTITRUST MODERNIZATION COMM'N, REPORT AND RECOMMENDATIONS 32 (2007).

88. United States v. Apple Inc., 952 F. Supp. 2d 638, 707 (S.D.N.Y. 2013), *aff'd*, 791 F.3d 290 (2d Cir. 2015).

89. *See, e.g.*, Luther Lowe, *It's Time to Bust the Online Trusts*, WALL ST. J., Nov. 1, 2017, at A15; Rana Foroohar, *Tech 'Superstars' Risk a Populist Backlash*, FIN. TIMES, Apr. 24, 2017, at 9; Derek Thompson, *America's Monopoly Problem: How Big Business Jammed the Wheels of Innovation*, ATLANTIC, Oct. 2016, at 26; Adrian Wooldridge, *The Rise of the Superstars*, ECONOMIST, Sept. 17, 2016, at 1; Steven Davidoff Solomon, *Tech Giants Gobble Start-Ups in a Regulatory Blind Spot*, N.Y. TIMES, Aug. 17, 2016, at B3; Paul Krugman, *Robber Baron Recessions*, N.Y. TIMES, Apr. 18, 2016, at A21; *The Problem With Profits*, ECONOMIST, March 26, 2016, at 11; *Too Much of a Good Thing*, ECONOMIST, March 26, 2016, at 23; Theo Francis & Ryan Knuston, *Wave of Megadeals Tests Antitrust Limits in U.S.*, WALL ST. J., Oct. 19, 2015, at A1; Greg Ip, *Why Corporate America Needs Some*

April 2016, President Obama issued Executive Order (EO) 13725 declaring that an efficient and competitive marketplace is also fair and emphasizing the positive effects of competition in labor markets.[90] Simultaneously with the issuance of the EO 13725, the Council of Economic Advisors released a short report stating that "decades-long decline in new business formation and increases in industry-specific measures of concentration" are at least partially related to permissive competition policies.[91] In October 2016, the Justice Department and the FTC issued *Antitrust Guidance for Human Resource for Professionals.*[92] The policy responds to developments in the economy, reflecting concerns about reduced competition and collusive practices in labor markets.

Microsoft's experiences with populism are somewhat symbolic. In December 2016, shortly after the victory of populism in the US elections, the European Commission approved

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More Competition, WALL ST. J., July 9, 2015, at A2; *Should Digital Monopolies Be Broken Up?*, ECONOMIST, Nov. 29, 2014, at 11; *Everybody Wants to Rule the World*, ECONOMIST, Nov. 29, 2014, at 19; Rana Foroohar, *Call in the Trustbusters*, TIME, Aug. 18, 2014, at 16; Steven Davidoff Solomon, *Changing Old Antitrust Thinking for a New Gilded Age*, N.Y. TIMES, July 23, 2014, at B5; *Robber Barons and Silicon Sultans*, *supra* note 61; Matt Taibbi, *Everything Is Rigged: The Biggest Price-Fixing Scandal Ever*, ROLLING STONE, May 9, 2013, at 32; *Survival of the Biggest*, ECONOMIST, Dec. 1, 2012, at 11; Barry C. Lynn, *Killing the Competition*, HARPER'S, Feb. 2012, at 27; Thomas Catan, *Trustbusters Try to Reclaim Decades of Lost Ground*, WALL ST. J., Feb. 1, 2010, at A2; *US Returns to Its Trust-busting Roots*, FIN. TIMES, May 13, 2009, at 10. See also Senator Elizabeth Warren, *Reigniting Competition in the American Economy*, Keynote Remarks at New America's Open Markets Program Event (June 29, 2016) (calling for "a revival of the movement that created the antitrust laws" to protect small businesses and fight large ones).

90. Exec. Order No. 13725 § 1, 81 Fed. Reg. 23417 (Apr. 20, 2016) ("Maintaining, encouraging, and supporting a fair, efficient, and competitive marketplace is a cornerstone of the American economy. Consumers and workers need both competitive markets and information to make informed choices."); Exec. Order No. 13725 § 2, 81 Fed. Reg. 23417 (Apr. 20, 2016) ("Agencies shall identify specific actions that they can take in their areas of responsibility to build upon efforts to detect abuses such as price fixing, anticompetitive behavior in labor and other input markets, exclusionary conduct, and blocking access to critical resources that are needed for competitive entry.")

91. COUNCIL OF ECON. ADVISERS, BENEFITS OF COMPETITION AND INDICATORS OF MARKET POWER (Apr. 2016).

92. U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDANCE FOR HUMAN RESOURCE FOR PROFESSIONALS (Oct. 2016).

Microsoft's acquisition of LinkedIn.[93] Brad Smith, Microsoft's President and Chief Legal Officer, released a statement recognizing that new technologies have broad negative welfare effects and alluding to the impact of populism:

> On both sides of the Atlantic, it has become increasingly apparent that many people feel left out and unable to participate in the economic growth and opportunities created by the rising digital economy.
>
> While technology tools are not a panacea for current economic challenges, we believe they can make an important contribution. Microsoft and LinkedIn together have a bigger opportunity to help people online to develop and earn credentials for new skills, identify and pursue new jobs, and become more creative and productive as they work with their colleagues. . . . Our ambition is to do our part to create more opportunity for people who haven't shared in recent economic growth.
>
> We readily recognize that no single company can come close to solving the many economic challenges that confront the world today. . . . [A]cross the private and public sectors, we all will need to come together and act with a sense of shared responsibility.[94]

Populism and the populist style, therefore, have always existed in antitrust law and are likely to continue to influence antitrust theories. Contrary to the common depiction in the literature, antitrust populism has several varieties. Although liberal varieties were particularly influential in the past, in recent decades, conservative varieties came to dominate antitrust law. With technological innovation and changes in the economy, especially since the Great Recession, the liberal varieties have become vocal again and possibly started regaining power.

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93. Press Release, European Comm'n, European Commission Approves Microsoft's Acquisition of LinkedIn, Subject to Conditions (Dec. 6, 2016).

94. Brad Smith, *Microsoft–LinkedIn Deal Cleared By Regulators, Opening New Doors for People Around the World*, MICROSOFT CORPORATE BLOGS (Dec. 23, 2016), https://blogs.microsoft.com/blog/2016/12/06/microsoft-linkedin-deal-cleared-regulators-opening-doors-people-around-world/.

Conclusion

The purpose of this Article is to correct the misguided antitrust tradition of associating "populism" with fears of bigness and sympathy for small businesses. The tradition refers to an old populist strain and fails to recognize that other populist strains may influence antitrust law and policy. It, thus, accommodates certain forms of populism in antitrust law, chiefly those related to anti-enforcement sentiments. For this tradition, courts, the agencies, and commentators escape the stigma of populism when they promote populist ideas, such as chronic skepticism of anticompetitive effects and hostility toward antitrust enforcement. Antitrust populists should be recognized for their approach. They have many varieties and represent diverse views, but they all rely on exaggerations, selective facts, and uncompromising beliefs.

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THE IMPORTANCE OF THE BUSINESS JUDGMENT RULE

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"A page of history is worth a volume of logic."[1]

Anyone who has had the opportunity to teach corporate law understands how difficult it is to provide a compelling explanation of why the business judgment rule (the "Rule") is so important. To provide a better explanation of why this is so, this Article takes the approach that the Aronson formulation of the Rule is not the proper starting place. Instead, this Article begins by starting with a close read of two cases that initiated the application of the Rule under Delaware law: the Chancery Court and Supreme Court opinions in Bodell v. General Gas & Electric. By taking this approach, the following insights into the Rule—which are not as readily apparent when the starting point is Aronson—are discovered.

First, without the Rule, the raw power of equity could conceivably require all challenged board of directors ("Board") decisions to undergo an entire fairness review. The Rule is the tool used by a court to restrain itself from persistently implementing such a review. This is the most important function of the Rule. Second, as a result of the need to restrain equity, there

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1. A quote from a Supreme Court opinion delivered by Justice Oliver Wendell Holmes. N.Y. Tr. Co. v. Eisner, 256 U.S. 345, 349 (1921).

is no room for fairness in the Rule's formulation; fairness and fiduciary duties must be mutually exclusive. Third, there are three policy drivers that underlie the use of the Rule: (1) protecting the Board's statutory authority to run the company without the fear of its members being held liable for honest mistakes in judgment; (2) respect for the private ordering of corporate governance arrangements, which almost always grant extensive authority to the Board to make decisions on behalf of the corporation; and (3) the courts' recognition that they are not business experts, making deference to Board authority a necessity. Additionally, the Rule is an abstention doctrine not just in terms of precluding duty of care claims, but also by requiring courts to abstain from an entire fairness review if there is no evidence of a breach in fiduciary duties or taint surrounding a Board decision. Moreover, stockholder wealth maximization ("SWM") is the legal obligation of the Board and the Rule serves to support that purpose. The SWM requirement enters into corporate law through a Board's fiduciary duties as applied under the Rule, not through statutory law. In essence, SWM is an equitable concept.

INTRODUCTION

The business judgment rule (the "Rule") is an equitable doctrine that is the most prominent and important standard of judicial review under corporate law. The Rule protects a decision of a corporate board of directors ("Board") from a fairness review ("entire fairness" under Delaware law) unless a well-pleaded complaint provides sufficient evidence that the Board has breached its fiduciary duties or that the decision-making process is tainted, such as with interestedness or a lack of independence.[2] However, anyone who has had the opportunity to teach corporate law understands the difficulty in providing a compelling explanation of why the Rule is so important.[3] For want of a better simile, trying to explain its importance is like throwing darts at a dart board with the goal of filling up every spot on the board. One eventually gets tired and becomes satisfied with the spots that were hit, but understands that the center of the bull's-eye has been missed.

To provide a better understanding of the Rule's importance, this Article takes the approach that the *Aronson* formulation of the Rule[4] is not the proper starting place for its explanation. The *Aronson* formulation is a common starting point because it includes an aspect of the duty of care—the need for a Board to make a decision "on an informed basis"[5]—that was not found in prior formulations used by the Delaware Supreme Court. Yet, starting with the *Aronson* formulation is like starting in the middle of a story, with much to be lost in its understanding.

Instead of starting with the *Aronson* formulation, this Article takes the novel approach of explaining the Rule by starting with a close reading of two cases which initiated the application of the Rule under Delaware General Corporation Law ("DGCL"): the Chancery Court (the "Chancery") and Delaware Supreme Court (the "Court") opinions in *Bodell v. General*

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2. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

3. One corporate law scholar, Lyman Johnson, even suggests that it is time to get rid of the Rule as a judicial standard of review. *See* Lyman P.Q. Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 DEL. J. CORP. L. 405, 423–31 (2013). Johnson would prefer that the courts focus simply on whether a fiduciary duty has been breached, with the Rule being reduced to a policy statement that directs the courts "not [to] weigh in on the substantive soundness of director decisions" when reviewing a corporate Board decision for a breach in the Board's duty of care. *Id.* at 425.

4. *See infra*, Part II.

5. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

Gas & Electric ("*Bodell I*" and "*Bodell II*").[6] By taking this approach, the following insights into the Rule were discovered, which may not have been so readily apparent by starting with the *Aronson* formulation.

First, without the Rule, the raw power of equity, as made clear in *Bodell I*, could conceivably require all challenged Board decisions to undergo an entire fairness review. In the face of this power, the issue for courts is to determine how the interests of stockholders are to be balanced against protecting the Board's statutory authority to run the company without the fear of constantly facing potential liability for honest mistakes in judgment. Protecting against this potential liability is the original policy driver underlying the Rule. This requires equity to be restrained so as not to create an imbalance. To do this, Courts use the Rule as a tool to distinguish situations in which a Board decision should stand without further review from situations in which an entire fairness review is required and the full force of equity is to be applied. This is the most important function of the Rule.

Second, given the need to restrain equity, there is no room in the Rule formulation for fairness; fairness and fiduciary duties must be mutually exclusive. An entire fairness review is not allowed unless there is evidence that a fiduciary duty has been breached or taint surrounds the decision-making process. If a court finds no breach or taint, then review is halted and the decision stands, thus upholding the Board's statutory authority to manage the corporation. The result is that the Rule serves as a fulcrum balancing the lever between the managerial discretion of the board of directors, as provided by statutory corporate law, on one end, and equity, with its focus on fiduciary duties and the potential for an entire fairness standard of review on the other end. The Rule and its formulation ensures that equity and statutory corporate law co-exist. Removing the Rule as a standard of judicial review (if it ever were to happen) could lead the court to ignore the implications of applying its equitable powers without restraint, potentially allowing the balance to move too far in the direction of equity and resulting in far too many decisions coming under a fair-

6. Bodell v. Gen. Gas & Elec. Corp. (*Bodell I*), 132 A. 442 (Del. Ch. 1926), *aff'd*, Bodell v. Gen. Gas & Elec. Corp. (*Bodell II*), 140 A. 264 (Del. 1927).

ness review. In essence, the Rule is a self-imposed constraint on a court's equitable powers.

Third, the role played by the Rule does not change under DGCL 141(a),[7] (*Bodell I* and *II* dealt with Section 4a of the old DGCL, currently embodied in DGCL § 152[8]) even though two additional policy drivers are identified which reinforce the use of the Rule versus an automatic entire fairness review. These policy drivers are: (1) respect for the *private ordering* of corporate governance arrangements, which almost always grant extensive authority to the Board to make decisions on behalf of the corporation, and (2) the recognition by courts that they are not business experts, making deference to Board authority a necessity.

Fourth, the Rule is an abstention doctrine not just in terms of precluding duty of care claims, as persuasively argued by Stephen Bainbridge,[9] but also in a more fundamental way, by requiring courts to abstain from an entire fairness review if there is no evidence of a breach in fiduciary duties or taint surrounding a Board decision.

Fifth, the Rule serves to support the default legal obligation of the Board known as stockholder wealth maximization ("SWM"), an approach to corporate governance that encourages a Board to implement all major decisions with only the economic interests of stockholders in mind. This is not readily apparent from the *Aronson* formulation of the Rule. The SWM requirement enters into corporate law through a Board's fiduciary duties as applied under the Rule, not through statutory law. In essence, SWM is an equitable concept. The implementation of SWM is indirect as all three of the major policy drivers that influence the Rule also guide courts to stay away from a direct focus on SWM unless the Rule has been rebutted.

The discussion that follows is specifically focused on those Board decisions which are permitted to be reviewed under the Rule. This means that the Article minimizes the discussion of those less common business decisions that come under corporate law's intermediate standards of judicial review, the *Revlon*

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7. DEL. CODE ANN. tit. 8, § 141(a) (2016).
8. DEL. CODE ANN. tit. 8, § 152 (2015).
9. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

duty[10] and the *Unocal* test,[11] both of which are meant to protect decisions from an automatic fairness review even if applied with a heightened level of judicial scrutiny. The Article also minimizes the discussions of those Board decisions that must initially come under the entire fairness standard of review, such as when a corporation enters into a self-dealing transaction with a controlling stockholder.[12]

Also, the discussion that follows—when it references state corporate law—has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the vast majority of the largest United States companies are incorporated,[13] and its corporate law often serves as the authority that other states look to when developing their own statutory and

10. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (establishing the *Revlon* duty to maximize stockholder wealth when the break-up, sale, or merger of a company is inevitable); *see also* Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).

11. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (creating a two-pronged test, commonly referred to as the *Unocal* test, to review defensive measures taken by a board of directors to repel attempts by an outside investor or group of investors to gain control of the corporation).

12. Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014) (according to the Delaware Supreme Court, "[w]here a transaction involving self-dealing by a controlling stockholder is challenged, the applicable standard of judicial review is 'entire fairness,' with the defendants having the burden of persuasion"). However, the Rule may still apply in a transaction where the controlling stockholder offers to buy out the minority stockholders (freeze-out) if the Board appoints a special independent committee to negotiate the transaction on behalf of the minority stockholders and the transaction is approved by an informed majority of minority stockholders. *Id.* at 645. In addition to Kahn's freeze-out merger scenario, it should also be noted that courts have recently taken other action to increase the number of Board decisions that come under the Rule, and not under an entire fairness standard of review, as long as they are satisfied that a majority of informed stockholders have approved the decision. *See* Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015).

13. *See* LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1, 1 (2007), http://corp.delaware.gov/whycorporations_web.pdf (stating that Delaware is the "favored state of incorporation for U.S. businesses"). According to the State of Delaware website, Delaware is the legal home to "[m]ore than 66% of all publicly-traded companies in the United States including 66% of the Fortune 500." STATE OF DELAWARE, ABOUT AGENCY, http://corp.delaware.gov/aboutagency.shtml (last visited Oct. 10, 2017).

common law.[14] Therefore, the primary examples are from Delaware, but the thinking is meant to be global.

This Article proceeds as follows: Part I discusses the origins of the Rule as a tool used by judges to restrain themselves from using their authority under equity to review Board decisions for (entire) fairness. Judges recognized that this was a necessity in order to protect directors from liability for honest mistakes in judgment that turn out badly. Part II describes how the Rule has been applied under DGCL § 141(a), the statutory law which provides the Board with almost unlimited authority to manage the corporation.[15] Part III discusses SWM as a legal obligation of Board decision-making and how the Rule is both consistent with and supportive of SWM.

I.
The Power of Equity

As early as 1742, equity recognized that corporate boards should not be held liable for honest mistakes in judgment. According to the Lord Chancellor of England:

> [Directors] are most properly agents to those who employ them in this trust, and who empower them to direct and superintend the affairs of the corporation. In this respect they may be guilty of acts of commission or omission, of mal-feasance or nonfeasance. Now where acts are executed within their authority, . . . though attended with bad consequences, it will be very difficult to determine that these are breaches of trust. For it is by no means just in a judge, after bad consequences have arisen from such executions of their power, to say that they foresaw at the time what must necessarily happen; and therefore, were guilty of a breach of trust.[16]

This judicial policy of protecting board members from liability when their honest mistakes in judgment turn out badly has been consistently identified as a major policy objective of

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14. *See* Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 Fordham J. Corp. & Fin. L. 393, 397 (2007).

15. Del. Code Ann. tit. 8, § 141(a) (2016).

16. Charitable Corp. v. Sutton [1742] 26 Eng. Rep. 642 (citations omitted).

the Rule. Fifty years ago, Henry Manne stated that the Rule "preclude[s] the courts from any consideration of honest if inept business decisions, and that seems to be the purpose of the Rule."[17] More recently, courts and commentators have become aware that protecting directors from such liability also allows for optimal risk-taking in corporate decision-making:

> Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.[18]

Protecting board members from liability when their honest mistakes in judgment turn out badly is not the Rule, as it is commonly mistaken to be.[19] Instead, it is a policy driver cited by courts in justifying the *use* of the Rule versus the alternative of an automatic (entire) fairness review. This will become clear when *Bodell II* is discussed, but first the discussion needs to focus on *Bodell I*.[20]

A. *Bodell I*

In *Bodell I*, the plaintiffs alleged that the Board violated its fiduciary duties by initiating a plan to sell no-par value stock for below its fair sales value.[21] In response, the Chancery had granted a temporary restraining order.[22] However, the Board itself was not accused of self-dealing or of personally profiting from the sales.[23] Moreover, the statute which allowed for the

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17. Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 271 (1967).

18. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009).

19. Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 680 (citing 1 DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 9 (5th ed. 1998 & Supp. 2002).

20. Bodell v. Gen. Gas & Elec. Corp. (*Bodell I*), 15 Del. Ch. 119, 132 A. 442 (1926), *aff'd*, 15 Del. Ch. 420, 140 A. 264 (1927).

21. *See id.* at 122–23, 132 A. at 444.

22. *See id.* at 123, 132 A. at 444.

23. *See id.*

issuance of no-par value stock, Section 4a of the DGCL,[24] provided the Board with unrestrained authority to determine the adequacy of the consideration to be received in exchange for the no-par value stock as long as the Board had authority to do so under the company's certificate of incorporation.[25]

However, even in the face of this "absolute power," the Chancery had no problem with identifying the countervailing power of equity[26] as authority for reviewing the Board's actions:

> So far as the literal language of the section is concerned, the directors may from time to time issue no par stock for any consideration they may see fit, even though the price they fix is far below its actual value . . . . What I am now pointing out is simply this - that the statute does not impose any restraint upon the apparent unbridled power of the directors. Whether equity will, in accordance with the principles which prompt it to restrain an abuse of powers granted in absolute terms, lay its restraining hand upon the directors in case of an abuse of this absolute power, is another question which will be presently considered and answered in the affirmative.[27]

If this was not clear enough, the Chancery also stated, "But notwithstanding the absolute character of the language in which the power to direct the directors is expressed, it cannot be that a court of equity is powerless in *proper cases* to circumscribe it."[28]

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24. A. R. BENSON, GENERAL CORPORATION LAWS OF THE STATE OF DELAWARE 19 (1921). No-par common stock was approved in 1917 to be followed by no-par value preferred stock in 1925.

25. *Id.*

26. According to Quillen and Hanrahan, "[t]he secret of Delaware equity rests in two old concepts, both English in origin. First, equity is a moral sense of fairness based on conscience. Second, equity is the recognition that the universal rule cannot always be justly applied to the special case. Equity is the flexible application of broad moral principles (maxims) to fact specific situations for the sake of justice. Delaware has preserved the essence." William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery – 1792–1992*, 18 DEL. J. CORP. L. 819, 821–22 (1993). For an excellent discussion of how equity is applied under corporate law, *see* Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 709–13 (2011).

27. *Bodell I*, 15 Del. Ch. at 128, 132 A. at 446.

28. *Id.* at 129, 132 A. at 446 (emphasis added).

As authority for using its equitable powers in the face of statutory law that suggests otherwise, the Chancery noted, "There is no rule better settled in the law of corporations than that directors in their conduct of the corporation stand in the situation of *fiduciaries*. While they are not trustees in the strict sense of the term, yet for convenience they have often been described as such."[29]

In *Bodell I*, the Chancery begins its legal analysis by noting that when statutory law provides the Board with authority, there "accords to the acts of the directors a *presumption* in favor of their propriety and fairness."[30] This presumption is an acknowledgment of Board authority as derived through statutory law.

Nevertheless, in identifying the balance between Board authority and equity where a statute provides the maximum amount of managerial discretion, the Chancery applied a balance that was strongly oriented toward equity, requiring the Board to demonstrate fairness in their decision-making.[31] This was the result of the factual finding that the sale of equity was to occur at a price below fair market value.[32]

The application of the Chancery's fairness review focused primarily on the substantive nature of the stock sales regarding their overall benefits to stockholders, but also appears to have taken into consideration director conduct and motivations by noting that the Board was not interested in the transaction[33] and by concluding that "[a] complete absence of selfish motive and of personal profit on their part forcefully argues that

29. *Id.* (emphasis added). Directors are fiduciaries of both the corporation and stockholders. *See* ROBERT C. CLARK, AGENCY COSTS VERSUS FIDUCIARY DUTIES, IN PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 56 (John W. Pratt & Richard J. Zeckhauser eds., 1985). This gives the misleading impression that they serve two masters. In Part III, it is described how the Court reconciles this unusual situation by taking the position that the fiduciary duties owed to the corporation are for the benefit of the stockholders. *See infra*, Part III.

30. *Bodell I*, 15 Del. Ch. at 129, 132 A. at 446 (emphasis added). This is perhaps the source for the famous presumption language in the current Rule formulation.

31. *Id.* at 132, 132 A. at 448.

32. *See id.* at 122–23, 132 A. at 444.

33. *See id.* at 123, 132 A. at 444.

judgment was formed in absolute honesty and entire good faith."[34]

The Chancery found that the shares were not sold below the fair sales value, thus absolving the Board of any liability.[35] The Chancery also vacated the outstanding restraining order.[36] However, was a fairness review really required? This was the issue taken up by the Court in *Bodell II*.

B. *Bodell II*

In *Bodell I*, the Chancery made an emphatic declaration that the power of equity can never be denied, even in the face of a statutory law that provides the Board with absolute authority in a specific area of corporate decision-making and where there is no evidence of director self-interest. This declaration is not in dispute.[37] A court of equity always has the right to circumscribe Board authority when the court perceives that a wrong has been committed.[38] However, what *Bodell I* did not answer is whether a challenged Board decision would always come under a fairness review, placing the Board in the position of constantly facing significant potential liability for honest mistakes in judgment that turn out badly. Does equity require this? If not, what kind of decision-making tool or filter would the court use to make the determination that a fairness

34. *Id.* at 135, 132 A. at 449.

35. *Id.* at 134–37, 132 A. at 449–50.

36. *Id.* at 139, 132 A. at 451.

37. Sample v. Morgan, 914 A.2d 647, 675 n.54 (Del Ch. 2007) ("That the operation of Delaware corporate law depends importantly on the subjection of action in conformity with legal rules to equitable principles has long been understood.").

38. *Bodell I*, 15 Del. Ch. at 129, 132 A. at 446; *see also* Lofland v. Cahall, 118 A. 1, 3 (Del. 1922) ("Directors of a corporation are trustees for the stockholders, and their acts are governed by the Rules applicable to such a relation, which exact of them the utmost good faith and fair dealing, especially where their individual interests are concerned."); Adams v. Clearance Corp., 121 A. 2d 302, 306 (Del. 1956) ("When the directors, or the majority stockholders, exercise a power that the general corporation law confers upon them, it is competent for anyone who conceives himself aggrieved thereby to invoke the processes of a court of equity for protection against its oppressive exercise. Notwithstanding therefore the absolute terms in which the power of the directors is expressed, equity will afford protection against its wrongful use." (citations and quotes omitted)); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").

review was or was not required? That tool turns out to be the Rule, the standard of judicial review that the Delaware Supreme Court used in *Bodell II* to affirm the Chancery's decision.[39]

In *Bodell II*, the Court was not reticent in taking issue with both the Chancery's apparent lack of respect for the managerial discretion provided by statutory law and its fairness standard of review. According to the Court, "the broad and general language of the statute, embodied in the Certificate of Incorporation, should be liberally construed in favor of the directors."[40] Continuing with this line of thinking, the Court also said:

> The Legislature, in enacting the statute, meant to clothe the directors of a corporation with exceptionally large powers in the sale of its no par value stock. If in the particular case there is nothing to show that the directors did not exercise their discretion for what they believed to be the best interest of the corporation, certainly an honest mistake of business judgment should not be reviewable by the Court.[41]

This is a direct repudiation of the approach applied by the Chancery and perhaps the first case that explained why fairness cannot be part of the Rule formulation. It makes clear that protecting director decision-making when it only involves honest mistakes of business judgment (most critical when director liability is involved) cannot coexist with a fairness standard of review. A fairness review is only concerned with an objective analysis into whether the results were fair to the plaintiffs; it does not take into consideration whether the decision was an honest mistake of business judgment. Either fairness or the policy of protecting honest mistakes of business judgment can be a component of the Rule, but not both. They are mutually exclusive. The Delaware Supreme Court chose the latter in formulating its Rule, an approach which still stands today:

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39. This was perhaps the first case where the Delaware courts applied the Rule under the DGCL, a statutory set of laws created in 1899 to allow for general incorporation. *See* 21 Del. Laws 273 (1899).

40. Bodell v. Gen. Gas & Elec. Corp. (*Bodell II*), 15 Del. Ch. 420, 426, 140 A. 264, 267 (Del. 1927).

41. *Id.*

> It may be impossible to lay down a general rule on this subject, but we think the discretion of a board of directors in the sale of its no par value stock should not be interfered with, except for fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders.[42]

By using the language, "discretion of a board of directors" this Rule formulation acknowledges the managerial authority of the Board as provided by statutory corporate law.[43] Most importantly, however, the formulation reduces the demands of equity by requiring only the absence of certain types of improper Board conduct, namely actual or constructive fraud, in order to allow the decision to stand. Moreover, in formulating its Rule without the inclusion of fairness as a substantive component, the Court established a critical precedent under Section 4a of the old DGCL (currently DGCL § 152[44]) that has been since applied to DGCL § 141(a).[45] This precedent holds that there are significant limits to the reach of equity at least where statutory law grants the board seemingly absolute authority to make corporate decisions.

In affirming the Chancery Court's decision, the Court found no evidence that the Board was not acting in the best interest of the corporation and the fact that the Board was not interested in the transaction served as significant evidence of this.[46] The Court concurred with the lower court and found that the directors had utilized their best judgment and acted in good faith.[47] Therefore, the fairness review as required by *Bodell I* was not required.

C. *Fairness (Entire Fairness) as a Standard of Review*

Before moving to a discussion of the Rule under DGCL § 141(a), it is important to understand what is meant by a fair-

42. *Id.*
43. DEL. CODE ANN. tit. 8, § 141(a) (2016).
44. DEL. CODE ANN. tit. 8, § 152 (2015).
45. DEL. CODE ANN. tit. 8, § 141(a) (2016).
46. *Bodell II*, 15 Del. Ch. 420, 426, 140 A. 264, 267 (the directors were not going to financially benefit from the transaction).
47. *Id.* at 268.

ness review. *Bodell I* required a rigorous review of the stock sales, focusing on both the substantive and procedural nature of the sales and on the conduct and motivations of the directors. Such a fairness review would have created a heavy burden on a Board if it were conjured up every time an honest mistake in judgment turned out badly. This is essentially why the Court in *Bodell II* found it inappropriate to use such a review unless its Rule had been overcome.

The fairness review found in *Bodell I* is the forerunner of the review currently used by Delaware courts when the Rule is overcome (now called "entire fairness).[48] Entire fairness is a court's most onerous standard of review[49] and the one that a Board would most like to avoid, thus encouraging a Board to conduct its decision-making process within the confines of the Rule. However, while starting afresh under entire fairness does put a heavy burden on a Board, it "is not an implication of liability."[50] Entire fairness requires a review of the result for "substantive fairness," with the burden of proof on the defendants.[51] According to Ezra (a.k.a. Lawrence) Mitchell, an "[entire] fairness [review] contemplates a range of values and fiduciary conduct that properly is analyzed within the totality of a transaction's circumstances."[52] When this standard of review applies, courts must "consider carefully how the board of directors discharged all of its fiduciary duties with regard to each aspect of the non-bifurcated components of entire fairness: fair dealing and fair price."[53] Moreover, "[n]ot even an honest

48. Cinerama, Inc. v. Technicolor, Inc., 663 A. 2d 1156, 1162 (Del. 1995) ("If the [R]ule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."); *see also*, Solomon v. Armstrong, 747 A.2d 1098, 1112 (Del. Ch. 1999) ("[T]he board's decision is reviewed through the lens of entire fairness, pursuant to which the directors lose the presumption of good business judgment, and where the Court more closely focuses on the details of the transaction and decision-making process in an effort to assess the fairness of the transaction's substantive terms.").

49. Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 459 (Del. Ch. 2011).

50. Emerald Partners v. Berlin, 787 A.2d 85, 93 (Del. 2001).

51. *Solomon*, 747 A.2d at 1112.

52. Lawrence E. Mitchell, *Fairness and Trust in Corporate* Law, 43 DUKE L. J. 425, 427 (1993).

53. *Emerald Partners*, 787 A.2d at 97.

belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be *objectively* fair, independent of the board's beliefs."[54]

Fair *dealing* "embraces questions of when the transaction was timed, how it was initiated, structured, *negotiated*, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[55] In addition, "[p]art of fair dealing is the obvious duty of candor . . . . Moreover, one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy."[56] Fair *price* "relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[57]

While in theory the review for entire fairness is a non-bifurcated process, in practice courts have great discretion in focusing more on one component than the other.[58] For example, "at least in *non-fraudulen*t transactions, price may be the preponderant consideration. That is, although evidence of fair dealing may help demonstrate the fairness of the price obtained, what ultimately matters most is that the price was a fair one."[59] In the uncommon fact pattern where a stock price, sale price of real estate, or level of compensation, etc. is not at is-

54. Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006) (emphasis added).

55. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (emphasis added).

56. *Id.*

57. *Id.*; *see also Encite LLC v. Soni*, No. 2476-VCG, 2011 Del. Ch. LEXIS 177 at *75 (Del. Ch. 2011). Memorandum opinion.

58. Valeant Pharm. Int'l v. Jerney, 921 A. 2d 732 (Del. Ch. 2007) (focusing on fair dealing in a Board decision to pay large cash bonuses to themselves and to certain non-Board employees). In the cash bonus context of *Valeant*, even if the "board used an unfair process to authorize the bonuses" it "does not end the court's inquiry because it is *possible* that the pricing terms were so fair as to render the transaction entirely fair. Nevertheless, where the pricing terms of a transaction that is the product of an unfair process cannot be justified by reference to reliable markets or by comparison to substantial and dependable precedent transactions, the burden of persuading the court of the fairness of the terms will be exceptionally difficult." *Id.* at 748 (emphasis added).

59. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); *see also Encite*, 2011 Del. Ch. LEXIS 177 at *24.

sue (e.g., where the Board of a non-statutory, closely-held corporation provided themselves with advantageous ways to liquidate their illiquid company stock holdings through company repurchases without providing such means for non-employee stockholders[60]), only fair dealing may apply.[61]

The heavy burden found in both the fairness review applied in *Bodell I* and the entire fairness review, at least in terms of the volume and duration of litigation, requires some way to avoid an automatic fairness review of Board decisions that turn out badly for shareholders. This makes the Rule a necessity.

D. *Summary*

Bodell I stands for the raw power of equity and how it can potentially trump statutory law, even where statutory law provides the Board with unlimited decision-making authority. According to the court, this was true even though the court acknowledged that there "accords to the acts of the directors a *presumption* in favor of their propriety and fairness."[62] *Bodell II* stands for the need to truly respect statutory authority, requiring the courts to restrain the power of equity in the face of this authority. This required restraint provides the foundation for understanding the essence of the Rule.

Bodell II's Rule formulation guides a court in how it should apply this restraint in its review of a Board decision. It first brings to the fore the requirement that a court must respect managerial discretion. This means that fairness cannot be the first stop in a court's review. Instead, a gentler approach must be taken, an approach that involves fiduciary duties, not fairness. There is no room in the Rule formulation for fairness; fairness and fiduciary duties must be mutually exclusive. A fairness review is not allowed unless a fiduciary duty has been breached or there is some taint surrounding the decision such as director' interestedness. This is the fundamental essence of the Rule and if there is one thing that law students must understand about the Rule, this is it.

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60. Nixon v. Blackwell, 626 A. 2d 1366 (Del 1993).

61. *Id.* at 1376.

62. Bodell v. Gen. Gas & Elec. Corp. (*Bodell I*), 15 Del. Ch. 119, 129, 132 A. 442, 446 (1926).

II.
THE BUSINESS JUDGMENT RULE AND § 141(a)

The significance of the Rule peaks when the Rule is applied under the critically important statutory corporate law that provides the Board with authority to manage the corporation. In Delaware, this law is DGCL § 141(a), which states, "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[63]

On its face, this statutory law can be interpreted as providing the Board with unlimited managerial authority, similar to the authority provided by DGCL Section 4a (as discussed in *Bodell I and II*). Unlike Section 4a and its successor DGCL § 152,[64] DGCL 141(a) is an opt-out or "default" rule, not an opt-in rule. As a default rule, the delegation of unlimited authority to the Board is not expected to be substantively altered through a charter amendment. In practice, this has certainly been the case, especially in the context of public companies.

Most importantly, both are examples of the private ordering or enabling approach found in statutory corporate law. According to the Court in *Williams v Geier*, "At its core, the Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial *private ordering*, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored."[65] Private ordering of authority is considered efficient because it allows for the implementation of market-driven corporate governance arrangements.[66] That is, "ob-

63. DEL. CODE ANN. tit. 8, § 141(a) (2016).

64. DEL. CODE ANN. tit. 8, § 152 (2015).

65. Williams v. Geier, 671 A.2d 1368, 1381 (1996).

66. According to Professor Jonathan Macey:

> [B]ecause informal norms generate outcomes that are generally welfare-enhancing, while law *at best* generates outcomes that are mixed (and tend strongly towards the welfare-reducing), informal norms should come with a strong presumption of legitimacy. Formal legal rules are likely to be inefficient at best and amorally redistributive at worst. Thus, under a wide range of circumstances, such as when society is interested in maximizing utilitarian considerations, and when society is interested in resolving standard legal disputes within groups, lawmakers are unlikely to improve upon the customary rules the group develops through voluntary, private interaction.

served governance choices are the result of value-maximizing contracts between stockholders and management."[67] Courts understand that this private ordering has been agreed to under the sanction of statutory corporate law and will feel compelled to respect the wishes of those parties to have the Board manage the company with minimal interference, including interference from the courts.[68] Such respect is not speculative. For example, when a corporation amends its charter to provide for an exculpation clause to protect directors from duty of care liability as allowed under the authority granted by DGCL § 102(b)(7),[69] courts have shown great deference for the authority provided by this type of amendment.[70] In essence, the Board and stockholders have agreed to contract away the Board's fiduciary duty of care. Thus, private ordering provides another policy rationale for why the courts should restrain themselves when applying equitable principles to Board decision-making, adding weight to the lever on the side where statutory law rests and away from equity under the Rule.

Why stockholders permit the Board unrestrained authority under both DGCL § 152 and DGCL § 141(a) is based on the recognition that the Board, with superior information, including confidential information, is in the best position to make the most important corporate decisions. The parties to the corporate contract recognize that a centralized, hierarchi-

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Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123, 1140–41 (1997).

67. David F. Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

68. Bernard S. Sharfman, *The Tension Between Hedge Fund Activism and Corporate Law*, 12 J. L. ECON. & POLICY 251, 253 (2016).

69. DEL. CODE ANN. tit. 8, § 102(b)(7) (2015). Section 102(b)(7) bars any claim for money damages against the director defendants based solely on the board's alleged breach of its duty of care.

70. Malpiede v. Townson, 780 A.2d 1075 (Del. 2001). Delaware courts have also demonstrated respect for the statutory right of corporations, by either a charter amendment or simply a Board resolution, to contract out of the fiduciary duty of loyalty when applying the corporate opportunities doctrine. *See* DEL. CODE ANN. tit. 8, § 122(17) (2000); Gabriel V. Rauterberg & Eric L. Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, COLUM. L. REV. (forthcoming 2017). However, as Lyman Johnson has pointed out, an exculpation clause does not eliminate the duty of care, only the consequences of its breach when the financial liability of the Board is the focus. *See* Johnson, *supra* note 26, at 705.

cal authority is necessary for the successful management of a corporation, especially as it grows to any significant size.[71]

Such deference to Board authority is shared by the courts in its application of the Rule. The Delaware Supreme Court has described the Rule as "an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a),"[72] a point which, if seriously taken, will help make sure the balance does not tip too far towards equity:

> The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority. In this sense the "business judgment" rule is not relevant in corporate decision-making until after a decision is made. It is generally used as a defense to an attack on the decision's soundness. The board's managerial decision-making power, however, comes from § 141(a). The judicial creation and legislative grant are related because the "business judgment" rule evolved to give recognition and deference to directors' business expertise when exercising their managerial power under § 141(a).[73]

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71. Robert Charles Clark, Corporate Law 801–16 (1986) (arguing that "facilitation of cooperation" allows for efficiently completing large tasks). According to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a centralized authority in order for a large organization to make informed decisions and minimize error in decision-making. Kenneth J. Arrow, The Limits of Organization 68–70 (1974). Arman Alchian and Harold Demsetz argued that a centralized authority was necessary to eliminate the problems associated with having a large number of stockholders:

> If every stock owner participated in each decision in a corporation, not only would large bureaucratic costs be incurred, but many would shirk the task of becoming well informed on the issue to be decided, since the losses associated with unexpectedly bad decisions will be borne in large part by the many other corporate stockholders. More effective control of corporate activity is achieved for most purposes by transferring decision authority to a smaller group, whose main function is to negotiate with and manage (renegotiate with) the other inputs of the team.

Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777, 788 (1972).

72. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citing Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981)).

73. Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).

Unlike the defensive nature of the policy rationale utilized in *Bodell II* (i.e., directors should not be blamed for honest mistakes of business judgment), this policy rationale focuses on how corporate decision-making is enhanced because of a Board's business expertise.[74] Embellishing this important point, the Court has also stated that "the core rationale of the Rule is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) . . . ."[75]

Judges need to respect Board decision-making for the simple reason that they are inferior to the Board in terms of determining what is the best corporate decision and therefore should not take on the role of reviewing the substantive decisions of the Board, including determining the "appropriate degrees of business risk."[76] Judges recognize that they lack information, decision-making skills, expertise, and vested interest (i.e., stake in the company) relative to corporate management.[77] As stated by the Michigan Supreme Court in the famous case of *Dodge v. Ford Motor Co.*,[78] "[J]udges are not business experts."[79] Therefore, as long as the courts do not find a breach in a Board's fiduciary duties, they typically do not want to get involved in any type of substantive review of a Board decision.[80]

In part, the humility expressed by courts with respect to their own decision-making abilities is reflective of their understanding that making a business decision can be the result of a long and complicated thought process requiring expertise that courts do not have. The following statement, in the context of a Board trying to make a wealth maximizing decision on behalf of stockholders, makes that point:

74. *Id.*
75. Corwin v. KKR Financial Holdings LLC, 125 A.3d 304, 313–14 (Del. 2015).
76. Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) (quoting Lewis v. Vogelstein, 699 A. 2d 327, 336 (Del Ch. 1997)).
77. Bernard S. Sharfman, *Shareholder Wealth Maximization and Its Implementation Under Corporate Law*, 66 FLA. L. REV. 389, 406–09 (2014).
78. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).
79. *Id.*
80. Sharfman, *supra* note 77, at 409–11.

> [D]etermining whether a business decision is stockholder wealth-maximizing is not just about plugging in a formula and calculating the result, which any computer or calculator can do. Rather, it refers to the specific formula that will be utilized by management to determine if a particular decision maximizes stockholder wealth. One can think of this in terms of a mathematical formula where the decision maker is given the responsibility of choosing the variables and estimating the coefficients of those variables. This requires many sources of knowledge and expertise that chancellors and judges lack, including experience in the particular business that the company may be in, product and company knowledge, management skills, financial skills, creative and analytical thinking pertinent to a company's business, confidential information, and so on. For example, who has the knowledge and expertise to decide whether a distinctive corporate culture enhances or detracts from stockholder value? The clear answer is that the board and its executive management are the proper locus of authority for making this decision.[81]

In sum, what courts desire in terms of corporate authority can be summarized in the following statement by Professor Stephen Bainbridge: the "[p]reservation of managerial discretion should always be the null hypothesis."[82] This approach is supported not only by the desire to refrain from punishing the Board for honest mistakes in judgment but also by two additional policy drivers: (1) respect for the *private ordering* of corporate governance arrangements, which almost always place the bulk of authority for decision-making with the Board, and; (2) courts' recognized lack of business expertise. All three policy drivers encourage a court to use the Rule and discourage it from going directly to an entire fairness review.

A. *The Business Judgment Rule Formulation*

In contrast to the Rule formulation found in *Bodell II*, the current formulation of the Rule under § 141(a) (the *Aronson*

81. *Id.* at 408.
82. Bainbridge, *supra* note 9, at 109.

formulation) includes an aspect of the duty of care, the need for a Board to make a decision on an informed basis:

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[83]

For many, this additional requirement was a mistake, leading to the heavily criticized decision in the famous corporate law case of *Smith v Van Gorkom*,[84] where the Court made absolutely clear that an uninformed Board decision could overcome a court's deference to Board authority and could create director liability.[85] In *Van Gorkom*, this liability occurred despite the fact that the Board had agreed to sell the company for a forty-eight percent premium above the previous day's closing price.[86]

Under *Van Gorkom*, to establish that a Board has made an informed decision, a court must determine "whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[87] Gross negligence is the standard used to determine

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83. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted). In *Aronson*, the Court addressed the issue of "when is a stockholder's demand upon a board of directors, to redress an alleged wrong to the corporation, excused as futile prior to the filing of a derivative suit?" *Id.* at 807.

84. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

85. Frank Easterbrook and Daniel Fischel found the criticism of *Van Gorkom* to be entirely justified:

> It is not hard to see why the case produced such a swift and sweeping reaction. Judicial inquiry into the amount of information managers should acquire before deciding creates the precise difficulties that the business judgment rule is designed to avoid. Information is necessary for corporate managers to maximize the value of the firm. But there is a limit to how much managers should know before making a decision.

FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 107–08 (1991).

86. *See* Bernard S. Sharfman, *The Enduring Legacy of Smith v. Van Gorkom*, 33 Del. J. Corp. L. 287, 291 (2008).

87. *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812).

if there has been a breach of the directors' duty of care in becoming informed.[88]

Soon after *Van Gorkom*, the Delaware General Assembly, responding to concerns that directors faced too much in the way of personal liability, enacted DGCL 102(b)(7),[89] a statutory provision that protects directors from monetary liability for any actions arising from a breach of their duty of care if corporations opt-in through a charter amendment.[90] In essence, Delaware lawmakers have given Delaware corporations the opportunity to veto the *Van Gorkom* decision if they found it was not in their best interests.

However, consistent with the underlying policies of not punishing the Board's honest mistakes in judgment and deferring to Board decision-making authority as provided by private ordering and the court's recognition of its lack of business expertise, the "informed" element of the Rule refers only to "procedural due care," not "substantive due care."[91] According to the Delaware Supreme Court in *Brehm v Eisner*, "Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is process due care only."[92] In sum, meeting the requirements of procedural due

88. *Id.* at 873.

89. DEL. CODE ANN. tit. 8, § 102(b)(7) (2015). Under § 102(b)(7), stockholders are allowed to incorporate into their certificate of incorporation:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . ; or (iv) for any transaction from which the director derived an improper personal benefit.

Id.

90. *Id.*

91. Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

92. *Id.* Interestingly, a valid waste claim may still exist even if the plaintiff cannot overcome the presumption of the Rule. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 73–74 (Del. 2006). In essence, waste is a standard of review that stands outside the Rule and is applicable when irrationality is not found to be associated with a lack of good faith:

> To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was so one sided that

care under the Rule means that a Board has not reached their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available."[93]

B. *Rebutting the Presumption*

Since *Bodell II*, courts have created a fuller picture of what kinds of conduct (fiduciary duties) and lack of taint surrounding the decisions (e.g., disinterestedness, independence and rational business purpose), are required in order for a Board decision to receive the protections of the Rule:

> The business judgment rule, as a general matter, protects directors from liability for their decisions so long as there exist "a business decision, disinterestedness[94] and independence,[95] due care, good

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> no business person of ordinary, sound judgment would conclude that the corporation has received adequate consideration. A claim of waste will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets. This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational purpose.

Freedman v. Adams, 58 A.3d 414, 417 (Del. 2013) (quotations and citations omitted) (citing *Disney*, 906 A.2d at 74).

93. *Brehm*, 746 A.2d at 264 n.66.

94. Under Delaware law, "[a] director is interested in a given transaction if she stands to gain monetarily from it in a way that other stockholders do not." Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 466 (2008) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm*, 746 A.2d at 254).

95. Under Delaware law:

> Directors must not only be independent, but must act independently. Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997). As this Court has previously stated in defining director independence: "[i]t is the care, attention and sense of individual responsibility to the performance of one's duties . . . that generally touches on independence." *Id.* at 430, quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984). Where only one director has an interest in a transaction, however, a plaintiff seeking to rebut the presumption of the business judgment rule under the duty of loyalty must show that "the interested director controls or dominates the board as a whole." Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1168 (Del. 1995).
>
> A party alleging domination and control of a company's board of directors bears the burden of proving such control by showing a

> faith[96] and no abuse of discretion[97] and a challenged decision does not constitute fraud, illegality, ultra vires conduct or waste." There is a presumption that directors have acted in accordance with each of these elements, and this presumption cannot be overcome unless the complaint pleads specific facts demonstrating otherwise. Put another way, under the business

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> lack of independence on the part of a majority of the directors. Odyssey Partners, L.P v. Fleming Cos., Inc., 735 A.2d 386, 407 (Del. Ch. 1999). Theoretically, a director can be "controlled" by another, for purposes of determining whether the director lacked the independence necessary to consider the challenged transaction objectively. A controlled director is one who is dominated by another party, whether through close personal or familial relationship or through force of will. Orman v. Cullman, 794 A.2d 5, 25 n. 50 (Del. Ch. 2002). A director may also be deemed "controlled" if he or she is beholden to the allegedly controlling entity, as when the entity has the direct or indirect unilateral power to decide whether the director continues to receive a benefit upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively. *Id.*

Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002).

96. In *Lyondell v. Ryan*, the Delaware Supreme Court stated that failing to act in good faith means that a Board has intentionally failed "to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009) (quoting *Disney*, 906 A.2d at 67).

97. For example, it may be an abuse of discretion when the Board refuses to pay out a dividend even though the company has accumulated a large amount of earnings. As stated by the Chancery Court in *Eshleman v. Keenan*:

> That courts have the power in proper cases to compel the directors to declare a dividend, is sustained by respectable authorities. But that they should do so on a mere showing that an asset exists from which a dividend may be declared, has never, I dare say, been asserted anywhere. In such a case a court acts only after a demonstration that the corporation's affairs are in a condition justifying the declaration of the dividend as a matter of prudent business management and that the withholding of it is explicable only on the theory of an oppressive or fraudulent abuse of discretion.

22 Del. Ch. 82, 87–88, 194 A. 40, 43 (1937). *See also* Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963) (citing *Eshleman* (in discussing when a court may direct a Board to declare a dividend, the court said: "[t]he principle of law applicable to the relief sought is well settled. Before a court will interfere with the judgment of the Board of Directors, fraud or gross abuse of discretion must be shown.").

> judgment rule, the Court will not invalidate a Board's decision or question its reasonableness, so long as its decision can be attributed to a rational business purpose.[98]

If the presumption has been overcome, "the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its stockholders."[99] As a result, even though the decision may have lost the protections of the Rule, the court cannot go directly to a determination of damages.[100] Instead, it must first make a determination that the transaction was not entirely fair.[101] Such a finding "will be the basis for a finding of substantive liability."[102]

Under this Rule formulation, relative to the Rule found in *Bodell II*, the balance provided by the Rule has shifted toward equity through the explicit requirements of independence, a rational business purpose and most importantly, the relatively new requirement that the Board be informed. These are additional ways for a court to move a Board decision out of the category of Board decisions that the courts are barred from scrutinizing and into the realm of a fairness review, notwithstanding the prevalence of exculpation clauses that mute the effect of a finding that the Board was not informed when it made the challenged decision.

Therefore, while director conduct and lack of taint requirements under this Rule formulation may seem more extensive and demanding than those found in *Bodell II*, this formulation's purpose is exactly the same: to serve as a tool that courts can use to determine whether a Board decision should stand or be subject to a fairness review, i.e., an entire fairness review. These additional requirements can be understood as simply technical corrections when put in the context of maintaining the Rule as the first and most important line of defense against an entire fairness review. In that vein, the presumption

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98. Robotti & Co. *ex rel.* Gulfport Energy Corp. v. Liddell, No. 3128-VCN, 2010 WL 157474, at *11 (Del. Ch. Jan. 14, 2010) (footnotes omitted) (quoting 1 STEPHEN A. RADIN ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES FOR CORPORATE DIRECTORS 110 (6th ed. 2009)).

99. *Id.* at 91.

100. *Id.* at 93.

101. *Id.*

102. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1165 (Del. 1995).

language can be understood to mean that the court must presume that a board decision does not come under a fairness review so long as a Board's fiduciary duties have been met.

C. *The Rule as Abstention Doctrine?*

Stephen Bainbridge, one of the most important corporate law scholars of the past twenty years, has argued that the Rule is an abstention doctrine.[103] As such, "the business judgment rule's function is to preclude courts from deciding whether the directors violated their duty of care."[104] Even though required to focus on procedural due care, courts are still precluded, under the Rule, from reviewing for substantive due care, i.e., the *quality* of a Board's decisions, or for breaches in the duty of care that arise from ordinary negligence in becoming informed. According to Bainbridge, courts are willing to abstain from the review of most duty of care claims because they find this the best way to protect Board authority from unwarranted court interference:

> Establishing the proper mix of deference and accountability thus emerges as the central problem in applying the business judgment Rule to particular situations. Given the significant virtues of discretion, however, one must not lightly interfere with management or the board's decision-making authority in the name of accountability. Preservation of managerial discretion should always be the null hypothesis.[105]

Duty of care claims that go beyond the judicially defined carve-out will quickly be dismissed without discovery even under the lenient standard of "reasonable conceivability," the standard of review that the Delaware courts use in determining whether a complaint will survive a defendant's motion to dismiss.[106] That courts define the duty of care in such narrow

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103. Bainbridge, *supra* note 9.
104. *Id.* at 101.
105. *Id.* at 109.
106. According to the Chancery Court:

> As recently reaffirmed by the Delaware Supreme Court, the governing pleading standard in Delaware to survive a motion to dismiss is reasonable conceivability. That is, when considering such a motion, a court must: accept all well-pleaded factual allegations in the Complaint as true, accept even vague allegations in the Complaint as "well-pleaded" if they provide the defendant notice of the

terms means that the claims simply do not describe a violation of the law.[107] Given this carve-out for most duty of care claims, the Rule can indeed be understood as an abstention doctrine.

But the Rule as a means of precluding duty of care claims could not have been the Rule's original intent, at least under Delaware corporation law. At the time of *Bodell I* and *II,* in 1926 and 1927 respectively, a Board's fiduciary duties did not include a duty of care.[108] It was not until 1963 that the Delaware courts recognized the duty of care as a Board duty and it was not even in the context of the Rule, but rather in regard to the Board's oversight of the company.[109] Finally, in 1971, the Delaware Chancery Court established that being informed was part of a Board's fiduciary duties under the Rule.[110]

> claim, draw all reasonable inferences in favor of the plaintiff, and deny the motion unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof. This reasonable "conceivability" standard asks whether there is a "possibility" of recovery. If the well-pled factual allegations of the complaint would entitle the plaintiff to relief under a reasonably conceivable set of circumstances, the court must deny the motion to dismiss.

Dent v. Ramtron Int'l Corp., C.A. No. 7950-VCP (Del Ch. 2014) (citing Central Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs. LLC, 27 A.3d 531, 536 (Del. 2011)).

107. As pointed out by Robert Rhee, the concept of the Rule as abstention doctrine does not imply judicial abnegation:

> The business judgment rule cannot be an abnegation of power because its very existence arises from the exercise of judicial lawmaking. The court's power to give deference must also mean the court's power to take it. . . . Rather, the systematic outcomes of no liability are achieved because the business judgment rule reflects a reasoned judgment of courts on the nature of a wrong; they evince the exercise of judicial power, and not the relinquishment of it.

Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1193 (2013).

108. Bernard S. Sharfman, *Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years After Van Gorkom*, 62 BUS. LAW. 135, 147 (2006).

109. *Id.* (citing Graham v. Allis-Chalmers Manufacturing Co., 188 A.2d 125, 130 (Del. 1963) ("It appears that directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances.").

110. *Id.* at 148 (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971)) ("Application of the Rule of necessity depends upon a showing that *informed* directors did, in fact, make a business judgment authorizing the transaction under review.") (emphasis added).

The observation that the duty of care was a late arrival as part of a Board's fiduciary duties is not meant to imply that the Rule was not originally meant to be an abstention doctrine. That is, it is not necessary to focus only on the preclusion of duty of care claims to come to the conclusion that the Rule is and has always been an abstention doctrine, at least since *Bodell II*. As already discussed, as a result of the application of the Rule formulation, courts must abstain from a fairness review when the plaintiff fails to show that the Board decision has been tainted with fraud, interest, lack of good faith, abuse of discretion, lack of independence, gross negligence in becoming informed, etc.[111] Therefore, in a very global and fundamental way, the Rule can be understood as an abstention doctrine, requiring the court to abstain from a fairness review unless some sort of director misconduct or taint surrounding the decision is found.

D. *Summary*

The role played by the Rule does not change under DGCL 141(a).[112] However, two additional policy drivers are identified which reinforce the use of the Rule as a means to restrain the courts from reviewing a Board decision for fairness. First, respect for the *private ordering* of corporate governance arrangements, which grant extensive authority to the Board to make decisions on behalf of the corporation. Second, the recognition by the courts that they are not business experts, meaning that they must typically defer to the judgment of the Board in the determination of whether a Board decision is wealth maximizing. Additionally, taints surrounding a business decision now include lack of independence or a rational business purpose. Moreover, the Rule is an abstention doctrine not just in terms of precluding duty of care claims, as persuasively argued by Stephen Bainbridge, but also in a more fundamental way, by requiring courts to abstain from a fairness review if there is no breach in fiduciary duties or taint surrounding a Board decision.

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111. Robotti & Co. *ex rel.* Gulfport Energy Corp. v. Liddell, No. 3128-VCN, 2010 WL 157474, at *11 (Del. Ch. 2010) (footnotes omitted) (quoting 1 STEPHEN A. RADIN ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES FOR CORPORATE DIRECTORS 110 (6th ed. 2009)).

112. DEL. CODE ANN. tit. 8, § 141(a) (2016).

III.
THE RULE AND THE OBJECTIVE OF SHAREHOLDER WEALTH MAXIMIZATION

The *Aronson* formulation does not expand on what it means for directors to act "in the best interests of the corporation."[113] This opens the door for some to argue that the objective of Board decision-making is not SWM, but rather the balancing of the interests of the multiple stakeholders that interact with the corporation. This point is very timely as a number of academics recently signed a statement arguing in part that the Rule serves as evidence that the Board is under no legal obligation to maximize the wealth of stockholders:

> Contrary to widespread belief, corporate directors generally are not under a legal obligation to maximize profits for their stockholders. This is reflected in the acceptance in nearly all jurisdictions of some version of the business judgment rule, under which disinterested and informed directors have the discretion to act in what they believe to be in the best long term interests of the company as a separate entity, even if this does not entail seeking to maximise short-term stockholder value. Where directors pursue the latter goal, it is usually a product not of legal obligation, but of the pressures imposed on them by financial markets, activist stockholders, the threat of a hostile takeover and/or stock-based compensation schemes.[114]

Does the Rule really serve as evidence that corporate law does not require the Board to maximize shareholder value? This Part makes the argument that the answer is a decisive "no."

113. Aronson v. Lewis, 473 A.2d 805, 812.

114. Lynn Stout et al., *The Modern Corporation Statement on Company Law*, JACK G. CLARKE BUSINESS LAW INSTITUTE (Oct. 29, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2848833 (this document was signed by 55 signatories, mainly corporate law scholars, but also including some prominent practitioners such as Martin Lipton, the purported inventor of the poison pill).

A. *Shareholder Wealth Maximization as the Objective of Corporate Governance*

There are several different reasons and explanations for why it is optimal to have SWM as the objective of corporate governance and why corporate law should support that objective by imposing legal obligations on the Board. First, unlike a stakeholder approach (to be discussed below) where the board of directors is given the unenviable task of balancing the interests of multiple stakeholders without maximizing the interests of any, SWM allows for the maximization of an objective function.[115] Second, by serving only one master—shareholders—a Board can be held more accountable for its decisions. According to Frank Easterbrook and Daniel Fischel, "a manager told to serve two masters . . . has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other."[116] According to Jensen, if a stakeholder approach is taken, then "[t]he result will be confusion and lack of purpose that will [fundamentally] handicap the firm in its competition for survival."[117] Third, according to Easterbrook and Fischel, one can think of SWM as the default rule under corporate law because it is "the operational assumption of successful firms."[118] Fourth, according to John Boatwright, "corporate decision-making is more efficient and effective when management has a single, clearly defined objective and shareholder wealth maximization provides not only a workable decision guide but one that, if pursued, increases the total wealth creation of the firm."[119]

Why SWM is preferable as the corporate objective can also be explained through two models of the corporation, the principal-agent model and the nexus of contracts model.

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115. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPL. CORP. FIN. 8 (2001).

116. EASTERBROOK & FISCHEL, *supra* note 85, at 38.

117. Jensen, *supra* note 115, at 11.

118. EASTERBROOK & FISCHEL, *supra* note 85, at 36.

119. See George A. Mocsary, Freedom of Corporate Purpose, 2016 BYU L. REV. 1319, 1390 (2016) (citing John R. Boatright, *What's Wrong—and What's Right—with Stakeholder Management*, 22 J. PRIVATE ENTERPRISE 106, 119 (2006)).

1. *Principal–Agent Model*

In a principal-agent model of the corporation, shareholders are viewed as owners of the corporation and Boards as their agents.[120] However, the typical separation within the corporation of ownership from control creates great potential for managerial self-dealing and shirking. If realized, the results are increased agency costs, including Board decisions that are not focused on SWM. Agency costs are a detriment to shareholder profit. Therefore, directors should be legally bound to minimize agency costs with the objective of maximizing shareholder profits.

2. *Nexus of Contracts Model*

Michael Jensen and William Meckling would describe an organization that takes the corporate form as a legal fiction that serves "as a nexus for a set of contracting relationships among individuals."[121] Under a nexus of contracts or "contractarian" model of the corporation, shareholders are not perceived to own the corporation but are considered to be only one of many parties that contract with the corporation.[122] Nevertheless, the board of directors still has fiduciary duties to maximize shareholders' wealth.[123] This is a result of the hypothetical bargain struck between shareholders and the other parties in the corporation.[124]

In this hypothetical bargain, shareholders, the sole claimants to the residual cash flows generated by the firm, would argue that since they are the least contractually protected relative to other parties, they deserve SWM as the gap filler in their corporate contract.[125] That is, they are the parties to the corporate contract that have the greatest risk of ending up with nothing as a result of their dealings with the corporation. In the context of public companies, shareholders enforce their

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120. Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1631 (2002).

121. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

122. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 547–48 (2003).

123. *Id.* at 548.

124. *See id.* at 547–48.

125. *See id.* at 547–48, 579.

preference for SWM through the market for corporate control[126] and hedge fund activism.[127]

One reason why other stakeholders would support a Board and executive management targeting SWM is because all other parties that have contracted with the corporation must be paid off prior to the shareholders receiving any residual.[128] As stated by Henry Manne, SWM as the corporate objective is an example of "pure positive economics"[129] and should be accepted as such.

Like the principal-agent model of the corporation, a nexus of contracts model tells us to expect the corporate ob-

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126. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Manne provides the following description of how the market for corporate control operates:

> Briefly, the market for corporate control in our system operates in the following manner: if an existing corporation with publicly traded shares is poorly managed, holders of those shares will respond by selling. This will drive the price down to the point indicated by the quality of management which the corporation is receiving. As the price of securities of any corporation is thought to be low relative to the price that would be generated by more efficient managers, the stage is set for the critical functioning of the market for corporate control. Outsiders . . . will respond to the opportunity to make substantial capital gains (not necessarily in the tax sense) by buying control, managing the company efficiently, and then perhaps disposing of the shares. It is not necessary that they remain permanently to manage the business.

Henry G. Manne, *Cash Tender Offers for Shares – A Reply to Chairman Cohen*, 1967 DUKE L.J. 231, 236 (1967) (citations omitted).

127. An activist hedge fund works in a similar manner to the potential acquirer. The difference is that the activist hedge fund attempts to correct inefficiencies through its influence, not its control of the company. It acquires a significant but not controlling share in a company at a relatively low price with the expectation that existing inefficiencies will eventually be corrected through its efforts and the price will rise to reflect these enhanced efficiencies. In essence, hedge fund activism provides a corrective function similar to, but with less investment and more advocacy than, what is found in the market for corporate control. *See* Bernard S. Sharfman, *A Theory of Shareholder Activism and Its Place in Corporate Law*, 82 TENN. L. REV. 791, 804–07 (2015); *see also* Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?*, 2015 COLUM. BUS. L. REV. 813 (2016).

128. EASTERBROOK & FISCHEL, supra note 85, at 38 ("[M]aximizing profits for equity investors assists the other 'constituencies' automatically.").

129. E-mail from Henry G. Manne, Professor Emeritus of Law, Geo. Mason Univ., to Bernard S. Sharfman (Dec. 29, 2012) (on file with author).

jective to be SWM. However, unlike the principal-agent model, it does not suggest that an exclusive focus on minimizing agency costs is the only way to achieve that objective. From a nexus of contracts approach, that determination should be up to the organizers of the corporation with input from all stakeholders. For example, the critical question of what should be the balance of power between the Board and shareholders needs to be resolved prior to commencing operations as a corporation. This, of course, is referred to as the private ordering of corporate governance arrangements and is assumed to be value-maximizing for all stakeholders, including shareholders. Again, the balance of authority is almost always tilted heavily toward the Board.

If one is to think of the corporation as a nexus of contracts, then one must also include the role played by the courts in making sure those contracts are enforced. The courts create fiduciary duties which serve "as gap-filling devices for incomplete contracts between shareholders and firm managers." Moreover, if fiduciary duties are crafted carefully to maximize shareholder value,[130] this would mean that all stakeholders would benefit from their application. However, the three policy drivers already discussed—(1) protecting the Board from liability for honest mistakes in judgment, which also serves the purpose of allowing the Board "to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses"[131]; (2) deference to private ordering as authorized by statutory law; and (3) courts' recognition that the Board, and not the courts, is in the best position to make corporate decisions—severely restrain judicial desire to take an active role in arbitrating disputes. These drivers strongly encourage courts, as a means of maximizing shareholder value, to defer to the judgment of the Board.

B. *A Stakeholder Model of Corporate Governance*

Those who signed off on the statement rejecting SWM as the legal objective of Board decision-making most likely be-

130. Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607 (2007).

131. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139 (Del. Ch. 2009).

lieve in a stakeholder model of the corporation. In such a model, there is no one stakeholder holding the position of residual claimant. According to Henry Hansmann and Reinier Kraakman, there are two types of stakeholder models.[132] The first model is called a "'fiduciary' model of the corporation."[133] In this model, "the board of directors functions as a neutral coordinator of the contributions and returns of all stakeholders in the firm."[134] This is in contrast to another type of stakeholder model which they describe as a "'representative' model of the corporation."[135] In this model, "two or more stakeholder constituencies appoint representatives to the board of directors, which then elaborates policies that maximize the joint welfare of all stakeholders, subject to the bargaining leverage that each group brings to the boardroom table."[136]

From a normative perspective, a stakeholder model would allow, without legal ramifications, a Board to consider multiple stakeholders, not just stockholders, in its decision-making. This would require the Rule to protect the interests of multiple stakeholders, not just stockholders. As a result, director conduct, as embodied in fiduciary duties, would not have SWM as the objective of this conduct.

Perhaps the best-known stakeholder model in corporate law literature is the team production model of Margaret Blair and Lynn Stout.[137] They use their model, a fiduciary model, to argue that SWM is not the correct objective[138] of a public company[139] and that this conclusion is already recognized by courts.[140]

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132. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 447–48 (2001).
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.*
137. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).
138. *Id.* at 249 ("In this Article we take issue with . . . the stockholder wealth maximization goal . . . .").
139. Blair & Stout focus exclusively on the corporation as a public company. *Id.*
140. *Id.* at 287–319. At the time of their article's publication, this was a relatively new argument. *Id.* at 252–53.

Blair and Stout model the public company as a team of members who make firm-specific investments in the corporation with the goal of producing goods and services as a team ("team production"), with the board of directors serving as a "mediating hierarchy."[141] In this role, board members are "mediating hierarchs whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together."[142]

Any person or entity that makes a specialized investment that has little or no value outside the joint enterprise (a "firm-specific" investment) is a member of the team.[143] The result is "that no one team member is a 'principal' who enjoys a right of control over the team."[144] Team members are primarily made up of executives, rank-and-file employees, and equity investors, but can also include researchers, creditors, the local community, marketers, and vendors who provide specialized products and services to the firm.[145] Like equity investors, these stakeholders have made firm-specific investments and therefore must be considered residual interest holders, protected only by long-term, implicit agreements (non-contractual and therefore not legally enforceable) that they enter into because they trust the board of directors to do its best to ensure the stakeholders recoup their investments.[146]

In their model, Blair and Stout suggest that "the business judgment rule may help prevent coalition members (and especially stockholders) from using lawsuits as strategic devices to extract rents from the coalition. This is because the Rule works to ensure that directors can only be found liable for breach of the duty of care in circumstances where a finding of liability serves the collective interests of all the firm's members."[147] Moreover, Blair and Stout find support for their understanding in the *Aronson* formulation[148] of the Rule, since it omits express language stating that directors who act in "the best in-

141. *Id.* at 271–76.
142. *Id.* at 281.
143. *Id.* at 272.
144. *Id.* at 277.
145. *Id.* at 288.
146. *Id.* at 274–76.
147. *Id.* at 300.
148. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).

terests of the company"[149] do so solely for the benefit of shareholders. While it is not known why the Court did not clarify what "best interests" means in the context of the Rule, it should be noted that the *Aronson* formulation was applied in a derivative suit where shareholders were suing on behalf of the corporation. In that case, the Court may simply have felt there was no need to clarify what "best interests" means. Nevertheless, Blair and Stout argue that the Rule works to support all team members, not just stockholders, when it is used to defend a legal challenge to a Board decision.

C. *For the Benefit of Stockholders*

While the stakeholder approach of Blair and Stout has much appeal, a much stronger argument can be made that the Board *does* have a legal obligation to maximize stockholder value and that the Rule, as applied, facilitates fulfillment of this legal requirement.

Surprisingly, this argument begins by noting that statutory corporate law is silent regarding this objective. Instead, DGCL simply states that corporations can be formed "to conduct or promote any lawful business or purposes."[150] This silence regarding the objective of the corporation has always been the approach of statutory corporate law. As a result, statutory corporate law must be understood as being concerned only with the "basic organizational design" of the corporation: its attributes as a legal entity (such as limited liability for stockholders), and how its default rules distribute decision-making authority.[151]

So, where does the idea of SWM as a legal requirement come from? In yet another twist, the idea is derived from courts applying principals of equity when determining if a Board has breached its fiduciary duties as applied under the Rule. In essence, SWM is a creation of equity, and not of statutory law.

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149. Blair & Stout, *supra* note 137, at 300.

150. DEL. CODE ANN. tit. 8, § 101(b) (1998).

151. Jonathan R Macey, *Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1269 (1999) ("Indeed, the very justification for having different types of business organizations is to permit investors, entrepreneurs, and other participants in the corporate enterprise to select the basic organizational design they prefer from a menu of standard form contracts.").

Under the Rule, fiduciary duties are a means to an end. They embody the type of conduct that the courts require of directors in order to avoid having their decisions fall under an entire fairness review. The courts have significant latitude in defining what that conduct should be. For example, as noted above, the duty of care is only *procedural* due care in the *Aronson* formulation. But most importantly, this conduct requires the Board to act in the best interests of stockholders. This was clearly spelled out in a series of statements by the Delaware Supreme Court in *NACEPF* v. *Gheewalla*,[152] a case which answered the critical question of whether the Board still owed fiduciary duties solely to its stockholders when the corporation entered the "zone of insolvency," i.e., when it is financially distressed and may become insolvent.

Gheewalla begins by explaining why only stockholders are given the right to bring derivative suits:

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is solvent, those duties may be enforced by its stockholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value.[153]

In opposition to a stakeholder model of the corporation such as the team production model, this statement reflects the understanding that *only* stockholders hold residual claims to the cash flows of the corporation.

The Court then goes on to explain that the separation of ownership and control as provided by the default rules of statutory corporate law is the reason fiduciary duties must be applied by the courts for the benefit of stockholders:

> Delaware corporate law provides for a separation of control and ownership. The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its stockholder owners.' Accordingly, fiduciary duties

152. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).
153. *Id.* at 101.

> are imposed upon the directors to regulate their conduct when they perform that function.[154]

Moreover, the Court stated that even when a corporation is in the zone of insolvency, a Board still owes fiduciary duties to stockholders and not to creditors:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its stockholders by exercising their business judgment in the *best interests of the corporation for the benefit of its stockholder owners.*[155]

Here, we have the Court telling us exactly what the phrase "best interests of the corporation" should mean in the context of a Rule review: the protections of the Rule will apply if Board decisions are made for "the benefit of its stockholder owners."

Vice Chancellor Laster, in *In re Trados Inc. Shareholder Litigation*,[156] encapsulates this thinking in the following quote:

> It is, of course, accepted that a corporation may take steps, such as giving charitable contributions or paying higher wages, that do not maximize profits currently. They may do so, however, because such activities are rationalized as producing greater profits over the long-term. Decisions of this nature benefit the corporation as a whole, and by increasing the value of the corporation, the directors increase the share of value available for the residual claimants. Judicial opinions therefore often refer to directors owing fiduciary duties to the corporation and its shareholders. This formulation captures the foundational relationship in which directors owe duties to the corporation for the ultimate benefit of the entity's residual claimants. Nevertheless, stockholders' best interest must always, within legal limits, be the end. Other constituencies may be considered only instrumentally to advance that end.[157]

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154. *Id.*
155. *Id.*
156. *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).
157. *Id.* at 36–37.

If that was not clear enough, Vice Chancellor Laster stated in *The Frederick Hsu Living Trust v. ODN Holding Corp.*, "Delaware case law is clear that the board of directors of a for-profit corporation . . . must, within the limits of its legal discretion, treat stockholder welfare as the only end, considering other interests only to the extent that doing so is rationally related to stockholder welfare."[158]

These statements are explicit endorsements of SWM and a direct repudiation of the idea that corporate law espouses a stakeholder model of the corporation. Almost 100 years ago this same understanding was espoused by the Michigan Supreme Court in the famous corporate law case of *Dodge v. Ford Motor, Co.*, noted above.[159] In *Dodge*, the Court found that the Board abused its discretion in withholding a special dividend payment because its decision to do so was a result of intentionally disregarding the interests of stockholders.[160] Speaking in terms of the duties that the Board and Henry Ford owed to minority shareholders under corporate law,[161] the Court stated that the Board had a legal obligation to maximize the profits of the corporation for the benefit of stockholders:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or the nondistribution of profits among stockholders in order to devote them to other purposes.[162]

This legal obligation was a result of the court applying its power of equity, as opposed to implementing statutory corporate law. In sum, equity requires the objective of the Rule to be

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158. Frederick Hsu Living Tr. v. ODN Holding Corp., No. 12108-VCL, 2017 Del. Ch. LEXIS 67, at *45 (Ch. Apr. 14, 2017) (citations omitted).

159. Dodge v. Ford Motor Co., 170 N.W. 668, 682 (1919).

160. *Id.* at 684–85.

161. *Id.* at 684. ("There should be no confusion . . . of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders.").

162. *Id.* George Mocsary notes that this was not something that the *Dodge* court came up with out of the blue, but an affirmation of Michigan case law. *See* Mocsary, *supra* note 119, at 1344.

SWM and only SWM. Unfortunately, starting with the *Aronson* formulation of the Rule may cause this to be overlooked.

D. *The Continued Denial of SWM*

Even in the face of clear statements by the courts that SWM is a legal obligation of all Board decision-making under corporate law, continued resistance to SWM should still be expected. I expect this for the following three reasons. First, as already mentioned, statutory corporate law is silent on SWM. This opens the door for those who believe in a stakeholder model of the corporation to argue that corporate law does indeed support such an approach in practice. Second, those who believe in a stakeholder model are not willing to accept SWM as being the objective of equitable principles, no matter how many times courts state this to be their understanding. Perhaps this is just inconsistent with their long-held views on what equity means and therefore cannot be accepted as true. Yet, what could be fairer to shareholders and other stakeholders who contract with the corporation than to require that Board decision-making be targeted to SWM if all parties benefit from such an objective? Third, the courts utilize the Rule in an indirect way to maximize shareholder value. This last point requires further explanation.

When a court reviews a Board decision under the Rule, a decision will rarely lose the protections of the Rule just because the decision was sub-optimal in terms of SWM. In this context, the protections will be lost only if it is clear that the decision was made without stockholder interests in mind, e.g. in *Dodge*, where the Court found that the Board had abused its discretion when it withheld the annual payment of its special dividend.[163]

However, this does not mean that the courts are not focused on SWM as the objective of a Board's fiduciary duties per se; it simply means that courts must restrain themselves in making such a determination. Underlying this approach are

163. This is consistent with what then Chancellor William Chandler said in the context of a rights plan (poison pill) as reviewed under the *Unocal* test: "Directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law." eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010).

the three policy drivers that have already been discussed; drivers which direct a court to forego a direct focus on SWM under the Rule. Instead, courts focus on the conduct of the directors and evidence of taint surrounding the decision-making process: fraud, self-dealing, lack of independence, etc. In essence, protecting the ability of Boards to make decisions without interference by shareholders and courts is the best way to ensure that SWM occurs.[164] However, this lack of direct focus on SWM provides the opportunity for those so willing to interpret this approach as a court's lack of interest in SWM, thereby helping make their case that the court is endorsing a stakeholder approach to corporate law over SWM.[165]

E. *Summary*

While one can argue that corporate law encompasses a stakeholder model and that the Rule serves as evidence of this, a better argument is that the legal obligation of the Board is SWM and that the Rule serves to support that purpose and only that purpose.[166] Case law clearly states that the Board is under a legal obligation to maximize shareholder wealth. The requirement of SWM enters corporate law through a Board's fiduciary duties, not through statutory law. In essence, SWM is an equitable concept. The implementation of SWM is indirect, as all three of the major policy drivers that influence the Rule guide courts away from a focus on SWM unless the Rule has been rebutted, either by a breach in a Board's fiduciary duties or because the court has identified a taint surrounding the decision-making process.

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164. Sharfman, *supra* note 77, at 399–412.

165. *Id.* at 400. ("Preserving managerial discretion necessarily means that fiduciary duties will be weak and that courts will primarily refrain from determining whether a decision maximizes shareholder wealth. The problem is that this approach is counterintuitive and therefore subject to being misunderstood, especially by those who have been trained in the law and believe that accountability should always be the default rule.").

166. While beyond the scope of this Article, a stakeholder model, such as team production, may be appropriate in the special case of a public benefit corporation (PBC). Newly enacted DGCL 365(a) allows the Board to manage the PBC in a manner that balances the interests of stockholders and those stakeholders who have made a significant non-stock investment in the corporation. DEL. CODE ANN. tit. 8, § 365(a) (2013).

Conclusion

In the court's decision in *Bodell I*, one is immediately struck by the power of equity and how the court felt so easily justified in challenging statutory law, Section 4a of the DGCL (currently DGCL § 152[167]), with a fairness review of a Board decision even when the Board had statutory authority to act without restraint.[168] The Court in *Bodell II* took a more sophisticated approach, understanding that corporate law is all about the separation of ownership from control and how the interests of stockholders must be in balance with the Board's statutory authority. The policy driver behind this approach is that the Board should be allowed to run the company without the fear of constantly facing potential liability for honest mistakes in judgment. For this to occur, equity must be restrained. In order to implement such restraint, the Court employed the Rule: the tool used to determine when a Board decision should stand without further review and when a fairness review is required and the full force of equity is to be applied. Here, the Court made clear that under the Rule, the review of a board decision could not include fairness unless a court had made a finding that a fiduciary duty had been breached or some sort of taint had surrounded the decision (i.e., interestedness). To serve as this tool of restraint is precisely why the Rule must be retained in its present form. If courts were to lose this ability to restrain themselves from imposing a fairness review, then Board decision-making and shareholder wealth would doubtless suffer as a result.

It should now be easy to see that the defining moment in the history of the Rule was not the famous case of *Smith v. Van Gorkom*,[169] where the Court made absolutely clear that director liability could result from an uninformed Board decision, but the much older case of *Bodell II*.[170] In *Bodell II*, the Court, by precluding a fairness review of a Board decision unless a fiduciary duty had been breached or some sort of taint had surrounded the decision, established the Rule as an abstention doctrine in the most fundamental way.

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167. Del. Code Ann. tit. 8, § 152 (2015).
168. Bodell v. Gen. Gas & Elec. Corp., 132 A. 442, 444 (1926).
169. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).
170. Bodell v. Gen. Gas & Elec. Corp., 140 A. 264, 267 (1927).

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THE MISSING ACCOUNT OF PROGRESSIVE CORPORATE CRIMINAL LAW

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This Article offers a modern, progressive account of corporate criminal law using foundational principles of twentieth century progressivism. The central role of science and advancing technology define the architecture of this account. Some of the intractable challenges of using the criminal law to regulate corporations are reviewed, followed by a recognition of a remarkable convergence of corporate compliance standards, measures, practices, and insights from conventional, plural, and polycentric theories of regulation. This is a convergence of informal corporate social controls offering a potentially powerful opportunity for the promotion of modern progressive interests, practices, and advocacy. Next, the two pillars of progressivism, the instrumental use of science and social control, are discussed. A "compliance conundrum," it is argued, undermines corporate commitments to compliance science, technology, data analytics, and more effective social controls. This conundrum contributes to a compliance game wherein corporate and regulatory players placate each other with an outcome that often has little to do with greater law abidance. With a glimmer of hope, this Article concludes by considering the unique position of progressives to disrupt the compliance game while promoting corporate criminal justice.

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INTRODUCTION

This seems to be an ideal time to revisit the normative, doctrinal, and policy-laden foundations of the corporate criminal law. With renewed calls for a repeal of the most costly of corporate regulations and reforms, it is tempting to speculate about the future of corporate compliance and corporate criminal liability.[1] A host of academics continue to worry about the many hard-to-quantify direct and collateral costs of corporate

1. *See, e.g.*, Tom Fox, TRUMP AND COMPLIANCE: THIS CONVERSATION IS JUST GETTING STARTED (2016) (discussing the future prospects of the Foreign Corrupt Practices Act); Robert Hahn, *Playing the Long Game on Regulation*, BROOKINGS (Jan. 13, 2017), https://www.brookings.edu/opinions/playing-the-long-game-on-regulation/; Bill Coffin, *What's Next for Compliance Under President Trump?*, COMPLIANCE WEEK: COFFIN ON COMPLIANCE (Nov. 14, 2016), https://www.complianceweek.com/blogs/coffin-on-compliance/whats-next-for-compliance-under-president-trump#.WdOnr9N97BI (speculating on how a Trump presidency will affect the compliance industry); Ben DiPietro, *Does Trump Spell End of 'Era of Compliance'?*, WALL ST. J. (November 21, 2016, 6:00 AM), https://blogs.wsj.com/riskandcompliance/2016/11/21/does-trump-spell-end-of-era-of-compliance/; Bruce Carton, *What does President Trump mean for the SEC?*, COMPLIANCE WEEK: ENFORCEMENT ACTION (November 9, 2016), https://www.complianceweek.com/blogs/enforcement-action/what-does-president-trump-mean-for-the-sec#.WdOr-9N97BI; Ben Rossi, *What Brexit and Trump Mean for Compliance*, INFORMATION AGE (December 6, 2016), http://www.information-age.com/brexit-trump-mean-compliance-123463516/; Jacob M. Schlesinger, *Donald Trump Took Aim at Dodd-Frank on the Stump*, WALL ST. J. (November 9, 2016, 11:24 AM), https://www.wsj.com/articles/donald-trump-took-aim-at-dodd-frank-on-the-stump-1478691726.

criminal liability.[2] Regulators and legislators still question whether some financial institutions are too big to prosecute, take to trial, and convict.[3] The general public fears that justice for those individuals responsible for the global debt crisis will remain undistributed.[4] Entity liability, we are told by the Department of Justice, should take a back seat to individual liability unless justice may not be accomplished otherwise.[5]

These conventional intuitions, musings, and fears are found scattered in four relatively distinct ideological camps. First, there are *stalwart advocates* of both individual and entity liability for "corporate" wrongdoing. For some, corporate so-

2. WILLIAM S. LAUFER, CORPORATE BODIES AND GUILTY MINDS: THE FAILURE OF CORPORATE CRIMINAL LIABILITY (2008) (discussing the longstanding ambivalence of "compliance stakeholders" using the blunt instrument of the criminal law with corporations); Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994); Andrew Weissmann, *A New Approach to Corporate Criminal Liability*, 44 AM. CRIM. L. REV. 1319, 1325–26 (2007); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1486 (1996).

3. *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERV., 114TH CONG., TOO BIG TO JAIL: INSIDE THE OBAMA JUSTICE DEPARTMENT'S DECISION NOT TO HOLD WALL STREET ACCOUNTABLE (2016); *see also* Staff of Sen. Elizabeth Warren, *Rigged Justice: 2016: How Weak Enforcement Lets Corporate Offenders Off Easy* (Jan. 2016), http://.warren.senate.gov/files/documents/Rigged_Justice_2016.pdf; BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS (2014).

4. For a recent summary of the government's enforcements efforts, see Bill Baer, Principal Deputy Assoc. Att'y Gen., Remarks at Society of Corporate Compliance and Ethics Conference (September 27, 2016), https://www.justice.gov/opa/speech/principal-deputy-associate-attorney-general-bill-baer-delivers-remarks-society-corporate. For a discussion of a responsibility remainder more generally, see Amy J. Sepinwall, *Crossing the Fault Line in Corporate Criminal Law*, 40 J. CORP. L. 102 (2015).

5. *See* SALLY Q. YATES, U.S. DEP'T OF JUSTICE, INDIVIDUAL ACCOUNTABILITY FOR CORPORATE WRONGDOING (2015) [hereinafter YATES MEMORANDUM]. For a post-Yates Memorandum eulogy see Elizabeth E. Joh & Thomas W. Joo, *The Corporation as Snitch: The New DOJ Guidelines on Prosecuting White Collar Crime*, 101 VA. L. REV. ONLINE 51 (2015); for a pre-Yates look at the perverse effects of pushing liability down the corporate hierarchy see William S. Laufer, *Corporate Prosecution, Cooperation, and the Trading of Favors,* 87 IOWA L. REV. 643, 653 (2002). An early and prescient call for individual liability may be found in BRENT FISSE & JOHN BRAITHWAITE, CORPORATIONS, CRIME AND ACCOUNTABILITY (1993). *See also* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984) (discussing enterprise versus individual liability).

cial controls are seen as a condition precedent to achieving justice with wayward and rogue capitalists.[6] This camp is agnostic to the idea of corporate personhood, embraces the discretionary use of parallel individual and entity liability, and is not motivated by any particular penal philosophy.[7] What matters is accountability for those responsible in the form of criminal liability.[8]

A second faction of sharply witted neoconservatives and right-of-center *corporate libertarians* regularly call on Congress to roll back the litany of federal criminal provisions and laws, including burdensome corporate regulations with criminal penalties.[9] The allergy of some committed conservatives to the illogical metaphysics of a corporate criminal law is expressed with a genuine disbelief about anthropomorphizing the firm.[10] Their core concern, though, has nothing to do with complex questions of corporate ontology. It is all about unjustifiable externalities. This century-old fiction of corporate criminal liability was crafted at a time when there was no rec-

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6. *See generally* LAUFER, *supra* note 2; Sara Sun Beale, *A Response to the Critics of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1481 (2009); Samuel W. Buell, *The Blaming Function of Entity Criminal Liability,* 81 IND. L.J. 473, 494–97 (2006).

7. Steven Walt & William S. Laufer, *Why Personhood Doesn't Matter: Corporate Criminal Liability and Sanctions,* 18 AM. J. CRIM. L. 263, 278 (1991).

8. *See* Brent Fisse & John Braithwaite, *The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism and Accountability*, 11 SYDNEY L. REV. 468 (1988); Lawrence Friedman, *In Defense of Corporate Criminal Liability*, 23 HARV. J.L. & PUB. POL'Y 833 (2000).

9. For a discussion of "corporate libertarians," see DAVID C. KORTEN, WHEN CORPORATIONS RULE THE WORLD (3d ed. 2015). For a variation of this theme, see John Hasnas, *The Centenary of a Mistake: One Hundred Years of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1329 (2009); John Hasnas, *Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics*, 39 LOY. U. CHIC. L.J. 507 (2008); John Hasnas, *Up from Flatland: Business Ethics in the Age of Divergence*, 17 BUS. ETHICS Q. 399 (2007); John Hasnas, *Ethics and the Problem of White Collar Crime*, 54 AM. U. L. REV. 579 (2005). These voices join a chorus of academics raising concerns with over-criminalization. *See, e.g.*, DOUGLAS HUSAK, OVERCRIMINALIZATION: THE LIMITS OF THE CRIMINAL LAW (Oxford Univ. Press 2008); Sara Sun Beale, *Too Many and Yet Too Few: New Principles to Define the Proper Limits for Federal Criminal Jurisdiction*, 46 HASTINGS L.J. 979 (1995); Kathleen F. Brickey, *Criminal Mischief: The Federalization of American Criminal Law*, 46 HASTINGS L.J. 1135 (1995).

10. *See* Donald R. Cressey, *The Poverty of Theory in Corporate Crime Research*, *in* ADVANCES IN CRIMINOLOGICAL RESEARCH 31 (W.S. Laufer and F. Adler eds., 1989).

ognizable regulatory state and misfeasance in railroad travel across state lines was the pressing federal concern.[11] Today, over-criminalization is of far greater concern than ensuring threshold levels of criminalization.[12]

A third group seeks justice for wrongdoing in corporations, but rejects the idea of corporate moral agency.[13] These commentators, though, set their normative sights on the attribution of moral agency to corporate functionaries who are the

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11. The outcome of this conservative and neoliberal position is a familiar and somewhat old abolitionist rant. *See* Gerhard O.W. Mueller, *Mens Rea and the Corporation: A Study of the Model Penal Code Position on Corporate Criminal Liability*, 19 U. PITT. L. REV. 21 (1957) ("Many weeds have grown on the acre of jurisprudence which has been allotted to the criminal law. Among these weeds is . . . corporate criminal liability . . . . Nobody bred it, nobody cultivated it, nobody planted it. It just grew."); Jeffrey S. Parker, *Doctrine for Destruction: The Case of Corporate Criminal Liability,* 17 MANAGERIAL & DECISION ECON. 381 (1996). For a discussion of the interstate expansion of the railroads and early calls for federal incorporation, see J. Newton Baker, *Regulation of Industrial Corporations*, 22 YALE L.J. 306 (1913); Frederick H. Cooke, *State and Federal Control of Corporations,* 23 HARV. L. REV. 456 (1910) (discussing the relative benefits of state versus federal control); Max Thelen, *Federal Incorporation of Railroads*, 5 CALIF. L. REV. 273 (1917) (arguing against existing plans and proposals for a federal incorporation law); H. L. Wilgus, *Need of a National Incorporation Law*, 2 MICH. L. REV. 358 (1904) (arguing in favor of a national incorporation law); William E. Church, *The Tramp Corporation*, 11 AM. LAW. 13 (1903) (discussing the concern over issues of state sovereignty and unbridled corporate power). Not so coincidentally, turn of the century progressives were thinking of how science could inform better management. *See* William J. Cunningham, *Scientific Management in the Operation of Railroads*, 25 Q.J. OF ECON., 539 (1911); HORACE B. DRURY, SCIENTIFIC MANAGEMENT: A HISTORY AND CRITICISM (1915); SAMUEL HABER, EFFICIENCY AND UPLIFT: SCIENTIFIC MANAGEMENT IN THE PROGRESSIVE ERA, 1890–1920 (1964).

12. *See* Husak, *supra* note 9; Sara Sun Beale, *The Many Faces of Overcriminalization: From Morals and Mattress Tags to Overfederalization*, 54 AM. U. L. REV. 747 (2005); Lisa H. Nicholson, *Sarbanes–Oxley's Purported Over-Criminalization of Corporate Offenders*, 2 J. BUS. & TECH. L. 43 (2007). For some historical antecedents, see Sanford H. Kadish, *The Crisis of Overcriminalization*, 37 ANNALS AM. ACAD. POL. & SOC. SCI. 157 (1967). For a critique of the criminalization of businesses, see JAMES V. DELONG, *The New "Criminal" Classes: Legal Sanctions and Business Managers*, *in* GO DIRECTLY TO JAIL: THE CRIMINALIZATION OF ALMOST EVERYTHING 9 (G. Healy ed., 2004).

13. Manuel Velasquez, *Debunking Corporate Moral Responsibility*, 45 BUS. ETHICS Q. 531 (2003); DAVID RÖNNEGARD, THE FALLACY OF CORPORATE MORAL AGENCY (2015).

most deserving.[14] Moral agency should not attach to any agent positioned in the corporate hierarchy. For *normative thinkers*, the criminal law reaches only high-level managers, responsible corporate officers, or blameworthy members of the board of directors.[15]

The final contingent includes a small cadre of *critical criminologists* who see important relations between the state and the private sector that compromise regulatory decision-making, distort the construction of what is labeled criminal, and misattribute who, ultimately, is justly to blame for corporate wrongdoing.[16] This often maligned collection of intellectual disobedients is long on critiques of positive theories, short on practical regulatory solutions, and quite justifiably motivated by fiery rhetoric.[17]

This Article explores an overlooked and largely missing progressive account of corporate criminal liability. This account builds a bridge between some of the foundational principles of twentieth century progressivism and its varied contemporary iterations. The structure of the bridge consists of compliance principles and regulatory instruments—an artifact of how corporate criminal law is translated into regulatory practice. The central role of science, scientific management, and associated social controls define the bridge's architecture. The hope is that these connections might inspire a new generation of *modern progressives* to assume these foundational principles in combating regulatory convention and taming wrongdo-

14. *See, e.g.*, Amy J. Sepinwall, *Guilty by Proxy: Expanding the Boundaries of Responsibility in the Face of Corporate Crime*, 63 HASTINGS L.J. 411 (2012).

15. *See, e.g.*, Amy J. Sepinwall, *Responsible Shares and Shared Responsibility: In Defense of Responsible Corporate Officer Liability*, 2014 COLUM. BUS. L. REV. 371 (2014).

16. *See* Dawn L. Rothe and David O. Friedrichs, *The State of the Criminology of Crimes of the State,* 33 SOC. JUST. 147 (2006); STATE-CORPORATE CRIME: WRONGDOING AT THE INTERSECTION OF BUSINESS & GOVERNMENT (Raymond J. Michalowski & Ronald C. Kramer eds., 2006); Dawn L. Rothe et al., *That Was Then, This Is Now, What About Tomorrow? Future Directions in State Crime Studies*, 17 CRITICAL CRIMINOLOGY 3 (2009). For a general review of critical criminology, see FREDA ADLER, GERHARD O.W. MUELLER & WILLIAM S. LAUFER, CRIMINOLOGY (9th ed. 2018).

17. *See, e.g.*, Ronald C. Kramer, Raymond J. Michalowski, D. & David Kauzlarich, *The Origins and Development of the Concept and Theory of State-Corporate Crime*, 48 CRIME & DELINQ. 263 (2002); David O. Friedrichs, *State-Corporate Crime in a Globalized World: Myth or Major Challenge?*, *in* CONTROVERSIES IN WHITE-COLLAR CRIME (Gary.W. Potter ed., 2002).

ing corporations.[18] Far less ambitious and important, it seems fair to say that the scholarly playing field is less-than-level without the recognition of some progressive principles, if not advocacy.

The construction of this bridge is, admittedly, treacherous.[19] There is wide ranging historical criticism of the ideas and positions of progressivism, and the real contours of the "progressive movement."[20] One should be cautious in looking for solid ground from the early 1900s that might support the weight of a "modern" progressivism. It is jarring to see that some widely-held progressive policies were both regressive and reactionary.[21] If given the latitude to parse progressivism, a focus on the place of science, science management, social control, and the power of law to address social welfare resonate

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18. Some progressives find important parallels and differences between an old and possibly new progressivism. *See, e.g.*, Paul Glastris, *Why a Second Progressive Era Is Emerging—and How Not to Blow It*, WASH. MONTHLY (Jan./Feb., 2015), http://washingtonmonthly.com/magazine/janfeb-2015/why-a-second-progressive-era-is-emerging-and-how-not-to-blow-it/ ("As many observers have noted, there are arresting parallels between our age and the 1890s, the dawn of the Progressive Era."). A share of the inspiration for the more modern account of progressivism in this Article comes from Ralph Nader, Mark Green, Joel Seligman, and Christopher Stone. *See, e.g.*, THE CONSUMER AND CORPORATE ACCOUNTABILITY (Ralph Nader ed., 1973); CORPORATE POWER IN AMERICA (Ralph Nader & Mark J. Green eds., 1973); RALPH NADER, MARK J. GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION: HOW THE LARGEST CORPORATIONS CONTROL OUR LIVES (1976); CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR (1975).

19. *See, e.g.*, MICHAEL E. MCGERR, A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA, 1870–1920 (2003).

20. For some of the more pointed criticism, *see* Daniel T. Rodgers, *In Search of Progressivism*, 10 REVIEWS IN AM. HIST. 113 (1982); Peter G. Filene, *An Obituary for "The Progressive Movement"*, 22 AM. Q. 20 (1970); John D. Buenker, *The Progressive Era: A Search for a Synthesis*, 51 MID-AM. 175 (1969); John D. Buenker, John C. Burnham & Robert M. Crunden, PROGRESSIVISM (1977); Arthur S. Link, *What Happened to the Progressive Movement in the 1920's?*, 64 AM. HIST. REV. 833 (1959). For a neo-progressive take, see Cass R. Sunstein, *A New Progressivism*, 17 STAN. L. & POL'Y REV. 197 (2006).

21. In forthcoming work, Prof. Hovenkamp offers an appropriately critical take on the role of race in the old progressive movement. *See* Herbert Hovenkamp, *Racism and Public Law in the Progressive Era*, ARIZ. L. REV. (forthcoming 2018).

today in ways that make this bridge so very irresistible.[22] It is also powerfully attractive because of the reticence of present-day progressives to embrace their intellectual heritage while pursuing legal, regulatory, and government reforms that would result in greater corporate responsibility and accountability.[23] Modern progressive voices on how the criminal law may tame corporate wrongdoing are rarely if ever heard, and vastly overshadowed by a coherent and well-conceived slate of progressive reforms to corporate governance.[24]

Part I of this Article explores the missing account of progressivism in the substance and practice of corporate criminal law. This is followed by a recognition of a remarkable convergence of corporate compliance technology, standards, measures, practices, and insights from conventional, plural, and polycentric theories of regulation. This is a convergence of informal corporate social controls that offers a significant opportunity for the adoption of progressive interests, practices, and advocacy.

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22. The essence of the progressive movement in law is well captured by Herbert Hovenkamp. *See* Herbert Hovenkamp, *The Mind and Heart of Progressive Legal Thought*, 81 IOWA L. REV 149, 150 (1995).

23. *See* Glastris, *supra* note 18 ("But for the most part today's left-leaning progressives are almost entirely focused on politics, economic justice, social issues, and the influence of money in politics. These are important subjects. But the vast complex of government is largely a black box to these folks."); Herbert Hovenkamp, *Appraising the Progressive State*, 102 IOWA L. REV. 1063, 1079–84 (2017).

24. A range of progressive reforms are regularly offered in an effort to "crack down" on corporate crime. Virtually all progressive proposals, however, neglect a consideration of corporate criminal law, and are a grab bag of largely untested interventions. For a representative list of proposals see, e.g., *Nader Proposes Crackdown on Corporate Crime, Fraud and Abuse,* OREGON PROGRESSIVE PARTY: CORPORATE CRIME (Sept. 24, 2010, at 9:20 PM), http://progparty.org/issues/market/corporate_crime. Governance reforms range from dismantling shareholder supremacy, ending Delaware's dominance, and limiting limited liability to limiting corporate intervention into political affairs. *See* Kent Greenfield & Daniel Greenwood, *An Incomplete List of Possible Progressive Reforms in Corporate Governance* (Dec. 2005), https://people.hofstra.edu/Daniel_J_Greenwood/opinion/Progressive%20Corporate%20Law%20Reform%20Proposals.pdf; s*ee also* KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES (2008); Kent Greenfield & D. Gordon Smith, *Debate: Saving the World with Corporate Law,* 57 EMORY L.J. 947 (2007); *cf.* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997).

Part II provides some reasons for the consideration of progressive ideals in corporate criminal law, from our collective failure to express moral indignation over corporate wrongdoing to the value of justifying this body of law in theories of desert. Next, the two pillars of twentieth-century progressivism, the instrumental use of science and social control, are explored. Measures of both corporate and government control have dominated progressive proposals for reform.[25] Progressive principles borrowed from the last century should support the consolidation of more rigorous compliance measures, measurement, and standards into formal regulatory policies. Progressive thinking about new models of regulatory-regulated engagement also are reviewed with an appreciation for the many challenges accompanying the coordinated delegation of regulation to firms.[26]

A "compliance conundrum," it is argued, undermines corporate commitments to compliance science, technology, cooperation, and more effective social controls. This conundrum reflects a deeply imbedded conflict in firms over how to diligently identify deviance, recognize the inevitability of a base rate of wrongdoing, honor disclosure requirements and, at the same time, avoid entity liability. This conundrum facilitates a "compliance game," a regulatory status quo where both corporate and government players are, at times, equally captured. The result is that all stakeholders placate each other with compliance expenditures that are largely incidental to ensuring compliance. This game is marked by disincentives for firms to take the measurement of compliance seriously, and a regulatory lethargy to resort to and require anything resembling compliance science. This game is profitable for many stakeholders, including an ever-burgeoning legion of compliance,

25. *See* BENJAMIN PARKE DEWITT, THE PROGRESSIVE MOVEMENT: A NON-PARTISAN COMPREHENSIVE DISCUSSION OF CURRENT TENDENCIES IN AMERICAN POLITICS 113–61 (1915) (discussing how progressive's view the rise and concentration of American business, along with the role of government).

26. Inspiration for this discussion of novel informal social controls comes from the work of Grabosky, Parker, Gunningham, Kagan, Coglianese, Orts, and other leading regulatory theorists. For concerns with the delegation of regulatory discretion to private firms, see Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State,* 56 DUKE L. J. 377, 386 (2006); *cf.* Cass Sunstein, *Administrative Substance,* 1991 DUKE L.J. 607, 627 (1991).

regulatory, and legal risk professionals. It does, however, take casualties, including the legitimacy of formal social controls that regulate firms, particularly for corporations of scale and power. Ultimately, the most significant loss is one of justice undone, or undistributed corporate criminal justice.[27] With a glimmer of hope and small dose of optimism, this Article concludes by considering the unique position of modern progressives to promote corporate criminal justice by disrupting the compliance game and addressing the conundrum.

I.
WHAT IS MISSING IN CORPORATE CRIMINAL LAW?

In the entrenched and divergent accounts of corporate criminal law there is a need for a reasonable counter to entity liability naysayers, an alternative to abolitionism that offers more than simple and unfounded hypotheses of how the criminal law deters corporations.[28] Also missing in these divergent accounts—from the positions of stalwart advocates to normative thinkers—is an antidote to the kind of corporate regulation that encourages compliance expenditures to run wild and unaccounted for as untested proxies of organizational due diligence.[29] Absent is a desert-based account that captures the

27. For more on the notion of an "undistributed" justice, see Laufer, *infra* note 29.

28. It is remarkable and yet true that systematic reviews of corporate crime deterrence research reveal no systematic evidence of effectiveness. *See* Sally S. Simpson et al., CORPORATE CRIME DETERRENCE: A SYSTEMATIC REVIEW 28–29 (2014); Natalie Schell-Busey et al., *What Works? A Systematic Review of Corporate Crime Deterrence*, 15 CRIMINOLOGY & PUB. POL'Y 387 (2016); Peter C. Yeager, *The Elusive Deterrence of Corporate Crime*, 15 CRIMINOLOGY & PUB. POL'Y 439 (2016); *cf.* Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 VA. L. REV. 1295 (2008). For an excellent consideration of how deterrence might be achieved with a commitment to responsive regulatory regimes, see Christine Parker, *The "Compliance" Trap: The Moral Message in Responsive Regulatory Enforcement*, 40 L. & SOC'Y REV. 591 (2006). For a fascinating empirical consideration of the motives to commit fraud, with significant consequences for thinking about the possible power of deterrence, see Utpal Bhattacharya & Cassandra D. Marshall, *Do They Do it for the Money*? 18 J. OF CORP. FIN. 92 (2012).

29. *See, e.g.*, Alnoor Bhimani, *Risk Management, Corporate Governance and Management Accounting: Emerging Interdependencies*, 20 MGMT. ACCT. RES. 2 (2009); Mark L. Frigo & Richard J. Anderson, *A Strategic Framework for Governance, Risk and Compliance*, 90 STRATEGIC MGMT. 20 (2009); Norman Marks, *Defining GRC*, 67 INTERNAL AUDITOR 25 (2010); Michael Rasmussen, *An Enter-*

moral indignation that stakeholders have, or should have, with the corporate malfeasance of large and powerful private sector institutions.[30] It is also difficult to find any regulatory approach, including those taken by creative "new governance" theories, with even a marginal chance of being integrated into existing "hard law" practices.[31]

As concerning, there is no coherent justification for why criminal justice expenditures so generously support the policing, processing, and confining of people of color from urban populations of the disenfranchised and disaffiliated poor.[32]

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prise GRC framework, 66 INTERNAL AUDITOR 61 (2009); ANTHONY TARANTINO, GOVERNANCE, RISK, AND COMPLIANCE HANDBOOK (Wiley 2008); OPEN COMPLIANCE AND ETHICS GROUP, GRC CAPABILITY MODEL "RED BOOK 3.0" (2015), https://go.oceg.org/grc-capability-model-red-book. Governmental prescriptions, it is argued, encourage the kind of due diligence imagery, rhetoric, and posturing that staves off the regulatory scrutiny necessary to fairly and justly oversee firm behavior. *See, e.g.*, William S. Laufer, *Integrity, Diligence, and the Limits of Good Corporate Citizenship*, 34 AM. BUS. L.J. 157 (1996).

30. *See* William S. Laufer & Alan Strudler, *Corporate Intentionality, Desert, and Variants of Vicarious Liability,* 37 AM. CRIM. L. REV. 1285 (2000) (arguing for the importance of a desert-based account).

31. Priority should be given to the correspondence between conceptions of corporate fault, as enterprise wrongdoing, and the commitment to corporate compliance expected, encouraged, and rewarded by prosecutors and regulators. *See, e.g.*, Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009) (describing "new governance" as conceptually quite different from the "hard law" approaches taken by the DOJ in its discretionary use of the corporate criminal law); *cf.* Peter N. Grabosky, *Using Non-Governmental Resources to Foster Regulatory Compliance*, 8 GOVERNANCE 527 (1995); Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 L. & SOC'Y REV. 691 (2003); CARY COGLIANESE, *Policies to Promote Systemic Environmental Management, in* REGULATING FROM THE INSIDE: CAN ENVIRONMENTAL MANAGEMENT SYSTEMS ACHIEVE POLICY GOALS? (Cary Coglianese & Jennifer Nash eds., 2001); Neil Gunningham, *From Compliance to Best Practice in OHS: The Role of Specification, Performance, and System-Based Standards*, 9 AUSTRALIAN J. LAB. L. 221 (1996). For a discussion of the principles behind new governance approaches, see BERTELSMANN STIFTUNG, FOSTERING CORPORATE RESPONSIBILITY THROUGH SELF- AND CO-REGULATION: SECTOR SPECIFIC INITIATIVES AS COMPLEMENTS TO PUBLIC REGULATION 17 (2013).

32. *See, e.g.*, JOHN HAGAN, WHO ARE THE CRIMINALS?: THE POLITICS OF CRIME POLICY FROM THE AGE OF ROOSEVELT TO THE AGE OF REAGAN (2nd ed. 2012); Pamela Irving Jackson & Leo Carroll, *Race and the War on Crime: The Sociopolitical Determinants of Municipal Police Expenditures in 90 Non-Southern U.S. Cities*, 54 AM. SOC. REV. 290 (1981); Christine Jolls & Cass R. Sunstein, *The Law of Implicit Bias*, 94 CALIF. L. REV. 969 (2006); Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA. L.

Government expenditures are decidedly tilted toward aggressively pursuing the poor and away from giving priority to bringing institutional offenders of scale and means to justice.[33] This is not to suggest that local and municipal policing expenditures are not needed or unjustifiable. The point is simply that the scarcity of local, state, and federal resources to investigate, pursue, and combat corporate deviance, relative to street crime, requires a far more thoughtful and careful explanation. Such tilted expenditures should not go unchallenged.[34]

Beyond government expenditures, advances in urban policing strategies, supported by sophisticated mapping and extensive data from evidence-based and place-based criminology, have no equivalent in the identification, investigation, and prediction of corporate offenses and offenders.[35] The failure to learn and heed lessons from the science on intelligence-led policing street crime is conspicuous.[36] This same point may be

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REV. 1295 (2001); James D. Unnever et al., *Public Support for Getting Tough on Corporate Crime: Racial and Political Divides*, 45 J. RES. CRIME & DELINQ. 163 (2008); JEFFREY REIMAN & PAUL LEIGHTON, THE RICH GET RICHER AND THE POOR GET PRISON: IDEOLOGY, CLASS, AND CRIMINAL JUSTICE (11th ed. 2016); JEROME G. MILLER, SEARCH AND DESTROY: AFRICAN-AMERICAN MALES IN THE CRIMINAL JUSTICE SYSTEM (1st ed. 1996).

33. Local and state criminal justice expenditures dwarf federal expenditures across the criminal process. *See, e.g.*, *Justice System Direct and Intergovernmental Expenditures*, SOURCEBOOK OF CRIMINAL JUSTICE STATISTICS (2004), http://www.albany.edu/sourcebook/pdf/t14.pdf. Backing in and out of state and federal data yield the same result: a simply overwhelming expenditure of criminal justice resources on street crime relative to corporate crime.

34. WILLIAM J. CHAMBLISS, POWER, POLITICS, AND CRIME (2001) (discussing class and race-based reasons for an expansion of the criminal justice bureaucracy); REIMAN & LEIGHTON, *supra* note 32 (reviewing the ways in which resources are disparate).

35. *See,* e.g., Wim Bernasco & Richard Block, *Where Offenders Choose to Attack: A Discrete Choice Model of Robberies in Chicago,* 47 CRIMINOLOGY 93 (2009); Wim Bernasco & Paul Nieuwbeerta, *How Do Residential Burglars Select Target Areas? A New Approach to the Analysis of Criminal Location Choice*, 45 BRIT. J. CRIMINOLOGY 296 (2005); Adam Boessen & John R. Hipp, *Close-Ups and the Scale of Ecology: Land Uses and the Geography of Social Context and Crime,* 53 CRIMINOLOGY 399 (2015); Anthony Braga & Ronald V. Clarke, *Explaining High-Risk Concentrations of Crime in the City: Social Disorganization, Crime Opportunities, and Important Next Steps*, 51 J. RES. CRIME & DELINQ. 480 (2014); Paul J. Brantingham, *Crime Diversity*, 54 CRIMINOLOGY 553 (2016); David L. Weisburd, *The Law of Crime Concentration and the Criminology of Place*, 53 CRIMINOLOGY 133 (2015).

36. LAWRENCE W. SHERMAN, EVIDENCE-BASED POLICING (1998); DAVID WEISBURD, ELIZABETH R. GROFF, & SUE-MING YANG, THE CRIMINOLOGY OF

made about all evidence-based advances at each and every stage of the criminal process, including the successful interventions, treatments, reforms, and strategies chronicled in the Campbell Collaboration's systematic reviews of experimental research.[37]

Lost in nearly any consideration of corporate criminal law is a rigorous victimology of corporate wrongdoing. There are distinct costs in failing to recognize the many stakeholders of corporate wronging; what role victim/stakeholder harm should play in a deterrence- or desert-driven criminal justice system; and what advances in the field of victimology, more generally, may offer the corporate criminal law. Evidence and principles from corporate victimology must be an inextricable part of the corporate criminal law.

Finally, corporate criminal law remains decidedly personal, even in its vicarious form. The substantive law, however, lags behind our understanding of the complexity of organizational life and organizational science. Moreover, policies associated with its use remain ill-conceived, and there is at best a half-hearted embrace of compliance science by those inside and outside of the firm entrusted with policing and ensuring the compliance function. Resisting the kind of compliance science that recognizes and supports the idea of an enterprise fault is at the core of what is missing in all accounts.[38] The hesitance to see advances in compliance science and technology as an opportunity to more fairly regulate, to be bound by reasonable and measured social controls, and to aspire to more creative innovations in regulation has roots in a longstanding ambivalence with respect to the attribution of fault to corporations. This ambivalence is quite defining for each and every compliance stakeholder.[39]

PLACE: STREET SEGMENTS AND OUR UNDERSTANDING OF THE CRIME PROBLEM (2012); PAUL J. BRANTINGHAM & PATRICIA L. BRANTINGHAM, PATTERNS IN CRIME (1984); JOHN E. ECK ET AL., MAPPING CRIME: UNDERSTANDING HOT SPOTS (2005).

37. *See The Campbell Collaboration Online Library*, CAMPBELL COLLABORATION, https://campbellcollaboration.org/library.html.

38. *See* Peter C. Yeager, *Science, Values and Politics: An Insider's Reflections on Corporate Crime Research*, 51 CRIME L. & SOC. CHANGE 5 (2009). For an excellent discussion of compliance theories and motivation, see Julien Etienne, *Compliance Theory: A Goal Framing Approach*, 33 L. & POL'Y 305 (2011).

39. *See* LAUFER, *supra* note 2.

Shining light on what is missing in corporate criminal law highlights limitations in doctrine, philosophy, and practice. It is not an exaggeration to say that this body of law is without a firm and coherent normative foundation.[40] The criminal law that is applied to corporations is nothing more than a patchwork of largely disregarded black letter principles of vicarious fault tacked together with an inconsistent set of prescriptive prosecutorial and sentencing guidelines.[41] The discretionary use of these guidelines by prosecutors determines charging and, thus, plea agreements, sentencing outcomes, and post-sentencing practices.[42] That prosecutorial discretion governs the entire criminal process is concerning for a host of reasons, not the least of which is that courts rarely have an opportunity to rule on substantive points of corporate criminal law, while legislatures fail to touch and mature its general part. Practitioners and academics thirst for federal and state decisional law that will begin to recognize basic fault principles. What they get instead is a corporate criminal law that is all too often conflated into canned compliance programs, practices, and functions that are played as a multi-stakeholder game.[43] When black letter law is applied, it is done so differently for firms

40. *See* Laufer & Strudler, *supra* note 30.

41. *See, e.g.*, LAUFER, *supra* note 2, at xiii ("We are left with century-old liability rules that are resurrected for reasons of prosecutorial convenience or symbolic need. The only substantive reform came in piecemeal fashion or through the back door of sentencing and prosecutorial guidelines."). For cases following *Hudson*, see William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance,* 52 VAND. L. REV. 1341 (1999) [hereinafter Laufer, *Corporate Liability*]. Most recently, the Department of Justice backed off from the issuance of memoranda and informal policy statements on corporate compliance, diligence, and liability. The stated objective is to move away from "management by memo" to a more systematic incorporation of formal policies directly into the United States Attorneys' Manual. See, Rod J. Rosenstein, *Keynote Address on Corporate Enforcement Policy*, NYU Program on Corporate Compliance & Enforcement Keynote Address, New York, (October 6, 2017), https://wp.nyu.edu/compliance_enforcement/2017/10/06/nyu-program-on-corporate-compliance-enforcement-keynote-address-october-6-2017/; Rod J. Rosenstein, *Deputy Attorney General Rosenstein Delivers the Morning Keynote Address at the U.S. Chamber Institute for Legal Reform*, Washington, DC (October 25, 2017), https://www.justice.gov/opa/speech/deputy-attorney-general-rosenstein-delivers-morning-keynote-address-us-chamber-institute.

42. For a very insightful review of post-sentencing reforms, see Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853 (2007).

43. *See infra* notes 152–73.

that are small versus those of any scale whose prosecution may bring about significant collateral consequences, or even systemic risk.[44] That the playing field is still not level for small and big firms alike should strongly exercise both old and more modern progressives.

Unfortunately for those looking for regulatory accountability, there are few good alternatives to wholly embracing or completely rejecting this unorthodox patchwork of criminal liability.[45] For those seeking to account for the decentered and plural nature of corporate regulation with new governance approaches, regulators offer no hint of relinquishing their formal grip on a brand of discretionary oversight and treatment of organizational actors that is often arbitrary, largely symbolic, and frequently determined by firm size and power.[46] For those looking to account for the influence of our complex political economy on the administration of corporate criminal law, there are sadly no reasonable alternatives.[47] And there is literally nothing in public law for those interested in a new and more expansive regulatory architecture to accommodate the players and stakeholders of our interconnected global markets, e.g., models of private regulation, collaborative governance, and regulatory capitalism.[48] There is little choice but to hold on to the faint promise that regulators will coordinate with their counterparts around the world.[49]

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44. GARRETT, *supra* note 3; WILLIAM S. LAUFER, THE COMPLIANCE GAME IN REGULAÇÃO DO ABUSO NO AMBITO CORPORATIVO: O PAPEL DO DIREITO PENAL NA CRISE FINANCEIRA (EDUARDO SAAD-DINIZ et al. eds., 2015).

45. *Cf.* Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Theory*, 89 MINN. L. REV. 342 (2004); Coglianese & Lazer, *supra* note 31; Cristie Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757 (2005).

46. Baer, *supra* note 31; Cristie Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1 (2008).

47. *See* Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L. Q. 95 (2004) (arguably the first and most important treatment of this complex relationship).

48. *See* Sara Sun Beale & Adam G. Safwat, *What Developments in Western Europe Tell Us About American Critiques of Corporate Criminal Liability*, 8 BUFF. CRIM. L. REV. 89 (2004); Ronald C. Slye, *Corporations, Veils, and International Criminal Liability*, 33 BROOK. J. INT'L L. 955 (2008).

49. *See, e.g.*, U.S. DEP'T OF JUSTICE, CRIMINAL DIV., THE FRAUD SECTION'S FOREIGN CORRUPT PRACTICES ACT ENF'T PLAN AND GUIDANCE 2 (2016) ("The Department is strengthening its coordination with foreign counterparts in the effort to hold corrupt individuals and companies accountable. Law en-

Sadly, without obvious alternatives, regulatory and compliance costs continue to grow in ways disconnected from—or not sufficiently connected to—legal requirements, regulatory risks, and actual compliance failures.[50] Conservative beltway think tanks estimate that the costs of federal regulations to the private sector exceed $1.8 trillion annually.[51] They reason that if federal regulation was its own economy, it would be the tenth largest in the world. And this excludes the regulatory administrative and policing costs that add an additional $59.5 billion.[52] For those who see regulatory compliance costs as another tax, the regulatory spending "tax" is greater than individual income and corporate income taxes combined.[53] Even assuming significant measurement error in these estimates, few dispute the enormity of the regulatory burden on businesses.[54]

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forcement around the globe has increasingly been working collaboratively to combat bribery schemes that cross national borders."); *see also* Brandon L. Garrett, *Globalized Corporate Prosecutions*, 97 VA. L. REV. 1775 (2011).

50. *See* STACEY ENGLISH & SUSANNAH HAMMOND, COST OF COMPLIANCE 2016 6 (2016), https://risk.thomsonreuters.com/content/dam/openweb/documen ts/pdf/risk/report/cost-compliance-2016.pdf; Julian R. Franks, Stephen M. Schaefer & Michael D. Staunton, *The Direct and Compliance Costs of Financial Regulation*, 21 J. BANKING & FIN. 1547, 1550 (1997); Gregory Elliehausen, *The Cost of Bank Regulation: A Review of the Evidence*, 84 FED. RES. BULL. 252, 252 (1998); Winston Harrington, Richard D. Morgenstern & Peter Nelson, *On the Accuracy of Regulatory Cost Estimates*, 19 J. POL'Y ANALYSIS & MGMT. 297 (2000); James A. Millar & B. Wade Bowen, *Small and Large Firm Regulatory Costs: The Case of the Sarbanes–Oxley Act*, 11 CORP. GOVERNANCE 161, 163 (2011). For a right critique of regulatory costs, *see* James L. Gattuso & Diane Katz, *Regulation: Killing Opportunity*, BACKGROUNDER (Heritage Found.), Oct. 31, 2014, at 1.

51. CLYDE WAYNE CREWS, JR., TEN THOUSAND COMMANDMENTS: AN ANNUAL SNAPSHOT OF THE FEDERAL REGULATORY STATE 2 (2016). For the official government report on federal regulatory costs, *see* OFFICE OF MGMT. & BUDGET, 2016 DRAFT REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND AGENCY COMPLIANCE WITH THE UNFUNDED MANDATES REFORM ACT 9–10 (2016). For an overall critique of regulatory cost estimates, see Robert W. Hahn & John A. Hird, *The Costs and Benefits of Regulation: Review and Synthesis*, 8 YALE J. ON REG. 233 (1991); James R. Chelius & Robert S. Smith, *Firm Size and Regulatory Compliance Costs: The Case of Workers' Compensation Insurance*, 6 J. POL'Y ANALYSIS & MGMT. 193 (1987).

52. CREWS, *supra* note 51, at 16–18.

53. *Id.* at 12.

54. *See,* e.g., Dieter Helm, *Regulatory Reform, Capture, and the Regulatory Burden*, 22 OXFORD REV. ECON. POL'Y 169, 169 (2006); U.S. GEN. ACCOUNTING OFFICE, REGULATORY BURDEN: MEASUREMENT CHALLENGES AND CONCERNS RAISED BY SELECTED COMPANIES (1996).

With a steep linear increase in compliance and regulatory risk staffing, particularly in the financial industry, one may ask: how much responsibility should the private sector assume for self-policing and self-regulation without good compliance science?[55] Any answer to this question must attend to increasing concerns over individual liability for compliance and regulatory staff and, ultimately, the risks of an over-controlled compliance state in the private sector.[56]

II.
A Compliance Convergence

This is an admittedly harsh critique of corporate criminal regulation. It would be unfair as well and quite incomplete, but for some more favorable reflection on how the corporate compliance industry has grown in response to certain regulatory reforms, threats of more aggressive corporate prosecutions, the availability of technology-driven risk and compliance applications, and the impressive marketing efforts by a large "business ethics" industry.[57] For example, the dramatic rise of both FinTech and RegTech applications and solutions lead to speculation about a transformative if not paradigmatic shift in technology-driven compliance, e.g., the digitalization of compliance.[58] The vast disruptive potential of the next generation

55. Corporate compliance staffing levels are at an historic high. For example, by 2015, JP Morgan had a compliance and regulatory staff of more than 43,000. *See Regulations, Regulators and the High Cost of Banking Compliance*, PYMNTS (May 31, 2016), http://www.pymnts.com/news/security-and-risk/2016/banks-spend-and-hire-in-new-regulatory-environment/. For this same period, the number of JP Morgan's compliance and regulatory staff exceeded the number of officers in the U.S. Custom's and Boarder Protection, and was three times the number of agents in the Federal Bureau of Investigation.

56. *See* English & Hammond, *supra* note 50, at 9 ("What is certain is that greater personal liability will become reality in 2016 in many jurisdictions.").

57. *See,* e.g., Michael Thoits, Enterprise Risk Management Technology Solutions (2009), https://www.rims.org/resources/ERM/Documents/ERM%20Technology%20Solutions.pdf (discussing the range of ERM solutions); Paul L. Walker, William G. Shenkir & Thomas L. Barton, *ERM in Practice*, Internal Auditor, Aug. 2003, at 51, 55; John Farrell, *A Broad View of Section 404*, Internal Auditor, Aug. 2003, at 88, 88 (2003).

58. For a discussion of the varied technologies that support the financial and regulatory communities, s*ee, e.g.*, Philip Treleaven, *Financial Regulation of FinTech*, J. Fin. Persp., Winter 2015, at 114, 118–19; Thomas Philippon, *The FinTech Opportunity* 15–17 (Nat'l Bureau of Econ. Research, Working Paper

of these technologies, across a wide range of business and regulatory functions, is only now coming into focus.[59] Advances in distributed ledger technology (e.g., DLT or blockchain) are producing some very promising hand-shaking experiments between and among banks with endless applications to domestic and international corporate regulation.[60] This includes, at least in theory, an era of increasingly sophisticated regulator-based systems, successful co-regulated systems, and even well-integrated supra-regulator systems.[61]

Regulators are recognizing the need for new resources to oversee FinTech and RegTech technologies while, at the same time, considering how both might enhance their own examination, compliance, and enforcement capabilities.[62] The rede-

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No. 22476, 2016), http://nber.org/papers/w22476.; C. Andrew Gerlach, Rebecca J. Simmons & Stephen H. Lam, *U.S. Regulation of FinTech—Recent Developments and Challenges*, CAPCO INST. J. FIN. TRANSFORMATION, Nov. 2016, at 87, 88; Lawrence G. Baxter, *Adaptive Financial Regulation and RegTech: A Concept Article on Realistic Protection for Victims of Bank Failures*, 66 DUKE L.J. 567, 598–99 (2016).

59. Iris H-Y Chiu, *FinTech and Disruptive Business Models in Financial Products, Intermediation and Markets-Policy Implications for Financial Regulators*, 21 J. TECH. L. & POL'Y 55, 56 (2016) (discussing the potential disruption).

60. DLT or Blockchain is distributed ledger technology that stores a tamper-proof, permanent ledger of transaction data. For a discussion of some creative applications, *see* Carlo R.W. de Meijer, *Blockchain and the Securities Industry: Towards a New Ecosystem*, 8 J. SEC. OPERATIONS & CUSTODY 322, 324 (2016); Richard T. Ainsworth & Andrew Shact, *Blockchain (Distributed Ledger Technology) Solves VAT Fraud* (Boston Univ. Sch. of Law, Working Paper No. 16–41, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2853428; *Cash Cows—How Blockchain is Transforming Trade Finance*, BARCLAYS (Nov. 1, 2016), https://www.home.barclays/news/2016/11/how-blockchain-is-transforming-trade-finance.html; Kim S. Nash, *IBM Pushes Blockchain into the Supply Chain*, WALL ST. J. (July 14, 2016, 5:20 PM), http://www.wsj.com/articles/ibm-pushes-blockchain-into-the-supply-chain-1468528824; James Langton, *Major Banks Complete Blockchain Test*, INV. EXECUTIVE (Jan. 21, 2016, 2:20 PM), http://www.investmentexecutive.com/-/major-banks-complete-blockchain-test.

61. Javier Sebastian Cermeño, *Blockchain in Financial Services: Regulatory Landscape and Future Challenges for its Commercial Application* 6–10 (BBVA Research, Working Paper No. 16/20, 2016); LAURENT PROBST, LAURENT FRIDERES, BENOÎT CAMBIER & CHRISTIAN MARTINEZ-DIAZ, EUROPEAN COMMISSION, BLOCKCHAIN (2016).

62. Michael del Castillo, *Blockchain Won't Just Change Regulation, It Could Reshape the SEC*, COINDESK (Nov. 15, 2016), https://www.coindesk.com/blockchain-wont-just-change-regulation-change-sec/ (discussing how the SEC's Distributed Ledger Technology Working Group (DLTWG) views the

sign and integration of compliance technologies across a wide range of business processes are more than promising.[63] Not known for hyperbole, the Securities and Exchange Commission (SEC) has publicly commented that "FinTech innovation has the potential to transform virtually every aspect of our nation's financial markets."[64] Of course, all of the obvious regulatory challenges accompany rapidly evolving and disruptive technologies, e.g., regulatory inertia, lack of standardization, and limited network capacity.[65]

At the same time as the FinTech and GenTech disruption, there is an increasing reliance on sophisticated governance, risk, and compliance ("GRC") solutions by firms in many sectors and markets. Big data across divisions, departments, and risk areas are only now beginning to be systematically aggregated, disaggregated, and mined. Innovative open-source GRC models and metrics are now more commonly adopted and promoted across industries. And technology from both artifi-

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demands of blockchain on regulators and how this technology might contribute to regulatory capacity); *see also* Michael del Castillo, *How the SEC's Blockchain Lead is Defining Future Regulation*, COINDESK (Nov. 17, 2016), https://www.coindesk.com/what-secs-involvement-means-blockchain-distributed-ledger-bitcoin/.

63. This includes the creation of uniform compliance risk categories; better regulatory risk identification; standardized compliance risk taxonomy; automated monitoring of compliance standards; and monitoring change and application. *See* ERNST & YOUNG, INNOVATING WITH REGTECH: TURNING REGULATORY COMPLIANCE INTO A COMPETITIVE ADVANTAGE (2016), http://www.ey.com/Publication/vwLUAssets/EY-Innovating-with-RegTech/$FILE/EY-Innovating-with-RegTech.pdf.

64. Press Release, Sec. & Exch. Comm'n, *SEC to Hold Forum to Discuss Fintech Innovation in the Financial Services Industry* (Sept. 27, 2016); *see also* Cliff Moyce, *How Blockchain Can Revolutionize Regulatory Compliance*, CORP. COMPLIANCE INSIGHTS (Aug.10, 2016), http://www.corporatecomplianceinsights.com/blockchain-regulatory-compliance/ (Blockchain applications will reach "trade reporting; clearing, confirmation, validation and settlement; recordkeeping; monitoring and surveillance; risk management; audit; management and financial accounting; and regulatory compliance (including—but by no means limited to—financial crime prevention).").

65. Moyce, *supra* note 64; *see also* Peter Yeoh, *Innovations in Financial Services: Regulatory Implications*, 37 BUS. L. REV. 190, 192–93 (2016). For a recent report by the EU on the challenges posed by blockchain, see EUROPEAN UNION AGENCY FOR NETWORK AND INFORMATION SECURITY, DISTRIBUTED LEDGER TECHNOLOGY & CYBERSECURITY (2016), https://www.enisa.europa.eu/publications/blockchain-security.

cial intelligence and the cognitive sciences are beginning to shape and re-shape GRC modeling.[66]

It is a fair prediction that some iteration of today's GRC thinking will lead to the integration of firm, industry, and regulatory standards tomorrow.[67] The emergence of more sophisticated machine learning approaches and cognitive GRC models hold particular promise as an enterprise, cross-functional platform for real-time monitoring of regulatory changes, minimizing operational risks, and managing risks from both vendors and multi-tier supply-chain partners.[68] Combining institutional frameworks with agent-based simulations (institutional agent-based models) and pairing AI robots with key compliance professionals offer a window into the complex dynamics

66. Estimates regarding the size and growth of the GRC market vary widely. Industry forecasts, however, remain very positive. *See, e.g.*, *The GRC Market is Expanding at an Exponential Rate,* LOCKPATH: THE LOCKPATH BLOG (June 29, 2015), https://www.lockpath.com/blog/the-grc-market-is-expanding-at-an-exponential-rate/ ("With over 600 GRC solutions on the market currently, it seems that predictions show that the GRC market would hit $31.77 billion by the year 2020 with global compliance market spend reaching $2.6 billion in 2015 alone"); John Verver, *Big Data and GRC*, CORP. COMPLIANCE INSIGHTS, June 21, 2013. For a wise critique of the GRC movement, one that promotes a more active role for regulators in crafting the GRC model, see Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 677 (2010). Next generation GRC models focus on increasingly open frameworks, more fluid implementation, and systems integration of additional stakeholders. *See* MICHAEL VOLKOV, THE IMPACT OF NEW TECHNOLOGIES IN CORPORATE GOVERNANCE, RISK MANAGEMENT AND COMPLIANCE PROGRAMS (2013).

67. *See infra* note 77 for a discussion of GRC in relation to international standards.

68. *See, e.g.*, ARTIFICIAL INTELLIGENCE IN FINANCIAL MARKETS: CUTTING-EDGE APPLICATIONS FOR RISK MANAGEMENT, PORTFOLIO OPTIMIZATION AND ECONOMICS (Christian L. Dunis, Peter W. Middleton, Konstantinos Theofilatos & Andreas Karathanasopolous eds., 2016) (an excellent collection of papers on artificial intelligence and neural networking applications for a wide range of topics in finance); Heiko Thimm, *ICT Support of Environmental Compliance—Approaches and Future Perspectives*, *in* ADVANCES AND NEW TRENDS IN ENVIRONMENTAL INFORMATICS 323 (Volker Wohlgemuth, Frank Fuchs-Kittowski & Jochen Wittmann eds., 2017); Carole Switzer, *Accelerating the Evolution of GRC*, COMPLIANCE WK. (June 28, 2016), https://www.complianceweek.com/news/news-article/accelerating-the-evolution-of-grc#.WdAAQhOPLGI (exploring the transformative power of cognitive GRC); *cf.* Sean Lyons, *Corporate Defence: Are Stakeholders Interests Adequately Defended?* 1 J. OF OPERATIONAL RISK 67 (2006) (questioning the value of risk management strategies for the firm).

of regulation that was unimaginable until only recently.[69] An increasing commitment to leading-edge compliance data analytics gives large financial institutions and hedge funds of all sizes surveillance and monitoring solutions that were science fiction until only recently. Augmented and virtual reality extensions to compliance offerings also offer new ways of delivering risk management practices, and new revenue streams for accountancies, consultancies, and law firms.[70]

Contemporaneous with FinTech, RegTech, the dramatic rise in the use of compliance data analytics, and advances in GRC, is a recognition that social science research on compliance may offer value in developing effective corporate crime policy.[71] While evidence-based research on corporate criminal regulation is still exceedingly difficult to find, there is an impressive stream of scholarship by psychologists, sociologists, and criminologists on the many motives that encourage or discourage compliance inside and outside of complex organizations.[72] In spite of long-standing and near insurmountable

69. *See, e.g.*, Tina Balke, Marina De Vos & Julian Padget, *I-ABM: Combining Institutional Frameworks and Agent-Based Modelling for the Design of Enforcement Policies*, 21 ARTIFICIAL INTELLIGENCE L. 371 (2013); Samson Esayas & Tobias Mahler, *Modelling Compliance Risk: A Structured Approach*, 23 ARTIFICIAL INTELLIGENCE L. 271 (2015); *see also* Anant Kale, *Artificial Intelligence: The New Super Power for Compliance*, CORP. COMPLIANCE INSIGHTS, (Aug. 31, 2016), http://www.corporatecomplianceinsights.com/artificial-intelligence-new-superpower-business-compliance/.

70. *See, e.g.*, Emilia Duarte, Francisco Rebelo & Michael S. Wogalter, *Virtual Reality and Its Potential for Evaluating Warning Compliance*, 20 HUM. FACTORS & ERGONOMICS IN MANUFACTURING & SERV. INDUSTRIES 526 (2010).

71. *But see* Christine Parker & Sharon Gilad, *Internal Corporate Compliance Management Systems: Structure, Culture and Agency*, *in* EXPLAINING COMPLIANCE: BUSINESS RESPONSES TO REGULATION (Christine Parker & Vibeke Lehmann Nielsen eds., 2011). These authors seriously question the application of compliance research. They write that: "There is considerable disagreement as to whether a wide range of corporations would ever have the motivation and capacity to implement effective compliance systems and whether such systems could be effective even if corporations were willing and able to implement them." *Id.* at 189.

72. David Hess, *Ethical Infrastructures and Evidence-Based Corporate Compliance and Ethics Programs: Policy Implications from the Empirical Evidence*, 12 N.Y.U. J.L. & BUS. 317 (2016); *see also* Parker & Gilad, *supra* note 71, for research on motives from Kagan, Gunningham, Thornton, Simpson, Rorie, and Tyler. *See, e.g.*, Tom R. Tyler, *Reducing Corporate Criminality: The Role of Values*, 51 AM. CRIM. L. REV. 267 (2014); Marie A. McKendall & John A. Wagner, III, *Motive, Opportunity, Choice, and Corporate Illegality*, 8 ORG. SCI. 624

challenges with access to good white collar and corporate crime data, there is also an emerging literature on the internal and external characteristics of firms that are most associated with law abidance.[73] A separate but related body of work, even more developed, explores organizational responses to innovations in regulation.[74] Some of the better quantitative research on environmental compliance, for example, is framed around a groundswell of new governance and new regulatory models that push plural and decentered concepts.[75] From systems-

(1997); Lynne M. Vieraitis, Nicole L. Piquero, Alex R. Piquero, Stephen G. Tibbetts & Michael Blankenship, *Do Women and Men Differ in Their Neutralizations of Corporate Crime?*, 37 CRIM. JUST. REVIEW 478 (2012); Wayne B. Gray & Ronald J. Shadbegian, *When and Why Do Plants Comply? Paper Mills in the 1980s*, 27 L. & POL'Y 238 (2005); Neil Gunningham, Robert A. Kagan & Dorothy Thornton, *Social License and Environmental Protection: Why Businesses Go Beyond Compliance*, 29 L. & SOC. INQUIRY 307 (2004).

73. For an excellent discussion of the difficulties of securing white collar crime research data, see SALLY S. SIMPSON & PETER CLEARY YEAGER, BUILDING A COMPREHENSIVE WHITE-COLLAR VIOLATIONS DATA SYSTEM 5 (2015); MARSHALL CLINARD & PETER YEAGER, CORPORATE CRIME 97–98 (1980) (discussing data limitations). The literature on organizational capabilities and characteristics assembled by Parker and Gilad, *supra* note 71, reflects the diversity of scholarship. It is worth highlighting Parker and Gilad's contribution on structure, culture, and agency. This is perhaps the best writing on the complex prospects of regulator-mandated compliance systems. *See also* Lori Snyder Bennear, *Are Management-Based Regulations Effective? Evidence from State Pollution Prevention Programs*, 26 J. POL'Y ANALYSIS & MGMT. 327, 328 (2007); Gary R. Weaver & Linda Klebe Treviño, *Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior*, 9 BUS. ETHICS Q. 315 (1999). Researchers are increasingly looking at changes in actual behavior of agents following the initiation of, or changes in, an integrity initiative. *See* Danielle E. Warren, Joseph P. Gaspar & William S. Laufer, *Is Formal Ethics Training Merely Cosmetic? A Study of Ethics Training and Ethical Organizational Culture*, 24 BUS. ETHICS Q. 85 (2014) (in a study of bank employees, two years after a single ethics training session, there were sustained positive effects on indicators of an ethical organizational culture).

74. *See generally* CHRISTINE PARKER, THE OPEN CORPORATION: EFFECTIVE SELF-REGULATION AND DEMOCRACY (2002). For the most notable industry and subject matter specific research, see JOHN BRAITHWAITE, TO PUNISH OR PERSUADE: ENFORCEMENT OF COAL MINE SAFETY (1985); VALERIE BRAITHWAITE, DEFIANCE IN TAXATION AND GOVERNANCE: RESISTING AND DISMISSING AUTHORITY IN A DEMOCRACY (2009); JOHN BRAITHWAITE, TONI MAKKAI & VALERIE BRAITHWAITE, REGULATING AGED CARE: RITUALISM AND THE NEW PYRAMID (2007); JOHN BRAITHWAITE, CORPORATE CRIME IN THE PHARMACEUTICAL INDUSTRY (1984).

75. Charles F. Sabel & William H. Simon, *Minimalism and Experimentalism in the Administrative State*, 100 GEO. L.J. 53 (2011); Neil Gunningham & Cam-

and principle-based regulation to smart regulation, meta-regulation, and regulatory excellence (RegX), the important role of third parties and non-state actors have helped reconceive thinking about conventional regulator–regulated relationships.[76]

When you add together recently introduced international enterprise-wide governance, risk, and compliance standards to this mix, such as those from the International Organization for Standardization (e.g., ISO19600, ISO31000, and ISO38500), and the Enterprise Risk Management standards from the Committee of Sponsoring Organizations of the Treadway Commission (COSO ERM), there is an impressive convergence. There is, quite simply, a gestalt of models, measures, metrics, data, analytics, standards, committed compliance professionals, relevant compliance scholarship, and vast firm resources dedicated to promoting compliance and good governance while minimizing enterprise risk and liability.[77] This is an opportunistic convergence of formal and informal social controls across the entire firm—from corporate strategy, organizational processes, and available technology to culture, leadership, and people. It is, in some ways, a challenge for a new, transformative promise of the scientific state. If there is

eron Holley, *Next-Generation Environmental Regulation: Law, Regulation, and Governance*, 12 ANN. REV. L. & SOC. SCI. 273, 274 (2016).

76. For an excellent collection of some of the best research on regulatory policy making, enforcement, responses to regulation, and next generation thinking about regulation, see REGULATION AND REGULATORY PROCESSES (Cary Coglianese & Robert A. Kagan eds., 2007). For a recent extension of Cary Coglianese's work, see CARY COGLIANESE, LISTENING, LEARNING, AND LEADING: A FRAMEWORK FOR REGULATORY EXCELLENCE (2015); ACHIEVING REGULATORY EXCELLENCE (Cary Coglianese ed., 2016) (a series of outstanding contributions to the conception, applications, and limitations of regulatory excellence).

77. *See, e.g.*, ROBERT R. MOELLER, COSO ENTERPRISE RISK MANAGEMENT: ESTABLISHING EFFECTIVE GOVERNANCE, RISK, AND COMPLIANCE PROCESSES (2d ed. 2011); ISO, INTERNATIONAL STANDARD ISO 19600, COMPLIANCE MANAGEMENT SYSTEMS—GUIDELINES (2014); Sylvie Bleker & Dick Hortensius, *ISO 19600: The Development of a Global Standard on Compliance Management*, J. BUS. COMPLIANCE, Feb. 2014; ISO, INTERNATIONAL STANDARD ISO 31000, RISK MANAGEMENT—PRINCIPLES AND GUIDELINES ON IMPLEMENTATION (2009); ISO, INTERNATIONAL STANDARD 38500, CORPORATE GOVERNANCE OF INFORMATION TECHNOLOGY (2008); Hesham Bin-Abbas & Saad Haj Bakry, *Assessment of IT Governance in Organizations: A Simple Integrated Approach*, 32 COMPUTERS HUM. BEHAV. 261 (2014).

any progress made in accessing a vast array of white collar crime and organizational crime data from federal and state agencies, this also may be a critical turning point in the scientific study of corporate crime.[78]

How architects of the corporate criminal law should embrace this convergence in ways that recognize the importance of private and public sector social control is a central challenge to the development of a progressive account.[79] This challenge would be "insurmountable" if conceived narrowly as a task for the state to assume the role of the new age experimentalists and decipher which specific variables, proxies, or metrics are part of a general prescription that should be offered to the private sector as effective compliance or organizational due diligence.[80] Instead, the burden must be shared across all compliance stakeholders to meet the challenges of this compliance convergence with a far more developed capacity that addresses regulatory needs, capabilities, and requirements. This is actually a co-regulatory challenge that will inevitably require different exchanges, revised instruments and analytics, and increasingly lower costs through the cross-

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78. SIMPSON & YEAGER, *supra* note 73, at 3 ("Despite its voluminous collections of data on conventional crimes and the legal responses to them, the Nation has long lacked systematic data on white-collar offenses and the sanctions employed against them."); *see also* Marshall B. Clinard & Peter C. Yeager, *Corporate Crime: Issues in Research*, 16 CRIMINOLOGY 255 (1978) (reviewing the dearth of corporate crime research).

79. As Daniel Richman astutely noted in his brief response to Brandon Garrett's work on structural reforms,

> I suppose that in theory, one could envision the Justice Department presiding over a lovely experimentalist regime in which the 'informal exchange of information amongst independent monitors, prosecutors, regulators, and industry experts will, over time, create a narrow set of accepted best remedial practices.' Figuring out what 'works'—that is, how to measure compliance—is not just a technical challenge here, however. It is a fundamental confounding problem in the whole area of white collar enforcement.

Daniel Richman, *Institutional Competence and Organizational Prosecutions*, 93 VA. L. REV. IN BRIEF 115, 119 (2007).

80. *Id.* at 120 ("Finding appropriate performance metrics is hard enough for those engaged in (or opposing) structural reform in prisons, schools, or other such institutions. In the white collar area, the challenge may be insurmountable."); *cf.* Simpson et al., *supra* note 28 (finding the challenge for any coherent corporate criminal justice policy in the dearth of evidence-based data).

enterprise integration of regulatory technology. It is also a challenge that will benefit from the lessons learned in maturing other regulatory settings, such as the many successful self-regulatory organizations (e.g., Financial Industry Regulatory Authority (FINRA); Municipal Securities Rulemaking Board (MSRB), and American Arbitration Association (AAA)), along with sector-specific co-regulation of environmental protection, health and product safety, and climate protection.[81] Finally, much can be learned from the many noteworthy co-regulatory successes in combating cybercrime, and ensuring cybersecurity and national security.[82]

This convergence in compliance thinking, standards, analytics, and metrics is certainly not provincial. The development and sharing of increasingly sophisticated and elaborate compliance models across Europe and Australia, for example, suggest that there is an emerging convention in regulatory technology and models, both in jurisdictions that have and those that lack the same threats from command and control approaches to entity liability.[83] Many of our old concerns still define foreign civil, administrative, and criminal regulation of corporations, including "paper compliance" programs, piecemeal and unpredictable changes to government guidance that tease the regulated with incentives and disincentives, and an absence of contemporaneous decisional and statutory laws to

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81. *See, e.g.*, BERTELSMANN STIFTUNG, FOSTERING CORPORATE RESPONSIBILITY THROUGH SELF- AND CO-REGULATION (2012); CAMERON HOLLEY, NEIL GUNNINGHAM & CLIFFORD SHEARING, THE NEW ENVIRONMENTAL GOVERNANCE (2013). What little is known about exchange-based conceptions of compliance will help as well. *See* Weaver & Treviño, *supra* note 73; *see also* Gary R. Weaver, *Ethics Programs in Global Businesses: Culture's Role in Managing Ethics*, 30 J. BUS. ETHICS 3 (2001); LAUFER, *supra* note 2.

82. *See, e.g.*, TATIANA TROPINA & CORMAC CALLANAN, SELF- AND CO-REGULATION IN CYBERCRIME, CYBERSECURITY AND NATIONAL SECURITY (2015).

83. *See, e.g.*, 2 CORPORATE CRIMINAL LIABILITY AND COMPLIANCE PROGRAMS: TOWARDS A COMMON MODEL IN THE EUROPEAN UNION (Antonio Fiorella ed., 2012); ULRICH SIEBER & MARC ENGELHART, COMPLIANCE PROGRAMS FOR THE PREVENTION OF ECONOMIC CRIMES: AN EMPIRICAL SURVEY OF GERMAN COMPANIES (2014); EUROPEAN DEVELOPMENTS IN CORPORATE CRIMINAL LIABILITY 1 (James Gobert & Ana-Maria Pascal eds., 2011); CORPORATE CRIMINAL LIABILITY AND COMPLIANCE (Luis Arroyo Zapatero & Antonio Fiorella eds., 2012); DENNIS BOCK, CRIMINAL COMPLIANCE (2011); Vibeke Lehmann Nielsen & Christine Parker, The ACCC Enforcement and Compliance Survey: Report of Preliminary Findings (Dec. 2005) (ANU Centre for Competition and Consumer Policy Working Paper).

provide and interpret clearly-stated principles.[84] Notably, many of the most significant concerns with advancing financial and regulatory technology were raised first by regulatory bodies and non-governmental organizations outside the United States.[85]

In countries with a less developed rule of law, there are also lessons to be learned from successful public, private, and non-state regulation and enforcement.[86] The challenges of bringing leading compliance solutions to companies and government agencies at different strata in the economic pyramid are discussed below. Seldom do we think about how governance, risk, and compliance solutions might apply, for example, to municipalities or state-owned enterprises in developing countries. The fair melding of private and public interests in a diverse set of enterprises across cultures would be of great interest to progressives, so long as the outcome is more corporate criminal justice.

III.
WHY A PROGRESSIVE ACCOUNT?

In some ways, not much has changed from the time of the Progressive Party platform of 1912.[87] Concerns over concentrated wealth are well over a hundred years old. Monopolies

84. *See, e.g.*, Adán Nieto Martin, *Cosmetic Use and Lack of Precision in Compliance Programs: Any Solution?*, 3 EUCRIM 124, 124 (2012); EDUARDO SAAD-DINIZ, INIMIGO E PESSOA NO DIREITO PENAL (2012); Marc Engelhart, *Corporate Criminal Liability from a Comparative Perspective*, *in* REGULATING CORPORATE CRIMINAL LIABILITY 53–76 (Dominik Brodowski et al. eds., 2014).

85. *See* Douglas W. Arner, Jànos Barberis & Ross P. Buckley, *FinTech, RegTech and the Reconceptualization of Financial Regulation*, 37 NW. J. OF INT'L. L. & BUS. 373 (2017).

86. Helle Weeke, Steve Parker & Edmund Malesky, *The Dynamics of Vietnam's Business Environment: Complying with Obligations Abroad and Competing at Home*, 12 DEVELOPING ALTERNATIVES 1 (2009); Andrew A. King & Michael J. Lenox, *Industry Self-Regulation without Sanctions: The Chemical Industry's Responsible Care Program*, 43 ACAD. OF MGMT. J., 698, 698 (2000). One of the most important lessons, for example, is that cooperation between regulators and the regulated in the design of instruments significantly improves law abidance. *See* Markus Taussig & Edmund Malesky, The Danger of Not Listening: How Broad-Based Business Participation in Government Design of Regulations Can Increase Compliance and Benefit Society (Feb. 1, 2016) (unpublished manuscript).

87. See AMERICAN PROGRESSIVISM 273–87 (Ronald J. Pestritto & William J. Atto eds., 2008) for the text of the platform.

were said to be fueled by inordinate greed, unbridled corporate power, and seemingly limitless growth.[88] Like today, progressives a century ago were concerned with the functioning and fairness of institutions of corporate social control, and how much regulatory discretion is left to the boundless imagination of the private sector. Modern progressives also recognize the ascendant power and stature of corporations, and the limitations of the market to produce fair and just outcomes. Like their ideological predecessors, they seek some semblance of responsibility, some accountability, and some long overdue legal reforms.[89] In playing off the Wall Street/Main Street dichotomy today, progressives' remain exercised by concentrated wealth extremes, unfair business tax provisions, and a wide range of unattended social, environmental, economic, and racial injustices.[90] They want to undermine corporate hegemony, break the corporate stranglehold on Capitol Hill, and abolish the idea of corporate personhood. Progressives also want more corporate wrongdoers debarred from government contracts; limited from exploiting offshore tax loopholes; subjected to expanded transparency and disclosure requirements about environmental, human rights, and worker safety records; and forced to reign in executive compensation.[91]

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88. These concerns were long-lasting. *See* ELLIS W. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY (2016).

89. Recent efforts to infuse the 2016 Democratic Party Platform with progressive ideology turn on improved corporate citizenship, enhanced shareholder activism, increased executive accountability, and more institutional commitment to sustainability. DEMOCRATIC PLATFORM COMMITTEE, 2016 DEMOCRATIC PARTY PLATFORM (2016).

90. *See* Nikiforos T. Laopodis & Bansi L. Sawhney, *Dynamic Interactions Between Main Street and Wall Street*, 42 Q. REV. ECON. & FIN. 803, 805 (2002); Anna Lamin & Srilata Zaheer, *Wall Street vs. Main Street: Firm Strategies for Defending Legitimacy and Their Impact on Different Stakeholders*, 23 ORG. SCI. 47 (2012); Kevin M. DeLuca, Sean Lawson & Ye Sun, *Occupy Wall Street on the Public Screens of Social Media: The Many Framings of the Birth of a Protest Movement*, 5 COMM., CULTURE & CRITIQUE 483, 483 (2012). See NEIL BAROFSKY, BAILOUT: HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET (2012) and ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2010) for a treatment of this dichotomy in the popular press.

91. *See Nader Proposes Crackdown on Corporate Crime, Fraud and Abuse*, OREGON PROGRESSIVE PARTY (Sept. 24, 2010, 9:20 PM), http://progparty.org/issues/market/corporate_crime.

A modest outline of progressive corporate criminal law is offered below as a catalyst both to combat the regulatory status quo, and, far less ambitiously, to build capacity into the modern progressive account. This outline is a blend of old progressive principles set in today's compliance environment, with an appreciation of the concerns of modern progressives. Part of the inspiration for a progressive account comes from the failure of the state to recognize the convergence of new enterprise-wide standards, metrics, analytics, new regulatory models, and asymmetric private sector investment in compliance products and services. Inspiration for this account may also be traced to how the moral reprehensibility of corporate crime is so often washed clean, as well as profound concerns with the ways in which corporate criminal justice system is successfully gamed.[92] It may be washed and gamed, at least in part, because of the absence of any systematic recognition of corporate victims and victimization. As suggested earlier, it is as remarkable as it is disturbing that there is no field of corporate victimology.

A. *Progressive Thinking*

The recent history of the progressive movement defies simple description.[93] Indeed, it is difficult to catalogue the diverse political and social factions of modern progressivism.[94] Those who claim to represent the progressive vision, issues, beliefs, and values of today often capture only a fraction of the

92. *See* William S. Laufer, *Social Accountability and Corporate Greenwashing*, 43 J. BUS. ETHICS 253, 255 (2003) (discussing ways in which reputations of firms are laundered).

93. *See, e.g.*, Yonathan Amselem, *The Formlessness of Progressivism*, MISES INST., (Dec. 30, 2015, 12:00 AM), https://mises.org/library/formlessness-progressivism ("Progressives are often good people with good intentions. However, modern Progressivism has evolved into something so shapeless and amorphous as to amount to little more than a belief in "things that sound nice."); *see also* Glastris, *supra* note 18, at 1 ("As many observers have noted, there are arresting parallels between our age and the 1890s, the dawn of the Progressive Era.").

94. It is much easier to distinguish old and modern progressives, and modern and post-modern progressives. For a right of center critique of the latter, see KIM R. HOLMES, THE CLOSING OF THE LIBERAL MIND: HOW GROUPTHINK AND INTOLERANCE DEFINE THE LEFT 92 (2016).

significant variance in prevailing theory and dogma.[95] At times, progressive accounts of law also fail to neatly converge.[96] That said, progressive ideology coalesces around issues of social justice, environmental sustainability, fair wages, and equitable workplace regulations. Even more prominent and relevant here, are concerns with the concentration of wealth and power in the hands of a corporate oligarchy.[97] Progressives are united behind the idea that our democracy and democratic institutions are compromised by elites and powerful interest groups who think and act in ways that are disconnected from the realities of non-elites.[98]

In recent years the ideology of progressivism, like liberalism and socialism, has also become a regular target of dismissive political barbs. The modern welfare state may be the greatest achievement of the progressive movement, but subscribing to welfare-state politics does, indeed, embolden foes and exact costs.[99] Some progressives, we are told, employ a thinly veiled guise for promoting a radical and, arguably, unjustifiable expansion of the role of government in our lives. In other cases, there is no veil, as with the stated desire to break up the big banks, along with the freethinking demonization of Wall Street and its resident institutions. Other progressives are said to be "boutique liberals" who depart from the shared understanding of our Founders about the text of the constitution,

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95. *See, e.g.*, AL YATES & ANNE BARTLEY, PROGRESSIVE THINKING: A SYNTHESIS OF AMERICAN PROGRESSIVE VALUES, BELIEFS, AND POSITIONS (2012); Elizabeth Sanders, *Rediscovering the Progressive Era*, 72 OHIO ST. L.J. 1281 (2011).

96. *See* KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 34 (2006); Kellye Y. Testy, *Linking Progressive Corporate Law with Progressive Social Movements*, 76 TUL. L. REV. 1227, 1229 (2002) (exploring the connection between progressivism and corporate social responsibility); Hovenkamp, *supra* note 22, at 153.

97. Bernie Sanders, *Democracy or Oligarchy*, THE PROGRESSIVE (Aug. 7, 2014), http://www.progressive.org/news/2014/08/187809/democracy-or-oligarchy ("The major issue of our time is whether the United States of America retains its democratic foundation or whether we devolve into an oligarchic form of society where a handful of billionaires have almost absolute control over the political and economic life of the nation.").

98. For a fascinating discussion of concentrated wealth and political orientation, see Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 PERSP. ON POL. 564 (2014). *See also* David Vogel, *The Power of Business in America: A Re-appraisal*, 13 BRITISH J. POL. SCI. 19 (1983).

99. *See, e.g.*, Hovenkamp, *supra* note 22.

and are committed to communitarianism, or something worse.[100] Progressives are cast, fairly or not, as an unruly band of politically left ideologues. We have clearly come a long way from Rousseau and Hegel, Wilson and Roosevelt.[101]

The kind of progressive corporate criminal law presented below is not a fair reflection of these positions or a reasonable target of this critique. The boundaries around this body of law are inspired by the brand of progressivism and institutionalism that marked a distinct shift from laissez-faire policies to a very limited and directed government engagement in the early 1900s.[102] In 1904, it was Thorstein Veblen's call for new thinking about institutional economics that coalesced in academic writing about the changing nature of the business firm, its growth, its scale, and its power.[103] Soon thereafter, J. M. Clark extended turn-of-the-century social control theory to the business firm, offering a path for new institutions to complement the power and suasion of the market—new institutions that would guide the social direction of a maturing administrative state.[104] Progressives and institutionalists, economists and sociologists, stepped in where "existing legal and social institutions . . . were outmoded and inadequate to the task of the social control of modern, large-scale industry."[105] This disconnect between functioning institutions of social control and corporations of scale and power should be the hard target of modern-day progressives. Disparate groups and factions in the larger progressive collective should target the emasculation and gaming of the corporate criminal law in regulatory practice.

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100. *See, e.g.*, *id.*

101. *Id.*

102. *See* GREENFIELD, *supra* note 96; Dalia Tsuk, *Corporations Without Labor: The Politics of Progressive Corporate Law*, 151 U. PA. L. REV. 1861, 1864 (2003); THE POLITICS OF LAW: A PROGRESSIVE CRITIQUE (David Kairys ed., 3d ed. 1998).

103. Stephen Edgell & Rick Tilman, *The Intellectual Antecedents of Thorstein Veblen: A Reappraisal*, 23 J. ECON. ISSUES 1003, 1004 (1989); John A. Hobson, *The Economics of Thorstein Veblen*, 52 POL. SCI. Q. 139 (1937).

104. JOHN M. CLARK, SOCIAL CONTROL OF BUSINESS (1939); *cf.* Don S. Kirschner, *The Ambiguous Legacy: Social Justice and Social Control in the Progressive Era*, 2 HIST. REFLECTIONS/RÉFLEXIONS HISTORIQUES 69 (1975) (raising justifiable concerns with the conventional progressive account).

105. Malcolm Rutherford, *Institutional Economics: Then and Now*, 15 J. ECON. PERSP. 173, 174 (2001).

The ingredients of twentieth century theories of institutional economics are largely pragmatic and policy-driven, with strong commitments to controlling the growth of big business and curbing corruption.[106] At the same time, both Progressivism and Institutionalism share important theoretical foundations. Institutions are not only central to the ordering of an economy, but are also dynamic, changing, and in need of appropriately gauged social controls that benefit from scientific and, in particular, experimental scrutiny.[107] The institutionalist creed, according to historians, is to construct institutions and related policies that are responsive to the challenges of social control. And this response must come from more than simple anecdotes, naïve theorizing, or political expediency.[108] For institutionalists, a positivist account requires that science mold and meld with the very institutional arrangements that order and govern markets.[109] The legacy of Ross's social realism and Taylor's call for science management have found new life.[110]

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106. Michael McGerr, A Fierce Discontent: The Rise and Fall of the Progressive Movement in America, 1870–1920 147–81 (2003) (discussing, in some depth, the reaction of progressives to the emergence of powerful large-scale enterprises). *See* Gerhard Peters & John T. Woolley, *Progressive Party Platform of 1912*, American Presidency Project (Nov. 5, 1912), http://www.presidency.ucsb.edu/ws/index.php?pid=29617 (for the text of the 1912 Progressive Party Platform relating to business enterprises).

107. Malcolm Rutherford, *Science and Social Control: The Institutionalist Movement in American Economics, 1918–1947*, 3 Erasmus J. for Phil. & Econ. 47, 47 (2010); Edward A. Ross, *The Sociological Frontier of Economics*, 13 Q.J. Econ. 386 (1899).

108. For a detailed and careful history of the emergence of social science in the progressive period, see Dorothy Ross, The Origins of American Social Science (1991).

109. Thomas C. Leonard, *Progressive Era Origins of the Regulatory State and the Economist as Expert*, 47 Hist. Pol. Econ. 49, 66 (2015) ("Progressives enthusiastically and rapidly seized on industrial efficiency as an exemplar, imagining that scientific management could increase efficiency not just on the shop floors of factories but in all corners of an industrial society plagued by waste, conflict, and injustice.").

110. *See* Sigmund Wagner-Tsukamoto, *An Institutional Economic Reconstruction of Scientific Management: On the Lost Theoretical Logic of Taylorism*, 32 Acad. of Mgmt. Rev. 105, 114 (2007) ("This paper points toward a high contemporary relevance of scientific management—and of institutional economics. They can well advise us on organizational problems, especially in "modern" interaction contexts that are defined by diversity and pluralism.").

The brand of progressivism promoted here takes the shape of a positivist account that looks to replace intuitions and politically-driven ideologies in crafting enterprise compliance and governance prescriptions with measured and just government *and* corporate controls.[111] To achieve this ideal, progressives look to the formality of social controls (along a continuum from informal to formal), the level of controls (across agent, firm, industry, and public sector levels), the responsibility for social controls (exploring the increasing privatization of regulation), and the locus of control (recognizing how the effects of social controls differ in private, state-owned, government entities).[112] To make the construction of this century-old bridge a bit more realistic, this brand of progressivism should recognize (1) the generally narrow motivations of the private sector to fend off anything but informal social controls, and (2) the limited capacity of government functionaries to assume responsibility for defining, crafting, and escalating these controls.

The history and heritage of this positive account lead to some zealously guarded positions. For example, neoconservatives make much of the regulatory burden as an unjustifiable incursion on the private sector.[113] Modern progressives would likewise bemoan current spending levels on defensive corporate self-regulation or preventive law, but do so because there is simply so little evidence that current compliance expenditures make firms and their agents more compliant. Expenditures may protect the entity from liability, but that is, of course, quite different. Corporate libertarians would dismantle and abolish entity liability if permitted. Modern progressives would likely see corporate wrongdoing as reducible to individual fault. At the same time, though, they should concede that organizational fault is a fair proxy for corporate wrongdoing (at least in some cases), and look to how an enterprise-wide

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111. For a lengthy discussion of progressivism in relation to both corporation and government control, see BENJAMIN P. DEWITT, THE PROGRESSIVE MOVEMENT: A NON-PARTISAN COMPREHENSIVE DISCUSSION OF CURRENT TENDENCIES IN AMERICAN POLITICS 113–61 (Transaction Publishers 2013) (1915).

112. *See* William S. Laufer & Diana C. Robertson, *Corporate Ethics Initiatives as Social Control*, 16 J. BUS. ETHICS 1029, 1029 (1997).

113. *See, e.g.*, James L. Gattuso & Diane Katz, *Red Tape Rising 2016: Obama Regs Top $100 Billion Annually*, BACKGROUNDER (Heritage Found.), May 23, 2016, at 1.

regulatory architecture might house the ingredients of fair and just corporate social controls.[114]

Recent moves constraining the discretion of federal prosecutors to individual rather than entity liability, modern progressives might add, risk a higher level of undistributed justice where evidence of individual agent culpability is lacking or is difficult, if not impossible, to secure. Moreover, shifts in formal policies about discretionary determinations of fault should be accompanied by more thoughtful and measured compliance standards that accommodate regulatory policy changes and embrace new technology.

Politicians and criminal justice functionaries pontificate about the need for corporate entities to adhere to prescriptive compliance and governance routines. Modern progressives would say, though, that regulators are long on moral rhetoric and short on due diligence expectations grounded in planning, process, and outcome factors that are measurable, e.g., using combinations of management-based, performance-based, or technology-based measures and metrics.[115]

Modern progressives should marvel at the stalemate between the government's failure to embrace evidence of compliance effectiveness as "due diligence," and the private sector's reluctance to make those kinds of compliance investments that will inevitably result in the need to "voluntarily" disclose non-compliance. Finally, modern progressives should spend significant political capital looking for ways to level the regulatory playing field for small firms vis-à-vis their more powerful counterparts.[116] That there are multiple tracks of adjudi-

114. For the historical debate between and among progressives on entity liability, see Mark M. Hager, *Bodies Politic: The Progressive History of Organizational Real Entity Theory*, 50 U. PITT. L. REV. 575 (1988–1989).

115. For a brief discussion of collaborative associations between government and business in progressive history, see MCGERR, *supra* note 106, at 315. Alternatively, as noted later, co-regulatory or collaborative systems should be proposed. Specific diligence expectations are "owed" regulated firms because certain legislative reforms and discretionary guidelines simply require companies to have such programs, policies, and practices. Further, prosecutors and regulators push incentives that drive firm compliance expenditures and investment, often without restraint, and rarely with any comparable government expenditures that builds regulatory capacity.

116. Hovenkamp, *supra* note 22, at 153 ("Progressives did though coalesce around the idea that the market was squarely to blame for noncompetitive business practices and an unfair transfer of wealth toward the rich. The fo-

cation associated with firm size requires more than a passing reference to collateral consequences or systemic risks.[117]

This roughly-conceived, modern account of progressivism highlights the failure of any significant corporate criminal law reform during a remarkable century of progress from our emerging interstate economy at the turn of the last century, to a truly global marketplace at the turn of this century.[118] The conspicuous absence of legislative reform, including long-abandoned federal recodification efforts, should be of particular concern for modern progressives.[119]

Perhaps most important, progressivism recognizes the "transformative promise of the scientific state," such that government will be both an instrument and object of reform.[120] Unfortunately, one is hard-pressed to find a constituency with the motivation and capacity for this transformative process. Inside the modern progressive community, voices of discontent about corporate fault are seldom raised and rarely heard. Of course, Wall Street abuses are an integral part of the progressive rallying cry. But with the stated desire to abolish corporate personhood, little to nothing is said about why liability rules and standards of culpability are not fashioned around corporate persons, i.e. around the enterprise as an enterprise.[121]

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cus centers around the limitations of the market and its remedy, the administrative state, and a playing field for big and small firms that lacked fairness and rules.").

117. *See* LAUFER, *supra* note 44 (discussing the compliance game).

118. *See generally* Julie R. O'Sullivan, *The Federal Criminal "Code" is a Disgrace: Obstruction Statutes as Case Study*, 96 J. CRIM. L. & CRIMINOLOGY 643 (2006); Sara Sun Beale & Adam G. Safwat, *What Developments in Western Europe Tell Us About American Critiques of Corporate Criminal Liability*, 8 BUFF. CRIM. L. REV. 89, 97–98 (2004).

119. For a discussion of the failure of federal criminal law reform, see Louis B. Schwartz, *Reform of the Federal Criminal Laws: Issues, Tactics, and Prospects*, 41 LAW & CONTEMP. PROBS. 1 (1977); Barbara Ann Stolz, *Interest Groups and Criminal Law: The Case of Federal Criminal Code Revision,* 30 CRIME & DELINQ. 91 (1984); NAT'L COMM'N ON REFORM OF FED. CRIM. LAWS, FINAL REPORT OF THE NATIONAL COMMISSION OF REFORM OF FEDERAL CRIMINAL LAWS (1971) (the National Commission on the Reform of the Federal Criminal Code, known as the Brown Commission, completed its work in 1969). *See also* STAFF MEMORANDA ON RESPONSIBILITY FOR CRIMES INVOLVING CORPORATIONS AND OTHER ARTIFICIAL ENTITIES 172 (1969); Commentary, *Corporate Criminal Liability*, 68 NW. U. L. REV. 870 (1973).

120. Leonard, *supra* note 109.

121. *See infra* notes 236–50.

Even less is said about how the construct of corporate compliance is so narrowly conceived, and related expenditures are too often seen as a good or best available proxy for compliance.

The fact that conceptions of entity liability are today moved to the margins with little fanfare and with so few objections is easily explained. Elsewhere, I argue that corporate criminal liability is a failure not because of confusing metaphysics, or because evidence of criminal wrongdoing is so well-guarded that it is difficult to obtain, or because of the obvious externalities of this blunt instrument of social control. The present regime of corporate criminal liability fails because there is no bounded constituency backing both a general and a specific part of corporate criminal law that is willing to address the inauthenticity of both the regulated and regulators as they play a game over compliance and compliance expenditures.[122]

Modern progressives, as a constituency, need not take on that role.[123] But it is one that progressives may rightly and quite effectively assume. It would take a strong embrace of the remarkable convergence in compliance thinking, advancing technology, emerging methods, and consensus-building standards—a strategic embrace aimed at bringing about a commensurate engagement by prosecutors and regulators. It would take a reluctant acceptance of corporate personhood for the purposes of facilitating attributions of criminal liability not only to blameworthy individuals, but to entities as well.

Modern progressives would have to muster enough moral indignation over corporate crime, enough outrage to make the case that corporate persons, large and small, also deserve their fair share of accountability.[124] There would have to be a

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122. *See* LAUFER, *supra* note 2.

123. For an idea as to how much change may result, see Clayton. M. Christensen et al., *Disruptive Innovation for Social Change*, 84 HARV. BUS. REV. 94 (2006).

124. One might say that modern progressives need to be driven by "a fierce discontent." *See* MICHAEL MCGERR, A FIERCE DISCONTENT: THE RISE AND FALL OF THE PROGRESSIVE MOVEMENT IN AMERICA 176 (1st ed. 2003) (quoting Theodore Roosevelt, "So far as this movement of agitation throughout the country takes the form of a fierce discontent with evil, of a firm determination to punish the authors of evil, whether in industry or politics, the feeling is to be heartily welcomed as a sign of healthy life."). For a discussion of how indignation might fuel changes in law, see Jack Katz, *The*

call for a reallocation of criminal justice expenditures to ensure that the administration of justice is fairly and justly distributed to all persons, human and corporate. And the victims of organizational wrongdoing must be recognized by a more formal corporate victimology. Alas, this is not too tall an order for a movement once wholly committed to scientism in the name of measured informal and formal social controls.[125]

B. *Moral Indignation and Desert*

The ideological core of a corporate criminal law progressivism reflects a more formal orientation, one that sits comfortably with new governance theories and to the political left of other theories of criminal justice that unabashedly promote comprehensive consequentialist ends. This includes, for example, the republican idea of justice, brilliantly fashioned with well-dressed utilitarian desiderata.[126] Unlike some rival neoclassical approaches and models, progressive corporate criminal law champions a brand of economic arrangements and regulatory practices that are "ethically defensible."[127] The ultimate question for twentieth century progressives, according to Professor Clark, was a moral one.[128] At minimum, economic activity should be consistent with, rather than at odds with, the public interest. The invisible hand, according to older progressives, becomes noticeably visible with corporations of significant scale and power.[129]

The limited and oddly shaped conception of orthodox economics was the target of progressives nearly a century ago. It remains so today. An economics of irresponsibility is a simple product of the primacy of excessive "individualism," "private interest," and a commitment to "laissez-faire."[130] "All industry

Social Movement Against White-Collar Crime, *in* CRIMINOLOGY REVIEW YEARBOOK 161 (1980).

125. Given the antecedents of racism in the history of progressive thought and dogma, one might be snide and say that this is their destiny. *See* Hovenkamp, *supra* note 22.

126. *See, e.g.*, JOHN BRAITHWAITE & PHILLIP PETTIT, NOT JUST DESERTS: A REPUBLICAN THEORY OF CRIMINAL JUSTICE (1st ed. 1992).

127. Leonard, *supra* note 109, at 70.

128. Clark, *supra* note 104, at 72.

129. As Rutherford notes, early theorists were concerned with corporate abuses of the day. *See* Rutherford, *supra* note 105, at 175.

130. Dell P. Champlin & Janet T. Knedler, *J.M. Clark and the Economics of Responsibility*, 38 J. ECON. ISSUES 545, 545 (2004).

and trade," both old and modern progressives would argue, "is primarily affected with a public interest."[131] Criminal violations by businesses compromise this public interest and breach this trust. This breach by both organizations and individuals reflects an actionable immorality.[132] Corporate wrongdoing engenders the kind of collective repugnance associated with offenders who have moral agency.[133] Corporate criminals are deserving of blame, and any wrongdoer left behind represents undistributed justice, part of an unpaid debt to society.[134] Modern progressives look to the promise of deterrence in responsive regulation, supporting the suasion of informal social controls. This progressive reincarnation, however, comes from a desert-based deontological world, where fault ultimately determines liability and a punishment proportional to wrongdoing ensures that justice is done.[135]

The genius behind neoconservative accounts of corporate liability is the promise of justice without resort to the force of a "criminal" justice. Administrative and civil regulatory regimes, it is argued, will do justice. We are told that the direct and collateral consequences of corporate criminal liability are injustices to a wide range of innocents, from shareholders to debtholders to employees. Beyond the failed metaphysics of a corporate criminal law, this is an antiquated formal social control with externalities that are nearly impossible to measure. Those promoting the use of corporate criminal law are simply corporate bashing.[136] Modern progressives would respond that this promise of justice done without the criminal law is simply illusory. Even if you put the idea of a "benign big gun" aside, assuming effective regulation without any formal responsive threat is a grand, if not magnanimous, concession to corporat-

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131. *See* Leonard, *supra* note 109.

132. William S. Laufer, *Where Is the Moral Indignation Over Corporate Crime?*, *in* REGULATING CORPORATE CRIMINAL LIABILITY 19, 21 (Dominik Brodowski et al. eds., 2014) ("The construct of moral indignation reflects, at least in part, a deeply-felt emotion one has over the commission of an immoral act.").

133. David Copp, *On the Agency of Certain Collective Entities: An Argument from "Normative Autonomy"*, 30 MIDWEST STUD. IN PHIL. 194, 195–96 (2006).

134. Laufer & Strudler, *supra* note 30.

135. KIP SCHLEGEL, JUST DESERTS FOR CORPORATE CRIMINALS (1990).

136. Martin H. Redish & Peter B. Siegal, *Constitutional Adjudication, Free Expression, and the Fashionable Art of Corporation Bashing*, 91 TEX. L. REV. 1447 (2012).

ism.[137] It is also a disturbing mismeasurement of moral indignation for corporate wrongdoing.[138]

Criminal justice functionaries use condemnatory rhetoric about corporate malfeasance, offering compelling but inauthentic outrage on behalf of the state.[139] And beneath the dismissive and patronizing arrogance about justice done is a clearly conceived deference to big business, markets, risk-taking, entrepreneurship, and unbridled capitalism.[140] After all, even the most serious corporate offenders are condemned by muted plea agreements that do little more than impose additional compliance costs. Corporations spend more and more compliance dollars, and are "monitored" until called to arms, once again, as the steady and obedient servants of economic growth.

As progressives know all too well, outrage, fear, anger, and genuine indignation abound for street criminals.[141] "Bad guys" are seen as the justifiable targets of aggressive and concentrated law enforcement and, once processed, mass punishment.[142] Our race- and class-based images of who are "bad" are as obvious as they are indelible.[143] When we think of innova-

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137. *See* RALPH NADER, GETTING STEAMED TO OVERCOME CORPORATISM: BUILD IT TOGETHER TO WIN (2011) (reviewing the decay in capitalism and corresponding betrayal of corporatism).

138. Laufer, *supra* note 132, at 20.

139. *Id.* at 24 ("Functionaries use moral rhetoric to convey a definite outrage at the temerity of such privileged wrongdoing. The message that justice must be done is conveyed with a pretense and sense of righteousness that mimics the emotions felt over an immoral act.").

140. *Id.* at 25.

141. Research reveals that indignation is often mediated by complex heuristics, framing effects, social dynamics, and other psychological factors (e.g., the "outrage heuristic," "moral framing," and "rhetorical asymmetry"). *See* Cass R. Sunstein, *Some Effects of Moral Indignation on Law*, 33 VT. L. REV. 405 (2008); Cass R. Sunstein, Daniel Kahneman, Ilana Ritov & David Schkade, *Predictably Incoherent Judgments*, 54 STAN. L. REV. 1153 (2002); Edward J. McCaffery, Daniel J. Kahneman, & Matthew L. Spitzer, *Framing the Jury: Cognitive Perspectives on Pain and Suffering Awards*, 81 VA. L. REV. 1341 (1995).

142. *See* Laufer, *supra* note 132.

143. Research on the salience of race as a heuristic for determining the blameworthiness of the defendant and the perniciousness of the crime is as telling and remarkable, as it is shocking. *See, e.g.*, Jennifer L. Eberhardt, Paul G. Davies, Valerie J. Purdie-Vaughns & Sheri Lynn Johnson, *Looking Deathworthy: Perceived Stereotypicality of Black Defendants Predicts Capital-Sentencing Outcomes*, 17 PSYCH. SCI. 383 (2006); Brown, *supra* note 32, at 1302.

tive law enforcement strategies, for example, our minds turn to "hot spots" and place-based policing in disenfranchised, poor neighborhoods; aggressive stop and frisk policies that target people of color; and the increasing militarization of municipal police resources.[144] But when thinking of innovative law enforcement strategies, who first thinks of innovations in state-of-the-art forensic accounting methods; the intricate mining of employee, customer, and client data; new algorithms and data analytics that deconstruct patterns of possible wrongdoing; and, more generally, the ingredients of successful experiments in private regulation?

When we think about how the debt owed to society from street crime may be repaid, we accept the idea of incarceration with reflection. We unabashedly use mass incarceration, ignoring the simple function of race, ethnicity, gender, age and education.[145] Who thinks of innovations in the design, content, and implementation of "corporate punishment"?[146] It should not be so trite to say that corporate punishment must resemble a true message of moral condemnation, rather than an itemized cost, optimal penalty, or additional revenue stream for a league of corporate gatekeepers.[147] Modern progressives should ask why corporate wrongdoing does not engender the kind of moral outrage and indignation that would support a fair regime of corporate criminal justice when lay perceptions of the seriousness of corporate crime rivals serious street crime.[148] In the absence of affective outrage, anger, disap-

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144. *See* FREDA ADLER, GERHARD O. W. MUELLER & WILLIAM S. LAUFER, CRIMINOLOGY 182–200 (9th ed. 2018).

145. For a recent review of the problem of mass incarceration, see Malitta Engstrom, Alexandra Wimberly & Nancy Franke, *Mass Incarceration: What's at Stake and What to Do, in* SOCIAL POLICY AND SOCIAL JUSTICE (John L. Jackson, Jr., ed. 2017).

146. Steven Walt & William S. Laufer, *Corporate Criminal Liability and the Comparative Mix of Sanctions, in* WHITE COLLAR CRIME RECONSIDERED 309, 315 (Kip Schlegel & David Weisburd, eds. 1992) (discussing the many sentencing alternatives to criminal fines).

147. *Id.* at 312.

148. *See* Cedric Michel, John K. Cochran & Kathleen M. Heide, *Public Knowledge About White-Collar Crime: An Exploratory Study*, 65 CRIME, L. & SOC. CHANGE 67 (2016); *cf.* JOHN HAGAN, WHO ARE THE CRIMINALS?: THE POLITICS OF CRIME POLICY FROM THE AGE OF ROOSEVELT TO THE AGE OF REAGAN (2012); William S. Laufer, *Commentary*, 42 CONTEMP. SOC. 679 (2013) (reviewing JOHN HAGAN, WHO ARE THE CRIMINALS? (2012)).

proval, and indignation, government functionaries successfully placate stakeholders with scripted retributive text, and yet leave in place the risk-taking, innovation, and entrepreneurship associated with propelling the economy forward. All along, firms are positioned in equally inauthentic ways, placating and pandering to regulators with an apparent moral outrage over an agent's "rogue behavior."[149] In both cases, this is fairly called "faux" indignation, and it should boil the blood of modern progressives.[150]

Without hesitation, modern progressives must look elsewhere for justice. They may find moral fault in organizational wrongdoing and justify their left-leaning rhetoric as a matter of desert. Liability rules that focus exclusively on vicarious liability disregard blameworthy features of the corporate form as well as those characteristics and attributes that should, in certain cases, absolve the entity from liability. Overlooking evidence of corporate intentionality also risks a compromise of desert principles.[151] And modern progressives should worry that far too much justice is already undistributed with a regulatory status quo that is comfortably, efficiently, and deftly gamed by captured and uncaptured stakeholders.

C. *The Compliance Game*

Game theoretic models of compliance practices inspire some thinking about how firms and government functionaries strategically position themselves. Researchers, for example, have used game theory to explore the endogeneity of honesty in tax compliance, i.e., those factors that explain why taxpayers pay in full. Perceptions about the fairness of the tax code and whether other taxpayers are somehow better able to "play the

149. LAUFER, *supra* note 2.

150. *See* William S. Laufer, *Corporate Inauthenticity and the Finding of Fault*, *in* LA RESPONSABILITA PENALE DELGLI ENTI 23 (F. Centronze & M. Mantovani eds., 2016) ("What makes this indignation faux? The text is calculated and crafted in ways that reveal an inauthenticity. The moral emotions and affect that capture indignation are missing. The anger and fear that combine in a very real way with street crime are simply not there. Faux indignation is, plain and simple, a convenient moral placeholder. And holding a place for moral indignation, as we shall see, is indispensable for regulatory equilibrium.").

151. *See* Laufer & Strudler, *supra* note 30 (arguing for the place of corporate intentionality in a conception of corporate deservedness).

system" are explanatory. Taxpayer reactions to government activities, policies, and personnel are also important.[152]

Others look at the tax compliance game by exploring the relative decision-making strategies of all tax stakeholders, e.g., taxpayers, elected government officials, appointed tax authorities, and tax accountants. These strategies are grounded in a wide range of economic and psychological factors. Tax payments depend, in part, on policies being perceived as legitimate: free riders must be eliminated, and the non-cooperative must be brought back into the fold with threats of command and control regulation.[153] Finally, there is significant potential for firms to free-ride in intra-industry collective action settings, i.e., individual firms may benefit from the compliance of others without regard to their own behavior. The result of this problem may be an obstacle to successful self-regulation. Game theory research reveals that overcoming free-riding problems turns on compliance motives as well as other strategic interactions.[154]

As mentioned earlier in this Article, there is a very active regulatory game played around corporate criminal compliance. To appreciate the premise of the game, though, it is necessary to go back in time. In the immediate aftermath of the passage of the Sentencing Guidelines for Organizations in 1991, a cottage industry of business ethicists, consultancies, accountancies, along with a significant number of white collar defense lawyers, coalesced around the marketing of corporate compliance programs and services.[155] The market was pitched with a coordinated campaign to ensure that companies were

152. Brian Erard & Jonathan S. Feinstein, *Honesty and Evasion in the Tax Compliance Game,* 25 RAND J. ECON. 1, 4 (1994).

153. James Alm, Erich Kirchler & Stephan Muehlbacher, *Combining Psychology and Economics in the Analysis of Compliance: From Enforcement to Cooperation*, 42 ECON. ANALYSIS & POL'Y 133, 148 (2012) ("It is thus necessary to apply strategies based on both economic and psychological arguments to promote mutual trust and cooperation.").

154. *See* Simon Ashby, Swee-Hoon Chuah & Robert Hoffmann, *Industry Self-Regulation: A Game-Theoretic Typology of Strategic Voluntary Compliance*, 11 INT'L J. ECONS. BUS. 91 (2004).

155. AM. LAW INST.-AM. BAR ASS'N COMM. ON CONTINUING PROF'L EDUC., ALI–ABA COURSE OF STUDY MATERIALS: ORGANIZING FOR CORPORATE COMPLIANCE: THE NEXT STEPS (1994) (an excellent compendium of due diligence strategies from the white collar bar—in many ways indistinguishable from today's strategic prescriptions).

"in compliance" with the Guidelines.[156] By 1994, the boundaries of the field of corporate compliance were already set.[157] From state-of-the-art compliance training techniques and checklists for effective compliance programs, to compliance program methodology and a nascent compliance science, an industry was born that catered to every conceivable private regulatory need.[158]

Remarkably, "custom" and even "proprietary" compliance products, programs, and solutions bought and sold until very recently were virtually indistinguishable.[159] This commodification of compliance, coupled with the failure of regulators to develop any significant capacity to evaluate compliance programs and practices, supported a complex brew of incentives and disincentives that lends itself to a multi-stakeholder compliance game.[160] The ultimate objective of this game, however, is not economic corporate criminal justice. The incentives and disincentives are not designed to change corporate behavior, improve corporate culture, or facilitate corporate decision-making.[161]

This compliance game is really a match of institutional appearances with some distinct characteristics, including the fact that the largest firms are spared prosecution due to perceived or at least expressed systemic risk; firms—of any size and scale—whose prosecution does not pose a risk are offered a crafted plea agreement; symbolic prosecutions of high profile defendants are sought, episodically, to assuage concerns over market fairness; and small firms, those with limited access to

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156. *See*, LAUFER *supra* note 2.

157. For a discussion of the emergence of the ethics industry, see Stuart Auerbach, *Company Lawyers in Shadows at Seminar on Crime,* WASH. POST, Oct. 16, 1977, at A4, and George P. Stamas & Joanne F. Catanese, *Compliance Programs Create a Shield from Corporate Wrongs*, 37 LEGAL TIMES (Feb. 24, 1997). *See also* William S. Laufer, *Integrity, Diligence, and the Limits of Good Corporate Citizenship*, 34 AM. BUS. L.J. 157 (1996).

158. William S. Laufer, *Illusions of Compliance and Governance*, 6 CORP. GOVERNANCE 239 (2006) (reviewing the compliance industry).

159. William S. Laufer, *Compliance and Evidence: Some Optimism from a Perennial Pessimist, in* DIE VERFASSUNG MODERNER STRAFRECHTSPFLEGE: ERINNERUNG AN JOACHIM VOGEL (K. Tiedemann, U. Sieber, H. Satzger, C. Burchard & D. Brodowski eds., 2016), http://www.nomos-shop.de/_assets/downloads/9783848733699_lese01.pdf.

160. *See* Laufer *supra* note 44.

161. *Id.*

counsel, are far, far more likely to be prosecuted to conviction. Ultimately, stakeholders in this game seek to protect and enhance their positions without disturbing the equilibrium and, remarkably, without concern for whether their efforts actually affect rates of offending behavior.

This is a game that seeks optimal compliance expenditures to minimize liability risks, gives all players moral and legal cover, placates constituencies with the appearance of legitimacy, and offers beautifully crafted images of leadership and governance with integrity. This game is aligned with a regulatory system that possesses a very limited capacity for determining the effectiveness and genuineness of compliance, and even less commitment to aggressively using the corporate criminal law.[162] This game encourages mind-numbing levels of documentation, from due diligence forms and internal audits to training attendance records and integrity affidavits.[163] The more content in this documentation regime, the more paper; the more paper, the less liability exposure for the firm. The quality of the representations in this regime is largely untested, by design.

Perhaps most important, this game is the centerpiece of a highly profitable and growing compliance and business ethics industry. Shining a much less favorable light, it is also an industry with a potentially exploitive value proposition. At their core, the rules of the game assume that neither firms nor regulators have or want to have evidence of compliance effectiveness. The game further assumes that there is no interest in exploring whether the compliance machine actually affects behavior, organizational decision-making, planning, programming, or corporate culture.[164] Both parties seem inextricably captured by their opponent.

Prosecutors and regulators speak about the expectations of firm disclosures and cooperation but know about all the ob-

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162. There is no shortage of commentary on compliance essentials. *See, e.g.*, RICHARD M. STEINBERG, THE GAME CHANGES: 10 ESSENTIAL ELEMENTS FOR TRULY EFFECTIVE COMPLIANCE PROGRAMS (2012).

163. *See, e.g.*, Richard Medina & Joe Fenner, *Controlling Your Documents*, 39 INFO. MGMT. 20 (2005).

164. For an interesting take on corporate culture and corporate crime, see John Conley & William M. O'Barr, *Crime and Custom in Corporate Society: A Cultural Perspective on Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 5 (1997).

vious conflicts.[165] Prosecutors speak about guidelines, but their discretion is too constrained by limited resources, limits in the priority given to the investigation of corporate fraud, and significant challenges in obtaining evidence of serious corporate wrongdoing at the officer or board level, even with all the incentivizing of whistleblowing. The result: with countless billions spent on some of the most impressive accountancies, consultancies, and law firms, it is practically impossible for regulators to make meaningful distinctions between and among ethical leaders and laggers, as well as compliant and non-compliant firms.[166] And if one looks at the history of this game, it is hard not to see interested stakeholders pushing compliance spending forward in extreme and, at times, perverse ways.

Modern progressives must think about how this game may be disrupted and how the rules governing the regulatory status quo may be changed. The promise of progressivism is great, because this game turns on the relative power and suasion of informal social controls. This is a game about *governance,* where boards and senior management are kept too far apart, and the former know far too little about day-to-day compliance issues and challenges; *culture and values*, where the tone of corporate leadership is indiscernible to mid-level managers and employees; *risk management*, where the idea of risk is reduced to protecting the firm from its own employees; *policies and procedures*, where policies and codes are perfunctory and disconnected from operations; *communication and training*, where training programs are decontextualized, if not vacuous; *monitoring and reporting*, where firms are over-controlled and reporting channels are limited; *escalation, investigation, and discipline*, where fear of retaliation is met with the reality of retaliation; *issues management*, where matters raised with compliance and audit are routinely neglected; and *ongoing improvements*, where investment in the appearance of compliance and risk management highlight the compliance function.[167]

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165. *See, e.g.*, Ronald H. Levine, *Government Contests Assertion of Attorney–Client Privilege in Assessing Cooperation*, WHITE COLLAR POSTS (Jan. 5, 2017), http://www.postschell.com/publications/1318-government-contests-assertion-attorney-client-privilege-assessing-cooperation.

166. *See* William S. Laufer, *Corporate Culpability and the Limits of Law*, 6 BUS. ETHICS Q. 311 (1996).

167. *See* Richard M. Steinberg, *The Game Changes: 10 Essential Elements for Truly Effective Compliance Programs*, 46 EDPACS, no. 5, Nov. 2012, at 1.

Modern progressives must be mindful that the path out of the compliance game, inevitable as it appears to be, will likely cross with another inevitability: the inauthenticity of organizational and regulatory action.[168] Corporate inauthenticity may be benign where the words from public affairs slightly outpace reality.[169] Inside and outside of the compliance game, though, inauthenticity may be non-trivial. The problem of inauthenticity is most concerning where significant regulatory responsibility is delegated and then shared with the firm, or where independent assessments of certain corporate representations are unavailable to both guardians and gatekeepers.[170]

Just as the ethics industry markets compliance in the form of commodities, the ingredients of both corporate pretense and posture are also bought and sold in a profitable consultants' marketplace. Ethical intangibles are sold as tangibles in a world that increasingly looks for evidence of a good return on values, broadly defined.[171] The selling of this instrumental brand of responsibility moves some stakeholders to invest in ways that result in a muddle of inauthenticity. Simply put, this muddle complicates and often confounds the very idea of self-regulation and co-regulation. And, to be fair, lack of authenticity may frustrate genuine efforts by government functionaries to be both measured and just.

In leading a constituency advocating for greater corporate accountability, modern progressives should also assume the responsibility of inspiring firms to align their behavior, and the

168. Corporations may be said to fall along a behavioral continuum from opacity (i.e., where firms are characteristically obscure, elusive, and dense) to transparency (i.e., organizations that are open with communications, frank, candid, and forthcoming), sincerity (i.e., firms that act, as a means to an end, without pretense and dissimulation), and finally authenticity (i.e., companies that, as an end in itself, align their decisions, policies, and actions with actual desires, motivations, and intentions). *See* Laufer, *supra* note 132.

169. Laufer, *supra* note 132, at 26 ("Lurking behind the corporate scandals that now seem common place on Wall Street is an inauthenticity, a disconnect between what corporations say they do and what they actually do, that leads to public displays by top management of naive surprise when the public hears the news of a criminal investigation or indictment.").

170. *Id.*

171. Chris Kelly, Paul Kocourek, Nancy McGaw & Judith Samuelson, *Deriving Values from Corporate Values*, THE ASPEN INST. (2005), https://assets.aspeninstitute.org/content/uploads/files/content/docs/bsp/VALUE%2520SURVEY%2520FINAL.pdf (discussing the concept of return on values (ROV)).

value they offer stakeholders, with principles.[172] Countless examples of both misfeasance and malfeasance over the past century reveal the difference between a genuine commitment to ethics, integrity, and compliance, and the appearance, rhetoric, and spin of ethicality.[173] This spin masks corporate efforts to avoid detection, deflects the need for more formal regulation, minimizes compliance and governance costs and, at times, facilitates the laundering of questionable corporate decisions. In the end, the prospects of a modern progressive agenda disrupting and changing the rules of the compliance game may be challenged by something as simply conniving as a corporation's inauthenticity.

IV.
The Promise of a Progressive Corporate Criminal Law

Critics would be fair to point out that there may be something instrumental in the resort to a progressive account of corporate criminal law. Having a modern progressive account at the table with the conventional guard, stalwart advocates, corporate libertarians, and normative thinkers is long overdue. The modern progressive case is much more than a call for empiricism or a resort to the latest LegalTech or RegTech solutions to support the convergent growth and unprecedented investment in the compliance industry. It is also more than a vision of government regulation as both an "instrument" and "object" of reform. The conspicuous intransigence in this neglected body of law, marked by the failure of any constituency to step forward to disrupt the compliance game, results in a certain kind of injustice, i.e., undistributed justice. Seeking recognition for this compromise of desert principles motivates a call to modern progressivism. Simply stated, the scales of justice must be balanced between corporate wrongdoing and our measured indignation.

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172. *See, e.g.*, R. Edward Freeman & Ellen R. Auster, Bridging the Values Gap: How Authentic Organizations Bring Values to Life (2015); S. H. Cady, J. V. Wheeler, J. DeWolf & M. Brodke, *Mission, Vision, and Values: What Do They Say?*, 29 Org. Dev. J., Spring 2011, at 63 (2011); Timothy L. Fort, *Steps for Building Ethics Programs*, 1 Hastings Bus. L. J. 194 (2005).

173. *See* Lynn Sharpe Paine, *Managing for Organizational Integrity*, 72 Harv. Bus. Rev.106 (1994) (distinguishing between law- and ethics-driven compliance programs).

Progressives today are well-suited to answer such a call, as answering involves resolving questions about the perennial tensions between regulatory power and increasing corporate power; about the social control of business and the turn-of-the-twentieth-century notion of excessive individualism; and about the economics of responsibility versus deference to the business community and its markets. How to regulate corporations fairly, justly, and without the specter of regulatory overreach is a trite, old, but exceedingly important *progressive* question. That this question still defines the ongoing dissonance over how to conceive, practice, and enforce corporate criminal law is a powerful argument for modern progressives to come forward and make their case.

The progressive sentiment that corporations are more than simple profit engines for shareholders is promoted with a realization that the social control of businesses is increasingly plural, decentered, and the responsibility of both state and non-state actors. Markets reflect a growing complexity, well-captured by Braithwaite's notion of "regulatory capitalism."[174] This complexity is more than a rudimentary migration away from command and control regulation in the developed world.[175] Instead, commentators argue that with regulatory capitalism "a new division of labor between state and society (e.g., privatization) is accompanied by an increase in delegation, proliferation of new technologies of regulation, formalization of inter-institutional and intra-institutional relations, and the proliferation of mechanisms of self-regulation in the shadow of the state."[176]

This division promotes some creative thinking about new ways of regulating, and about some possible modern progressive positions.[177] After all, the role of science in new govern-

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174. JOHN BRAITHWAITE, REGULATORY CAPITALISM: HOW IT WORKS, IDEAS FOR MAKING IT WORK BETTER (2008); David Levi-Faur, *The Global Diffusion of Regulatory Capitalism*, 598 THE ANNS. OF THE AM. ACAD. OF POL. & SOC. SCI. 12 (2005).

175. Julia Black, *Decentering Regulation: Understanding the Role of Regulation and Self-Regulation in a "Post-Regulatory" World,* 54 CURRENT LEGAL PROBS. 103 (2001).

176. Levi-Faur, *supra* note 174, at 13.

177. Consider, for example, the move toward a shared or collaborative approach to regulation with the work of Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998).

ance theory, dogma, and practice should be at the core of their case. So, too, is the commitment of governance theorists to a new institutional design, one that "relies on information-based and information-forcing techniques: specifically, reason-giving, transparent processes, benchmarking and outcome analysis, and shared information."[178] But these kinds of idealized regulatory ingredients and designs are challenged by a fixed institutional architecture and the deeply embedded interests reflected in the existing oversight and administration of the corporate criminal law.[179] There is no simple solution here.[180]

Thinking about how science and the accelerated advance of regulatory technology may inform policies and practices is no longer what it once was. Plural and decentered conceptions of all variants of informal and formal constraint should move modern progressives to, for example, rethink how to conceptualize, operationalize, and measure compliance and reconsider what motivates compliance. Should compliance be conceived and measured as a complex enterprise problem between and among state and non-state regulatory stakeholders? If so, what kind of social controls will accommodate and fairly

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178. For an outstanding exposition of the new governance approach, and the obvious challenges for extant regulatory practice, see Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, 2010 WISC. L. REV. 441 (2010).

179. Baer, *supra* note 31 (wrestling with how hard law approaches connect to new governance models).

180. Responsive and reflexive regulatory structures attempt to take into account business incentives and internal business incentives, along with decision-making processes. *See* Neil Gunningham, *Strategizing Compliance and Enforcement: Responsive Regulation and Beyond, in* EXPLAINING COMPLIANCE: BUSINESS RESPONSES TO REGULATION (C. Parker & V. L. Nielsen eds., 2011); Eric Orts, *Reflexive Environmental Law*, 89 NW. U. L. Rev. 1227 (1995); Paul R. Kleindorfer & Eric W. Orts, *Informational Regulation of Environmental Risks*, 18 RISK ANALYSIS 155 (1998); Gunther Teubner, *Substantive and Reflexive Elements in Modern Law*, 17 LAW & SOC'Y REV. 239 (1983); *see also* Christine Parker, *Twenty Years of Responsive Regulation: An Appreciation and Appraisal*, 7 REG. & GOVERNANCE 2 (2003); *cf.* Peter J. May & Robert S. Wood, *At the Regulatory Front Lines: Inspectors' Enforcement Styles and Regulatory Compliance*, 13 J. of PUB. ADMIN. RES. & THEORY 117 (2003). For a discussion of Smart Regulation, see NEIL GUNNINGHAM, PETER N. GRABOSKY & DARREN SINCLAIR, SMART REGULATION: DESIGNING ENVIRONMENTAL POLICY (1998). For an interesting extension of Smart Regulation, see Peter Van Gossum, Bas Arts & Kris Verheyen, *From "Smart Regulation" to "Regulatory Arrangements"*, 43 POL. SCI. 245 (2010).

reflect the complexity of global business regulation in countries with and without a mature rule of law? The complexity of global business and markets would challenge the imagination of twentieth century progressive thinkers.[181] A modern account of the progressive corporate criminal law must at least begin to capture this complexity and respond in measured ways.

With the benefits of contemporary knowledge, century-old progressives would likely embrace research on how corporate structure, agency, and culture informs any theory of "meta-regulation."[182] Formal compliance systems would be evaluated for their content and structure (but in the larger context of the strategies, perceptions, and motivations of agents), the position of agents, and the overall culture of the firm.[183] Reference would be made to the nodes that Parker identified as critical for corporations to successfully respond to regulatory demands: top management attention and response, development of professional compliance management, and employees' internalization of compliance and communication.[184]

Modern progressives would also address other challenges in regulating corporations.[185] There are significant concerns over the risks and costs of regulatory delegation to private firms and, in particular, how private firms might misuse this

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181. JOHN BRAITHWAITE & PETER DRAHOS, GLOBAL BUSINESS REGULATION (2000) (an encyclopedic treatment from vast interview data of the move from national to global regulation).

182. PARKER, *supra* note 74.

183. Dick Hobbs, *The Firm: Organizational Logic and Criminal Culture on a Shifting Terrain*, 41 BRITISH J. CRIMINOLOGY 549 (2001); Linda Trevino, *A Cultural Perspective on Changing and Developing Organizational Ethics*, 4 RES. ORGANIZATIONAL CHANGE & DEV. 195 (1990); Linda Trevino, *Ethical Decision Making in Organizations: A Person–Situation Interactionist Model*, 11 ACAD. MGMT. REV. 601 (1986); Bart Victor & John B. Cullen, *The Organizational Bases of Ethical Work Climates*, 33 ADMIN. SCI. Q. 101 (1988).

184. *See* PARKER, *supra* note 74.

185. These considerations are an extrapolation of progressive dogma. *See* Allan G. Cruchy, *Government Intervention and the Social Control of Business: The Neoinstitutionalist Position*, 8 J. ECON. ISSUES 235, 238 (1974) ("Effective social control of business must take account of the efficiency, the power, and the value aspects of the problem of how to fit private business into the advanced industrial society if the issue is to be dealt with adequately.").

discretion.[186] The idea of enforced self-regulation raises concerns over privatizing a public function.[187] In fact, it raises another conundrum worthy of progressive contemplation. As Bamberger writes, there is a need to rely on the private sector for risk assessment and management.[188] Failures of assessment and management, however, carry significant costs to both regulators and the regulated—and neither are well-equipped to minimize those costs.[189]

Modern progressives would, nevertheless, embrace compliance science and technology so that firms, regulators, and prosecutors move, as one, toward the objective of assessing organizational diligence and adjudicating non-compliance. At the same time, they would work toward the social control of corporations by state and non-state actors in measured and proportional ways. Progressives also would recognize the immense and unique power of the giants of industry, within and across all borders, to serve both private and public interests.[190] And, finally, they would seek to maintain the trust and legitimacy of the criminal process, the sine qua non of regulatory regimes, by fairly allocating criminal justice resources toward all offenders, human and corporate.[191] These reincarnate considerations, organized around some of the challenges posed by compliance science and social controls, are reflected below in thinking about a progressive corporate criminal law.

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186. Kenneth A. Bamberger, *Regulation as Delegation: Private Firms, Decision-making, and Accountability in the Administrative State,* 56 DUKE L. J. 377 (2006).

187. Gillian E. Metzger, *Privatization as Delegation*, 103 COLUM. L. REV. 1367, 1370–71 (2003); *cf.* John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466 (1982). For an excellent exploration of self-regulatory practices in securities firms, see DAVID P. MCCAFFREY & DAVID W. HART, WALL STREET POLICES ITSELF: HOW SECURITIES FIRMS MANAGE THE LEGAL HAZARDS OF COMPETITIVE PRACTICES (1998).

188. Bamberger, *supra* note 186.

189. *Id.*

190. *See, e.g.*, William S. Laufer, *The Importance of Cynicism and Humility: Anti-Corruption Partnerships and the Private Sector,* 8 DEV. OUTREACH 18 (2006).

191. This is a trend that is not only unjustifiable, but misses an opportunity for the United States to serve as an example to a host of countries that look for guidance during periods of law reform. *See* Raymond J. Michalowski & Ronald C. Kramer, *The Space Between Laws: The Problem of Corporate Crime in a Transnational Context,* 34 SOC. PROBS. 34 (1987).

A. *The Role of Science and the March of Technology*

How science is situated in historical thinking about progressivism is defining.[192] Economic institutions, policies, and practices—our economic order—should be founded on a scientific order that requires systematic observation and measurement. There is a carefully documented history that the scientific aspirations of progressives and institutionalists were also inextricably connected to the social control of business. The institutional arrangements that exert constraint on the economic order must not be based solely on expediency, symbolism, ideology, and politics. Science and the scientific method are coextensive with sound regulatory policies and practices.[193]

It is with this historical background that we ask how science informs, influences, and molds corporate criminal law relative to the regulatory investment in compliance. This is every bit a rhetorical question, because so much more compliance science is necessary to support and, at the same time, to justify the costs of corporate social controls, from the least formal (e.g., corporate codes of conduct and corporate culture) to the most formal (e.g., criminal law).[194] This includes research on holistic and plural models of business compliance. It includes moving from conceptual and experimental models of machine learning applications to regulation, and the promised value, more generally, of LegalTech and RegTech. It also includes research that explores descriptive and inferential questions that, according to Parker and Nielsen, span four levels of analysis: (1) motives of agents (e.g., economic, social, and normative motives in support of an agent's or firm's decision or decision-making), (2) organizational capacities, characteristics, and responses to regulation (e.g. internal firm resources, knowledge, leadership, and available technology), (3) how regulatory enforcement strategies and styles move organizations and their agents to respond (e.g., how regulatory insti-

192. *See* Rutherford, *supra* note 107, at 49 ("The concern with proper scientific methods was a concern to make economics more empirical and investigational, and to avoid the speculative and untestable nature of much orthodox theorizing.").

193. *See, e.g.*, Rutherford, *supra* note 107; Clark, *supra* note 104, at 221.

194. These questions could be asked more broadly of all regulatory efforts with corporations. *See* Laufer & Robertson, *supra* note 112, at 1030.

tutions affect firm compliance), and (4) the effects of the external environment (i.e., social, political, and economic environment) on both regulators and the regulated.[195]

The advent of enterprise models of compliance also invites compliance research across the entire organization. A rigorous internal (company) and external (government) management-based system of regulation should generate a large, impressive, and long-overdue body of research on corporate compliance that is both endogenous (i.e., exploring the construction and meaning of compliance as both an independent and as a dependent variable) and exogenous (i.e., using preexisting, pre-defined constructions and meanings of compliance to address specific descriptive and causal research questions).[196] Both kinds of research directly address concerns over the metrics used for measuring effectiveness across a wide range of regulatory approaches.[197]

Perhaps most important, as seasoned compliance officers know all too well, successful implementation of formal compliance systems will require more than evidence of effective metrics and measures.[198] The recipe for successful compliance programs, research reveals, will hinge on "top management attention and motivation to implement a compliance system; the existence and strategies of specialized or professional compliance managers; and the way in which compliance systems are communicated to and experienced by the teams and individual workers that make up the organization."[199] Perceptions,

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195. Christine Parker & Vibeke L. Nielsen, *The Challenge of Empirical Research on Business Compliance and Regulatory Capitalism*, 5 ANN. REV. L. SOC. SCI. 45 (2009) (further classifying exogenous research as operationalizing compliance by reference to attitudes and motivations; by reference to policy goals; as compliance behavior; and by observation of regulatory compliance behavior).

196. *Id.*

197. These metrics are the ingredients of meta-regulation, attempts to operationalize self-regulation. *See* PARKER, *supra* note 74; Christine Parker & Vibeke L. Nielsen, *Corporate Compliance Systems: Could They Make Any Difference?*, 41 ADMIN. & SOC. 3 (2008).

198. In addition to corporate cultures that resist compliance programming, there are concerns with "avoidance, resistance, ritualism and creative compliance." *See* Christine Parker & Sharon Gilad, *Internal Corporate Compliance Management Systems: Structure, Culture and Agency*, *in* EXPLAINING COMPLIANCE: BUSINESS RESPONSES TO REGULATION 175 (2011).

199. *Id.* at 172–73.

motivations, and actions of compliance stakeholders do, indeed, matter.[200] So, too, do the expectations of society and external stakeholders.[201]

Conceptual models of corporate compliance that span individual, organizational, regulatory, and institutional levels reveal the complexity of the research enterprise—and how much more scholarship is needed.[202] In particular, there is a great need to develop and test theories of regulation or components of theories. This is, admittedly, a challenge for a wide range of reasons, including the lack of data and the complexity of regulatory instruments.[203] While modern progressives would strongly support meeting these challenges, they would, at the same time, look beyond the conventional challenges and explanations for what is known and not known about compliance.

Systematic evaluation research on corporate crime deterrence, what little there is of it, suggests the possible perils of making regulatory policies without well-executed randomized controlled experiments, good longitudinal data, time series

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200. *Id.* at 173. *See, e.g.*, Tom R. Tyler, *Procedural Fairness and Compliance with the Law*, 133 SWISS J. ECON. & STAT. 219, 220–22 (1997); Neil Gunningham, Dorothy Thornton & Robert A. Kagan, *Motivating Management: Corporate Compliance in Environmental Protection*, 27 LAW & POL'Y 289 (2005); Søren C. Winter & Peter J. May, *Motivation for Compliance with Environmental Regulations*, 20 J. OF POL'Y ANALYSIS & MGMT. 675 (2001); Peter J. May, *Compliance Motivations: Affirmative and Negative Bases*, 38 LAW & SOC'Y REV. 41 (2004); Toni Makkai & John Braithwaite, *Praise, Pride and Corporate Compliance*, 21 INT'L J. SOC. L. 73 (1993); Peter J. May, *Compliance Motivations: Perspectives of Farmers, Homebuilders, and Marine Facilities,* 27 LAW & POL'Y 317 (2005); Leigh Raymond & Timothy N. Cason, *Can Affirmative Motivations Improve Compliance in Emissions Trading Programs?*, 39 POL'Y STUD. J. 39, 659 (2011); Cindy R. Alexander & Mark A. Cohen, *Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost*, 5 J. CORP. FIN. 1 (1999).

201. *See* Neil Gunningham, Robert A. Kagan & Dorothy Thornton, *Social License and Environment Protection: Why Businesses Go Beyond Compliance*, 29 LAW & SOC. INQUIRY 307 (2004).

202. *See, e.g.*, Parker & Nielsen, *supra* note 195, at 5.

203. Some of the challenges and difficulties posed by empirical research on compliance are addressed by Parker and Nielsen, *supra* note 195, at 6 (challenges and difficulties include access to data; complexity, range, and interrelatedness of compliance constructs; and the impracticality of testing grand theories). *See also* Sally Simpson, *White-Collar Crime: A Review of Recent Developments and Promising Directions for Future Research*, 39 ANN. REV. OF SOC. 1 (2013).

analyses, and case studies that provide rich qualitative data. In the only meta-review of corporate regulation, it seems as if regulatory policies produce as much defiance as compliance. And the more rigorous the method and design of the research project, the less of a deterrent effect obtained. Notably, those firms who adhered to multiple legal interventions (i.e., enforcement, monitoring, and inspections) were more likely to be deterred, whereas firms experiencing single intervention strategies were less likely to be so deterred.[204]

All conclusions found in this meta-review were cast as quite tentative, though, because of limited data and scarcity of rigorous research. The authors were more confident in concluding that there is simply insufficient evidence that law actually deters corporate offending.[205] One commentator writing about the meta-review hoped that this analysis would be "a loud wake-up call for corporate crime researchers to start getting their methodological, conceptual, and analytical house in order."[206] Another commentator was equally as grim in calling for better impact assessment research with replications. Studies are needed across institutional and organizational contexts. The status quo, commentators note, is literally regulating in the dark.[207]

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204. Natalie Schell-Busey et al., *What Works? A Systematic Review of Corporate Crime Deterrence*, 15 CRIM. & PUB. POL'Y 387, 410 (2016).

205. *Id.* at 410 ("We need to undertake more focused and high-quality (particularly randomized experiments or quasi-experiments) focused on program-specific interventions (with replications). Until then, the answer to the question of what works, what doesn't, and what's promising in the area of corporate deterrence will remain elusive.").

206. Ray Paternoster, *Deterring Corporate Crime: Evidence and Outlook*, 15 CRIM. & PUB. POL'Y. 383, 384 (2016); *see also* John Braithwaite, *In Search of Donald Campbell: Mix and Multimethods*, 15 CRIM. & PUB. POL'Y 417 (2016) (discussing some reasonable expectations of corporate criminology).

207. The idea of regulating in the dark was first discussed by Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 HOFSTRA L. REV. 25 (2014); Roberto Romano, *Regulating in the Dark*, *in* REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION 86 (Cary Coglianese ed., 2012). For an incisive critique of corporate crime research, see Peter Cleary Yeager, *The Elusive Deterrence of Corporate Crime*, 15 CRIM. & PUB. POL'Y 439 (2016).

B. *Beyond the Compliance Conundrum*

Judging the effectiveness of compliance efforts on organizations is said to be one of the more elusive if not daunting regulatory challenges.[208] This challenge is certainly recognized by the modern progressive account. As noted earlier, this embrace of empirics is confounded by increasing concerns in the private sector that a more careful, technology-driven and, indeed, scientific consideration of compliance would result in expectations of "voluntary" disclosures to regulators and prosecutors. This is what I call a true *compliance conundrum*.[209]

That there is such a conundrum should not come as a surprise to regulators and prosecutors. The standard refrain continues to be: in the absence of clear guidance from government functionaries as to what are, in fact, effective compliance systems and compliance programs, generating and applying a science of compliance will be shunned by those general counsel, corporate counsel, and white collar criminal defense counsel who are even minimally risk-adverse.[210] Shunned, even though all stakeholders know that ever-increasing compliance costs, to be justified, must be supported by well-conceived internal plans that meet or exceed regulatory criteria and expectations. Shunned, even though regulators and prosecutors admit that their proxies for compliance effectiveness are most often no better than intuitive and experiential—that their confidence in a firm actually exercising due diligence, good governance, and reasonable risk management is, in fact, faith-filled. Simply stated, the choice is not so difficult if it is between disclosure and cooperation with law enforcement, or the in-

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208. *See, e.g.*, Vibeke L. Nielsen & Christine Parker, *Mixed Motives: Economic, Social, and Normative Motivations in Business Compliance*, 34 LAW & POL'Y 428 (2012). Adan Nieto Martin, *supra* note 84, paints a nuanced portrait of the complications associated with ensuring against cosmetic compliance (e.g., lack of legal certainty for regulated firms and lack of trust of compliance programs by regulators). Martin then offers a critique of the remedies against cosmetic compliance, including certification and standardization.

209. *See, e.g.*, Susan Lorde Martin, *Compliance Officers: More Jobs, More Responsibility, More Liability*, 29 NOTRE DAME J. L. ETHICS & PUB. POL'Y 169 (2015).

210. Even more than shunned, there is a distinct risk that regulation will be gamed. *See, e.g.*, Bamberger, *supra* note 186; *see also* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

house handling of inculpatory evidence from those who do compliance data analytics.

Regulatory and administrative law scholars would find this conundrum to be part of a larger problem of the delegation of regulatory discretion.[211] This delegation, some conclude, often makes a mess of compliance norms, expectations, and incentives. There is simply insufficient guidance for the regulated, combined with a lack of recognition of sound compliance programs that effectively reveal non-compliance. Add to this the reticence of prosecutors to get into the business of making nuanced judgments about the effectiveness and completeness of integrity, ethics, and compliance efforts. One is hard-pressed to find a genuine desire for regulatory capacity-building in government agencies and departments, at least one even remotely comparable to the convergence of investments by private sector compliance stakeholders.

The recent announcement of a compliance counsel appointed to the Fraud Section of the Criminal Division of the Department of Justice is a surprising admission that expertise in compliance metrics were until only recently missing in the discretionary calculus of federal prosecutors. Unless modern progressives seize the opportunity that this convergence provides, it is fair to conclude that intuition and experiential evidence will continue to guide prosecutorial discretion. Prosecutors are simply not compliance professionals, as we are told by the Department of Justice, and the best that can be done is to ask a seasoned Main Justice compliance professional for a "reality check."[212] This reality check will be determined by such a professional with reference to some very familiar due diligence factors. These include the need to be reasonably proactive and reactive, the importance of organizational climate, and communication and enforcement of standards, among others.[213]

211. *See* Bamberger, *supra* note 186, at 388.

212. *See* Leslie R. Caldwell, Assistant Att'y Gen., Dep't of Justice, Remarks at SIFMA Compliance and Legal Society, New York Regional Seminar (Nov. 2, 2015), https://www.justice.gov/opa/speech/assistant-attorney-general-leslie-r-caldwell-speaks-sifma-compliance-and-legal-society ("Our goal is to have someone who can provide what I'll call a 'reality check.'").

213. These factors are derived from the pillars of diligence first announced in the Defense Industry Initiative (DII), subsequently enshrined in Chapter Eight of the Sentencing Guidelines for Organizations, and ulti-

Due diligence factors broadly offer guidance but, without more, are intuitions and hypotheses about the behavior of persons and organizations that leave firms conflicted about pursuing systematic evaluations.[214] In the end, these factors are an invitation to make additional investments in a wide range of compliance solutions that, most often, are critically evaluated for their efficacy only when there is a notable event of noncompliance that inadvertently or advertently comes to the attention of regulators or prosecutors.[215]

Modest suggestions for addressing the conundrum should acknowledge the complexity of compliance regimes in large institutions, including the iterative process of determining a regulator's discretionary expectations for corporate compliance; the regulatory challenges of monitoring firm compliance over time; the challenge of training employees to conform to articulated legal risks; and the increasing suasion of self-regulatory associations.[216] All suggestions should also address how this conundrum, along with any trading of regulator/regulated favors, figures in the long-awaited partnership between the government and corporations.[217] First conceived as the "good corporate citizen" movement more than two decades ago, this partnership was designed to reasonably share regulatory burdens by firms and criminal justice functionaries. For this partnership to be successful, regulators would shoulder the burden of providing clear guidance as to the kind and quality of compliance metrics required for measuring the ethi-

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mately spun off into a series of iterative memoranda from the Department of Justice, i.e., the Holder, McNulty, Thompson, and Filip Memoranda.

214. For a discussion of the history of compliance beginning with the Defense Industry Initiative (DII), see Laufer, *supra* note 2.

215. Miriam Baer captures the process well in writing that extant practice ". . . is at best an illusory delegation of responsibility whereby the government commands firms *ex ante* to implement 'effective' compliance programs, but offers little practical guidance for determining effectiveness, and intentionally leaves them very little room for discretion in the event that such programs uncover violations of law." Baer, *supra* note 31, at 954.

216. *See* Parker & Nielsen, *supra* note 195, at 49; *see also* Matthew Potoski & Aseem Prakash, *Regulatory Convergence in Nongovernmental Regimes? Cross-National Adoption of ISO 14001 Certifications,* 66 J. OF POL. 885 (2004).

217. PROCEEDINGS OF THE SECOND SYMPOSIUM OF CRIME AND PUNISHMENT IN THE UNITED STATES, CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION (Sept. 7–8, 1995). For a critical take on this movement, see, e.g., Laufer *supra* note 29.

cal and legal risks assumed by the firms they regulate, i.e., going beyond the simple prescription that firms must invest in sophisticated risk assessments; maintain clear policies, standards, and procedures; engage in effective training and communication; regularly test compliance monitoring and auditing; perform thorough internal and external investigations; and promote a culture of compliance.[218]

What these suggestions miss, however, are the distinct limitations of seeing compliance exclusively in performance terms with specific outcome metrics. In fact, any focus on performance metrics alone *fuels* the compliance conundrum, exploiting the lack of systematic compliance science and data, and neglecting the fact that a firm's compliance with the law is often not entirely reducible to any narrow construction of compliance performance at a single level of analysis. As Parker and Nielsen write, it is wrong to assume that changes in behavior are necessarily the product of new or changing compliance systems.[219]

Researchers must control for other structural, agency, and cultural co-variates.[220] Researchers must also look to successful efforts to "regulate from the inside" using environmental management systems and other technologies that support self-regulatory efforts.[221] Much research highlights the value of management-based regulation as a complement to technology-based (i.e., firms must adopt specific technologies or methods to comply), performance-based (i.e., firm must achieve specific level of compliance), and other conventional and market-

218. Of these, creating an ethical corporate culture is most challenging. *See, e.g.*, AMBER L. SELIGSON & LAURIE CHOI, CRITICAL ELEMENTS OF AN ORGANIZATIONAL ETHICAL CULTURE 7–8 (2006) (ethical culture may be captured by 18 factors).

219. *See* Parker and Nielsen, *supra* note 195. *See also* Warren et al., *supra* note 73 (surveying bank employees before and after the introduction of formal ethics training—an important component of formal ethics programs—to examine the effects of training on ethical organizational culture.)

220. *See* Neal Shover &Andy Hochstetler, *Cultural Explanation and Organizational Crime*, 37 CRIME, L. & SOC. CHANGE 1 (2002).

221. For a discussion of the successes and challenges of these management systems, see REGULATING FROM THE INSIDE: CAN ENVIRONMENTAL MANAGEMENT SYSTEMS ACHIEVE POLICY GOALS? (Cary Coglianese & Jennifer Nash eds., 2001).

based instruments.[222] Advances in the regulation of environmental pollution, food safety, and industrial safety using management-based regulation are notable.[223] Environmental management systems and other flexible and light-handed regulatory approaches offer a least-cost solution with incentives to meet—and in some cases exceed—that which is required by law.[224]

Proponents still ponder, though, just how prescriptive they should be about the plan and its implementation, how to monitor a firm's compliance, what the consequences for noncompliance should be, and exactly how this kind of regulation should be subject to the latest evaluation science. Long overdue answers to these questions are needed to combat the compliance conundrum and integrate new approaches into the broader progressive agenda.[225] And, alas, the fast-paced movement of regulatory and legal technology holds much promise.

V.
Revisiting the Modern Progressive Agenda

The modern progressive agenda is often broadly defined by the pursuit of individual freedom; freedom from undue government interference; the opportunity to work toward economic and civic success; taking personal responsibility, and a sense of responsibility to others.[226] Modern progressive issues revolve around jobs and the economy; taxes and deficits;

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222. *See, e.g.*, Cary Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals,* 37 Law & Soc'y Rev. 691, 714 (2003).

223. *See, e.g.*, Cary Coglianese & Jennifer Nash, Leveraging the Private Sector: Management-Based Strategies for Improving Environmental Performance (2006). For a discussion of the limitations of management-based regulatory approaches, see Neil Gunningham & Darren Sinclair, *Organizational Trust and the Limits of Management-Based Regulation*, 43 Law & Soc'y Rev. 865 (2009).

224. *See, e.g.*, Cary Coglianese & Jennifer Nash, *Environmental Management Systems and the New Policy Agenda*, *in* Regulating From the Inside: Can Environmental Management Systems Achieve Policy Goals? (Cary Coglianese & Jennifer Nash eds., 2001).

225. For early calls for corporate monitoring from a special seat on the board, see Christopher Stone, Where the Law Ends: The Social Control of Corporate Behavior 174–83 (1975).

226. *See* Al Yates & Anne Bartley, Progressive Thinking: A Synthesis of Progressive Values, Beliefs, and Positions (2012).

health care, social security and Medicare; education; immigration; environmental, climate and energy policy; reproductive rights and health; money in politics; and gay rights and marriage equality.[227]

Matters of corporate responsibility, accountability, and justice are the subject of vociferous advocacy over what it means to break up the big banks, to separate commercial and investment banking by bringing back a replica of the Glass-Steagall Act (Banking Act of 1933), to enact financial speculation taxes, to limit executive compensation, and to use principles and practices of collective civil disobedience in order to "occupy" Wall Street.[228] This advocacy attaches to the core progressive idea of "taming the giant corporation" that dominated progressive dogma in the 1970s and 1980s. Calls from Ralph Nader for federal incorporation laws, and Christopher Stone for general and special public directors, inspired a share of the new progressive agenda.[229]

In recognition of the harm flowing from serious wrongdoing on the part of the largest businesses, progressives see corporations as artificial entities whose domination and unconstrained power has now crept into every aspect of life. This power has a damaging hold on the political process. We live in a near corporate state, modern progressives say, where our most significant issue should be how to best constrain, disable, and disassemble the largest private institutions that have so successfully aggregated corporate power. Something must be done to address the disconnect between the interests of Wall Street and a law-abiding, honorable if not selfless Main Street.

If this generation of progressives will be the constituency supporting a measured and just corporate criminal law, they will have to know where to best direct government and corporate controls. This means balancing the value of abolishing corporate personhood with the importance of personhood for

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227. *See* John Nichols, *Elizabeth Warren Offers Democrats More Than a 2016 Candidacy—She Offers a 2014 Agenda*, THE NATION (July 19, 2014), https://www.thenation.com/article/elizabeth-warren-offers-democrats-more-2016-candidacy-she-offers-2014-agenda/ ("We believe that Wall Street needs stronger rules and tougher enforcement, and we're willing to fight for it.").

228. *See id.*

229. *See* NADER, *supra* note 137; STONE, *supra* note 225. For an older progressive take, *see* Melvin I. Urofsky, *Proposed Federal Incorporation in the Progressive Era*, 26 AM. J. L. HIST. 160 (1982).

the attribution of criminal liability. This also means sharing the power of informal social controls between regulators and the regulated, as co-regulators, using leading enterprise technology; accepting the increasing delegation and, thus, privatization of public regulation with increasingly plural and decentered models of regulation; and recognizing how a progressive corporate criminal law will apply to enterprises of all sizes and ownership statuses.

It also means thinking about how modern progressive advocacy is affected by criminal justice strategies that, according to some, make black lives all but incidental.[230] Neoconservative policing strategies characterized by containment, surveillance, pacification, and deception may meet law enforcement objectives but, at the same time, risk racial injustice.[231] Aggressive urban police policies and practices, modern progressives might argue, target precious criminal justice resources, a reasonable percentage of which could and should be used to combat corporate wrongdoing by companies of all sizes. Our malevolent portrait of street criminals and the "badness" of street-level wrongdoing contribute to a concentration of criminal justice attention and resources away from more aggressive investigation and prosecution of corporations.[232] These and other challenges to the modern progressive agenda are briefly detailed below, concluding with a reflection on how the rules of the compliance game would change with a little nudge from modern progressives.

A. *The Bridge From Old to New*

Casting a dark shadow on the ethics and integrity of big business may successfully connect old and new ideologies.[233] It is a very satisfying rant for all of the obvious reasons. At the

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230. *See* MICHELLE ALEXANDER, THE NEW JIM CROW: MASS INCARCERATION IN THE AGE OF COLOR-BLINDNESS (2010); MARIE GOTTSCHALK, CAUGHT: THE PRISON STATE AND THE LOCKDOWN OF AMERICAN POLITICS (2014).

231. Alex S. Vitale & Brian J. Jefferson, *The Emergence of Command and Control Policing in Neoliberal New York*, *in* POLICING THE PLANET: WHY THE POLICING CRISIS LED TO BLACK LIVES MATTER 157–72 (J. Camp & C. Heatherton, ed., 2016).

232. *See, e.g.*, Doron Teichman, *The Market for Criminal Justice: Federalism, Crime Control, and Jurisdictional Competition*, 103 MICH. L. REV. 1831 (2005).

233. Alfred D. Chandler, Jr., *The Beginnings of "Big Business" in American Industry*, 33 BUS. HIST. REV. 1 (1959).

same time, assuming that all businesses beget evil is a lazy and distorted caricature. Progressives of old did much to unpack the value that different forms of constraint have on creating and successfully sustaining order within firms. Asking how social controls promote pro-social corporate behavior falls within the province of modern progressives as well.[234]

Progressives today have a significant stake in how compliance requirements are conceived, integrated into organizations, and evaluated for efficacy and effectiveness. Their failure to be true to their history by actively exploring the disconnect between functioning institutions of social control and powerful corporations diminishes the legitimacy of their calls for dismantling large financial institutions. Modern progressives should be leading this convergence of compliance solutions to reduce corporate deviance, and to disrupt the perennial game of compliance. Modern progressives also should be studying how this convergence may, at times, produce overly controlled and rigid workplaces.[235] And modern progressives should be exploring how the use of both informal and formal social controls may more meaningfully connect to the characterization of corporations as moral agents and as persons.

In an effort to undo the grant of corporate constitutional rights, modern progressives regularly and consistently attack the very idea of personhood.[236] Corporate personhood unfairly transforms the concept of property and unjustly limits liability. In the view of modern progressives, the idea of corporate personhood is inextricably tied to the evils associated with globalization, the dominance of corporate power, unjust wealth concentration, and an all-encompassing neoliberal disingenuousness.[237] Modern progressives also worry about how

234. So, too, is charting a progressive course of corporate social responsibility. *See* Greenfield, *supra* note 96.

235. *See* Laufer & Robertson, *supra* note 112.

236. Matthew Rothschild, *Corporations Aren't Persons*, THE PROGRESSIVE, Apr. 2, 2010, http://www.progressive.org/mrapril10.html ("We need to slay the dragon of corporate personhood once and for all."). For a wonderful discussion of the history of these rights, *see* Margaret M. Blair & Elizabeth Pollman, *The Derivative Nature of Corporate Constitutional Rights,* 56 WM. & MARY L. REV. 1653 (2015).

237. This extends to the evils of corporate political influence in this post-Citizens United era. *See, e.g.*, Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 924–28 (2013); Michael D. Guttentag, *On Requiring Public Companies to Disclose Political Spend-*

large corporations epitomize corruption in modern form.[238] Modern progressives join populists, and others to the left, in recoiling at our corporate economy and corporate society.[239] Some go so far as to think that we are inching toward fascism with the rise of corporate control over the legislative and now executive branch, significantly diminishing civic power.

The deeply-held views of modern progressives on personhood in this post-*Citizen's United* period complicate any substantive reform of corporate criminal law.[240] So, too, does the defining role of personhood in reproductive rights, more generally. Personhood statutes and initiatives are weapons of abortion foes.[241] All of these invectives beg the question: How can corporate personhood be abolished as a matter of progressive principles, while simultaneously accepting that part of the criminal law that generally looks to, if not requires, the very qualities and characteristics associated with personhood?[242] With the narrow exception of strict liability offenses, the fault requirements of federal and state criminal codes extend a distinct human form and logic to the *persona ficta* of a corporation.[243] The corporate person is, in essence, more than a simple construction or empty metaphor.[244] For progressives it is a facilitative legal fiction that allows criminal law principles to be attributed to culpable and thus deserving entities. Abolishing personhood may be the perfect way to avenge corporate evils. At the same time, though, undermining this fiction would

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ing, 2014 COLUM. BUS. L. REV. 593 (2014); Richard L. Hasen, *Citizens United and the Illusion of Coherence*, 109 MICH. L. REV. 581 (2011); Amy J. Sepinwall, *Citizens United and the Ineluctable Question of Corporate Citizenship*, 44 CONN. L. REV. 575 (2012).

238. William S. Laufer, *Modern Forms of Corruption and Moral Stains*, 12 GEO. J. L. & PUB. POL'Y 373 (2014).

239. For a discussion of big business and "Corporate" America, *see* MCGERR *supra* note 19, at 147–81.

240. *See* Amy J. Sepinwall, *Citizens United and the Ineluctable Question of Corporate Citizenship*, 44 CONN. L. REV. 575 (2012).

241. Lee Rubin Collins & Susan L. Crockin, *Fighting 'Personhood' Initiatives in the United States*, *in* 24 REPRODUCTIVE BIOMEDICINE ONLINE 689 (2012).

242. *See* Walt & Laufer, *supra* note 7.

243. *See, e.g.*, STONE, *supra* note 18 at 3.

244. *See* Donald R. Cressey, *The Poverty of Theory in Corporate Crime Research*, *in* 1 ADVANCES IN CRIMINOLOGICAL RESEARCH 31 (William S. Laufer & Freda Adler eds., 1989).

likely diminish the role and suasion of the most formal of social controls to address this evil.[245]

Modern progressives face a difficult dilemma. Take away the person, and principles of corporate criminal law must be formally recast. Abolish personhood and one might have to reconstruct any responsive regulatory architecture, straining to find a place for the benign big gun.[246] The analytic challenge is exceptionally difficult if one is committed to a consistent conception of personhood across the criminal law.[247] How should modern progressives inherit the old progressive's consternation over organizational personhood? Practically, there is no need to ask whether the progressive call for strengthening the regulatory system may be satisfied while at the same time abolishing the fictional form that allows for liability. Modern progressives benefit from parallel fault standards that allow for prosecutions of either human or corporate persons, or both.[248] The Yates Memorandum distracts attention from well-

245. For a comparable argument, *see* Kent Greenfield, *Let Us Now Praise Corporate Persons*, WASH. MONTHLY, January/February 2015, http://washingtonmonthly.com/magazine/janfeb-2015/let-us-now-praise-corporate-persons/ ("But the attack on corporate personhood is a mistake. And it may, ironically, be playing into the hands of the financial and managerial elite. What's the best way to control corporate power? More corporate personhood, not less.").

246. In fairness, while some courts find personhood to be incidental, most corporate criminal prosecutions assume certain relational properties commonly associated with personhood. *See, e.g.*, State v. Knutson, 537 N.W.2d 420, 427 (Wis. Ct. App. 1995) (" . . . it is not in virtue of being a person that criminal liability attaches. It is in virtue of possessing the complex relational property of causing harm—voluntarily—with a wrongful state of mind—without excuse."); *see also* Walt & Laufer, *supra* note 7.

247. This raises the more general question of why the "personhood" epithet must be employed consistently. Perhaps different parts of the criminal law might apply to corporations differently because the interests at stake are different? Why create a useful heuristic (personhood) and then use it many different contexts where it may not be useful? Both are good questions that are not answered by the tendency of courts and legislatures to reflexively resort to personhood heuristics or person-based analogies.

248. *See, e.g.*, John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655, 658 (1926) ("[B]efore anything can be a jural person it must intrinsically possess certain properties, the existence of which is necessary to constitute anything a person."). The strategic use of parallel civil and criminal proceedings has been discussed at length. *See Developments in the Law—Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions,* 92 HARV. L. REV. 1311, 1333–40 (1979).

settled principles that prosecutors have the discretion to proceed in parallel or proceed separately.[249] Strategic considerations account for variations in prosecutorial behavior, with a distinct preference for individual cases evident well before the Yates Memo.[250]

Changes to the general part of the corporate criminal law over the past century are nearly impossible to find. In place of successful corporate criminal law reform, a legion of strange bedfellows have battled over corporate metaphysics, moral agency, and what it means for a company to have a "soul" and be culpable or liable.[251] These battles are undeniably engag-

249. *See* Memorandum from Mark Filip, Deputy Attorney Gen., U.S. Dep't of Justice, to Heads of Dep't Components and U.S. Attorneys, U.S. Dep't of Justice (Aug. 28, 2008), https://www.justice.gov/sites/default/files/dag/legacy /2008/11/03/dag-memo-08282008.pdf ("Where a decision is made to charge a corporation, it does not necessarily follow that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation."). It is interesting to note that outside of the United States, there is an ongoing debate over the implications of *ne bis in idem* in proceeding against both "legal" and human persons. *See* Dominik Brodowski, *Minimum Procedural Rights for Corporations in Corporate Criminal Procedure*, *in* REGULATING CORPORATE CRIMINAL LIABILITY 211–225 (Dominik Brodowski, Manuel Espinoza de los Monteros de la Parra, Klaus Tiedemann, Joachim Vogel eds., 2014).

250. Memorandum from Mark Filip, *supra* note 249. The Yates Memo signals that liability risk for firms should be conceived in terms of an individual agent's non-compliance. No prosecution of a corporation will result unless there is prima facie evidence of an agent's fault. The result for compliance officers is simple: Focusing resources on organizational fault is unresponsive to this regulatory prescription. To be responsive, firms should focus attention on the acts and omissions of individual agents. The compliance function is justifiably tied to regulatory prescriptions. Elsewhere, it was argued that changes in requirement of the general part of the corporate criminal law invite congruence or consistency problems. *See* William S. Laufer & Alan Strudler, *Corporate Crime and Making Amends,* 44 AM. CRIM. L. REV. 1307, 1311 (2007).

251. *See generally* ERIC W. ORTS & N. CRAIG SMITH, THE MORAL RESPONSIBILITY OF FIRMS (2017); PETER A. FRENCH, COLLECTIVE AND CORPORATE RESPONSIBILITY (1984); MARGARET GILBERT, SOCIALITY AND RESPONSIBILITY (2000); Philip Pettit, *Responsibility Incorporated*, 117 ETHICS 171 (2007); Susan Wolf, *The Legal and Moral Responsibility of Organizations*, *in* 27 CRIMINAL JUSTICE: NOMOS 267, 268 (J. Roland Pennock & John W. Chapman eds., 1985).

ing, and so very longstanding.[252] With no metrics for progress created, and no inspired law reform to show, however, statutory and decisional law is left to rest in a state of doctrinal decay.

It is also true that a wide range of proposed entity fault standards that show promise for more meaningful and genuine determinations of fault were left on the table. These determinations turn on connections between the decisions, actions, and inactions of agents, and the quality and characteristics of the firm.[253] More relevant to the progressive case, these "genuine" fault standards tend to facilitate reasonable attributions of fault.

Modern progressives should seize the opportunity for greater corporate accountability and push for the adoption of culpability and liability standards that conceive of fault as (1) an entity's acts and intentionality, (2) a function of an agent's status in the corporate hierarchy, (3) a collection of intentions, (4) or the nature of an agent's relationship to the principal. Constructive corporate fault, corporate character and culture theory, and proactive/reactive fault are also candidates for liability and culpability standards that are organizational in nature.[254]

Progressives might, for example, adopt a corporate liability standard that conceives of fault as an entity's acts and intentionality or perhaps a function of an agent's relationship to the principal. This approach is consistent with a constructive corporate liability.[255] A constructive corporate liability and culpability exists where there is proof of: (1) an illegal corporate act, and (2) a concurrent corporate criminal state of mind. The former requirement may be satisfied by evidence of a pri-

252. *See* Max Radin, *The Endless Problem of Corporate Personality*, 32 COLUM. L. REV. 643 (1932). For a recent treatment on agency questions, *see* ORTS & SMITH, *supra* note 251.

253. *See infra* notes 255–256.

254. William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 648, 678 (1994) (detailing different conceptions of "genuine corporate fault"); *see also* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1121 (1991); Ann Foerschler, Comment, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CAL. L. REV. 1287, 1299–1300 (1990). For a fascinating take on corporate culpability and cognitive science, *see*, Mihailis E. Diamantis, *Corporate Criminal Minds*, 91 NOTRE DAME L. REV. 2049 (2016).

255. *See* Laufer, *supra* note 2, at 70–72.

mary act—an act that is owned or authored by the corporation. Primary action may be identified through an objective test where it is determined that given the size, complexity, formality, functionality, decision-making process, and structure of the corporate organization, it is reasonable to conclude that the agents' acts are the actions of the corporation. This reasonableness test is a threshold assessment that serves to separate those cases in which primary corporate acts have occurred, from those appropriately considered as individual non-corporate acts (or secondary acts). Constructive corporate fault replaces vicarious liability with a constructive test of primary corporate action.

Any reasonable departure from corporate vicarious liability, it seems, would be preferred by modern progressives. Principles of vicarious fault are simply too difficult and costly to apply to agents of large and powerful corporations. The larger the organization, the more likely that the agent's acts and intents are attenuated; the more likely that there are relevant policies, procedures, and training that further disconnect the wrongdoing from the corporation's diligence; the more likely that corporations will engage in "reverse whistleblowing"; and the more likely that for reasons of sheer size and steady base-rates of deviance, vicarious fault would apply to far too many agents to be both reasonable and practical.[256]

B. *Taming the Giant Corporation?*

Targeting and taming giant corporations excites progressives of both old and new stripes. There are many good reasons to attend to iconic companies of great scale, from their market and political power, to the lasting effects of their ethical and legal violations.[257] The largest private sector actors powerfully influence both regulation and any attribution of

256. See Laufer, *supra* note 5, at 657–58, for a discussion of corporate scapegoating (called "reverse whistleblowing") by deflecting blame to low-level employees.

257. *See* NADER, *supra* note 137, at 7. There is a long history to the progressive's concern with big business. *See, e.g.,* MCGERR, *supra* note 19, at 151 ("The rise of large-scale corporations was unsettling, even frightening. Big business, as one newspaper warned, could well "lead to one of the greatest upheavals that has been witnessed in modern history.""); *see also* Charles A. Moore, *Taming the Giant Corporation? Some Cautionary Remarks on the Deterrability of Corporate Crime*, 33 CRIME & DELINQUENCY 379 (1987).

criminal responsibility.[258] Corporations are deft at undermining legislative efforts to limit industry self-regulation and firm self-governance. What remains of corporate crime reforms often has as much to do with the exercise of corporate power as with the congressional intent behind the legislation.[259] Corporate political influence is a longstanding and sustained concern of progressives.[260]

Classic research by Marshall Clinard and Peter Yeager in 1979 revealed that wrongdoing is generously distributed in the largest companies.[261] Many years of employee surveys from large firms confirm high base rates, much of which is washed through non-reporting or management inertia, if not inaction.[262] Giant corporations also benefit significantly from a multi-tier system of corporate criminal justice, one in which the only companies generally prosecuted to conviction are the small ones wherein owners had direct knowledge of the illegalities.[263] Larger corporations are often diverted from the criminal process into deferred prosecution agreements, non-prosecution agreements, and corporate integrity agreements.[264] A small number of the largest corporations, those that offer something quite important or strategic—or whose existence is systemically important—are simply too big to indict, prosecute, take to trial, and convict.[265] Nowhere is this more apparent than in the torpor to bring criminal cases against the largest financial institutions for wrongdoing during the subprime mortgage crisis.[266]

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258. Thomas M. Jones, *Corporate Governance: Who Controls the Large Corporation,* 30 HASTINGS L.J. 1261 (1979).

259. *See* Laufer, *supra* note 2, at 7; Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L. Q. 95, 104 (2004).

260. *See, e.g.,* Herbert Hovenkamp, *The Mind and Heart of Progressive Legal Thought*, 81 IOWA. L. REV. 149 (1995).

261. CLINARD & YEAGER, *supra* note 73.

262. Laufer, *supra* note 2, at 144.

263. Laufer, *Corporate Liability*, *supra* note 41, at 1344.

264. *See* BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS (2014) (an excellent treatment of the challenges associated with prosecuting and not prosecuting some of the most powerful corporation).

265. *See, e.g.*, REPUBLICAN STAFF OF THE COMM. ON FIN. SERVICES, U.S. HOUSE OF REPRESENTATIVES, TOO BIG TO JAIL: INSIDE THE OBAMA JUSTICE DEPARTMENT'S DECISION NOT TO HOLD WALL STREET ACCOUNTABLE (2016).

266. Sharon E. Foster, *Too Big to Prosecute: Collateral Consequences, Systemic Institutions and the Rule of Law,* 34 REV. BANKING & FIN. L. 655 (2015).

There is an obvious and justifiable attraction to think of business crimes and organizational wrongdoing as the province of giant corporations. Part of the lure comes from very real concerns over concentrated resources, the sheer power and scale on which to do wrong, boundless capabilities to deflect and defend any accusation, access to extant regulatory strategy, and the difficulty of obtaining inculpatory evidence given the complexity of the corporate form. The other part of the lure is the sheer scale of their economies in comparison to other, different kinds of economies.

There is some risk, though, in uncritically accepting archetypal images of the largest private sector institutions, especially when conceiving corporate crime policy. At times, too little reflection is given to the variety of iconic images of corporations that do wrong. It is not only that there are many different types of corporations, many different kinds of corporate cultures, and sustained base rates of deviance in all.[267] It is not that big businesses who do wrong are less deserving of blame. The real risk is that such images make too convincing a case that regulatory attention should focus only on giant corporations and that all giant corporations are, in progressive terminology, evil. It is unfortunate that old and modern progressives are guilty of seducing and being seduced by symbolic imagery, as much as big business and government functionaries.

The near-exclusive focus by progressives on the giants of industry is also not justified by any evidence of greater rates of deviance in the largest corporations. On the contrary, in small to medium sized enterprises ("SMEs"), those with few resources to commit to compliance policies and programs, the rates of wrongdoing are likely as high, if not higher.[268] Cer-

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267. For a fascinating exploration of base rates of misconduct, *see* MARK EGAN, GREGOR MATVOS, & AMIT SERU, THE MARKET FOR FINANCIAL ADVISOR MISCONDUCT (Apr. 2016) (unpublished manuscript) (on file with the University of Chicago Becker Friedman Institute for Research in Economics).

268. *See,* Donald F. Kuratko, Jeffrey S. Hornsby & Douglas W. Naffziger, *Crime and Small Business: An Exploratory Study of Cost and Prevention Issues in U.S. Firms*, 38 J. OF SMALL BUS. MGMT. 1 (2000); Michael L. Ettredge, Karla Johnstone, Mary Stone, & Qian Wang, *The Effects of Firm Size, Corporate Governance Quality, and Bad News on Disclosure Compliance*, 16 REV. OF ACCT. STUD., 866 (2011); Giampaolo Gabbi, Paola Musile Tanzi, & Loris Nadotti, *Firm Size and Compliance Costs Asymmetries in the Investment Services,* 19 J. OF FIN. REG. & COMPLIANCE 58 (2011); Darryl K. Brown, *The Problematic and Faintly Promising Dynamics of Corporate Crime Enforcement*, 1 OHIO ST. J. CRIM. L. 521 (2003).

tainly, regulatory disclosure requirements decrease appreciably in SMEs, in particular in the nearly 30 million small businesses in the United States.[269]

Images that target and tame giant corporate wrongdoing, on occasion, carry the neoconservative and neoliberal baggage of over-criminalization.[270] The time is long overdue for modern progressives to reposition the policing of all corporate crimes as a problem of under-criminalization and under-enforcement.[271] After all, the use of the criminal law against corporations both large *and* small remains a very rare event in the criminal justice system.

Modern progressives are left with several avenues for justice, and one can hope that this movement will transcend objections and follow in the footsteps of both history and tradition. Progressive proposals for federal chartering of the largest and most powerful corporations suggest that this transcendence is possible.[272] The case for federal chartering is premised on the failure of individual accountability, the unparalleled impact of big businesses on markets, the failure of state chartering laws to reign in corporate abuses, marked failures of corporate disclosures, and market concentration that prevents fair competition.[273] The chartering proposals, while unsuccessful, offered modern progressives a powerful vector for a more ambitious reform agenda.

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269. For a fascinating discussion of the challenges of self-regulation and wrongdoing in small businesses, see Robyn Fairman & Charlotte Yapp, *Enforced Self-Regulation, Prescription, and Conceptions of Compliance within Small Businesses: The Impact of Enforcement*, 27 L. & POL'Y 491 (2005).

270. *See* Erik Luna, *Overextending the Criminal Law, in* GO DIRECTLY TO JAIL: THE CRIMINALIZATION OF ALMOST EVERYTHING (Gene Healy ed., 2004).

271. Richard A. Bierschbach & Alex Stein, *Overenforcement*, 93 GEO. L.J. 1743, 1778 (2005); Stuart Green, *Is There Too Much Criminal Law?* 6 OHIO ST. J. CRIM. L. 737 (2009) (reviewing DOUGLAS HOUSAK, OVERCRIMINALIZATION: THE LIMITS OF THE CRIMINAL LAW (2008)); Sara Sun Beale, *The Many Faces of Overcriminalization: From Morals and Mattress Tags to Overfederalization,* 54 AM. U. L. REV. 747, 778 (2005).

272. RALPH NADER, MARK GREEN, & JOEL SELIGMAN, TAMING THE GIANT CORPORATION: HOW THE LARGEST CORPORATIONS CONTROL OUR LIVES (1976) (discussing the design and prospects of federal chartering).

273. *Id.*

CONCLUSION

If the century-old-history of corporate criminal law is any guide, our regulatory destiny is bounded by a repeated episodic pattern. Start with a period of regulatory laxity, followed by a period of "unprecedented" corporate scandals, leading to a time of heightened regulatory scrutiny and then on to legislative reforms.[274] The reforms will usually be followed by targeted lobbying and legislative amendments, ending, once again, with an uncertain time of regulatory laxity. That there is no modern progressive account of corporate criminal law is a missed opportunity to disrupt the regularity of this century old pattern of recurring scandals and reforms. Such disruption might ensure the integrity and longevity of corporate crime reforms, shift the priority given to corporate criminal law enforcement and prosecution, push lawmakers toward enacting greater accountability for corporate wrongdoing and, all along, promote the proper measure of social controls with a commitment to science.

Modern progressives inherit the tradition of using science to fashion a fair and just sociology of social control. Raising a progressive voice at this convergence of compliance science and disruptive technology, methods, and standards, would countenance the founding ideas of progressivism. There is also immeasurable value in hearing a loud progressive voice when the politics of the moment place at risk many of the regulatory reforms of the past two decades.

This is a time when the voices of modern progressives should compete with the stalwart advocates, corporate libertarians, and those of other ideologies in defining compliance constructs and principles. The days of faint speech at the margins should be over. Entering a more robust debate over corporate accountability is no short order given the boundaries

274. Laufer *supra* note 2 at 43 ("With a certain sense of regulatory bravado, names of some of the most respected companies on Wall Street are now held out as deviant and deserving of criminal sanctions. If history is any guide, though, this period of active regulation will see a change, a regulatory shift that accommodates economic prosperity brought about by new forms of business innovation and risk taking. One day, perhaps not so long from now, the inevitability of regulatory laxity will bring about waves of seemingly unprecedented scandals that will surprise and shock us all, again."); *see also* Sally S. Simpson, *Cycles of Illegality: Antitrust Violations in Corporate America*, 65 SOCIAL FORCES 943 (1987) (suggesting some comparable patterns).

around disciplinary methods, journals, and intellectual exchanges. To have impact on the content and contours of corporate criminal law, proponents must speak in ways that engage policy makers as active partners in this competition.[275]

The good news is that modern progressives know that there is an inevitability to the development of increasingly integrated regulatory instruments, an inevitability to more sophisticated enterprise wide systems, an inevitability to the widespread adoption of plural and decentered non-state regulatory solutions, and an inevitability to some kind of fair and just international regulatory regime. And modern progressives are uniquely positioned to understand what the inevitability of progress might mean for the future of corporate criminal justice.[276]

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275. Daniel S. Nagin & Cody W. Telep, *Procedural Justice and Legal Compliance*, 13 ANN. REV. OF L. & SOC. SCI. 1 (2017) (reviewing the translation of research on compliance); Robert J. Sampson, Christopher Winship, & Carly Knight, *Overview of: "Translating Causal Claims: Principles and Strategies for Policy-Relevant Criminology*, 12 CRIMINOLOGY & PUB. POL'Y 585 (2013).

276. The future prospects of a science of corporate criminal justice was recently discussed at the National Academy of Sciences. *See* What Does Science Offer Corporate Criminal Justice, Planning Meeting, NATIONAL ACADEMY OF SCIENCES COMMITTEE ON LAW AND JUSTICE & ZICKLIN CENTER OF THE WHARTON SCHOOL (2015). Claims about the inevitability of the progress of science are made with an appreciation for positions other than that of the inevitabilist. *See, e.g.*, Ian Hacking, *How Inevitable are the Results of Successful Science?*, 67 PHIL. SCI. S58 (2000); Katherina Kinzel, *State of the Field: Are the Results of Science Contingent or Inevitable?*, 52 STUD. IN HIST. & PHIL. SCI. 55 (2015); Lena Soler, *Are the Results of Our Science Contingent of Inevitable?* 39 STUD. IN THE HIST. & PHIL. SCI. 221 (2008); Lena Soler, *Revealing the Analytical Structure and Some Intrinsic Major Difficulties of the Contingentist/Inevitabilist Issue,* 39 STUD. IN THE HIST. & PHIL. SCI. 230 (2008); Howard Sankey, *Scientific Realism and the Inevitability of Science*, 39 STUD. IN HIST. & PHIL. SCI. 259 (2008).

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ARE MUTUAL FUNDS ROBBING RETIREMENT SAVINGS?

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"When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients."

– Warren Buffet, 2017 Letter to Shareholders[1]

"The mutual fund industry is the world's largest skimming operation."

– U.S. Senator Peter G. Fitzgerald[2]

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1. Aaron Hankin, *Warren Buffet's Annual Shareholder Letter for 2017*, INVESTOPEDIA (Feb. 25, 2017), http://www.investopedia.com/news/warren-buffetts-annual-shareholder-letter-2017-brka-aapl/.

2. *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors: Hearing Before the Subcomm. on Fin. Mgmt., the Budget, and Int'l Sec. of the S. Comm. on Governmental Affairs*, 108th Cong. 3 (2004), https://www.gpo.gov/fdsys/pkg/CHRG-108shrg91038/html/CHRG-108shrg91038.htm [hereinafter Oversight Hearing on Mutual Funds].

INTRODUCTION

Almost all Americans who want to grow their savings entrust them to various financial institutions promising monetary returns.[3] Mutual funds,[4] "commonly defined as pools of stocks, bonds, or other investment securities,"[5] are among the most popular of those. There are now more than 16,000 mutual

3. *See generally*, TAMAR FRANKEL & KENNETH E. BURDON, INVESTMENT MANAGEMENT REGULATION 1–7 (5th ed. 2015).

4. For general information about the regulation of mutual funds, *see* U.S. Securities and Exchange Commission (SEC), *Investment Company Registration and Regulation Package,* www.sec.gov/divisions/investment/invcoreg121504.htm.

5. Quinn Curtis & John Morley, *The Flawed Mechanics of Mutual Fund Litigation*, 32 YALE J. ON REG. 1, 4 (2015). The U.S. Supreme Court has given this definition of a mutual fund: ". . . a pool of assets, consisting primarily of [a] portfolio [of] securities, and belonging to the individual investors holding shares in the fund." Burks v. Lasker, 441 U.S. 471, 480 (1979).

funds cumulatively holding in excess of $18 trillion in assets[6] that belong to over 90 million investors.[7] The managers of these holdings and their affiliates are paid an astronomical amount for their services—$100 billion annually—all of which comes from the funds of their investors.[8]

Because self-funded retirement plans like 401(k)s[9] and IRAs[10] have in large measure replaced defined benefit pensions that companies used to provide for their employees, individuals have increasingly turned to these investment programs to build resources to sustain them after their working years.[11] As a result, mutual funds have grown prodigiously in both numbers and assets during the last several decades.[12]

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6. An interesting comparative figure here is the national debt which is slightly higher than this amount, $20.5 trillion. U.S. Department of the Treasury, Bureau of the Fiscal Service, TREASURY DIRECT, http://www.treasurydirect.gov/NP/debt/current (last visited Nov. 16, 2017).

7. INVESTMENT COMPANY INSTITUTE, 2016 INVESTMENT COMPANY FACT BOOK 6 (2016), https://www.ici.org/pdf/2016_factbook.pdf.

8. *See infra* note 189 and accompanying text. An interesting comparative figure here is the cost to society of incarcerating the 2.3 million people who are currently in U.S. prisons and jails. One study found that the aggregate price of incarceration for 40 participating states was $39 billion annually. *See* Peter Wagner & Bernadette Rabuy, *Mass Incarceration: The Whole Pie 2017*, *in* PRISON POLICY INITIATIVE (Mar. 14, 2017), www.prisonpolicy.org/ reports/ pie2017.html; Christian Henrichson & Ruth Delaney, *The Price of Prisons: What Incarceration Costs Taxpayers*, VERA INSTITUTE OF JUSTICE (2012), http://archive.vera.org/sites/defaul/files/resources/downloads/price-of-prisons-udated-version-021914.pdf.

9. 26 U.S.C. § 401(k). These are "tax sheltered retirement plans. Funds placed in them are not taxable to the employee and are deductible by the company; contributions and earnings increase tax-free until they are withdrawn." CHARLES J. WOELFEL, THE FITZROY DEARBORN ENCYCLOPEDIA OF BANKING AND FINANCE (10th ed. 1996).

10. 26 U.S.C. § 408(a), 26 C.F.R. § 1.408-2. These are pension plans that allow "annual sums to be set aside from earnings free of tax and accumulated in a fund, which pays interest. Basic-rate tax is payable once the saver starts to withdraw from the account, which must be done no later than the participant's 70th birthday." *Individual Retirement Account (IRA)*, OXFORD DICTIONARY OF FINANCE AND BANKING (4th rev. ed. 2008).

11. *See* Barbara A. Butrica, Howard M. Iams, Karen E. Smith & Eric Toder, *The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Incomes of Baby Boomers*, 69 SOC. SECURITY BULL. NO. 3 (2009). Among other findings, this study reports that the percentage of workers participating in traditional pensions declined from 38% to 20% from 1980 to 2008.

12. INVESTMENT COMPANY INSTITUTE, *supra* note 7.

The companies providing these financial services have features that many find attractive. They afford a form of "mass-produced"[13] investment advice to individuals who are not typically able to afford such personalized services. In lieu of individualized guidance, mutual funds also give those with limited nest eggs the ability to pool their resources with others to buy shares in a portfolio containing various types of securities. Such an aggregation is said to provide small investors with significant benefits like diversification, expert management, and economies of scale.[14]

Consequently, it is important that firms offering these opportunities be run honestly and effectively and that the funds committed to them be administered with care. However, as with all situations where individuals hold and manage the money of others, the possibilities for overcharging and, even worse, outright fraud, are ever present.[15] In the 1930s and 40s, therefore, the federal government set up a system to regulate these firms and has amended it over the years to assure that those who commit their resources to mutual funds will not be cheated.[16]

For some time, this industry was perceived to be conservatively managed and fairly run. So, in the last decade it came as a shock that some of the most prominent of these funds were involved in a series of "market-timing" and "late-trading" scandals.[17] While that misconduct brought a swift response from regulators,[18] it would be a mistake to assume that all is now well with this crucial segment of our economy. Concerns persist because of how these firms are structured. They are set up in a way that seems to invite conflicted loyalties and allow their managers to charge fees that drain away the savings of their investors. These fees amount to an astounding $100 billion an-

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13. FRANKEL & BURDON, *supra* note 3, at 9.

14. *Id.* at 9–10.

15. The seminal work there is LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914).

16. *See infra* notes 78–105 and accompanying text.

17. For a fine description of such scandals *see* ANDREW PETERSON, WHITE COLLAR CRIME IN THE MUTUAL FUND INDUSTRY (2012). *See also infra* note 145 and accompanying text.

18. For a list of SEC actions brought in that wake of market-timing and late-trading scandals, *see* H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions,* 23 ANN. REV. BANKING & FIN. L. 777 (2004).

nually which, necessarily, must come out of the money entrusted to the funds.[19] As a well-regarded financial journalist put it, "Wall Street is bleeding savers dry."[20]

While investment companies began with their own staffs, they are now primarily run by outside firms which serve as their advisers under contracts with the funds' directors. This Article will discuss how this external model functions,[21] how the law has sought to regulate it, and how courts have reacted to allegations that such advisers engage in reprehensible conduct. Such allegations typically involve claims that the advisers have charged excessive and unjustifiable fees[22] or have, with the complicity of their directors, acted in other harmful ways that diminish the value of their funds.[23]

The best way to combat these injurious practices is for shareholders to hold those advisers accountable in litigation. This Article will therefore discuss ways in which this can be done effectively.[24] It will also focus on the potential liability of fund directors who continue to renew the contracts of adviser/managers even as the advisers are breaching the fiduciary duties they owe investors.[25] As a prelude to that discussion, this Article will present relevant background information about the mutual fund industry.

19. *See infra* note 137 and accompanying text. The fees taken from mutual fund investors continue to grow. A report from a few years earlier put them at $88 billion. Jeff Sommer, *Fees on Mutual Funds Fall. Thank Yourself.*, N.Y. TIMES, May 9, 2015, at BU3. The fees on these actively managed funds have been desribed as "one of the great gravy trains in financial history." Landon Thomas, Jr., *Why Are Mutual Fund Fees So High? This Billionaire Knows*, N.Y. TIMES (Dec. 30, 2017), https://www.nytimes.com/2017/12/30/business/why-are-mutual-fund-fees-so-high-this-billionaire-knows.html.

20. Eduardo Porter, *Americans Aren't Saving Enough for Retirement, but One Change Could Help*, N.Y. TIMES (Mar. 3, 2015) *quoted in* WILLIAM A. BIRDTHISTLE, EMPIRE OF FUNDS 50 (2016).

21. *See infra* notes 47–49 and accompanying text.

22. *See infra* notes 124–133 and accompanying text.

23. *See infra* notes 140–146 and accompanying text.

24. *See infra* notes 151–88, 247–48 and accompanying text.

25. *See infra* notes 244–247 and accompanying text.

I. MUTUAL FUNDS AND HOW THEY ROSE TO PROMINENCE

A. *The Size and Scope of the Industry*

The most common type of U.S. mutual fund is the open-end investment company,[26] a firm which exists to hold and trade securities issued by other entities.[27] It funds its operations by daily selling its own shares to the public.[28] If its investors so desire, it must also buy them back at the end of each business day at the net asset value (NAV) of the securities it is then holding.[29] An open-ended investment company therefore expands or contracts daily based on its assets.[30] This immediate redemption feature, a special right of exit, gives investors valuable liquidity. Other investment vehicles like hedge[31]

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26. John Morley, *Collective Branding and the Origins of Investment Fund Regulation,* 6 Va. L. & Bus. Rev. 341, 354 (2012) [hereinafter Morley, *Collective Branding*]. As that author elsewhere states, "Mutual funds are sometimes called 'open-end' funds to distinguish them from 'closed-end' funds." (*See infra* notes 34–35 and accompanying text). John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation,* 123 YALE L.J. 1228, 1235 (2014) [hereinafter Morley, *The Separation of Funds and Managers*]. According to the last report of the Investment Company Institute, open-end funds have $15.6 trillion of the $18.1 trillion currently held by investment companies. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 9.

27. Curtis & Morley, *supra* note 5, at 5.

28. *Id.* at 4.

29. Morley, *Collective Branding, supra* note 26, at 352. The name "open-end" indicates that almost immediate right of exit. Elsewhere that author asserts that such liquidity is a feature of mutual funds which is compatible with investors having little control over those companies. *Id.* at 1233. *See also* BIRDTHISTLE, *supra* note 20, at 26.

30. Since a good bit of the compensation that fund advisers make is based on a percentage of the assets they manage, this gives them substantial incentives to grow the size of their funds. For the problems that may cause fund investors *see infra* notes 121–123 and accompanying text. *See also* Steven Fox, *Your Financial Advisor May Not Be Looking Out for You*, EXPERIENCE, June–July 2017, https://www.americanbar.org/groups/senior_lawyers/ publications/experience/2017/june-july/your-financial-advisor-may-not-be-looking-out-you.html.

31. These are typically structured as unit trusts (*see infra* notes 36–38 and accompanying text) that attempt to achieve large gains by exploiting market anomalies. "These funds are often high-return and are regarded as speculative." *Hedge Fund*, OXFORD DICTIONARY OF FINANCE AND BANKING (4th ed. 2008). They are subject to much less regulation than traditional mutual funds because they only accept contributions from "accredited investors," a

or private equity funds[32] lack this feature, so they are primarily sold only to wealthy individuals or institutions who can take the risk of a long-term illiquid investment.[33]

There are two other types of investment companies, but these are much less prevalent and contain far fewer assets than open-end companies. The first are closed-end funds, which sell shares to the public only once and do not stand ready to repurchase them like open-end firms. Instead, their stockholders can only exit by selling their shares to others in the market.[34] Closed-end funds must also distribute their income to investors every year, which can make them less advantageous than open-end firms in two ways. First, the annual distribution requirement can result in tax consequences for their share-

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term defined under Securities Act Rule 501, 17 C.F.R. § 230.501, to only include individuals with high net worth or annual incomes. Hedge funds allow only limited redemptions (monthly or quarterly), unlike mutual funds which allow investors to withdraw their contributions daily. Morley, *The Separation of Funds and Managers*, *supra* note 26, at 1235.

32. These are investment firms that attempt to "make high returns by (1) obtaining a controlling interest in a target company. . . . (2) subjecting it to radical financial and organizational restructuring . . . . and (3) selling the revitalized company or floating it on the stock exchange." *Private Equity Firm*, OXFORD DICTIONARY OF FINANCE AND BANKING (4th rev. ed. 2008). Private equity firms do not allow their investors to withdraw their contributions. "Instead, they exist for terms of years—usually around five or ten years—after which they wind up by distributing their assets or by selling them and distributing the proceeds." Morley, *The Separation of Funds and Managers*, *supra* note 26, at 1236.

33. *See id.* at 1235.

34. As Professor Morley describes them: "Closed-end funds are similar to mutual funds [open-end funds] in many respects. They are pools of investment securities, they sell interests widely to the public, and they must comply with the ICA [The Investment Company Act, *see infra* note 84 and accompanying text]. The primary difference is that closed-end funds do not allow shareholders to redeem. Rather than redeeming, closed-end fund shareholders dispose of their shares by selling them on stock exchanges, just as they might do with shares of operating companies." *Id.* Elsewhere Professor Morley provides a good description of how closed-end funds dominated the investment industry until the 1929 market crash when many became insolvent—particularly those that were leveraged and traded below their NAVs. By the mid-1930s however open-end funds that redeemed their shares daily at their NAVs became much more attractive to investors and they have come to dominate the industry to this day. *See id.* at 348–54.

holders, and second, such payments will automatically diminish the assets of those funds.[35]

The second alternative to open-end funds is the Unit Investment Trust. It is typically established for a set duration and begins with a portfolio of shares that does not change.[36] Therefore, unlike the other two types of investment companies, it does not require an investment manager.[37] Investors can redeem their shares daily as in an open-end company or wait until the trust terminates and receive their proportionate payouts at that time.[38]

Exchange-Traded Funds (ETFs) should also be included in this group of investment vehicles. These are essentially participations in a basket of stocks traded on an exchange.[39] Their values are therefore based on the shares in a particular index which provide a broad exposure to the market. Like mutual funds,[40] they also offer diversified investment opportunities. ETFs are commonly structured as open-end companies or unit trusts and their shares are typically traded on an exchange.[41] Unlike mutual funds, however, they are not just redeemable at the end of each day, but can be bought or sold at any point in time.[42]

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35. Professor Morley, suggests that this different treatment arose because the mutual fund industry lobbied for it, knowing that it would promote its interests at the expense of closed-end funds. The payments they must make drain resources away and discourage new investments. Open-end funds, by contrast, do not suffer such losses in their assets. In addition, they do not have to deal with the tax disadvantages that result from those required distributions which may scare away new investors. *See id.* at 346.

36. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 20.

37. FRANKEL & BURDON, *supra* note 3, at 15.

38. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 20.

39. *See* BIRDTHISTLE, *supra* note 20, at 179–80. *See also* U.S. SECURITIES AND EXCHANGE COMMISSION, Fast Answers, https://www.sec.gov/answers/etf.htm. Among other things that discusses one type of ETF known as "Spiders" or "SPDR"s which invest in all the stock in the S&P Composite Stock Price Index.

40. *See* Michael Chamberlain, *What's the Difference? Mutual Funds and Exchange Traded Funds Explained,* FORBES, Jul. 18, 2013.

41. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 39.

42. *See* Chamberlain, *supra* note 40. ETFs also have tax advantages over mutual funds. When shareholders redeem their stock from mutual funds they may have to pay capital gains tax. The sale of an ETF by contrast does not result in the sale of the underlying securities so no gain arises. *Id.*

Although ETFs are increasing in popularity,[43] open-end companies continue to comprise the largest portion of the mutual fund industry. At the close of 2015 there were 9,520 of them in the United States compared to 558 closed-end funds, 5,188 unit investment trusts, and 1,594 ETFs.[44] In dollar amounts, open-end companies at that point in time had holdings valued at $15.6 trillion, while closed-end funds, unit investment trusts, and ETFs respectively had assets of $261 billion, $94 billion, and $2.1 trillion.[45] Since open-end firms thus comprise the lion's share of the investment company market, this Article will focus on them and refer to them synonymously as "mutual funds."[46]

Although there are thousands of U.S. mutual funds, many of them have the same financial service company as their common sponsor. They are therefore usually referred to as complexes or families of funds.[47] Some of those fund advisers run other operations as well, such as insurance, banking, and brokerage operations.[48] Seventy-nine percent of the complexes, however, are run by independent fund advisers that operate no other businesses, and those firms manage 67% of all the money held by investment companies.[49]

In fact, five fund families hold 45% of all mutual fund assets,[50] and two of the largest— Fidelity and Vanguard—are so well known that they are household names.[51] Additionally, the industry is highly concentrated, with the 25 largest complexes controlling 75% of the assets held by all U.S. mutual funds.[52]

These families typically offer a variety of funds that provide diverse investment opportunities. Overall, equities (i.e. long-term investments in U.S. corporations) comprise the ma-

43. At the end of 2015 there was double the number of ETFs than at the same time in 2009. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 22.

44. *Id.*

45. *Id.* at 9.

46. *See* Chamberlain, *supra* note 40.

47. Morley, *The Separation of Funds and Managers*, *supra* note 26, at 1239.

48. *Id.* at 1238.

49. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 15.

50. *Id.* at 17.

51. Their gigantic size gives them that status. For instance, the Vanguard Total Stock Market Index Fund holds stock in more than 3,700 companies and is valued at $350 billion. BIRDTHISTLE, *supra* note 20, at 25.

52. INVESTMENT COMPANY INSTITUTE, *supra* note 7, at 17.

jority (56%) of their assets.[53] In fact, mutual funds hold 25–26% of the outstanding stock in U.S. companies.[54] Bonds, money-market and commodity investments make up most of their remaining assets.[55]

Importantly, 22% of the assets of U.S. households are invested in mutual funds,[56] a percentage that has been steadily increasing over the last thirty years. A large portion of U.S. household savings are held in 401(k)s, IRAs, and other retirement accounts.[57] Since 80 million baby boomers are expected to retire over the next two decades at a rate of 10,000 per day,[58] Americans will become even more dependent on mutual funds for their livelihood in the years to come.

Many of these retirees will be living longer, since the life expectancy in this country has increased by more than a decade over the last 25 years.[59] Yet, it looks like many of those seniors will have only meager resources on which to live during their elongated life spans. The average monthly social security benefit for a retired person is just $1,259[60] and workers today between the ages of 55 and 64 shockingly have a median balance of only $111,000 in their personal retirement accounts.[61]

53. *Id.* at 8.

54. *Id.* at 14.

55. *Id.* at 8.

56. *Id.* at 11.

57. *Id.* at 12. *See also* PETERSON, *supra* note 17, at 3. For a good discussion of the decline of pensions formerly provided by companies to their employees and the rise of these self-funded retirement programs to take their place, *see* BIRDTHISTLE, *supra* note 20, at 1–11.

58. BIRDTHISTLE, *supra* note 20, at 7. Boomers hold roughly $10 trillion in these tax-deferred savings accounts. Vipal Monga & Sarah Krouse, *Pulling Retirement Cash, but Not by Choice,* WALL ST. J. (Jan. 16, 2017), https://www.wsj.com/articles/pulling-retirement-cash-but-not-by-choice-1484568043. According to consumer reports, an average two-income couple will pay more than $150,000 in fees on their 401(k) plans during their lifetimes. Tobie Stranger, *Be a Gold Medal Winner When It Comes To Your Personal Finances,* CONSUMER REPORTS (Aug. 6 2016), https://www.consumerreports.org/personal-finance/be-gold-medal-winner-when-it-comes-to-personal-finances/.

59. BIRDTHISTLE, *supra* note 20, at 7. *See also* Monga & Krouse, *supra* note 58.

60. SOC. SEC. ADMIN., MONTHLY STATISTICAL SNAPSHOT, SEPT. 2017 https://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/.

61. BIRDTHISTLE, *supra* note 20, at 11.

B. *The Origins and Growth of Mutual Fund*

Mutual funds were invented by Dutch merchants in the late 1770s,[62] and grew to prominence in the next century when English and Scottish investment trusts began offering to the public shares of stock in companies which owned shares in other firms.[63] Those investments were attractive to investors because they promised small savers expertly managed broad holdings.[64] The idea soon caught on in the United States, where its spread was fueled by the rapid economic growth and frequent stock issuances that occurred during the late 1800s.[65] The first American investment companies took the form of closed-end funds, which gave individuals with limited resources a way to participate in those offerings while ostensibly affording them the advisory services of investment professionals as well.[66]

In 1924 the first American open-end fund, the Massachusetts Investment Trust, was created.[67] It was structured as a business trust[68] under Massachusetts state law and was run by its own trustees and staff.[69] Closed-end firms continued to dominate during the boom years of the late 1920s,[70] when public

62. PETERSON, *supra* note 17, at 2.

63. *Id.*

64. FRANKEL & BURDON, *supra* note 3, at 10.

65. *Id.* at 8.

66. *Id.* Morley, *Collective Branding*, *supra* note 26, at 350–54, describes how closed-end funds boomed from then until the Great Crash of 1929 and were eclipsed by mutual funds in the 1930s.

67. PETERSON, *supra* note 17, at 3.

68. This is an unincorporated business organization created by an instrument of trust empowering trustees to hold and manage property by trust for the benefit of those who hold beneficial interests in the trust estate. As a recent case stated: "One of the significant features that distinguishes a Massachusetts trust from the ordinary or private trust 'lies in the manner in which the trust relationship is created; investors in a business trust enter into a voluntary, consensual and contractual relationship, whereas the beneficiaries of a traditional private trust take their interests by gift from the donor or settlor.'" Northstar Financial Advisors v. Schwab Investments, 779 F.3d 1036, 1040 (9th Cir. 2015) (citation omitted). As that case found, "[s]uch a trust today is a preferred form of organization for mutual funds and asset securitizations." *Id.* at 1040 (citation omitted).

69. PETERSON, *supra* note 17, at 3.

70. Morley, *Collective Branding*, *supra* note 26, at 350–54.

investors became enthusiastic about investment companies and the supposed "financial genius" of their management.[71]

These companies were originally structured as "trusts" with the understanding that their management was subject to fiduciary duties. That notion, however, soon gave way to a new arrangement, the "investment corporation," which allowed its operators to run things under a more pliant legal regime.[72] Those firms were set up not to be run by their own internal managers, but by external operating companies whose primary loyalties lay with their owners.[73] That bifurcation of ownership and management increased the potential for conflicts of interests and self-dealing.[74]

The market crash of 1929 hit investor funds hard, with holders of shares in those firms witnessing their capital contribution diminished by 90%.[75] A study by the Securities and Exchange Commission (the "SEC" or the "Commission") made several years later found that those losses were caused not only "by the decline in security value," but also by "unscrupulous mismanagement" made possible because many of those companies had their assets in cash and marketable securities which could easily be "looted."[76] Such improvident and fraudulent practices caused shareholders in investment companies to lose more than $1 billion by the early 1930s[77]—an incredibly large sum at that time.

II.
FEDERAL REGULATION OF FUNDS

A. *The Great Reforms of the 1930s*

The stock market crash of 1929 and the ensuing Great Depression provided the impetus for national financial regula-

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71. FRANKEL & BURDON, *supra* note 3, at 11 (quoting JOHN KENNETH GALBRAITH, THE GREAT CRASH, 1929, 46–55 (1988)).

72. *Id.* at 10.

73. *Id,* at 11. PETERSON, *supra* note 17, at 3.

74. PETERSON, *supra* note 17, at 3.

75. FRANKEL & BURDON, *supra* note 3, at 12.

76. Remarks of Commissioner Robert E Healey, Securities and Exchange Commission, *Investment Trust Study, Investment Company Act of 1940 and Investment Advisers Act of 1940, H.R. Rep. No. 76-2639.*

77. William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?,* 57 N.Y.U. L. REV. 1059, 1068 (1982).

tion.[78] President Franklin Roosevelt was swept into office in 1932 promising wide-scale reforms of investment firms that he claimed had betrayed their "sacred trust."[79] As part of FDR's famed "100 days" of legislation, Congress passed the Securities Act of 1933 (the "Securities Act")[80] which brought significant changes to the way securities were bought and sold.[81] The Act requires that, absent an exemption, all offers and sales of securities be registered[82] with a federal agency, the SEC.[83] Shares in mutual funds offered to the public are included in that mandate and such funds must therefore file a registration statement that makes full disclosure of all relevant information about their offerings.[84]

The next year, Congress passed a companion piece of legislation to expand its reform of the financial industry, the Securities and Exchange Act of 1934 (the "Exchange Act").[85] The Exchange Act is designed to regulate the trading of securities and the markets where such trading occurs.[86] As part of that process, all companies whose shares are held by the public

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78. LOUIS LOSS AND JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 28 (4th ed. 2001).

79. President Franklin D. Roosevelt, First Inaugural Address, (Mar. 4, 1933).

80. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012).

81. *See generally,* James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

82. The relevant provisions are contained in Section 5 of the Securities Act of 1933. 15 U.S.C. § 77e (2012).

83. The SEC was created by Section 4 of the Securities Exchange Act of 1934. 15 U.S.C. §78d (2012). It is an independent federal regulatory agency. For more on the SEC and its mission, see *What We Do*, U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/about/whatwedo.shtml (last visited Sept. 29, 2017).

84. *See* U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 83.
The Investment Company Act of 1940, (ICA), 15 U.S.C. §§ 80a-1-80a-64 (2012), mandates this requirement. While requiring a separate registration for those firms, it includes provisions allowing certain information and documents already filed in a Securities Act registration to be part of an ICA registration statement or for certain parts of it to be filed in lieu of an ICA registration statement. 15 U.S.C. §§ 80a-8(b)(5), 80a-8(c)(1) (2012).

85. 15 U.S.C. §§ 78a–78mm.

86. *See generally,* U.S. SECURITIES AND EXCHANGE COMMISSION, *supra* note 83.

must publicly file extensive periodic reports about their operations.[87] Those requirements likewise apply to mutual funds.[88]

B. *The Two '40 Acts*

Yet it soon became apparent that those two cornerstone laws of securities regulation (which have disclosure as their fundamental purpose[89]) would not be enough to protect investors in mutual funds from the unfairness produced by mutual funds' structures.[90] Examples of such unfairness include self-dealing and breaches of fiduciary duties by insiders, as well as embezzlement and other deceptive practices specific to these actors.[91]

Congress therefore gave the SEC a mandate to study the industry and propose additional reforms.[92] The Commission followed up with a report[93] which found that the national interest required further legislation geared particularly toward mutual funds. It would require that a fund present complete information about the nature of its investments and mandate that its operators and affiliates put the concerns of investors ahead of their own. The SEC's report also found that federal policy should limit concentrations of power in investment companies and prohibit them from engaging in discriminatory practices and excessive borrowing. It also determined that legislation was needed to ensure that investment companies be adequately capitalized and keep accurate books and records.[94]

87. Sections 12(b) and 12(g) of the Exchange Act, 15 U.S.C. §§ 78l(b), (g) mandate that public companies register with the SEC and bring into play requirements under Section 13(a), 15 U.S.C. § 78(o) that companies so registered file various period reports with the Commission. Among those are annual, quarterly and current reports.

88. As is the case with information and documents filed in Securities Act registration statements, *see supra* note 84, the Investment Company Act (ICA) includes provisions allowing that materials filed under the Exchange Act be part of an ICA registration statement, Investment Company Act §§ 8(b)(5), (c)(1). For those separate registration requirements under the ICA see *What We Do*, *infra* note 83 and accompanying text.

89. Knickle, *supra* note 18, at 783–84.

90. FRANKEL & BURDON, *supra* note 3, at 12.

91. Knickle, *supra* note 18, at 781.

92. FRANKEL & BURDON, *supra* note 3, at 11.

93. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966).

94. *See supra* note 80 and accompanying text; FRANKEL & BURDON, *supra* note 3, at 12–14.

The Commission's study led to the enactment of two additional pieces of legislation in 1940—The Investment Company Act[95] (the "ICA") and the Investment Advisers Act (the "IAA").[96] The ICA and the IAA are designed to address issues unique to those firms. The ICA set up a legal framework for the federal regulation of mutual funds that responded to the SEC's concerns. Chief among its reforms is a requirement that investment companies register with the Commission.[97]

Among other things, the registration has to include general information about the company, along with certified financial statements. Those disclosures must be updated each year in an annual report.[98] The ICA also mandates that funds provide their shareholders with full information about all aspects of their investments and comply with particular rules of operation which, among other things, are designed to prevent fund distributors from charging large commissions.[99]

To further its reform of investment companies, Congress enacted the IAA as a companion piece of legislation. It federally regulates those who receive compensation for giving investment advice, including those who publish information for that purpose. Its goal is to prevent harmful activity by which advisers enrich themselves at the expense of their clients.[100]

For the first twenty years of its existence, however, the IAA only required that investment advisers register with the Commission, which one commentator derided as "little more than a census of investment advisers."[101] Since that time it has been amended to add specific substantive provisions[102] to protect the public from fraudulent practices such as scalping, where an adviser purchases a security herself before urging the public to buy it and then sells the security at the higher price resulting from her recommendation.[103]

95. *See supra* note 88 and accompanying text.
96. Investment Advisers Act, 15 U.S.C. §§ 80b-1 to -21.
97. Investment Company Act § 8; *see supra* notes 98, 99 and accompanying text.
98. Knickle, *supra* note 18, at 784.
99. PETERSON, *supra* note 17, at 3.
100. FRANKEL & BURDON, *supra* note 3, at 33.
101. *Id.*
102. *Id.*
103. Sec. Exch, Comm'n v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181 (1963).

In addition, the IAA gained importance as investment companies came to be run more and more by the external managers who set them up.[104] In that process the external managers appoint directors for their funds and then receive their authority to operate them from contracts which they enter into with those very same directors. That conflicted situation was formally recognized by Congress in 1970, when it amended the IAA to make it specifically applicable to advisers of investment companies.[105]

C. *New Concerns During the Post-War Stock Surge*

As confidence in the stock market returned in the post-World War II era, mutual funds grew in popularity. With the generalized prosperity that was in full swing by the 1960s, they saw prodigious increases in their assets.[106] Questions then arose, however, about whether investors were getting a fair shake, since funds were coming to be controlled more and more by their advisers in what one commentator called a relationship of "business incest."[107]

Responding to that concern, the Wharton School of Business published an influential study on the growth of the mutual fund industry, and found that its inbred management structure led to excessive fees for retail investors.[108] While institutional clients could bargain to reduce those charges, the ordinary, individual shareholder lacked that negotiating power and was stuck with higher costs.[109]

The SEC then built on the Wharton study and issued its own report in 1966 about the lack of any meaningful competi-

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104. *See supra,* notes 73-74, and accompanying text.

105. FRANKEL & BURDON, *supra* note 3, at 64.

106. H. Norman Knickle, *The Mutual Fund's Section 15(c) Process: Jones v. Harris, The SEC and Fiduciary Duties of Directors,* 31. REV. OF BANKING AND FIN. L. 265, 268 (2011–12).

107. Note, *The Mutual Fund and its Management Company, An Analysis of Business Incest,* 71 YALE L.J. 137 (1961). John C. Bogle, the founder of the Vanguard family of funds, used the same language in his testimony before the Fitzgerald committee to describe the relationship between mutual fund directors and their investment advisers. *See supra* note 2 and accompanying text.

108. H.R. Rep. No. 87-2274 (1962). *See also,* D. Bruce Johnsen, *Myths about Mutual Fund Fees: Economic Insights on Jones v. Harris,* 35 J. CORP. L. 561 (2010).

109. Knickle, *supra* note 106, at 268.

tion in awarding contracts to advisers and controlling their fees. It found that fund directors, even independent ones, were powerless to meaningfully negotiate those arrangements. One reason for that was their part-time status. As outsiders, they had to rely on their colleagues who were affiliated with the company for information about fund policies and appropriate fees.[110]

Even more troubling to the SEC, however, was that advisers had become so imbedded in the operation of their funds that their removal, or even the *threat* of their termination, was virtually impossible.[111] Compounding that problem of accountability, the case law had, in the words of one commentator, "all but immunized" directors for their decisions to renew their advisers' contracts and approve their fees.[112]

To that end, a leading case found that such charges could not be excessive if they were disclosed, ratified by shareholders, and in line with industry averages.[113] That ruling seemed consistent with statutory history, which required that plaintiffs challenging such compensation show that it was wasteful.[114] In addition, the case went on to say that a finding of excessive fees could only be made if the adviser's services "were of such inadequate value that no person of ordinary judgment . . . would deem them worth what the mutual fund paid."[115]

D. *The 1970 Amendments*

The SEC thus urged Congress to amend the '40 Acts to mandate that adviser fees be "reasonable." Mutual fund companies opposed the SEC, claiming that such language would authorize the courts to set fees.[116] In an apparent response to mutual fund lobbying, Congress avoided using that term. It decided instead to impose strict duties on directors in their

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110. *See supra* note 93.
111. *Id.* at 148.
112. Cynthia L. Kahn, Note, *Direct not Derivative: Recovering Excessive Investment Advisor Fees in Mutual Funds,* 71 GEO. L.J. 1595, 1609, n. 84 (1983).
113. Saxe v. Brady, 184 A.2d 602, 612 (Del. Ch. 1962).
114. S. REP. NO. 91-184, at 4901 (1969).
115. Colin B. Davis, *Nudging Mutual Fund Fees Downward: Using Default Rules to Combat Excessive Advisory Fees,* 47 SAN DIEGO L. REV. 185, 204 (2010) (citing Saxe v. Brady, 184 A.2d 602, 611 (Del. Ch. 1962)).
116. Knickle, *supra* note 106, at 269.

approval of contracts and fees with the funds' advisers[117]—a distinction that a leading Court called "more semantical than substantive."[118] Congress did note, however, that the new legislation would abrogate the "waste" standard because it was "unduly restrictive."[119]

In its 1970 amendments Congress also added requirements that would ostensibly facilitate the exercise of those duties by fund directors—a mandate that the directors be furnished material information on the fee issue[120] and that they evaluate it appropriately, meeting in person annually to do so.[121] In addition, Congress imposed a fiduciary duty on the adviser itself "with respect to the receipt of compensation for [its] services"[122] and specifically authorized the SEC to bring enforcement actions for any breaches of fiduciary duty by individuals connected with an investment company.[123] For good

117. Section 15(c) of the ICA provides in part: "It shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of, or principal underwriter for, such company, unless the terms of such contract or agreement and any renewal thereof have been approved by a vote of a majority of directors . . . cast in person at a meeting called for the purpose of voting on such approval."

118. Gartenberg v. Merrill Lynch Asset Mgmt. Inc., 694 F.2d 923, 928 (2d Cir. 1982).

119. S. Rep. No. 91-184, at 5 (1969).

120. Section 15(c) of the ICA provides in part: "It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

121. *See* Knickle *supra* note 106, at 270.

122. Section 36(b) of the ICA provides: "For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser."

123. Section 36(a) of the ICA provides: "The Commission is authorized to bring an action. . .alleging that a person. . .serving or acting [as an adviser, depositor, or principal underwriter] has engaged. . .or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company."
The language about "personal misconduct" here has led most courts to require a showing of fraud or self-dealing in these actions. *See* William K. Sjos-

measure, it also created another right of action in favor of the SEC or any shareholder to redress breaches of fiduciary duty by an investment adviser in its receipt of compensation.[124]

III.
EXCESSIVE FEES AFTER THE 1970 AMENDMENTS

A. *The* Gartenberg *Precedent*

The 1970 amendments thus put the problem of excessive fees front and center and furnished an express remedy that could be sought by either the SEC or private investors. Aggrieved shareholders responded with a number of suits alleging just that, and many of them were successful, producing settlements that avoided trials on the merits.[125] That favorable trend, however, was cut short in 1982 by a major decision from the U.S. Court of Appeals for the 2nd Circuit: *Gartenberg v. Merrill Lynch*.[126]

The plaintiffs in that case were shareholders in a large money market fund affiliated with a major brokerage house. They alleged that the fund's manager, Merrill Lynch, had breached its fiduciary duties by charging excessive fees based on a percentage of the fund's net assets. The net assets had grown substantially during the previous decade when new money came into the fund because the returns it offered increased as interest rates rose. The end result of such an enlargement of the fund's assets was therefore more revenue for Merrill Lynch, the advising manager.

The fund's independent trustees had correspondingly negotiated a reduction in its adviser's compensation rate. The shareholders alleged, however, that since the fund was a captive of its manager, its fees were too high. To support that contention they pointed to Merrill Lynch's massive bargaining power and other indirect remuneration it received, such as the

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trom, Jr., *Tapping the Reservoir: Mutual Fund Litigation Under Section 36(A) (sic) of the Investment Company Act of 1940*, 54 U. KAN. L. REV. 251 (2005).

124. Section 36(b) of the ICA. Directors of the fund are included here as potential defendants in these suits by a reference in this subsection to their listing in Section 36(a).
Unlike the preceding subpart, this provision does not require a showing of "personal misconduct" for liability. ICA Section 36(b)(1).

125. Knickle, *supra* note 18, at 310.

126. Gartenberg v. Merrill Lynch Asset Management, Inc. 694 F.2d 923 (2nd Cir. 1982).

likelihood that fund shareholders would open other accounts with Merrill Lynch's brokers.

The lower court held that the adviser could breach its fiduciary duty if its fees were unfair to the fund and its shareholders. That in turn depended on assessing factors like the nature and extent of the services the advising manager offered and the fees charged by advisers to other money market funds.[127] After conducting that inquiry, however, the District Court found that the relationship of Merrill Lynch to the fund's shareholders was not unfair and dismissed the action.

The Appellate Court affirmed, but used a different standard of review. It started out by holding that a test of "reasonableness," not "fairness," should be used to determine whether an adviser's fees were excessive. In addition, it recognized that "a mutual fund cannot as a practical matter sever its relationship with the adviser" and therefore "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."[128] It therefore disagreed with the District Court's ruling that the fees charged by similar advisers should be relevant. Such findings, said the Appellate Court, would not necessarily support an inference that competition existed "between adviser-managers for fund business."[129]

Yet despite such comments expressing skepticism about the reasonableness of adviser fees, the panel went on to set what has been called a "notorious" standard for recovery in an excessive fees case.[130] "The adviser manager must charge a fee that is *so disproportionately large* that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[131] (*Emphasis added*). That language appeared to set a high bar for a shareholder to meet in order to prevail.

In what seemed to be an afterthought, however, the *Gartenberg* court went on to list six non-exclusive considerations that would have a bearing on whether or not a fee is excessive. Those included the quality of the services provided,

127. *Id.* at 927.
128. *Id.* at 928.
129. *Id.* at 929.
130. Knickle, *supra* note 106, at 273.
131. Gartenberg, 649 F.2d at 923.

the profitability of the adviser including its collateral benefits, the independence and expertise of the fund's board, and strangely, a comparison to the fee structures of other funds.[132] That last point appeared to belie the Court's earlier suspicion of that factor as an appropriate concern, particularly when the panel had acknowledged that the reality of "arm's-length" bargaining over an adviser's fees was problematic.[133]

Gartenberg's six factor test appeared to create legitimate criteria that a shareholder could use to challenge a fund's fee structure. Yet the damage was done by the court's "disproportionately large" language, which was set up as the ultimate requirement for a shareholder to recover. After *Gartenberg* it therefore became quite difficult for shareholders to prevail in excessive fee cases.[134]

Concerns about wrongdoing in mutual funds, however, did not subside. The SEC focused on Section 15(c) of the ICA, which detailed the process that fund directors must follow in their annual review of the investment adviser's contract.[135] It re-enforced them in a 2004 rule requiring that the annual reports filed by funds discuss the factors that their directors consider in approving advisers' contracts.[136] Issues also arose in several post-*Gartenberg* decisions about whether the business judgment rule would automatically protect fund directors from any liability arising from those deliberations.[137]

B. *The Impact of the Market-Timing and Late-Trading Scandals*

Even more significant, however, were the market-timing and late-trading scandals that erupted in the early years of the last decade.[138] Up until then, the mutual fund industry en-

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132. *Id.* at 930.

133. *See supra* note 131 and accompanying text.

134. Jones v. Harris Assocs. L.P., 537 F.3d 728 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc) (per curiam). *See also* Knickle, *supra* note 106, at 276. A law review article written in 2007 reported that "in the twenty-five years since *Gartenberg,* no plaintiff ever has obtained a reported judgment under Section 36(b)." Lyman Johnson, *A Fresh Look at Director 'Independence': Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 500 (2007).

135. Knickle, *supra* note 106, at 294–95.

136. Investment Company Act Release No. IC-26486 (June 23, 2004) (amending Form N-1A).

137. Knickle, *supra* note 106, at 304–07.

138. *See generally* Knickle, *supra* note 18, at 798–805.

joyed a reputation for honesty due to the clean record it had seemed to compile due to the integrity of its operations.[139] All of that ended when 160 brokerage firms were investigated for illegal market-timing and late-trading practices. Stiff sanctions ensued, including fines and prison terms for fund executives and traders.[140]

Such wrongdoing was widespread and had been occurring for some time, giving those who were gaming the system an unfair advantage over the long-term shareholders of a fund. The possibility for such illegal activities arose because the execution price for transactions in mutual funds during any trading day is set at 4:00 pm when the market closes. Purchases or sales after that time are supposed to be made at the price existing at 4:00 pm the following day, but late traders were allowed to have their orders executed at the earlier closing price before the market opened the next day. They therefore had knowledge of subsequent events that might affect the share's price, unfairly benefitting them in the same way as someone who is permitted to "[bet] on a horse race after the race has been run."[141]

For instance, suppose that after the trading day ends, good news is announced which will favorably impact the market when it opens the next day. Someone who can then purchase stock at its earlier price will dishonestly profit because other shareholders will have to pay a higher price when they buy. This "late trading" is also called "forward trading" and is specifically made illegal by the ICA.[142]

"Market timing," a strategy in which an investor trades back and forth to take advantage of short term fluctuations in share prices, is not illegal in and of itself. Its success, however, is highly questionable and mutual fund prospectuses typically state that they restrict it because it usually increases a fund's administrative expenses, thereby harming all of its investors.[143]

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139. PETERSON, *supra* note 17, at 4; *see also* BIRDTHISTLE, *supra* note 20, at 10.

140. PETERSON, *supra* note 17, at 7; BIRDTHISTLE, *supra* note 20, at 11 ("Twenty of the country's oldest and most renowned fund complexes paid out unprecedented settlements to government regulators.").

141. PETERSON, *supra* note 17, at 7 (quoting New York Attorney General Eliot Spitzer).

142. Investment Company Act Rule, 17 C.F.R. § 270.22-c-1 (2016).

143. PETERSON, *supra* note 17, at 8–9.

Some funds, however, violated their own representations in their prospectuses by allowing privileged customers to trade more frequently than permitted. In addition, some managers also alerted favored clients when the fund was planning to make a large trade in a particular stock. That gave them inside information which could be used to procure an unfair advantage in their trades.[144]

C. *The Fitzgerald Hearings*

The late-trading and market-timing scandals propelled a one-term Republican Senator, Patrick Fitzgerald, to call hearings to explore a host of concerns in the mutual fund industry. Experts agreed that those illegal practices were prohibited by existing laws. Senator Fitzgerald, however, wanted to investigate what he called "the full panoply of mutual fund fees and other abusive practices"[145] that he said were "eating away at the savings of many Americans."[146]

During the hearings, other senators and witnesses helped Fitzgerald substantiate his case by exposing various hidden arrangements that funds had with the brokerage houses which sold their shares.[147] They also called into question the accuracy of expense ratios published by funds because they excluded other fees and costs paid by investors.[148] Most importantly, they charged that the compensation arrangements for funds, which all came out of investor contributions, were hidden from investors and were exacerbated by the inherently conflicted way those companies were organized.[149]

Although the Fitzgerald Hearings did not produce any new legislation, they did highlight serious problems in the mutual fund industry, and thus may have provided the impetus

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144. BIRDTHISTLE, *supra* note 20, at 11.

145. Oversight Hearing on Mutual Funds, *supra* note 2, at 2. Senator Fitzgerald said the market timing and late trading scandals were "a blessing in disguise" because "[t]he growth of the mutual fund industry has been so rapid during the past 20 years that the industry has managed to escape the thorough review and oversight that it merits." *Id.*

146. Fitzgerald, *supra* note 2, at 3.

147. One of Senator Fitzgerald's key witnesses was John C. Bogle, the founder of the Vanguard family of funds who testified about the exorbitant fees charged investors in those investments. *See supra* notes 107 and accompanying text.

148. Oversight Hearing on Mutual Funds, *supra* note 2, at 2–3.

149. Oversight Hearing on Mutual Funds, *supra* note 2, at 15.

for another round of litigation revolving around new claims about how fund officials were breaching their fiduciary duties. What ultimately became the most prominent of those cases, *Harris v. Jones,*[150] just happened to be filed in federal court in Illinois, the state Senator Fitzgerald represented.

D. Harris v. Jones

The plaintiffs in this action were shareholders in three different mutual funds managed by Harris Associates, LP, their investment adviser. They alleged that Harris was breaching its fiduciary duties by charging the funds that it organized and controlled (the so-called "captive-funds") much more than the ones it merely managed for non-affiliated entities. A panel of the U.S. Court of Appeals for the 7th Circuit dismissed the action, refusing to accept that the structure of the captive funds inherently suppressed competition and thus resulted in higher fees for investors. If that were so, held Judge Frank Easterbrook, a noted law-and-economics scholar, those high prices would drive investors away.[151]

The panel for which Judge Easterbrook wrote then extended that logic to reject the *Gartenberg* test altogether.[152] That precedent allowed courts to find breaches of fiduciary duties whenever fund fees were so "disproportionately large" that they were excessive. Instead, Easterbrook declared, the statute's touchstone of unreasonable compensation should be interpreted as only requiring full disclosure of all fee arrangements.

With that, competition in the market would supposedly make sure that all manager compensation was reasonable.[153] Judge Easterbrook therefore stated his new test succinctly. A

150. *See* Jones v. Harris Assocs., 559 U.S. 335 (2010).
151. Jones v. Harris Assoc., 527 F.3d 627, 633 (7th Cir. 2008).
152. *Id.* at 632.
153. For an article written in support of Judge Easterbrook's position, *see* D. Bruce Johnsen, *Myths about Mutual Fun Fees: Economic Insights on Jones v. Harris,* 35 J. CORP. L. 561 (2010) (arguing, among other things, that fees are irrelevant to rational investors and that lower advisory fees will not increase investor returns). *See also* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy,* 33 J. CORP. L. 151 (2007) (finding competition in the mutual fund industry). One of the authors' reasons for that assertion is that shareholders have easy rights of exit because they are allowed to freely redeem their shares. *Id.*

fund must only "make full disclosure and play no tricks."[154] As an apparent afterthought, however, Easterbrook conceded that the amount of an adviser's compensation might be relevant if it is so high that it could only have been gotten by deceit.[155]

Judge Easterbrook's judicial colleague and fellow law-and-economics specialist Richard Posner, however, wrote a *per curiam* opinion arguing unsuccessfully that Easterbrook's views were wrong and that the case should therefore be reargued *en banc* before the full Court.[156] He began his critique with an apt analogy to the "feeble incentives" of corporate boards to rein in ever-larger executive compensation paid to their executives.[157] Drawing from that, Posner then pointed to numerous reports and studies showing that abuses in compensation had become "rampant" in the financial services industry.[158]

Thus competitive pressures, argued Posner, could not be relied upon to check excessive fees for mutual fund managers any more than they could when directors who are beholden to CEOs set their CEO's pay. Fund trustees are likewise compromised in that they are prone to favoring the investment advisers who have appointed them to their lucrative positions. While fees paid to managers by independent funds are likely to be the product of arm's-length negotiation, those from captive funds, Posner concluded, are not.[159]

Since other Appellate Circuits followed *Gartenberg,* the Easterbrook ruling from the 7th Circuit split from that consensus. The Supreme Court therefore took the case and reversed. While endorsing the *Gartenberg* standard, however, the Supreme Court's opinion seemed to indicate a more welcoming attitude toward Section 36(b) suits. It accepted *Gartenberg's* deference to directors' actions but also recognized shareholder suits as an "independent mechanism for controlling conflicts."[160] It drew two inferences from that: "First, a measure of deference to a board's judgment may be appropriate in some

154. Jones, 527 F.3d at 632.
155. *Id.*
156. Jones v. Harris Assocs., 537 F.3d 728 (7th Cir. 2008).
157. *Id.* at 730.
158. *Id.*
159. *Id.* at 731-32.
160. Jones v. Harris Assocs., 559 U.S. 335, 348 (2010).

instances. Second, the appropriate measure of deference varies depending on the circumstances."[161]

Much of the remainder of the Supreme Court's opinion was given over to the justifiable differences in the fees that an adviser might charge its captive and independent clients. The Court made no outright ruling on that, but instead said (with some vagueness) that it would give such distinctions the weight that they merit while avoiding "inapt comparison."[162] The Court concluded its analysis by discussing the importance that process and disclosure play in those decisions. In other words, the question of excessive fees cannot, in the Court's thinking, be divorced from an inquiry into the deliberative process that directors use to determine them.

E. *The* Janus *Case*

Yet just a year after the Supreme Court cracked the door open for excessive fees suits in *Harris*, the Court shut it on another action that investment company shareholders might bring to redress wrongdoing by those running their funds. The case, *Janus Capital Group, Inc. v. First Derivative Traders*[163] arose out of the market timing scandals discussed previously. The plaintiffs were shareholders of Janus Capital Group, a public company, which had set up a number of funds which it ran through a wholly-owned subsidiary, Janus Capital Management, which acted as the investment adviser of the funds. That firm drafted prospectuses for various funds in the family which all stated that they would not allow market timing.

An investigation by the Attorney General of New York, however, revealed that market timing had in fact occurred. When that became known, investors started withdrawing substantial amounts from the Janus funds. Because the fees of the adviser were based on the amount of assets it managed, its income fell. That negatively impacted its parent's revenue as well by causing its share price to decline. When the shareholders saw the value of their stock drop they sued both the parent and its subsidiary (the adviser), under Securities Exchange Act

161. *Id.* at 349.
162. *Id.* at 350.
163. *See* Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135 (2011).

Rule 10-b-5,[164] which provides an implied cause of action against those who "make" false statements in the purchase or sale of securities. The shareholders thus alleged that their losses were caused by the adviser because it made materially false statements in the prospectuses of the funds which it drafted.

Since the adviser concededly controlled the funds and actually wrote their prospectuses, it seemed only logical to attribute the misstatements to it. However, in a 5-4 decision written by Justice Clarence Thomas, the Supreme Court adopted a narrow meaning of the verb "make." It disregarded what the plaintiff called "the well-recognized and uniquely close relationship of an adviser to its funds"[165] and held that the only entities under that subsection that could "make" a false statement were the funds themselves, since they alone were ultimately responsible for the questionable pronouncements.[166]

The adviser and others who might have drafted the false prospectus, said the Court, were akin to "speech-writers" since they did not have formal control over the content of the statement and whether and how to communicate it.[167] Since that literalistic distinction was the basis of its opinion, it didn't matter to the Court that employees of the adviser drafted the false language about market timing and disseminated the prospectuses through the parent company's website.

Because the misstatements appeared in the prospectuses of the funds, reasoned Justice Thomas, only the funds had "made" them, and the suit against the adviser and its parent was therefore dismissed. One of the foremost linguistic philosophers of the 20th century, Ludwig Wittgenstein, famously stated, "Philosophy is a battle against the bewitchment of our

164. Exchange Act Rule 10b-5(b), 17 C.F.R. 240.10b-5(b) provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. . . ." *See* 17 C.F.R. 240.10b-5(b)

165. Janus Capital Group, Inc. v. First Derivative Traders, 564 U.S. 135, 145 (2011). As Justice Breyer noted in dissent, "The relationship between Janus Management and the Fund could hardly have been closer." *Id.* at 161 (Breyer, J., dissenting).

166. *See id.* at 142.

167. *See id* at 143.

intelligence by means of language."[168] Perhaps the same could be said of Justice Thomas's opinion in *Janus*.

F. Northstar

Fund investors charging wrongdoing by advisers have recently fared better under an alternative theory—one borrowed from common law contracts. The opinion, *Northstar Financial Advisors v. Schwab Investments*,[169] keyed in on a provision in the ICA that requires a mutual fund to recite all its investment policies in its registration statement, which can only be changed by a shareholder vote.[170]

Based on this requirement, the plaintiff, a financial planning firm that manages accounts on behalf of its clients, filed suit against a Schwab-sponsored mutual fund, alleging that it had deviated from its stated investment policies. The plaintiff claimed that by doing so, the fund's trustees breached both their contracts and their fiduciary duties to their shareholders, exposing these shareholders to tens of millions of dollars in losses.

Specifically, the fund's prospectus stated that it would offer a high amount of current income by tracking the performance of a certain index comprised of government, corporate, and other bonds and that such policy was "fundamental."[171] It also stated that it would not invest more than 25% of its assets in any one industry unless that was necessary to track the index. The Schwab fund nevertheless deviated from that policy, diverting its shareholders' funds into more speculative investments by increasing its holdings in mortgage-backed securities beyond the stated percentage (25%). The deviation ended up causing substantial losses for shareholders.

Northstar alleged that its cause of action arose under contract law. In particular, Northstar argued that promises by the Schwab fund regarding how it would invest its shareholders' money were breached when it did not follow through with those commitments. The shareholders supplied the necessary

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168. LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS 47 (G.E.M. Anscombe trans., Basil Blackwell 3d ed. 1974).

169. *See* Northstar Fin. Advisors, Inc. v. Schwab Invs., 779 F.3d 1036 (9th Cir. 2015).

170. 15 U.S.C. § 80a-8(b)(2).

171. *Northstar*, 779 F.3d at 1041.

consideration to make those promises binding by investing and continuing to invest their money with the fund. The Court upheld Northstar's claim, finding that the fund indeed made those promises in both its registration statement and in the prospectus that it had filed with the SEC. The shareholders therefore had a cause of action in contract when the fund breached those commitments.

In addition to forming a contract between the fund and its shareholders, the Court held that the promises in the prospectus did the same between the trust that ran the fund and the Schwab-sponsored adviser. The trust entered into an agreement with the adviser that committed it to managing the fund with the fundamental investment policies spelled out in the fund's SEC filings. The shareholders of the fund were thus third-party beneficiaries of that contract. As such, the Court held, the shareholders could hold the adviser liable for their losses under that theory as well.

Defendants made arguments that all of the plaintiffs' causes of action, for breaches of both contract and of fiduciary duties, as well as the third-party beneficiary claims, were preempted by the Securities Litigation Uniform Standards Act of 1998 (SLUSA), a statute which bars securities class actions based on state law claims when they involve deceptive statements or conduct.[172] The breach of fiduciary duty claims, however, could survive such preclusion, said the Court, under an exemption for actions that are brought under the law of the state that had organized or chartered the entity issuing the securities. The Court of Appeals then found that the state in question, Massachusetts, did in fact permit such direct fiduciary duty claims.

However, the panel declined to rule on the issue of whether SLUSA preempted any of the claims. Those questions had not been directly addressed by the District Court because it had dismissed all of the Plaintiff's claims on the merits. Since the Court of Appeals was reversing the dismissal, it sent the matter back to the District Court to determine whether they would survive under SLUSA.[173]

Schwab, not unexpectedly, petitioned the Supreme Court for a writ of certiorari. It argued that the common law contract

172. 15 U.S.C. § 78bb(f)(1).
173. *Northstar*, 779 F.3d at 1050.

and other state law causes of action upheld by the Court violated the carefully crafted federal disclosure regime set up by the Investment Company Act and the 1933 and 1934 Securities Acts. That comprehensive scheme, said Schwab, was not designed to create a contractual relationship between a fund and its shareholders, but rather only to apprise those investors of the details of their fund's operations.[174]

The Mutual Fund Directors Forum weighed in with its own amicus brief, which also urged the Supreme Court to take the case and reverse the *Northstar* decision.[175] The Mutual Fund Directors Forum is an organization made up of the self-styled independent members of investment company boards—such individuals would obviously have the most to lose if the standards for fair treatment of mutual fund investors were heightened. In its amicus brief, the Forum therefore made arguments, similar to Schwab's, that claims under state law were precluded by comprehensive federal regulation.

More significantly though, the Forum seemed upset that the Court of Appeals, in approving the common law causes of action, had impugned the status of its members as independent watchdogs for shareholders. What the Forum appeared to find most distressing was the Court's statement that "the definition of 'independent' is fairly loose when it comes to fund board members"[176] and directors could therefore be "puppets"[177] of the adviser. Those remarks by the Court of Appeals, argued the Forum, were in derogation of the self-regulatory scheme that Congress had approved for mutual funds.

Notwithstanding those arguments, the Supreme Court declined to review the Court of Appeal's opinion.[178] When the case came back down to the trial judge, however, she used the SLUSA pre-emption question in two separate rulings to dismiss all the plaintiffs' claims. In the first opinion,[179] the Dis-

174. Petition for Writ of Certiorari, *Northstar*, 779 F.3d 1036 (No. 15-134).
175. *See* Brief of Mutual Fund Directors Forum as Amici Curiae Supporting Petitioners, *Northstar*, 779 F.3d 1036 (No. 15-134).
176. *Northstar*, 779 F.3d at 1061 (quoting John Shipman, *So Who Owns Your Mutual Fund?*, WALL ST. J., May 5, 2003, at R1).
177. *Id.*
178. Northstar Fin. Advisors, Inc. v. Schwab Invs., 779 F.3d 1036 (9th Cir.), *cert. denied*, 136 S. Ct. 240 (2015) (mem).
179. Northstar Fin. Advisors v. Schwab Invs., 135 F. Supp. 3d 1059 (N.D. Cal. 2015).

trict Judge initially held that the Trust itself had no fiduciary duties to its shareholders. She then went on to find that the third-party beneficiary claim for deviation from the fund's objectives was not a "garden variety contract claim."[180] Rather, it involved misrepresentations of the sort that SLUSA precludes from being litigated under state causes of action.

Following that logic, the District Judge then went on to rule out the breach of contract claims themselves because they arose "from the same core allegations."[181] The fund's adviser had "stated [it] would do one thing, but ended up doing another."[182] Those claims, said the Court, constituted "a misrepresentation or omission of material fact."[183]

In the second opinion,[184] the Court used the same SLUSA logic to give the coup de grâce to the plaintiffs' breach of fiduciary duty claim. It distinguished a case, *Freeman Investments., L.P. v. Pacific Life Insurance Co.,*[185] where SLUSA pre-emption did not apply because it "involved a dispute over the meaning of a specific contractual term."[186] *Northstar,* the Court said, was different because it alleged that the adviser promised to manage the fund a certain way but neglected to do so—thus making a misrepresentation. The Court repeated this point a number of times throughout the opinion on the apparent theory that by saying it over and over again it somehow became true.

The case is once again on appeal, and the Court of Appeals will have the opportunity to correct the lower court's understanding that a breach of contract necessarily gives rise to a tort claim. In doing that it should find instructive a Supreme Court case entitled *The Wharf (Holdings) Limited v. United International Holdings, Inc.*[187] There the Supreme Court found that a party to a contract had committed securities fraud, actionable under Rule 10b-5, when it made a promise it never in-

180. *Id.* at 1083–84.
181. *Id.* at 1088.
182. *Id.*
183. *Id.* at 1089.
184. Northstar Fin. Advisors Inc. v. Schwab Invs., No. 08-CV-04119-LHK, 2016 WL 706018 (N.D. Cal. Feb 23, 2016).
185. Freeman Invs., L.P. v. Pac. Life Ins. Co., 704 F.3d. 1110 (9th Cir. 2013).
186. *Northstar*, 2016 WL 706018, at *9.
187. Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001).

tended to keep. The court held that promissory fraud exists when a promisor makes a commitment knowing that she is never going to do what she has promised.

"Garden variety" breach of contract claims (to use the District's Court's own phraseology)[188] are different. There a promisor makes a commitment but then breaks it by acting contrary to what she promised to do. Such was the case in *Northstar*. There was no showing that Schwab intended from the start to deviate from the stated objectives of its fund. The *Northstar* case therefore does not involve deception that would cause its claims to be pre-empted under SLUSA. Rather, it alleges a simple breach of contract. Unless the Appellate Court reinstates the case, however, there will be no recourse for fund shareholders who suffer damages to their expectation interests when their adviser lays out a set of objectives and then fails to follow them.

IV.
MUTUAL FUND FEES AND THE DIRECTORS WHO AUTHORIZE THEM

A. *Adviser Compensation*

The most astounding thing about mutual funds is their fees and costs, which amount, in the aggregate, to $100 billion annually.[189] What makes these fees and costs so troubling is that they are paid by investors. One writer described that situation with the following apt, if somewhat mixed, metaphor: "The economics of a mutual fund are not terribly different from a leaky bathtub . . . [because of] the way in which advisers and their sibling entities arrange their compensation . . . it is always bleeding money in the form of fees."[190] As Senator Peter G. Fitzgerald put it during his Senate hearings: "The mutual fund industry is the world's largest skimming operation."[191]

John C. Bogle, the renowned founder of the Vanguard family, substantiated this insight in an essay appropriately

188. *See supra* text accompanying note 179.
189. BIRDTHISTLE, *supra* note 20, at 50.
190. *Id.*
191. Fitzgerald, *supra* note 2.

called *The Relentless Rules of Humble Arithmetic*,[192] and made many of the same points in his testimony before the Fitzgerald committee. Bogle indicted the profession he helped create for moving from "stewardship to salesmanship"[193] and abandoning its traditional role as "trustees of other peoples' money."[194]

He also laid out this computational basis for his charge: "The overarching reality is simple. Gross returns in the financial market minus the costs of financial intermediation equal the net returns actually delivered to investors."[195] If a fund therefore makes a 5% annual return on its holdings but charges its shareholders 2% "for advisory fees, marketing expenditures, sales loads, brokerage commissions, legal and transaction costs, custody fees and security-processing expenses,"[196] the investor nets just 3%. Over a long period of time these "compounding costs"[197] drain a substantial amount from a worker's retirement savings. For instance, over their lifetimes a typical dual-income couple will pay more than $150,000 in fees on their 401(k) plans.[198]

Even more problematic, these high fees are often hidden away from ordinary investors.[199] To elaborate on Mr. Bogle's point, let us consider some aspects of the cost structure of a typical fund. Right up front, the adviser fee is calculated by applying a percentage rate to the total assets under management, between 1 to 200 or more basis points per year.[200] The adviser's basic compensation is thus a cut of the assets it manages. A few initial observations can be made about this arrangement.

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192. John C. Bogle, *The Relentless Rules of Humble Arithmetic,* FIN. ANALYSTS J., Nov.–Dec. 2005, at 22.
193. *Id.* at 24.
194. *Id.*
195. *Id.* at 22.
196. *Id.* at 23.
197. *Id.* at 25.
198. *See* Bogle, *supra* note 192 and accompanying text.
199. Jeff Sommer, *The High Fees You Don't See Can Hurt You,* N.Y. TIMES, Apr. 23, 2016.
200. Johnsen, *supra* note 153, at 567. A basis point is "One hundredth of one percent; this unit is often used in finance when prices involve fine margins." *Basis Point,* OXFORD DICTIONARY OF BUSINESS AND MANAGEMENT (6th ed. 2016). Thus 150 basis points would amount to 1.5% of the total assets of a fund.

First, while the calculation of the adviser fee sounds simple, there are several ways fund advisers can manipulate the calculation to enrich themselves at the expense of their shareholders. Two of the most prominent methods are an over-valuation of the fund's assets, done most easily for holdings that are not publicly traded,[201] and failure to promptly liquidate a shareholder's holdings upon her request. The latter not only deprives the investor of the prompt return of her capital but also keeps more assets in the fund, allowing the adviser to increase its compensation by applying its fee charges against a larger asset base for a longer period of time than is justified.[202]

Second, like many business and professional services, the adviser's compensation could be based on a flat fee and therefore not dependent on the assets under management.[203] This would provide a more stable situation for shareholders. As the system is currently set up, however, investors only benefit when the fund they have invested in appreciates in value, that is, when total assets under its management increase, regardless of how the increase happens. The adviser who wishes to enhance its revenue, therefore, has a couple of ways of doing that.

If an adviser wants more compensation, rather than adjusting its percentage fee upward (which might be unpopular if done publicly), it can simply increase the amount of assets it manages.[204] That will happen as a matter of course if the assets in the fund appreciate in value. However, this may be the result of a general rise in the market, and have nothing to do with the adviser's management skill.

Yet fund growth can also occur when more money is put into the fund. One could argue that the corresponding extra investments will require more work by the adviser and thus legitimize its greater compensation. Those extra costs, however, could largely be offset by economies of scale. Such savings,

201. BIRDTHISTLE, *supra* note 20, at 101–06. See also remarks by SEC chair Mary Jo White discussing ICA Rule 38a-1 which covers the duties of boards to assure that fund assets are fairly valued. Mary Jo White, Chair, Sec. Exch. Comm'n, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (Mar. 29, 2016).

202. BIRDTHISLE, *supra* note 20, at 99.

203. *Id.* at 54.

204. See *Id.*

however, are rarely passed back to the shareholders.[205] Another technique used by funds to create unjustified fees involves the hiring of sub-advisors who provide the real management services, with the adviser doing very little to justify its compensation.[206]

Concerns also arise when investors try to come to better understand the fees they are paying. Where can an investor find out exactly what the fees are in the aggregate? Digging out the total charges levied on investors is not an easy task.[207] The SEC requires that fees be disclosed, and they must therefore be stated somewhere in a firm's prospectus.[208] But how many pages of those voluminous documents are actually read by shareholders?

And even if investors *do* look at a prospectus, these documents typically cover a number of funds from a common sponsor —each one charging different fees. As one observer said about the "farcical" nature of those disclosures, "[the prospectuses run] a hundred pages in length, bloated with regurgitated boilerplate. They are often squirreled away on obscure websites visited by only a handful of investors and understood by fewer."[209]

As John Bogle noted, however, the management fees paid to advisers are just the start of investor costs.[210] In fact, they may be preceded by a sales load—up-front and back-end

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205. As Bogle commented on the changes he had seen in his 56 years in the mutual fund industry, "We've imposed soaring coasts on our investors that belie the enormous economies of scale in money management." *See* Bogle, *supra* note 192, at 24; *see also,* Sommer, *supra* note 199. For a case finding the possibility of excessive fees because savings from economies of scale were not passed back to investors, *see In re* Federated Mut. Funds Excessive Fee Litig., 2009 WL 5821045 (W.D. 2009).

206. For a case with such allegations see Curran v. Principal Mgmt. Corp., 2010 WL 2889752 (S.D. Iowa June 8, 2010). *But see* Kasilag v. Hartford Inv. Fin. Servs., LLC, 2012 U.S. Dist. LEXIS 178234, *23 (2012) (finding an inference that defendant's fees were "so disproportionately large that they bear no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining.").

207. Bogle calls these "opaque fees," *supra,* note 192, at 2.

208. Sec. Exch. Comm'n, *Information Available to Investment Company Shareholders,* www.sec.gov/answers/mfinfo.htm.

209. BIRDTHISTLE, *supra* note 20, at 215.

210. Bogle, *supra* note 192, at 22.

charges by brokers who sell them the shares.[211] Then come the operating expenses.[212] Funds buy and sell securities in transactions that typically executed by brokerage firms. These brokerage firms charge fees too. Legal and accounting fees are also added into operational costs, as are the sizeable compensation and expense payments that fund directors get for attending meetings.

In addition, there are distribution fees—the so-called Rule 12b-1 expenses, described that way because the SEC permits them under the regulation of the same name.[213] These cover all the advertising and promotional costs that funds pay to get more investors to purchase their shares.[214] Like every other fee, they must ultimately come out of the money owned by investors.[215]

Growing a fund's assets, as has been said, directly benefits the adviser by increasing one of the multiplicands used to calculate its compensation.[216] It is questionable, however, whether existing shareholders profit by such an enlargement of their fund's holdings, particularly if the economies of scale that may result are not passed along to them by a reduction in

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211. *See* Johnsen, *supra* note 153, at 566 (discussing they would normally be about 5% of the purchase price of the shares). *See also* BIRDTHISTLE, *supra* note 20, at 58. The author points out these extra, up-front costs are not as prevalent as they used to be. "Loads are sufficiently galling that many investors have rebelled against them, and most fund families now offer no-load share classes."

212. These must all be disclosed to investors but many of these costs are found only in the Statement of Additional Information (SAI). Funds must give these reports to investors on request, but they are not required to provide them. 17 C.F.R. § 230.430(b)(2) (2014).

213. ICA Rule 12b-1, 17 C.F.R. § 270.12b-1 (2013).

214. See BIRDSTHISTLE, *supra* note 20, at 81–88 for a lengthy discussion of these and whether they are justified as being in the best interests of investors.

215. Johnsen, *supra* note 153, at 567. See Curran v. Principal Mgmt. Corp., 2010 WL 2889752 (S.D. Iowa June 8, 2010), for a case sustaining a claim for excessive fees for distribution services; *see also* Chill v. Calamos Advisors LLC, 175 F.Supp.3d 126, 150–52 (S.D.N.Y. 2016).

216. *See* Bogle, *supra* note 192, at 5. The author comments about the results of this practice, ". . .managers focus on salesmanship, their agendas dominated by a desire to bring in assets under management."

the percentage rate that the adviser uses to calculate its aggregate payments.[217]

Even beyond that, there are also several types of what can euphemistically be called "soft dollar" compensation arrangements that benefit fund advisers when they enter into transactions using their shareholders' money.[218] For instance, major brokerage firms reward managers who execute their fund's lucrative trades through them with premiums that are similar to the benefits that can be purchased with mileage accumulated in frequent flyer programs.[219]

Even more egregious, perhaps, are various payments that advisers make to brokerage firms to entice the brokerage firms to recommend the advisers' funds as investments to their clients.[220] One thinks of the payola scandals involving radio disc jockeys and other kickback and "play to pay" schemes.[221] Under the federal securities laws, those too are legitimate as sales expenses under Rule 12b-1 if disclosed. Yet how can brokers who receive those payments not be influenced to recommend funds that may not be in their clients' best interests?[222]

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217. *See* Sommer, *supra* note 199 ("As an analyst put it: 'The cost of individual funds has dropped, but the assets have gotten so much bigger that the companies' revenues from fees have grown tremendously. . .They could be sharing more of those revenues with consumers, but they're not.'").

218. BIRDTHISTLE, *supra* note 20, at 89–98. See Gallus v. American Express Fin., 370 F.2d 862 (D. Minn. 2005), for a case with such allegations.

219. BIRDTHISTLE, *supra* note 20, at 89.

220. For a good discussion of this "revenue sharing" and the SEC's attempts to make it more transparent, *see* James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective,* 83 WASH. U. L. REV. 907 (2005).

221. BIRDTHISTLE, *supra* note 20, at 86.

222. An important advance for investors here was a new Labor Department rule promulgated in June, 2016 under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C.A. § 1002. It imposes a fiduciary duty on brokers and investment advisers in recommending securities to people saving for retirement. 29 C.F.R. § 2510.3–21. That is stricter than the previous standard that only required that brokers recommend "suitable" investments for that purpose. Jonnelle Marte, *Labor Department Rule Sets New Standards for Retirement Advice*, WASH. POST (Apr. 6, 2016) https://www.washington post.com/news/get-there/wp/2016/04/06/labor-department-rule-sets-new-standards-for-retirement-advice/?utm_term=.704505770857.

President Trump however at the behest of Gary Cohn, his appointee as director of the National Economic Council, has signed an executive order asking for a review of that rule. According to Cohn, a former executive of Goldman Sachs, the rule interferes with the ability of future retirees to invest

On top of all of these concerns looms another major question: how and why do costs vary from fund to fund? Advisers typically charge more for funds they actively manage than those they just passively hold, such as an index of certain stocks.[223] But is that differential a good thing for investors? Are extra payments to advisers who actively manage their shareholders' funds really justified by the service they provide?

Numerous academic studies say "no," supported by the efficient market hypothesis, which is also known as the "random walk" theory of stock valuation.[224] In short, the theory holds that it is impossible for any individual to regularly outperform the market. Active, well-informed traders are constantly buying and selling stocks which result in their prices instantaneously reaching an equilibrium point, reflecting their value.[225] Only a consistently lucky trader then (unless she has inside information) can outperform the market over time.

For decades, investors seemed to put their faith in famous stock-pickers who were said to beat the market.[226] That made it possible for those active managers to charge their customers

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their savings as they chose. Ron Lieber, *Fiduciary Rule is Now in Question. What's Next for Investors,* N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/your-money/estate-planning/fiduciary-rule-is-now-in-question-whats-next-for-investors.html?mcubz=1.

On a related issue, ERISA requires that fiduciaries of a pension plan act prudently in managing the plan's assets. 29 U.S.C.A. § 1104. There has been substantial litigation on this issue in recent years with the Supreme Court weighing in with two important cases. *See* Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828–29 (2015) (holding that fiduciaries who select investment options for a 401(k) have a continuing duty under ERISA to monitor holdings and remove imprudent investments); Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2464 (2014) (holding that a decision by a fidiciary of an employee stock option plan (ESOP) is not entitled to a "presumption of prudence." Instead, such fiduciaries are subject to "the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets.").

223. Sommer, *supra* note 19.

224. The classic explanation of this can be found in BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (1973).

225. In discussing the theory with approval, the U.S. Supreme Court stated its effects this way, "The market price of shares traded on well-developed markets reflects all publicly available information. . . ." Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988); *accord* Halliburton Co. v. Erica P. John Fund, Inc., 134 S.Ct. 2398, 2401–02 (2014).

226. Sarah Krouse & Ben Dummett, *Janus to Be Acquired by U.K. Fund Giant Henderson Group*, WALL ST. J., Oct. 4, 2016, at A1.

higher fees.[227] Of late, however, investors appear to be getting savvier, and have begun to shift their resources out of those funds and into cheaper, passively managed ones—those that buy and hold stocks across a broad market index.[228] According to one report, "[a]lthough 66% of mutual-fund and exchange-traded-fund assets are still actively invested, . . . those numbers are down from 84% 10 years ago and are shrinking fast."[229]

B. *Directors and What They Are Paid*

Who then is responsible for allowing these arrangements that appear to be gouging the retirement savings of so many Americans? Advisers run the funds, but they are supposed to be overseen by their trustees/directors who, in the end, set policy.[230] Yet how effective can that supervision be? At a fund's origination, the adviser/founder is its only shareholder and thus has the prerogative to name the trustees and directors.[231] How free can such officials possibly be from the adviser's con-

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227. As one commentator put the question, "If corporate stock itself is efficiently priced, how can fund managers possibly hope to pick stocks that outperform the S&P 500 Market Index after charging brokerage commissions and other transactions costs, the advisory fee, and various administrative expenses to the fund?" Johnsen, *supra* note 108, at 569–70.

228. Anne Tergesen & Jason Zweig, *The Dying Business of Picking Stocks,* WALL ST. J. (Oct. 17, 2016), https://www.wsj.com/articles/the-dying-business-of-picking-stocks-1476714749. As the article continues: "Hedge-fund managers, the quintessential active investors, are facing mounting withdrawals as they struggle to justify their fees. Hedge funds, which . . . generally have higher fees than mutual funds, haven't outperformed the U.S. stock market as a group since 2008." *Id.*

The push-back against high fees is also continuing with arguments that they should be based on performance—the so-called "fulcrum fee," allowed by SEC regulations but disfavored by advisers because they require a lowering of fees when a fund underperforms. Jason Zweig, *It's Time for Investor Fees to Go Even Lower,* WALL ST. J., Jan. 6, 2017, at B1. Section 205(b)(2) of the IAA permits this arrangement. 15 U.S.C.A. § 80b-5(b) (2011).

229. Tergesen & Zweig, *supra* note 226.

230. 15 U.S.C. § 80a-51(a)–(c).

As Mary Jo White, chair of the SEC put it in an address to the Mutual Fund Directors Forum, "A fund's board oversees the operations of the fund and provides an independent check on fund management, particularly where the interests of the adviser and other service providers may conflict with the interest of the fund." White, *supra* note 201.

231. BIRDTHISTLE, *supra* note 20, 36–37.

trol when the statute only requires that 40% of them be independent from the adviser?[232]

From the beginning, 60% of a fund's directors may be in a dependent relationship with its adviser, and might even be the adviser's employees. Even beyond that, however, the legal definition of independence covers only financial arrangements, not other ties that the directors/trustees may have with the adviser, such as friendship.[233] Virtually all those supposed guardians of shareholders' funds therefore owe their lucrative positions to the adviser whose performance they review and whose compensation they set.[234]

The directors'/trustees' most important task, which the 1970 amendments requires be done as a fiduciary for the funds' shareholders, is to annually review the contract of its adviser to see if it should be renewed.[235] That obligation also involves setting the adviser's fee. The statutory process that the trustees must follow appears stringent, requiring them to meet in person and review a number of documents.[236] Funds' directors are supposed to do what one observer called their "single job—insuring that investors get fair returns at a fair price from their adviser."[237] And directors/trustees are rewarded hand-

232. Section 10(a) of the ICA, 15 U.S.C. § 10(a), prohibits more than 60% of a fund's directors from being "interested persons" of the fund. Section 2(19) of the ICA defines that term. 15 U.S.C. § 2(a)(19).

233. Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 501 (2008). There the author faults the ICA's "narrow definition of 'independence.'" In that connection he argues that courts should follow the trend in general corporate law which calls for demanding greater fiduciary duties from directors. *Id.* at 502 (citing Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty,* 83 WASH. U. L. REV. 1017 (2005)).

234. As one commentator put it, "While many directors are classified as "independent" they don't have a lot of incentive to active independently if their sole source of income is directors' fees." Chuck Jaffe, *What Investors Don't Know About Mutual Fund Directors*, MARKET WATCH: SMART MONEY (May 7, 2012), http://www.marketwatch.com/story/what-investors-dont-know-about-mutual-fund-directors-1336421572207.

235. 15 U.S.C. § 80a-51(a)–(c).

236. 15 U.S.C. § 80a-15(c).

237. James Sterngold, *On Board, at a Mutual Fund,* WALL ST. J. (Sept. 3, 2014).

For a more detailed description of that duty which includes monitoring the performance of the adviser and analyzing whether its fee is warranted, *see* Knickle, *supra* note 106, at 318–28.

somely for discharging that duty, with payments well into six figures. For instance, some on the board of Pacific Investment Management Co. (Pimco) pull in upwards of $300,000 annually[238] and the outside directors of some of Fidelity's funds make more than $400,000.[239] These fees, like every other charge to the fund, ultimately come out of the investors' pockets.

To earn these amounts, fund directors typically attend meetings (some quarterly, others more frequently). They also serve on committees, and some oversee a group of funds in a particular family.[240] Yet directors/trustees almost never fire underperforming advisers and replace them with new ones.[241] Yale Professor John Morely, who has written extensively in this area, summed that up with this comment: "Corporate boards fire CEOs all the time, or they change the company's direction, but with mutual funds it almost never happens."[242]

As another commentator put it, "Directors would show that they get it by pruning and harvesting funds that deserve to be closed when no one but the fund firm is benefitting or the strategy hasn't proven viable."[243] Yet, to the contrary, these theoretical watchdogs for investors nearly always approve a renewed contract for the advisers who just so happen to have appointed them to their highly lucrative positions.

Conclusion: Shareholder Litigation as the Effective Remedy

Since the great reforms of the 1930s (and perhaps before), there have been substantial concerns that mutual funds have not been treating their shareholders fairly, and that their operators and affiliates have been using them as a means of personal enrichment. Congress addressed these concerns directly in its 1970 amendments to the ICA—focusing on the obvious flash point in such charges—the fees that advisers

238. Sterngold, *supra* note 237.
239. Birdthistle, *supra* note 20, at 37.
240. Jaffe, *supra* note 234.
241. For cases upholding Section 36(a) charges that trustees renewed advisers' contracts despite records of poor performance, *see Curran v. Principal Mgmt. Corp.*, No. 4:09-cv-00433, 2010 WL 2889752 (S.D. Iowa June 8, 2010); *Chill v. Calamos Advisors LLC*, 175 F. Supp. 3d 126, 142–43 (S.D.N.Y. 2017).
242. Sterngold, *supra* note 237.
243. Jaffe, *supra* note 234, at 3.

receive. It therefore placed fiduciary duties directly on advisers with regard to fees, and imposed similar obligations on fund directors in their approval of adviser contracts that legitimize such compensation arrangements. To assure that those safeguards would be enforced, the amendments also gave both the SEC and private investors express causes of action against advisers and fund directors for excessive fees.

While Commission officials from time to time have talked about bringing cases for excessive fees,[244] their enforcement actions of late have only been for less serious charges involving deficiencies in the process that directors must employ when they renew adviser contracts.[245] Such cases typically involve issues of whether directors were supplied the information they needed to evaluate the performances of their advisers. While of some significance, such actions pose no direct challenge to excessive fees themselves.

In addition to being more aggressive in attacking those abuses, the Commission could use its rule-making ability to compel more conspicuous and meaningful disclosure about the total compensation paid by mutual fund shareholders and the negative impact those expenses have on the returns from their investments. Truth-in-Lending statutes present an obvious practice for the Commission to emulate. Under those, full information about the cost of loans, including their annual percentage rates, must be presented in a highly visible box that all borrowers can understand.[246]

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244. The SEC has created the "Fund Fee Initiative" in its Asset Management Unit. Its co-chief stated recently that its purpose is ". . . to develop analytics. . . for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees." Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, U.S. Sec. and Exch. Comm'n, Conflicts, Conflicts Everywhere—Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015), https://www.sec.gov/news/speech/conflicts-everywhere-full-360view.html.

245. Mary P. Hansen & Daniel E. Brewer, *SEC Charges Mutual Fund Board Members and Investment Adviser with Violations of Section 15(c) for Deficient Advisory Contract Approval Process,* NAT'L L. REV., July 8, 2016, http://www.natlawreview.com/article/sec-charges-mutual-fund-board-members-and-investment-adviser-violations-section-15c-.

246. *See, e.g.*, 15 U.S.C. § 1604 (laying out the disclosure requirements for mortgage loans). As to the requirement that finance charges be "clear[ ] and conspicuous[ ]," *see* 12 C.F.R. § 1026.17 (2015). With the election of Donald Trump as president, however, there may be a major overhaul of the federal regulations covering consumer transactions which could deregulate

With the failure of the Commission's enforcement here, however, shareholders themselves must use the cause of action provided by the statute. The narrow ruling in *Janus* unfortunately restricts such shareholder suits under Rule 10b-5, but *Harris v. Jones* and the claims recognized in *Northstar* (which should be reinstated on appeal) will be helpful. *Harris* in particular showed a welcoming attitude toward such breach of fiduciary duty actions.[247]

In addition, as this Article has demonstrated, there is increasing public awareness of the unfairness of excessive fees charged by mutual funds.[248] Aided by skillful and aggressive counsel, shareholders should go after both the advisers who breach their fiduciary duties and the directors who condone their activity. Through such litigation, the mutual fund industry can then be made accountable and brought back to serve the real needs of the investing public.

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much of this. *See* Ryan Tracy, *The Trump Train Takeover*, WALL ST. J. (Nov. 11, 2016).

247. Some may characterize this case as pertaining just to situations where funds charge institutional and retail clients substantially different fees. The opinion however should be read more broadly as a general endorsement of Section 36(b) suits, particularly in light of Judge Posner's dissenting opinion in the lower court proceeding. *See supra* notes 155–58 and accompanying text.

Harris reflects a refreshing change from earlier interpretations of the *Gartenberg* standard which were not helpful to such actions. *See supra* notes 150–59 and accompanying text. *See also* Cox, *supra* note 218, at 924 which characterized the plaintiff's burden of persuasion in the *Gartenberg* tests as "enormous."

For a recent "*post-Jones*" case signaling a more open attitude by Courts to these claims, *see Chill*, 175 F. Supp. 3d at 149.

248. As Professors Curtis and Morley put it, " . . . we acknowledge that excessive fee litigation retains substantial political support . . . ." Curtis & Morley, *supra* note 5, at 4.

The authors also urge a reformulation of the *Gartenberg* liability standard more along the lines of reasonableness. They would replace *Gartenberg's* six factors with three: "1) how a fund's fees compare to those of its peers; 2) whether the fund is a persistent underperformer; and 3) whether the fund provides ancillary services to justify high fees." *Id.* at 41.

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TOEHOLD COLLABORATIONS BEYOND INSIDER TRADING

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With the proliferation of the new practice of wolf packing, the incidence of toehold ("TH") collaborations as part of a takeover campaign is likely to increase as well. In addition to affecting the size of the TH—potentially transforming the TH into a foothold—TH collaborations may include asymmetric agreements between the collaborators that distort the incentives of the bidders and lead to inefficient results. For example, the asymmetric agreement may include contingent distribution rights that make losing the takeover bid to a rival bidder—even to a higher-value use bidder—undesirable. Losing may become so prohibitively expensive that the bidder may continue to bid beyond its reservation-value. As a result, ex ante, asymmetric TH collaborations are likely to deter potential rival bidders, which may motivate the collaborators to enter into such agreements. Bidders may use TH collaborations to present a credible threat of winning determination in order to curb competing bids (including efficient bids) which will negatively affect both shareholder value and social wealth. This Article demonstrates and analyzes potential distortions caused by TH collaboration agreements.

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Introduction

Wolf packing, the novel practice of investors collaborating in the targeting of publicly traded firms, has changed the market for corporate control.[1] Hedge funds and institutional investors join forces and form a unified active front against management of publicly traded US firms. This collaboration has rattled the balance of power in the market and has thus gained a dominant role in the corporate governance debate.[2]

Practitioners and academics have analyzed and evaluated the effects of wolf packing on the market. This has led to a review of the applicable securities laws and a renewed focus on disclosure requirements and trade restrictions promulgated under the Securities and Exchange Act of 1934.[3] Specifically, opponents of the current early notification requirements of

1. *See, e.g.*, John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. Corp. L. 545, 549 (2016) ("activist hedge funds have recently developed a new tactic—'the wolf pack'—that effectively enables them to escape old corporate defenses").

2. *See, e.g.*, Alon Brav et al., *Wolf Pack Activism,* Harvard Law Sch. Forum on Corp. Governance and Fin. Regulation (February 9, 2015), https://corpgov.law.harvard.edu/2015/02/09/wolf-pack-activism/ ("The use of wolf packs has intensified in recent years and has attracted a great deal of attention.").

3. Martin Lipton, *The Threat to Shareholders and the Economy from Activist Hedge Funds*, Harvard Law Sch. Forum on Corp. Governance and Fin. Reg-

Rule 13d-3 have used the collaboration as fresh ammunition to argue for tightening the rule and shortening the notification period.[4]

ULATION (January 14, 2015), https://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds/.

4. The securities rules require an acquirer to disclose its stake in the company and purpose of the acquisition within 10 days of owning at least 5% of the company. *See* § 13(d)(1) of the Securities and Exchange Act of 1934 and Rule 13d-1 promulgated thereunder. 15 U.S.C.A. § 78m(d)(1) (2015); 17 C.F.R. § 240.13d-101 (as amended in 1997). Tomas Lee Hazen, THE LAW OF SECURITIES REGULATION 405 (7th ed. 2009) ("There have been many proposals before the SEC to require advance filing under Section 13(d)"); *see, e.g.*, H.R. REP. NO. 90-1711 (1968); *see* Cleary Gottlieb, *The Schedule 13D Ten-Day Window and Other Issues: Will the Pershing Square/Valeant Accumulation of a 9.7% Stake in Allergan Lead to Regulatory or Congressional Action?*, CLEARYMAWATCH.COM (Apr. 24, 2014), http://www.clearymawatch.com/2014/04/the-schedule-13d-ten-day-window-and-other-issues-will-the-pershing-squarevaleant-accumulation-of-a-9-7-stake-in-allergan-lead-to-regulatory-or-congressional-action/ ("For many years numerous market participants have urged Congress to shorten the [ten-day] window . . . . Eventually, the Dodd-Frank Act authorized the SEC to close the ten-day window . . . . The SEC has not yet taken a position and has not yet exercised its authority . . . high-profile events regarding Allergan may put pressure on the SEC (and potentially Congress) to address . . . whether the 13D 'window' should be closed"); David Gelles & Michael J. De La Merced, *Threatening a Proxy Battle, Valeant Raises Its Offer on the Botox Maker Allergan*, N.Y. TIMES (May 28, 2014), http://dealbook.nytimes.com/2014/05/28/valeant-raises-bid-for-allergan/?php=true&_type=blogs&_r=0 (quoting California Congressman Ed Royce's statement, "[t]his proposed merger has also raised questions about the efficacy of the ten-day rule outlined in Schedule 13D. Taking into account technological advancements, there are good public policy reasons for the S.E.C. to again revisit this rule and shorten the window that investors have to disclose stakes of 5 percent or more in a target company."); Trevor Norwitz, *A New Takeover Threat: Symbiotic Activism*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (April 25, 2014), https://corpgov.law.harvard.edu/2014/04/25/a-new-takeover-threat-symbiotic-activism/ ("This new stratagem emphasizes the crying need for the SEC to bring its early-warning rules into the 21st century, as we have been urging for several years."); *cf.* Lucian A. Bebchuk & Robert J. Jackson, JR., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 40, 45–47 (2012) ("This legislative history suggests that the ten-day window between the acquisition of a 5% stake and required disclosure is not a technical 'gap' left open by incompetent congressional drafters. Instead, the window reflects the balance that Senator Williams and his colleagues struck between the benefits that the holders of large blocks of stock convey upon public investors and the need for disclosure of these blocks," and "tightening the rules that apply to blockholders can be expected to reduce the incidence of outside blocks as well as blockholders' investments in monitoring and disciplining manage-

One significant form of collaboration in the market is the emerging practice of corporate bidders collaborating in toehold acquisitions prior to the formal launch of a takeover attempt. A toehold ("TH") is a stake in a target firm that a bidder acquires on the open market before publicly announcing its plans to acquire the target.[5] Economic and finance scholars as well as legal academics have studied the TH in the simple context of a bidder interested in acquiring a target, without the added complexity of collaboration with additional investors. Indeed, the review of the reasons for this practice and its efficiency has produced an important body of work.[6] This Article adds to the existing body of work on THs by analyzing the evolving practice of collaborations in TH acquisitions, and uncovers a new concern associated with the purchase of a TH that may have an adverse effect on the market for corporate control and which should not be ignored.

This new practice of TH collaboration has reached the headlines in the widely publicized case of the failed acquisition attempt of Allergan Inc. ("Allergan"),[7] in which Valeant Pharmaceuticals International Inc. ("Valeant") joined forces with renowned hedge fund manager William Ackman and his fund Pershing Square Capital Management ("Pershing"). While Valeant's acquisition attempt was unsuccessful and a

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ment."); Nagel, et al., *The Williams Act: A Truly "Modern" Assessment*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION 23 (2011) ("[T]he proposals for piecemeal changes to the Williams Act regime raised by advocates of incumbent management are self-serving and flawed," and "further disclosure requirements on engaged investors will have widespread and detrimental impact to the markets and will benefit only underperforming managers.").

5. *See, e.g.*, Deon Strickland et al., *Toeholds as an M&A Strategy?*, 21 J. CORP. ACCT. & FIN. 57 (2010) ("Toeholds are defined as a bidder-investor purchasing an ownership interest in a target firm prior to initiating merger-and-acquisition (M&A) discussions.").

6. For a survey of the financial literature see Sandra Betton, et al., *Corporate Takeovers*, 2 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 330–56 (Elsevier/North-Holland Handbook of Finance Series, 2008), http://mba.tuck.dartmouth.edu/pages/faculty/karin.thorburn/publications/ch15-n53090.pdf.

7. Allergan is also famous for being the maker of Botox. For a description and comparison of the business-strategies of both Allergan and Valeant see Max Nisen, *How Allergan Rose and Valeant Fell*, BLOOMBERG GADFLY (March 24, 2016), www.bloomberg.com/gadfly/articles/2016-03-24/allergan-and-valeant-similar-starts-different-outcomes.

competing bidder, Actavis plc,[8] ultimately acquired Allergan, Pershing reportedly made a substantial gain on its TH position.[9] In a subsequent lawsuit, plaintiffs alleged that the collaboration between Valeant and Pershing, specifically the purchasing of the TH, violated insider trading rules, because it allegedly took place while preparations for a tender offer,[10] rather than a friendly acquisition, were already underway.[11] The particular facts of the Allergan case have given rise to concerns regarding violations of tender offer rules partly because the collaboration in the TH acquisition came on the heels of a failed attempt to negotiate a friendly acquisition, making it likely that a hostile tender offer was in the offing. Putting aside the factual question of whether the acquisition of the TH preceded or followed the decision to pursue a tender offer in this unique case, collaboration in the acquisition of a TH is a novel practice that has the potential of affecting the market for corporate control and the corporate governance of firms. Thus, as this Article will show, this novel practice has far-reaching implications that go beyond the question of the applicability of insider trading rules in a specific case.[12]

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8. *See, e.g.*, Margaret Cronin Fisk & Cynthia L Koons, *Valeant, Ackman Lose Bid to Escape Suit Over Allergan Offer*, BLOOMBERG (Nov. 11, 2015), www.bloomberg.com/news/articles/2015-11-11/valeant-ackman-loses-bid-to-dismiss-suit-over-allergan-offer; David Gelles, *Allergan Escapes Valeant's Pursuit, Agreeing to Be Bought by Actavis*, N.Y. TIMES (Nov 17, 2014), dealbook.nytimes.com/2014/11/17/allergan-agrees-to-be-sold-to-actavis/?_r=0.

9. Over $2.2 billion profit. S*ee, e.g.*, Fisk & Koons, *supra* note 8; Complaint & Demand for Jury Trial, Basile v. Valeant Pharmaceuticals Int'l, Inc., No. 8:14-cv-02004-JLS-JCG (C.D. Cal. S. Div. filed Dec. 16, 2014).

10. To be sure, the bidder (defined as an "offering person" in 17 C.F.R § 240.14e-3 (2015) (hereinafter Rule 14e-3)), unlike "any other person," can purchase shares in the open market and acquire a TH even after it starts preparing for a hostile takeover and before plans for a tender offer are publicly announced.

11. The Williams Act and Rule 14e-3, which was promulgated thereunder, focus on tender offers because at the time of adoption "tender offers were the principal means of acquisitions and there were concerns about people trading based on advanced knowledge of tender offers." *See* Cleary Gottlieb, *supra* note 4.

12. To avoid allegations of insider trading due to collaboration in the purchase of the TH while contemplating a tender offer, bidders can enter into a TH collaboration agreement before negotiations with the target company begin.

To the best of my knowledge, this Article is the first to analytically study the novel practice of TH collaboration, including its potentially distortive effects.[13] The natural outcome of TH collaboration is that it may affect the size of the TH[14] or the *effective* size of the TH, which is the size of the TH that the bidder benefits from and internalizes even if it does not own it directly. Even more importantly, it is crucial to distinguish between two forms of TH collaboration: symmetric and asymmetric. I measure the symmetry in relation to the outcome of the acquisition attempt by the bidder. An asymmetric agreement will treat winning and losing the bid for the target differently and will provide for different outcomes accordingly. Conversely, in a symmetric TH collaboration agreement the profit sharing arrangement is not contingent upon the fate of the bidding for the target.

The symmetry of the TH collaboration or lack thereof is central to the understanding of the effect of the TH collaboration. The effects of a symmetric TH collaboration are broadly equivalent to changing the size of the TH that the bidder holds when making decisions about the proposed acquisition. For example, it may increase the size of the TH, which will amplify the positive effects of the TH. On the other hand, as this Article will show, an asymmetric collaboration may have

13. To be sure, practitioners have noticed the novelty of the practice and reviewed the relevant legal rules. *See, e.g.*, Jeffery B Floyd et al., *Hostile Activists: Collaborations between Shareholder Activists and Hostile Bidders*, 14 M&A J., no. 10, 2014, at 1, 3 ("[T]he first collaboration between a strategic acquirer and a shareholder activist to launch a hostile takeover as co-bidders."). Practitioners also noted that the novel practice helps "to establish a bigger beachhead more quickly and cheaply than had previously been thought possible". Trevor Norwitz, *A New Takeover Threat: Symbiotic Activism*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (April 25, 2014), https://corpgov.law.harvard.edu/2014/04/25/a-new-takeover-threat-symbiotic-activism/. However, they did not identify the potentially distortive effects of the novel practice analyzed in this Article.

14. The level of noise trading is another example for what may affect the size of the TH. *See* Albert S. Kyle & Jean-Luc Vila, *Noise Trading and Takeovers*, 22 RAND J. ECON., no. 1, 1991, at 54, 55 ("'[N]oise trading'—uninformative trading for liquidity or life cycle motives—provides enough camouflage to enable a large outsider to profit by acquiring a significant stake in a target first without being noticed. When there is a great deal of noise trading. . . the market attributes changes in the quantity of shares supplied in the market to changes in noise trading, not to changes in the behavior of a large trader with private information about takeover prospects.").

distortive effects on the potential acquirer which, depending on the direction of the asymmetry, may incentivize it to either over- or under-bid in a bidding competition for the target. Furthermore, the asymmetric agreement may have deterrent effects on additional potential bidders, chilling the competition in the market for corporate control. In fact, the bidder may use an asymmetric TH collaboration agreement to make a credible threat to continue bidding past the reservation value, thereby deterring efficient competing bids.

To be sure, if the potential acquirer acts unilaterally and purchases a larger TH without collaboration, the purported harm to the selling shareholders who consent to the sale of their stake in the target with no knowledge of the contemplated acquisition is identical to a case in which the acquirer collaborates with another entity to acquire a larger TH. The collaboration, however, may allow the potential acquirer to accumulate a larger combined TH than it would have been able to acquire unilaterally. The reasons for this may stem from the fact that the collaborator may provide additional funds and ease liquidity constraints as well as lower the risk associated with purchasing a larger stake at a preliminary stage when the ultimate success of the proposed takeover is uncertain.[15]

If the bidder does not have the required liquidity to purchase a large TH, the bidder can take out a loan to purchase the TH,[16] which allows the bidder to reap the expected profits from the larger TH. Alternatively, the bidder can join forces with a collaborator and share the TH and the future profits from the TH with the collaborator who will own part of the TH. In other words, the parties can enter into a financing transaction and structure it in a manner that has similar financial results to a TH collaboration agreement. One complication with the financing solution can be that in order to convince the lender to extend the loan to purchase the TH,

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15. *See, e.g.*, Floyd et al., *supra* note 13, at 7 ("By teaming up with a deep-pocketed and experienced activist hedge fund, the new structure significantly lowers the risks of a hostile takeover.").

16. If one identifies a good investment, such as an investment with a positive net present value, then even if it does not have the required funds needed to undertake the investment, it can take out a loan to finance the investment assuming the financial markets are efficient. To be sure, the investment expected return should cover the cost of financing (the interest on the loan) to make the investment still viable.

the bidder may be required to disclose the contemplated takeover to the lender and trust the lender's ability to maintain the secrecy of the bidder's plans. If information leaks, the price will rise,[17] making the takeover more difficult to execute, more expensive for the acquirer to purchase the TH (and possibly the target itself), and potentially lowering the benefits of acquiring a TH in the first place.[18] Thus, the bidder may prefer to use a collaborator who shares the interest of keeping the plans for the contemplated takeover concealed.

Yet, the increase in the size of the TH is most likely to affect uninformed public shareholders who will sell shares without knowing about the contemplated takeover. Still, regardless of collaboration, the size of the TH has an upper limit: a ceiling of generally 10% of the target, which stems from numerous concerns such as poison pill triggers,[19] controller laws,[20] the Hart-Scott-Rodino Antitrust Improvements

17. For example, after Valeant publicly disclosed its plans to acquire Allergan, Allergan's stock increased by 22% in one day. Fisk & Koons, *supra* note 8.

18. In particular, such benefits include profiting from a sale of the TH to a free-rider bidder who ultimately takes over the target.

19. In order to avoid triggering a poison pill, the TH will be just below the threshold, which is typically 10 or 15%. *See* Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 904–07 (2002) (explaining the mechanism of a poison pill); Ronald Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COL. L. REV. 863, 910–11 (2013) ("The poison pill affords a remedy that can effectively prohibit undisclosed accumulations. . . One way to read the current campaign to compel quicker disclosure of shareholder accumulations is as an effort to persuade the SEC to impose the equivalent of a poison pill with a very low trigger at a time when institutional investors are successfully pressuring boards to turn away from poison pills."); Paul H. Edelman & Randall S. Thomas, *Selectica Resets the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?*, 87 IND. L. J. 1087 (2012) (studying poison pills, their triggering level, and the relevant case law).

20. Transactions with controllers may be subject to the higher judicial standard of entire fairness review. *See, e.g.*, Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014).

Act of 1976,[21][22] change-of-control provisions,[23] and short-swing profit disgorgement under Section 16(b) of the Securities Exchange Act of 1934.[24][25] Whether this ceiling is set at the

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21. *See, e.g.*, Gilson & Gordon, *supra* note 19, at 911 n. 164 ("[B]arriers to rapid accumulation of equity positions are [ ] significant. For example, for large capitalization firms, the requirement to file under Section 7A of the Clayton Act, 15 U.S.C. § 18a (2006), which is keyed to the value of the stock acquired rather than the percentage of outstanding equity acquired, will often limit the toehold to a level far short of that allowed under § 13(d).").

For a summary of the current thresholds of the HSR Act filing requirements, which apply to potential mergers of competitors see FED. TRADE COMM'N, WHAT IS THE PREMERGER NOTIFICATION PROGRAM?: AN OVERVIEW (2009), https://www.ftc.gov/sites/default/files/attachments/premerger-introductory-guides/guide1.pdf; J. Hart Holden, *2016 Revised (Higher) Hart-Scott-Rodino Act Thresholds*, PAUL HASTINGS LLP (Feb. 8, 2016), http://www.paulhastings.com/publications-items/details/?id=3f52e869-2334-6428-811c-ff00004cbded; COOLEY ALERT, *Revised 2016 Hart-Scott-Rodino Antitrust Thresholds – Effective February 25, 2016*, COOLEY LLP, (Jan. 26, 2016), https://www.cooley.com/news/insight/2016/2016-01-26-revised-2016-hsr-antitrust-thresholds-effective-feb-25-2016.

22. However, the collaboration agreement might be used to circumvent the HSR requirements by choosing a collaborator who is not a competitor. *See, e.g.*, Floyd, *supra* note 13, at 6 ("If Valeant, rather than Pershing Square, would have had to file for HSR clearance with respect to the toehold stake in Allergan, there likely would have been significant delays in obtaining antitrust approval because of Allergan's and Valeant's overlapping business.").

23. For change-of-control provisions that act as embedded defenses see Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 582 (2003) ("[T]he inclusion of a 'change of control' provision in an everyday business contract (such as lease, joint venture, license, employment agreement or debt instrument) that imposes costs on the firm in the event of a change of control. These provisions, particularly when employed in a variety of the firm's contracts, can be sufficient to deter most (if not all) bids.").

24. Section 16 of the Exchange Act is triggered when a shareholder who owns more than 10% buys and sells shares within 6 months. If another bidder buys the target, including the TH, before half a year from the acquisition of the TH has lapsed, or if the Bidder decides not to proceed with the takeover and sell the TH back to the market less than half a year since acquiring the TH, then the bidder's profits will fall under the short swing profit disgorgement requirements of Section 16. *See, e.g.*, Basile v. Valeant Pharms. Int'l, Inc., Case No. 8:14-CV-02004-JLS-JCG (C.D. Cal. Dec. 16, 2014) (Noting that a TH acquisition of 9.7% "was just shy of the 'short swing' profits prohibition in Section 16 of the Exchange Act, which requires holders of greater than 10% of a company's stock to disgorge any profits made in six-month buy-sell period.").

25. For a list of regulations and provisions that the acquisition of a TH may trigger see David Fox, "Toehold Stakes" in Target Firms, Harvard Law

right level is a policy question. The answer to this question lies in the balancing of (i) the negative effects on the uninformed selling shareholders on the one hand, and (ii) the benefits of a TH—including supporting the market for corporate control by compensating the bidder for searching and monitoring costs if a competing bidder ultimately acquires the target—on the other.

The size of the TH matters not merely because of concerns about the number of uninformed selling shareholders whom the acquisition of the TH may directly affect, or the effect on remaining shareholders who may face a new controlling shareholder.[26] The size of the TH is likely to affect the bidder as well.[27] Collaboration agreements may convert the TH into a foothold, making the searching endeavor more

Sch. Forum on Corp. Governance and Fin. Regulation (May 15, 2012) https://corpgov.law.harvard.edu/2012/05/15/toehold-stakes-in-target-firms/.

26. I should note that when the uninformed shareholders sell their shares to the bidder, who accumulates shares to create a TH, they are doing so out of their own free will but without full information. The sale itself is not under duress, unlike a freeze out merger transaction, and the decision whether to sell is in each individual shareholder's hands. Nonetheless, the lack of information renders the decision to sell on the eve of a price increase an economically misfortunate decision for the selling shareholders, whether the shareholders sell to the bidder or to an unrelated third party. The TH acquirer does not owe a duty to disclose to the selling shareholders its plans because its decision to attempt a takeover is not information that was misappropriated. Furthermore, the intent of Rule 13d, which requires disclosure of the intent and purpose of the 5% or more acquisition, is to protect the remaining shareholders, those who did not sell their shares, from a new controller rather than those who did sell and thus severed their affiliation with the target. *See* Thomas Lee Hazen, THE LAW OF SECURITIES REGULATION 399 (7th ed. 2017) ("Section 13(d) of the 1934 Act was enacted as part of the Williams Act to give investors and the public markets as early warning of a major stock acquisition that could be a first step in acquiring control of the target company. . . . The Purpose of the Section 13(d) filing is to give investors and/or the public markets early warning of the existence of a person or a group that may be in a position to exert control over the corporation."); SEC v. Savoy Industries, Inc., 587 F.2d 1149, 1165 (D.C. Cir. 1978) ("[S]ection 13(d) was designed, in part, to allow investors an opportunity to know of potential changes in corporate control and to evaluate the situation").

27. *See, e.g.*, Edelman & Thomas, *supra* note 19 ("Reducing the amount of target stock that strategic acquirers can accumulate will decrease the expected value of a takeover attempt and adversely affect their incentive to pursue value-enhancing acquisitions.").

profitable and a takeover more attainable to the bidder. To be sure, if the bidder ultimately takes over the target, a larger TH allows it to purchase a larger stake in the target for less than the price of the takeover deal. A larger TH will also increase the benefit from the TH in case a more efficient bidder competes with the first bidder and acquires the target (including the first bidder's TH), and thus will compensate for the bidder's costs as well as help it overcome concerns of reputational losses[28] that otherwise may prevent an efficient outcome.

On the other hand, a larger TH may increase the bidder's incentive to overbid in an attempt to force a competing bidder to increase its offer closer to the competing bidder's reservation price.[29] The bidder may adopt this overbidding strategy in order to increase its profits from selling the TH to the competing bidder. The larger TH means a larger potential upside to the bidder from selling the TH for an even higher price.[30] Thus, the larger TH may increase the incidence of overbidding and the associated risk of failure and inefficient outcome where the first bidder wins despite being the lower-valuing bidder.

In the case of TH collaboration, the actual size of the bidder's *direct* interest in the TH (that is, how much it *personally* owns) matters.[31] In addition, the collaboration agreement may provide for the transfer of a portion of the profits gained from the TH between the first bidder and its collaborator. Such provisions will have the effect of changing (increasing or decreas-

28. *See* John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 54 STAN. L. REV. 307, 360 (2000) (showing that reputational effects may distort the bidding choices of first bidders); Guhan Subramanian, *The Drivers of Market Efficiency in Revlon Transactions,* 28 J. CORP. L. 691, 702 (2003) ("[T]here may be potential reputational costs that are borne disproportionately by a first bidder. . .having a deal taken away may create a reputation for weakness, which would then impose costs (or reduce opportunities for profits) in future rounds.").

29. *See* discussion of strategic overbidding *infra* Part II.B.3.

30. For an algebraic model of the bidder's decision process see Appendix.

31. The collaborator may vote in favor of the deal, however, it will be against its own interest to favor the deal over a higher bidder's offer. Though the parties might be in a repeat game in which they would like to collaborate in future deals and value the potential profits from such future relationship more than the present benefit of selling to a competing higher-value bidder.

ing) the de facto size of the TH that the bidder takes into account.

The size of the aggregate TH (that is, the holdings of both collaborators taken together), can be identical to the size of the TH in the case of an acquirer who acts independently, and thus the direct effect on the uninformed shareholders in such a case would also remain the same. In other words: the acquirer may purchase fewer shares, enabling the collaborator to purchase shares without exceeding the aggregate limit of just under 10% of the target.[32] However, the fact that it is not the acquirer who owns part of the TH has novel effects on the incentives and outcome of the planned acquisition, especially when the collaboration agreement is asymmetric.

The following points summarize the potential effects of the TH, which I discuss and illustrate with numerical examples below:

1) The TH may compensate the first bidder for search costs in case a competitor buys the target.[33]
2) The TH opportunity cost makes a higher-valuing bidder the optimal winner for the first bidder.[34]
3) Strategic bidding above the reservation price aimed at increasing the offer price of the competing bidder for the TH may result in overbidding above the competitor's reservation value.[35]
4) Forward asymmetric collaboration agreements may motivate the first bidder to increase the offer price above its reservation price and the reservation price of the competitor in order to win.[36]
5) Forward asymmetric collaboration agreements may credibly deter a competing bidder from entering the competition for the target, thus resulting in a lower price and potentially inefficient acquisition of the target.[37]

32. *See supra* notes 20–26 and accompanying text.

33. *See* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 17 (1982) ("Reductions in the number of shares the bidder can buy in secret make it harder still for the bidder to recover the costs of search."); for the numerical example *see infra* Part II.B.2.

34. *See infra* Part II.B.2.

35. *See infra* Part II.B.3.

36. *See infra* Part IV.A.1.

37. *See infra* notes 164–165 and accompanying text.

6) Reverse asymmetric collaboration agreements may motivate the first bidder to offer less than its reservation price, possibly below the reservation price of the competitor, causing it to lose the bidding war.[38]
7) Reverse asymmetric collaboration agreements may repel free-riders who will be confused by the signals received.[39]

The Article proceeds as follows: Part I provides a concise review of the wolf packing practice. Part II offers an analytic review of the costs and benefits of the TH acquisition. Part II also includes a discussion on strategic over-bidding. A numerical example illustrates the effects of acquiring a TH without collaboration. Part III analyzes TH collaboration agreements. Part IV focuses on the special case of asymmetric TH collaboration agreements and examines both forward and reverse asymmetric agreements. The Appendix studies TH collaborations with the use of algebraic modeling.

I.
Wolf Packing Review

The term "wolf pack" commonly refers to activist investors and institutional investors who engage in a target collaboratively. A wolf pack consists of multiple activist investors who share the goal of, and work towards, corporate control.[40] For example, forming a wolf pack can help an activist investor in a proxy fight. Typically, a lead investor will initially acquire a stake in a target and will subsequently encourage other investors to acquire large stakes in the target, thereby establishing a wolf pack.[41] The wolf pack increases the pressure on the target and thus the likelihood of success in implementing the corporate scheme promoted by the activist investors.[42]

While the members of the wolf pack exploit the advantages of collaborating with activist investors with whom they share similar interests, they are careful to avoid classification as

38. *See infra* Part IV.A.2.
39. *Id.*
40. Carmen X.W. Lu, *Unpacking Wolf Packs*, 125 Yale L. J. 773 (2016) (defining a wolf pack as a "group of activist investors working in unison to gain control of corporate boards").
41. *Id.* at 775.
42. Beth E. Flaming, *Best Defense Against 'Wolf Pack' Investors Is to Anticipate Their Attack*, Forbes (Nov. 3, 2015), http://onforb.es/1kpkNv4.

a "group of persons" under the Securities Exchange Act (the "Act").[43] Thus, the members of the wolf pack normally avoid entering into a formal and explicit agreement in an attempt to circumvent disclosure and reporting requirements[44] and to avoid disgorgement of short-swing profits[45] that may apply to groups under the Act. Despite the risk of violating the Act, the lack of a uniform judicial definition for the term "group" under Section 13(d) of the Act may account for the proliferation of wolf packs.[46] In the case of TH collaboration, which is the focus of this Article, investors collaborate in the acquisition of a TH in a way that mirrors the collaboration by the members of the wolf pack. However, as this Article shows, unlike the members of a traditional wolf pack, the collaborators in the TH acquisition join forces openly and publicly.[47]

Wolf pack activism is reportedly on the rise,[48] though it is difficult to measure wolf pack activism with certainty because those activist investors who form wolf packs seek to keep their relationship as tenuous as possible in order to avoid disclosure requirements.[49] With the proliferation of wolf packs, the debate among scholars and practitioners about the long-term benefit of activist intervention has intensified.[50] Recent empiri-

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43. John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 562 (2016); Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 697–98 (2007).

44. *See* 17 C.F.R. § 240.13(d)-1 (2010) (requiring any person or "group" of persons owning more than a 5% of the voting rights of a corporation to file a Schedule 13D with the SEC within 10 days of acquisition); *id.* at § 240.16(a)-2 (requiring any ten percent beneficial owner to report short swing transactions, i.e., a sale and purchase of stock within a 6-month period).

45. *See* 17 C.F.R. § 240.16a-1 (2010).

46. Lu, *supra* note 40, at 776 (exploring the over and under inclusive nature of SEC regulations and case law with respect to wolf pack activism).

47. *See infra* notes 153–57 and accompanying text.

48. Martin Lipton, *The Threat to Shareholders and the Economy from Activist Hedge Funds*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE AND FIN. REGULATION (Jan. 14, 2015), https://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds ("Again in 2014, as in the two previous years, there has been an increase in the number and intensity of attacks by activist hedge funds. Indeed, 2014 could well be called the 'year of the wolf pack.'").

49. Briggs, *supra* note 43 at 698.

50. Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1087 (2015).

cal studies have found support for the view favoring activist investors' involvement.[51]

II.
TH Review

A. *Costs and Benefits*

Shortly before a merger or a tender offer takes place, acquirers often purchase part of the target in anticipation of the takeover deal.[52] The opportunity to buy some of the shares at the lower price—the price that prevails before the dissemination of plans of a potential deal—motivates this purchase. Thus, the equity stake in the target may serve the important role of covering the search costs of the first bidder.[53] A raider can also use the acquired equity stake to influence the target's shareholder vote either directly (by voting the shares) or indirectly (by initiating a proxy fight or threatening to do so).[54] However, since the TH does not confer a control position on the bidder, its direct influence may be only marginal. The benefits from the TH are further limited since the size of such purchase of equity is restricted by several factors[55] including

51. *Id.* at 1154 (empirically testing "the claim that interventions by activist hedge funds have an adverse effect on the long-term interests of companies and their shareholders" and finding that "activist interventions are on average associated with beneficial outcomes in the long term").

52. *See, e.g.*, Ronald Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan. L. Rev. 819, 871 (1981) ("Increasingly, a potential bidder takes a potential block position in the stock of a target before announcing its intentions.").

53. *See* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 Stan. L. Rev. 1, 16 (1982) ("Reductions in the number of shares the bidder can buy in secret make it harder still for the bidder to recover the costs of search.").

54. *See, e.g.*, pSivida Ltd., Annual Report for the fiscal year ended June 30, 2007 (Form 20-F) at 17, https://www.sec.gov/Archives/edgar/data/1314102/000119312507211073/d20f.htm (describing the potential risk from Pfizer's ownership of about 13% of its equity: "Pfizer owns a significant percentage of our ordinary shares and therefore may be able to influence our business in ways that are less beneficial to [the shareholders]. . . . As a result, Pfizer may be able to exert significant influence over our board of directors and how we operate our business. The concentration of ownership may also have the effect of delaying or preventing a change in control of our company.").

55. *See* Fox, *supra* note 25, for a list of regulations and provisions that acquiring a TH may trigger.

poison pill triggers,[56] controller laws,[57] Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act),[58] change-of-control provisions,[59] and short-swing profit disgorgement under Section 16(b) of the Securities Exchange Act of 1934.[60]

In addition, Section 13(d) of the Securities Exchange Act of 1934 further restricts the acquirer, as it requires disclosure of an acquisition of a stake in the company of 5% or greater and disclosure of whether the purpose of a purchase that results in more than 5% ownership of a company is to acquire control of the company.[61] The securities rules, however, allow the acquirer both to file the report up to 10 days after reaching the 5% threshold, *and* to continue to purchase additional shares of the target during that window.[62] Thus, in the Allergan case, for example, the collaborators were able to acquire a 9.7% TH.[63]

The acquisition of a TH has clear benefits for the bidder.[64] It signals to the management of the target and its share-

56. *See supra* note 19.

57. If the bidder is a controlling shareholder, or becomes one following the acquisition of the TH, then the takeover transaction might be subject to heightened review as a self-dealing transaction. *See, e.g.*, Kahn v. M & F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014) (reasoning that absent certain procedural approvals, a transaction involving self-dealing is subject to the more demanding "entire fairness" judicial review standard as opposed to the business judgment standard).

58. *See supra* note 21.

59. *See supra* note 23.

60. *See supra* note 24.

61. *See* 15 U.S.C. § 78m(d)(1)(C) (2008); *see also* Gaf Corp. v. Milstein, 453 F.2d 709, 720 ("[S]ection 13(d) was intended to alert investors to potential changes in corporate control so that they could properly evaluate the company in which they had invested or were investing."); *cf.* Easterbrook & Fischel, *supra* note 33 ("Reductions in the number of shares the bidder can buy in secret make it harder still for the bidder to recover the costs of search.").

62. Hazen, *supra* note 4, at 400 ("This ten-day period provides a window of opportunity for acquiring considerably more than the five percent threshold before Section 13(d)'s early warning disclosures must be made.").

63. *See, e.g.*, Cleary Gottlieb, *supra* note 4.

64. *See, e.g.*, Easterbrook & Fischel, *supra* note 33, at n.6 (1982) ("We agree with Bebchuk and Gilson that bidders' purchase of targets' shares in advance of their offers is both desirable and lawful. A bidder has the right to do this without disclosing any intent to make a tender offer eventually. Staffin v. Greenburg, 672 F.2d 1196, 1202–03 (3d Cir. 1982).")

holders that the bidder is serious about the acquisition.[65] It also lowers the total cost of acquisition of the target.[66] The expected profit from the TH enables the bidder to pay the remaining shareholders more and to potentially overcome the free-rider problem of small shareholders holding out in an attempt to gain a higher premium.[67] Becoming a shareholder of the target due to the TH acquisition confers both the right to vote and to have standing, which may enable the bidder to bring a lawsuit against the target and its management.[68] Notably, the TH also enables the bidder to hedge against the cost of losing to a competing bidder.[69]

A competitor can free-ride on the search costs and takeover activities of the first bidder. This is amplified by the securities laws (Williams Act), which require that a tender offer remain open for a lengthy period.[70] Furthermore, state corporate law requires management to retain a fiduciary-out option and to renege on a board-approved agreement to pursue the best interest of the shareholders, including selling to a higher bidder who did not incur search costs in certain situations such as a sale of the company for cash.[71] Ex post, these laws help secure an efficient result: placing the target in the hand of the assigner of highest value. One ex ante effect of the potentially successful free-rider counterbid, however, is the reduction of the incentive to search for a target.[72]

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65. Fox, *supra* note 25; Floyd et al., *supra* note 13, ("It. . . sends a message to a target's shareholders about the extent of the bidder's commitment.").

66. Fox, *supra* note 25 ("[The TH] could advantage a buyer in a subsequent sale process by reducing its average cost (by acquiring shares before a deal premium attaches)").

67. *See, e.g.*, Strickland et al., *supra* note 5; Shaul Grossman and Oliver Hart, *Takeover bids, The Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980) (Studying the problem of shareholder free-riding and its adverse effects on the market for corporate control); Shleifer and Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986) (Studying the ability of large shareholders to overcome the shareholder free-rider problem and facilitate takeovers).

68. *See* Fox, *supra* note 25.

69. *Id.*

70. *See* 17 C.F.R. § 240.14e-1 (requiring a tender offer to remain open for at least 20 business days).

71. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

72. *See* Easterbrook & Fischel, *supra* note 33, at 7.

The TH serves to mitigate this free-rider problem by giving an incentive to search for potential targets and identify poorly managed businesses or potential synergies. If a free-riding competitor-bidder successfully acquires the target, then the increase in the price of the TH itself may offset the costs associated with searching for and initiating the takeover of the target.[73] Thus, the TH facilitates the market for corporate control by encouraging searches for potential targets.

On the other hand, the bidder has to take into consideration the potential negative effects that acquiring a TH entails. The TH may antagonize the management of the target, who may perceive this move as either a hostile attack or as a precursor to one, and respond with defensive tactics, which may stand in the way of friendly negotiations.[74] Additionally, the TH acquisition may affect the reputation of the bidder both in case of failure and in case of success.[75] The TH also increases the economic risk that the bidder faces: should the acquisition attempt fail the TH investment itself may lose its value.[76]

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73. *See* Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers: A Last (?) Reply*, II:2 J. L. ECON. ORG. 253, 255 (1986) ("Whether or not the searcher ultimately acquires the target, the searcher will usually make a substantial profit on its pre-bid purchases.").

74. Fox, *supra* note 25; Strickland et al., *supra* note 5, at 57 ("[The toehold] may cause the target management to turn hostile and oppose the acquisition.").

75. *See, e.g.,* Fox, *supra* note 25 ("([S]trategic acquirers have largely avoided [acquiring toehold stakes] . . . fearing the possible negative reputational . . . consequences.").

76. Strickland et al., *supra* note 5, at 57, 59 ("If bidder establishes a large toehold and, for whatever reason management successfully opposes the transaction, the bidding firm will likely lose on their investment in the Target firm, because toehold shares will probably decline in value . . . . [The failed takeover may be interpreted by the market as a signal that the target is not] a viable takeover candidate."); Vijay S. Sekhon & Jason Kornfeld, *Efficient Disclosure by Public Company Shareholders of Takeover Proposals*, 44 SEC. REG. L. J. 283, 288 (2016) (referring to the reputation of a takeover target as "damaged goods" reputation if the takeover is not consummated); Floyd et al., *supra* note 13, ("[I]f the target remains independent, the bidder is left with a large investment that might be impossible to divest without incurring significant losses."). *But cf.* Bebchuk, *supra* note 73, at n.2 ("And if the target's shareholders reject all available bids, then the searcher will still make a substantial gain, because in such a case the market price of the independent target's shares will probably be higher than the pre-bid price for which the searcher bought the shares."); GEORGESON, 2012 ANNUAL CORPORATE GOVERNANCE REVIEW 7 (2012) (describing the case of Airgas Inc. and of CF In-

Furthermore, potential acquirers may refrain from acquiring a TH because of the effect such purchase may have on the price of the stock of the target.[77] The increased demand produced by a TH acquisition is likely to increase the stock price in the market and subsequently the price that the bidder will have to pay for the entire target.[78] The higher stock price in the market right before the formal takeover commences may also increase the stock price that a court will consider in determining the stock value in appraisal procedures, and thus increase the cost for the bidder.[79] However, for the purpose of appraisal valuations[80] the court usually goes beyond the unaffected share price.[81] Additionally, sophisticated acquirers will trade in intervals so that the break in trading will help estab-

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dustrial Holdings, Inc., whose respective stock price substantially surpassed failed hostile bids); Liz Hoffman, *Investors Press Airgas To Destagger Board*, LAW360 (Aug. 7, 2013, 3:53 PM), http://www.law360.com/articles/463213/investors-press-airgas-to-destagger-board ("Since the chase ended, Airgas' stock is up nearly 65 percent.").

77. *See* Abraham Ravid & Matthew Spiegel, *Toehold Strategies, Takeover Laws and Rival Bidders*, 23 J. BANKING & FIN. 1219, 1229 (1999) ("[T]o the degree that a toehold drives up the stock price, and thereby increases the target's value in the eyes of the court system, a toehold purchase may actually hurt the bidding firm.").

78. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 570 (1984) ("[E]ven a single knowledgeable trader with sufficient resources[ ] can . . . cause prices to reflect information by persistent trading at a premium over 'uninformed' price levels."). *But see* Kyle & Vila, *supra* note 14, at 55 (1991) ("When noise traders are heavy sellers, the large informed trader notices an opportunity to buy a large stake at favorable prices and does so . . . the large trader has an incentive to declare a takeover . . . .").

79. *See* Ravid & Spiegel, *supra* note 77.

80. *See, e.g.*, Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121, 1156–60 (1998) (describing and analyzing procedural rules of appraisal remedy); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 40 (1995) (describing the requirements of appraisal).

81. *See, e.g.*, Martin Lipton & Theodore N. Mirvis, *Delaware Court of Chancery Appraises Fully-Shopped Company at Nearly 30% Over Merger Price*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (June 3, 2016) ("Chancery decisions have held that the merger price . . . is the most reliable indicator of fair value."), https://corpgov.law.harvard.edu/2016/06/03/delaware-court-of-chancery-appraises-fully-shopped-company-at-nearly-30-over-merger-price/; Gail Weinstein & Philip Richter, *2017: Where Things Stand—Appraisal, Business Judgment Rule and Disclosure*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULA-

lish an unaffected stock price despite the large share accumulation prior to the takeover.[82]

I should note that some view termination fees (pre-negotiated fees paid by the target to the bidder in the event of a sale of the target to a competing bidder[83]) as a substitute for a TH that avoids the potential negative outcomes of a TH.[84] However, in addition to the fact that the management of the target has to agree to the granting of termination fees to the bidder, termination fees are imperfect substitutes for THs because of their effect on the target's value. Termination fees lower the value of the target for a competing bidder because termination fees transfer value from the target itself to the bidder in the event the competing bidder acquires the target.[85] If the termination fees are high, they may discourage an even higher-valuing competing bidder from purchasing the target.[86] If the competing bidder purchases a target that must pay termination fees to the first bidder, the competing bidder will pay less for the target than it would without the agreement to

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TION (2017), https://corpgov.law.harvard.edu/2017/02/28/2017-where-things-stand-appraisal-business-judgment-rule-and-disclosure/.

82. *See, e.g.*, Floyd et al., *supra* note 13 at 5 ("Pershing Square . . . initially accumulate[d] 4.99% of Allergan's common stock . . . then halted trading for two days in order to establish a colorable claim for Allegan's unaffected share price . . . . After this brief waiting period, Pershing Square attempted to accumulate as many shares as possible.").

83. For a general analysis of termination fees *see, e.g.*, Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VAND. L. REV. 1161, 1179–80 (2010).

84. *See, e.g.*, Strickland et al., *supra* note 5, at 60 ("Sometimes the termination fee can be used as a substitute for a toehold."); Floyd et al., *supra* note 13, at 7, ("This [TH Reverse collaboration] arrangement effectively serves as the functional equivalent of a 'break-up fee' for the hostile bidder . . . .").

85. *See* Ian Ayres, *Analyzing Stock Lockups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 684 (1990); Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1544 (1996) ("If a target grants a lockup to one bidder, the lockup will effectively constitute a liability to another bidder . . . that succeeds in acquiring the target. The lockup reduces the profit the locked-out bidder obtains from acquiring the target at any given price by a sum equal to the value of the lockup. It therefore reduces the locked-out bidder's reservation price by that amount. . . . Lockups have this effect whether they take the form of a termination fee, a stock lockup, or an asset lockup.").

86. *See, e.g.*, Ayres, *supra* note 85, at 684 ("[E]xtreme forms of treasury sales can foreclose third parties with higher target valuations from making competitive bids.").

pay termination fees, thus negatively affecting all of the shareholders of the target.

On the other hand, THs do not have the same negative effect on the *value* of the target. A TH transfers value between the first bidder and the shareholders of the target who agree to sell their stake to the first bidder without information about the forthcoming acquisition attempt, but does not affect the intrinsic value of the target itself.[87] Should a subsequent takeover materialize, the uninformed selling shareholders will not receive compensation for the sale of control. If the target remains independent, however, the stock price may decline following the failure of the acquisition,[88] and the selling shareholders may be better off. Hence, the choice between a TH and termination fees may have both distributional effects and efficiency effects. This choice may determine (i) whether all the shareholders bear the costs of negotiating with the first bidder, or whether only the uninformed selling shareholders do, and (ii) whether a higher-valuing competing bidder acquires the target, or is instead discouraged from even competing because of the additional cost associated with the termination fees.

In addition, as long as the termination fees are lower than the expected profit from the acquisition, termination fees do not affect the outcome of the bidding contest: the bidder who wins the contest will still be the higher-value user. This is because the termination fees have an identical effect on the value that all bidders assign to the target, decreasing the value by the size of the termination fees. If the first bidder loses, the target has to pay the fees to the first bidder; and if the first bidder wins, it is forfeiting the value of the termination fees it would have otherwise received. In other words, termination fees lower the valuation of both sides—the competing bidders—by exactly the same amount.[89] On the other hand, a TH acquired without collaboration does not change the valuation of the target for the competing bidder because the TH only changes the identity of the shareholders from whom it will ac-

87. To be sure, once the market learns about the increased transaction volume and the purchase of the TH it is likely to react positively and increase the stock price in anticipation of the contemplated acquisition of the target.

88. *See* Ravid & Spiegel, *supra* note 77.

89. *Cf.* Ayres, *supra* note 85, at 684 ("[S]elling treasury shares causes all auction participants to lower their maximum bid.").

quire the shares. In addition, a TH acquired without collaboration also does not affect the bidding contest's outcome because the first bidder will prefer to sell its TH to a competing bidder if that bidder is willing to pay more than the TH's worth to the first bidder.[90] A classic TH makes winning less valuable to the holder of the TH only if a competing bidder is willing to pay more for the target than is the TH holder (who is, thus, the efficient winner). However, as I will demonstrate numerically in Part IV.A.1 below, a TH asymmetric collaboration agreement may distort the outcome of the bidding war and lead to a lower-value bidder winning the contest. This is because the TH affects only the first bidder's value of the target and its effect is asymmetric. For example, it can make losing more expensive for the collaborating first bidder, thus making it harder to beat the first bidder. In comparison, termination fees lower the gain from winning symmetrically for all bidders, and thus do not entail the same potential for an adverse efficiency effect. A TH that includes an asymmetric agreement may change the equilibrium and result in an inefficient outcome in which the lower-valuing bidder wins the contest.

B. *Numerical Example*

The following example illustrates the effects of purchasing a TH before announcing the proposed acquisition of the target. The basic framework consists of a potential acquirer, the First Bidder, who has identified the target—a company suitable for acquisition. In the following Parts, I will analyze three scenarios.

Under the first scenario there is no competition for the target and the First Bidder attempts to convince the target's shareholders to either tender their shares or merge the target with the acquirer, instead of allowing the target to continue as an independent entity.

The second scenario introduces competition for the target in the form of the Competing Bidder. The latter learns about the First Bidder's plans to acquire the target following the public announcement of the First Bidder's acquisition of the TH and the disclosure of its plans to acquire the entire

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90. See *infra* Part II.B.2 for a numerical example.

target.[91] The Competing Bidder decides to compete and attempts to acquire the target in lieu of the First Bidder. Once there is competition for the target, the First Bidder may decide to engage in strategic-bidding because of the TH, as discussed in Part II.B.3 below.

Under the third and final scenario, the First Bidder enters into an agreement with a Collaborator. This agreement between the First Bidder and the Collaborator focuses on the purchase of the TH and on the profits gained from the TH in the event of an acquisition of the target. I will analyze this scenario in Part III below. In the Appendix, I further study TH collaborations using algebraic modeling.

1. *TH with Neither Competition nor Collaboration*

The First Bidder purchases the TH before it announces the proposed acquisition of the target. At the time of the purchase of the TH, the selling shareholders are unaware of the buyer's intent to purchase control of the target. At this preliminary stage, the market price is low, as it does not include a control premium.[92] Thus, the First Bidder profits from the low share price, which prevails in the market. Following the announcement of the proposed acquisition, negotiations about the deal terms ensue, particularly the price per share of the target. The management of the target will not have to approve the deal, which could take the form of a hostile takeover directly targeting the shareholders of the target using a tender offer.[93] Nonetheless, management will influence the shareholder vote: formally, management is required to recommend to the shareholders whether to sell or not to sell even in the

91. The actual size of the TH is likely to surpass the 5% ceiling, which triggers the disclosure requirement under Section 13(d) of the Securities Exchange Act of 1934, by the time of the actual disclosure, because the acquirer may continue and purchase shares in the market during the ten-day period between reaching 5% ceiling and making the disclosure. *See* Cleary Gottlieb, *supra* note 4.

92. *See* Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 542 (2004) ("[T]he control premium . . . represents an estimate of private benefits of control enjoyed by the controlling party.").

93. A merger transaction requires the approval of the board as well as the shareholders. *See* DEL. CODE ANN. tit. 8, § 251 (West 2011). To circumvent management opposition to a merger, the bidder may initiate a proxy fight in an attempt to replace the management with a supportive management.

case of a tender offer.[94] More restrictive than management's recommendations to the shareholders are antitakeover and entrenchment mechanisms that management is likely to utilize in order to prevent a hostile takeover.[95] Winning management support[96] may not be enough either, as recommendations by shareholder advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, may render the negotiations more challenging for the First Bidder, even without any direct competition.

The First Bidder may successfully negotiate the acquisition of the target, either with or without management's blessing. The aggregate price the First Bidder will agree to pay will be less than its reservation value so that it will expect to profit from the deal.[97] To be sure, paying less for the TH increases the First Bidder's total profit. Thus, the low cost of the TH enables the First Bidder to increase the price paid to the holders of the remaining shares of the target in case of fierce resistance and tough negotiations.

I now turn to consider the following basic numerical example, which illustrates the effect of the TH under the scenario at hand. The target has 100 shares issued and outstanding.

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94. The board of the target is required to advise the shareholders and disclose its position regarding the tender offer, including the reasons therefor, within 10 business days of the commencement of a tender offer. *See* 17 C.F.R. § 240.14d-9 (2010).

95. *See, e.g.*, Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 116–17 (2001) ("The most restrictive level of our [antitakeover protection] variable is either dual-class or a staggered board combined with prohibitions on voting by written consent and prohibitions on shareholders calling a special meeting. . . . The second most restrictive . . . is a staggered board without shareholder voting restrictions."); Bebchuk et al., *supra* note 19, at 890 ("[S]taggered boards make it extremely difficult for a hostile bidder to gain control over the incumbents' objections.").

96. Management support may be influenced by self-interest incentives such as consulting agreements and perpetual thrones. *See, e.g.*, Lucian A. Bebchuk & Jesse M. Fried, *Pay without Performance: Overview of the Issues*, 30 J. CORP. L. 647 (2005), at 24, http://lsr.nellco.org/cgi/viewcontent.cgi?article=1316&context=harvard_olin (discussing the award of "post-retirement consulting contracts" as "stealth compensation" to CEOs). *See generally* Mira Ganor, *Salvaged Directors or Perpetual Thrones?*, 5 VA. L. & BUS. REV. 267 (2010) (analyzing the award of perpetual thrones to target directors).

97. *See, e.g.*, Kahan & Klausner, *supra* note 85, at 1547 ("A party will make a bid only if its expected profits exceed the expected cost of bidding.").

Its current market capitalization is $80, in other words the trading price of the target's stock is $0.8 a share.[98] Our First Bidder values the target at $100. The First Bidder is purchasing a TH in the open market before announcing its intent to buy the whole target. I assume that the size of the TH is 10% of the target, and the First Bidder is able to accumulate the TH without affecting the market price.[99] Thus, the First Bidder pays $8 for the 10% TH in the target, i.e., $0.8 per share. Negotiations between the management of the target and the First Bidder will follow, and the First Bidder may decide to initiate a tender offer.[100] The First Bidder will try to acquire the remaining 90% of the target for a price as close as possible to the old market price of $0.8 per share. At the same time, the shareholders will hope to receive a price closer to the first bidder's reservation price, which they will not know with certainty but which they will attempt to estimate via professional valuations of the target by investor bankers.[101]

Should the bidder succeed, it will own the entire target, including the TH; and the target will be worth $100. This will increase the value of the TH, which is currently worth only $8. The difference, $92, is the maximum aggregate price that the First Bidder may pay the remaining shareholders for their shares. The highest price that the first bidder is willing to pay for each of the 90 shares of the target that it does not currently own is therefore $1.0222.[102,103] Thus, the TH allows the bidder

98. 80/100.

99. I assume that no arbitragers, momentum traders, or other investors notice the increased demand for the stock, there is no speculation about a potential acquirer who is responsible for the noise in the market, and thus no upward adjustment to the price occurs at this time.

100. The assumption under this Part is that the first bidder is the only bidder; there is no competition for the target.

101. To be sure, the shareholders may believe that both the market and the First Bidder undervalue the true intrinsic value of the target and thus refuse to sell their shares below that price, which exceeds the reservation value of the First Bidder.

102. 92/90.

103. The law prohibits the bidder from discriminating against any shareholders in a tender offer and all shareholders should receive the same price per share, as per the best price rule, codified in Rule 14d-10 under the Securities Exchange Act of 1934; 17 C.F.R. § 240.14d-10(a)(2) (2010) ("The consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer."). In a merger, however, disap-

to offer a higher price per share—higher than what it evaluates the price of the share to be. This is because shareholders who valued the shares at or below the market value presumably sold the TH for the lower market price. These shareholders were willing to sell because they valued the shares for less,[104] and because they did not have information about the proposed sale of control, which would have suggested the opportunity to sell for more.[105]

2. *TH with Competition but without Collaboration*

In this scenario, the Competing Bidder enters the scene after the First Bidder has done the preliminary work of identifying the target and incurring various costs in pursuing the acquisition transaction. These include costs for searching for a suitable (underpriced) target and costs related to the preparation for the acquisition following the discovery of the target. The Second bidder decides to compete for the target only after learning about the First Bidder's plans, not because it had performed an independent search. The Second bidder is thus attempting to free-ride on the efforts of the First Bidder.[106]

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proving shareholders may have an appraisal right; *see* sources cited *supra* notes 80–81.

104. In efficient markets, the price of the target should incorporate all material information available in the market and thus, assuming the absence of any material inside information, closely reflect the target's intrinsic value. From a supply and demand perspective, the price of the stock on the market represents the value of the company to the marginal shareholder, who is the least-value seller. *See* Mira Ganor, *Manipulative Behavior in Auction IPOs*, 6 DEPAUL BUS. & COM. L.J. 1 (2007) (demonstrating a strategic use of the downward sloping of the demand for shares). Once the bidder discloses its takeover plans, the shareholders of the target will attempt to capture as much as possible of the surplus between the higher value that the bidder assigns to the target (the reservation price) and the lower value that the sellers assign.

105. Assuming no liquidity constraints on the part of the selling shareholders, which may have forced them to sell at the time they did.

106. To be sure, the free-rider will have to conduct some independent checks of the target and will not rely blindly on the signal from the First Bidder; however, the First Bidder may well have incurred research costs for checking other potential targets first before identifying the target. *See, e.g.,* Ayres, *supra* note 85, at 698 ("Potential bidders may need to incur sunk costs to investigate the value of the target."); Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239, 242 ("[Bidding] typically requires the services of outside legal, accounting, and financial advisors . . . [and usually entails] commitment and

Should the Second bidder win, the First Bidder will potentially incur further costs (including reputational costs) for losing the bid.[107] Thus, ex ante, potential bidders might be deterred from searching for acquisition targets because of the risk of losing to free-riders who may materialize following the announcement of the proposed acquisition.[108] This may well stifle the market for corporate control.[109] However, the acquisition of the TH may serve as compensation to offset the potential cost of losing to a free-rider. In fact, the First Bidder may profit even where it loses the target by choosing to sell the TH to a free-riding competing bidder. The potential profit from selling the TH may be large enough to encourage search for acquisition targets despite the free-rider risk.[110] Thus, a TH may support the market for corporate control, even where a bidding war between an initial bidder and a free-rider ensues. Should a competitor value the target for more than the First Bidder does, that competitor will win the bidding contest.[111] The First Bidder will lose its search costs and may suffer reputational losses, but its profits from the sale of the TH to the competitor who is the higher bidder will compensate the First Bidder for its efforts.

While trying to overcome the other bidder, each bidder attempts to purchase the target for the lowest price acceptable to the target's shareholders. In the bidding war between the first and the Competing Bidder, each bidder attempts to counter the other bidder's offer in an auction-like competition. Once a bidder offers a price that is equal to or higher than the other bidder's reservation price, the other bidder will cease to raise its offer, since the other bidder will not pay more than the value it assigns the target. Thus, the higher-value bidder will be the last to bid and, assuming the shareholders accept the offer, it will win the bidding war.

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other financing fees."). For further discussion on free-riders, see *supra* notes 67–73 and accompanying text.

107. *See* sources cited *supra* note 28.

108. *See, e.g.*, Easterbrook & Fischel, *supra* note 33, at 7.

109. *Id.*

110. *See, e.g.,* Bebchuk, *supra* note 73, at 255–56.

111. To be sure, this result may not happen in case of reputational costs, *see supra* note 28, or in the case of strategic bidding gone wrong, *see infra* note 118 and accompanying text.

To illustrate the effects of the TH under this scenario, I revisit the numerical example from Part II.B.1 above. The First Bidder is interested in acquiring the target, a company whose stock trades at $0.8 per share. The First Bidder values the target at $1 per share, which is 25% more than the market price. The First Bidder's initial move is to purchase a TH of 10% of the target for $8. Then the First Bidder publicly announces its plans to acquire the target.

This time another bidder is also interested in the target and values it at $102. In this example, the Competing Bidder is assigning a higher-value to the target. The following Table I summarizes the different valuations of the target.

TABLE I

	Market Value (target stays independent)	First Bidder	Competing Bidder
Expected Value of Target	$80	$100	$102

It is easy to see that the highest price per share that the Competing Bidder will offer to pay for the target is $1.02 for each one of the 100 shares of the target.[112] The First Bidder, however, had acquired a TH of 10% of the target prior to its announcement of the acquisition plan, paying the market price of $0.8 per share. At the end of the day, the value of the TH, which is a function of the value of the target, will depend on who will ultimately own the target. The value of the TH in each event is as indicated in the following Table II.

TABLE II

	Target stays independent	First Bidder buys target	Competing Bidder buys target
Expected Value of TH	$8	$10	$10.2

Once the First Bidder offers $1 per share or more to acquire the remaining 90 shares, it expects to profit only from

112. 102/100.

the TH, because it values the share of the target at $1 per share, for a total of $100. In the case of purchasing the 90 remaining shares for $1 a share, the First Bidder's profit will be $2, or the increase in the value of the TH from $8 to $10.

The Competing Bidder will counter the First Bidder's offer of $1 per share, since it values the target at a greater sum than $1, and will bid a little higher in order to win the auction and the target. It will then offer $1.01 per share, for example. This offer includes an offer to pay a total of $10.1 for the First Bidder's TH.[113] If the First Bidder accepts the Competing Bidder's offer it will profit from the difference between the consideration paid by the Competing Bidder ($10.1), and the cost of acquiring the TH ($8), for a total profit of $2.01. The profit from accepting the Competing Bidder's offer is higher, and thus more lucrative, than increasing the bid and offering more for the 90 shares of the target that are still traded in the market. Thus, assuming there are no additional costs from losing the bidding war, such as reputational costs,[114] and without taking into account strategic bidding,[115] a rational First Bidder will allow the Competing Bidder to win at this point. Ending the bidding war will maximize the First Bidder's profit from the target at this time. The First Bidder will allow the competitor to win even though the First Bidder could increase its bid all the way up to $1.0222 per share, as we saw in the scenario in which there is no competing bidder,[116] and win the bidding war. If the First Bidder were to offer $1.0222, it would force the Competing Bidder out, since the Competing Bidder's reservation value is only $1.02 per share and it will not want to pay more for the target than the value the Competing Bidder assigns to it. The First Bidder could offer to pay $1.0222 per share without incurring a direct loss from its purchase of the target, even though it values the shares of the target for less, because the First Bidder purchased the TH at a discounted market price. However, should the First Bidder pay $1.02 per share for the target, it will lose the opportunity to profit from selling the TH to the competitor. Thus, despite the presence

113. The offer for the TH equals to 10% of the total proposed consideration for the target.

114. *See* sourced cited *supra* note 28.

115. Continue bidding in an attempt to lure the competing bidder to increase its bid. *See supra* Part II.B.3.

116. *See supra* Part II.B.1.

of the TH, the result of the bidding war will be efficient in the sense that the higher valuing bidder will acquire the target. The First Bidder will profit, and may well be compensated for the costs it sustains in discovering the opportunity to purchase the target and competing for it.[117]

3. *Strategic Overbidding*

To the extent that the First Bidder, who owns the TH, is the lower-valuing bidder, however, it may decide to act strategically. Rather than ending its attempt to acquire the target once the Competing Bidder offers a price that is equal to or higher than the First Bidder's reservation price, it may continue to bid and counter the Competing Bidder's last offer. The First Bidder may do so in order to cause the Competing Bidder to increase its offer further. Should this strategy succeed, the Competing Bidder will purchase the shares of the target—including the TH (which is owned by the Fist Bidder)—for a higher price than the price it would have paid without this strategy. This higher price will be closer to the Competing Bidder's reservation price. Thus, following this strategy, the First Bidder may increase its profits from the sale of the TH.

To illustrate the strategic overbidding process, we can think about the bidding war. Each bidder will continue to bid and attempt to acquire the target so long as the bid does not exceed the bidder's valuation of the target. The bidding will stop when the higher-value bidder offers a marginally higher bid than the reservation price of the competing bidder, who values the target for less. This last bid will set the purchase price of the target (assuming the selling shareholders accept the highest bid offered to them without additional attempts to increase the sale price at the end of the bidding war). The higher bidder will attempt to conceal its reservation price and only offer an incrementally higher bid than the bid of the competing bidder, thus profiting from the difference between its reservation price and the purchase price that is below the reservation price.

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117. Ex ante, this will encourage searching for undervalued, inefficiently managed targets and for synergies, and it will discourage shirking and private extractions by managers and enhance the market for corporate control. *See* Bebchuk and Jackson, *supra* note 4.

The First Bidder does not want to pay more for the target than the value it assigns the target. If the Competing Bidder wins the bidding war and the First Bidder loses, the Competing Bidder will purchase the target, including the First Bidder's TH. Thus, when the Competing Bidder wins and purchases the target, the First Bidder is selling its TH to the Competing Bidder, and the First Bidder would like to receive the highest possible price for its TH, which is the Competing Bidder's reservation price. In order to induce the Competing Bidder to offer its reservation price, the First Bidder may strategically continue bidding after it reaches its own reservation price. The First Bidder will do so if it believes that there is a reasonable likelihood that the Competing Bidder values the target for even more, so that the Competing Bidder will have to increase its bid for the target, which will increase the First Bidder's profit from the TH.

However, this strategic bidding is not without risk: if the First Bidder over-estimates the Competing Bidder's reservation value, the Competing Bidder will not counter the strategic over-bidding. Since the bidders conceal their reservation prices and each bidder only attempts to predict the other bidder's reservation price, the First Bidder might over-estimate the Competing Bidder's reservation price. Thus, the First Bidder might continue bidding, surpassing both the First Bidder's true reservation price and the Competing Bidder's in a failed attempt to force the Competing Bidder to pay more for the target (including the First Bidder's TH). Offering to pay more for the target than it is worth to the competitor (and to itself) may actually force the First Bidder to overpay for the target. The First Bidder might unintentionally win the auction and acquire the target for an excessive price.[118]

This result will have both distributive and efficiency effects. The First Bidder will pay for the target more than its own valuation of the target, transferring value to the target's shareholders. This undoubtedly creates a positive outcome for the shareholders, which may have the effect of encouraging investment in the stock market. The First Bidder will end up owning the target despite valuing it for less than the Competing Bidder does. An efficient, subsequent transfer of the target from

118. Restrictions, such as reputational costs, may prevent the first bidder from renouncing its offer at this time even though the price is excessive.

the First Bidder to the Competing Bidder may not take place, even though the latter assigns a higher-value to owning the target. Such subsequent transfer may not take place because of transaction costs, reputational costs,[119] or because of the delay, which may have caused the window of opportunity to close by the time the First Bidder is ready to allow the transfer of the target to the Competing Bidder.[120] For example, a business opportunity may be time sensitive and the competitor may no longer assign a higher-value to the target than the value the First Bidder assigns it. The Competing Bidder may have pursued an alternative business transaction once it lost the auction and purchased another firm that competes with the target, even though the target would have been a better fit initially. At this later time, however, adjustment may have already taken place and the Competing Bidder may no longer have a use for the target.

To be sure, the First Bidder's decision to overbid strategically will not always result in an inefficient outcome, because the First Bidder may estimate the Competing Bidder's evaluation of the target at or below the true value and thus will stop the bidding war at a stage that will allow the Competing Bidder to win the auction. This will transfer value from the Competing Bidder to the First Bidder and the other target's shareholders, but will be an efficient transaction in the sense that the Competing Bidder—the higher-value bidder—will acquire the target.

III.
TH Collaboration Agreements—Size and Sharing

With the increased use of wolf packs,[121] bidders can collaborate in the acquisitions of THs. TH collaborations may be similar to collaborations in the acquisition of an equity stake in the company prior to the formal initiation of a proxy fight; such collaborations aim at increasing the benefit from, and

119. *See* sources cited *supra* note 28.

120. Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 Stan. L. Rev. 23, 39 (1982) ("Impeding competing bids would substantially increase the likelihood that a target will be acquired by a firm other than the highest-valuing user. While such an acquirer may resell the target's assets to the highest-valuing user, this resale may involve delay and transaction costs and may never occur.").

121. *See supra* Part I.

the probability of success of, shareholder activism.[122] Yet, TH collaboration, which involves a takeover attempt, has different and notable consequences. The collaboration can take nuanced forms and can vary in the particularities of the specific collaboration agreement.

As an example, we can look at the collaboration between Valeant and Pershing Square in the failed acquisition of Allergan. In the Allergan case, Valeant and Pershing Square formed a jointly owned entity as a vehicle to purchase and hold the TH in Allergan. The TH collaboration agreement between Valeant and Pershing Square served a few goals. Arguably, it helped circumvent the requirements of the HSR Act by using an entity that would not trigger extensive anti-trust examinations.[123]

The agreement between Valeant and Pershing Square included a provision which provided that if Valeant's attempt to acquire the target, Allergan, did not succeed and there existed a competing bid, then Valeant would be entitled to 15% of the profits from the TH that would otherwise be allocated to Pershing Square, in addition to its own profit from the TH.[124]

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122. The purpose of the collaboration is to benefit from the price increase that is likely to ensue following the proxy fight. *See, e.g.*, Transcript of Record, Yucaipa America Alliance Fund II, L.P. v. Riggio, 1 A.3d 10 (Del. Ch. 2010) ("I call it the stupid acquirer rule . . . . [I]f you could capture all these upside for yourself, why not do it . . . .") (Strine, J.).

123. Floyd et al., *supra* note 13 ("If Valeant, rather than Pershing Square, would have had to file HSR clearance with respect to the toehold stake in Allergan, there likely would have been significant delays in obtaining antitrust approval because of Allergan's and Valeant's overlapping business.").

124. Letter from J. Michael Pearson, Chairman and CEO, Valeant Pharmaceuticals, to William A. Ackman, Managing Member, Pershing Square § 3 (Feb. 25, 2014) (attached as exhibit 99.3 to Schedule 13D filing No. 0001193125-14-150906); *see also* Basile v. Valeant, No. SACV 14-2004-DOC, 2015 WL 7352005, at *14 (C.D. Cal. Nov. 9, 2015) (denying motion to dismiss) ("Plaintiffs have included many specific allegations regarding Pearson, including that 'Pearson convinced Ackman to agree that if Valeant's takeover bid was trumped and defeated by a competing bid, Pershing would kick back 15% of its insider trading profits to Valeant . . .'."); Valeant Pharmaceutical International Inc., Schedule 13D, Item 6 (April 21, 2014) ("Valeant will have a right to 15% of the net profits otherwise allocated to Pershing Square if, before dissolution and at a time when a Valeant business combination proposal for the Issuer [Allergan, Inc.] is outstanding, a proposal for a third party business combination with the Issuer is outstanding or made . . . .").

In addition to a special profit sharing arrangement in case Valeant lost the bid for Allergan, Pershing Square agreed to a few provisions that would benefit Valeant if it successfully took over Allergan: it agreed to receive Valeant stock as consideration.[125] Furthermore, in an attempt to convince the other shareholders of Allergan to accept Valeant's offer, Ackman announced that his fund, Pershing, was willing to accept about 12% less per share than the other Allergan shareholders.[126]

In the Allergan case, the claim made by pension funds shareholders was that the acquisition of the TH took place while the acquirer was contemplating a *tender offer* rather than a friendly acquisition, thus triggering the Williams Act.[127] Even though the acquirer was describing its actions as an attempt to negotiate a friendly acquisition with the target's management, prior failed attempts to do the same, according to the plaintiffs, led the acquirer to plan a tender offer at that stage. However, without such history between the acquirer and the target at the time of the collaborative efforts to purchase the TH, a tender offer would be premature and the Williams Act and insider trading rules would likely not be applicable.[128] Outside the realm of the Williams Act, insider trading violations require either misappropriation of the information or a breach of a duty,[129] none of which applies to a standard TH collaboration. Whether the acquisition of a collaborative TH in Aller-

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125. Complaint at ¶ 119, Basile v. Valeant, No. 8:14-cv-02004-JLS-JCG, 2014 WL 7176420 (C.D. Cal. Dec. 16, 2014) ("Pershing Square agreed to forego all cash and accept 100% of its consideration in Valeant stock . . . .").

126. Michael J. De La Merced, *In a Surprise Move, Valeant Again Raises Its Bid for a Rival, Allergan*, N.Y. TIMES: DEALBOOK, (May 30, 2014), http://dealbook.nytimes.com/2014/05/30/valeant-raises-bid-for-allergan-again/.

127. *See* Complaint, *supra* note 125, at ¶ 32 ("Because Allergan's board was not interested in a transaction with Valeant in 2012 and declined to engage in discussions, Valeant was well aware in early 2014 that Allergan was not likely to be supportive of a friendly merger.") and ¶ 107 ("While Valeant initially tried to characterize its takeover as a 'merger' in an effort to skirt the federal securities regulations triggered by a tender offer, its plan from the very beginning was to launch a tender offer.").

128. Similarly, should the parties agree that both are equally involved in the takeover attempt and sufficient control is given to the collaborator, a co-bidder relationship may be deemed to be created so that they may be regarded as a single offering person.

129. *See* Chiarella v. U.S., 445 U.S. 222, 235 (1980) ("[A] duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information.").

gan was in violation of the securities laws, and specifically insider trading rules, is a factual question that is specific to the particular facts of that case. However, it does not restrict the adoption of the strategy of a collaborative TH in general, in cases that do not involve a tender offer.

The first bidder may enter into a TH collaboration agreement and as a result may own, directly, fewer shares in the target, since the collaborator will own a portion of the TH.[130] Why would the first bidder share in the opportunity to purchase shares for a lower price on the eve of the planned takeover? It may choose to do so because it receives other benefits from the collaborator. Such benefits may be direct and related to the specific transaction, such as lower financing costs, as the collaborator may serve as the lender and provide financing for the acquisition at a more favorable cost. Alternatively, the benefit can be unrelated to the specific transaction; rather it may involve other business relations between the two collaborators, such as the collaborator identifying additional potential targets. The first bidder may also decide to use a collaborator for the purchase of the TH because of liquidity constraints that may prevent it from acquiring all of the TH directly.

There is disagreement about whether increasing the size of the TH is desirable. Proponents of THs argue that high costs lead to suboptimal levels of searching efforts and shareholder activism, while sizable THs may help incentivize searches for underperforming targets and enhances corporate governance.[131] On the other hand, opponents of THs and of

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130. The total size of the TH is likely to be less than 10%. *See supra* notes 19–25 and accompanying text.

131. Bebchuk, *supra* note 73, at 256 ("The rewards for search could be substantially increased by raising the statutory limit on the amount of the target's shares that a searcher can purchase without being required to disclose its purchases. As long as the researcher is required to stay below the threshold of effective control, an increase in the disclosure threshold would be consistent with an auctioneering regime."); Ronald J. Gibson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 53–54 (1982). *See also* Subramanian, *supra* note 28, at 709 ("[Toe-holds] provide some offset against the search costs, operational costs, and reputational costs . . . ."); *Id.* at 713 ("Economic theory and anecdotal evidence suggest that first bidder costs may be substantial. . . particularly when reputational and operational costs are also considered, and that toe-holds and breakup fees may not be sufficient to mitigate these costs."); Easterbrook &

increasing their size argue that, first, shareholder activism has surpassed the optimal level and intervenes to efficiently manage corporate businesses,[132] and second, that the stock market will benefit from increased transparency and prompt disclosure of lower thresholds on TH acquisitions, which will curtail the size of THs.[133]

The TH collaboration agreements can affect both the actual and effective size of the TH through agreements to join in the purchase of the TH and share in the profits it produces. The agreement between the collaborator and the bidder can provide that the collaborator will pay the bidder if it loses and another bidder wins (meaning that the collaborator agrees to transfer part of the profits from selling the TH to the second bidder). For example, in Valeant's failed acquisition of Allergan, Pershing entered into an agreement with Valeant that provided, in part, that the fund would pay Valeant 15% of its profits from its stake in the TH if a second bidder acquired Allergan instead of Valeant. The effect of this agreement is similar to owning a larger TH directly in the sense that it increases the profits when a competing bidder wins the bidding war and acquires the TH and the rest of the target.

However, this agreement has the effect of increasing the size of the TH without the risk and expense of the original bidder acquiring a larger TH directly. Since the collaborator, rather than the First Bidder, purchases at least part of the TH, the risk to the First Bidder is lower than if it had purchased the collaborator's share of the TH directly. After all, there are no assurances that an additional bidder will materialize; and even if another bidder attempts to acquire the target, it may be that despite the potential acquirers' best efforts, the target will remain independent, and the First Bidder will be left holding

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Fischel, *supra* note 33, at 17 ("The optimal level of regulation of tender offers for either purpose is zero. Private and social wealth is greatest when bidders choose their own time periods and disclosures, subject to a prohibition of fraud.").

132. *See, e.g.*, Lipton, *supra* note 3.

133. David Benoit & Liz Hoffman, *Taking Sides on Activist Investors*, WALL ST. J., (March 19, 2015), https://www.wsj.com/articles/strine-urges-closing-of-10-day-investment-disclosure-window-1426791548 (reporting that Chief Justice Leo Strine recommended changing the disclosure requirements of Rule 13d in order to increase transparency in the stock market. He suggested shortening the disclosure period from 10 day to 24 hours and lowering the 5% threshold to 2%.).

the TH. It is also possible that no one will succeed in acquiring the target (and along with it, the TH), either because the target's management will prevent it[134] or because further due diligence on the target reveals that it is not a worthwhile acquisition. Selling the TH back to the market may well involve a loss, as noise traders are likely to have noticed the increased demand, especially in the 10 days after the bidder crossed the 5% threshold.[135] Dispensing the TH back to the market may increase the loss of the First Bidder who already spent money and reputation on the failed acquisition attempt. The price the First Bidder paid for the TH may be significant if it purchased a sizable amount, which may well have increased the price of the stock because of the noise in the market and the increased demand and upward movement on the supply curve.[136] The target's value may have declined since the TH's original purchase because the target's management may have spent resources in an effort to fight off a hostile takeover at-

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134. *See, e.g.*, the case of the management of Airgas, which successfully used a prolonged poison pill to fend off a hostile takeover. Gina Chon, *"Poison Pill" Lives as Airgas Wins Case*, WALL ST. J. (Feb. 16, 2011), https://www.wsj.com/articles/SB10001424052748704343404576146821120717658 ("Minutes after the judge's ruling [upholding the poison pill], Air Products dropped its effort to buy Airgas.").

135. For example, in the Allergan case the price of the stock of Allergan increased allegedly because market participants had picked up on something, such as unusual increased momentum, or because of illegal insider trading. *See, e.g.*, Joe Van Acker, *Allergan Investors Accuse Valeant, Pershing of Takeover Plot*, LAW360 (Dec. 17, 2014) ("The complaint also quoted analysts who said the volume of trading in Allergan stock in the 10 days before Valeant's announcement was 86 percent higher than the previous year, indicating that additional tipping by Pershing Square and Valeant may have occurred."); Matt Levine, *Predatory Traders Front-Ran Bill Ackman's Botox Buy*, BLOOMBERGVIEW (Apr. 23, 2014), https://www.bloomberg.com/view/articles/2014-04-23/predatory-traders-front-ran-bill-ackman-s-botox-buy ("Whoever did it—tippees, momentum-seeking tape-reading day traders, or HFT algorithms—someone traded ahead of Ackman here.").

136. *See, e.g.*, Kyle & Vila, *supra* note 14 ("'noise trading'—uninformative trading for liquidity or life cycle motives—provides enough camouflage to enable a large outsider to profit by acquiring a significant stake in a target firm without being noticed. When there is a great deal of noise trading . . . the market attributes changes in the quantity of shares supplied in the market to changes in noise trading, not to changes in the behavior of a large trader with private information about takeover prospects.") (footnote omitted).

tempt.[137] While the TH can prove beneficial if another bidder wins, it may be a liability in the case of a failed hostile takeover wherein the target remains completely independent.[138]

Thus, sharing the TH enables the bidder to share and lower its risk and may in fact promote challenges to corporate control, as it may enable hostile takeovers to succeed in cases wherein there is a non-negligible probability that the target's management may strongly oppose the takeover and potentially succeed in blocking the takeover attempt.[139] In addition, from a reputational perspective, the reputational cost of the failed takeover attempt may be lower if a collaborator shares it, especially a collaborator that has a positive track record. If such a collaborator backed the attempt, albeit a failed attempt, the failure will reflect less poorly on the bidder. The collaboration may also help the bidder to protect its reputation by letting the collaborator take the role of the aggressor and by refraining from openly participating in any hostile attacks on the target's management.[140]

Alternatively, the asymmetric collaboration agreement can provide that the collaborator will pay the bidder if it wins and acquires the target. This time, the parties agree to share in the profit in the event of a successful bid. This type of agreement can take the form of agreeing to accept a less valuable consideration for the TH as part of the acquisition of the target. In the Allergan case, for example, Pershing agreed to receive stock as sole consideration for its TH in the event Valeant acquired Allergan, even if the other shareholders of Allergan receive a combination of cash and stock or even all-cash.[141] Such agreements make it easier for the acquirer to

137. *See, e.g.,* Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (upholding the self-tender plan of Unocal's board, which required Unocal to incur significant debt, as a defense tactic aimed at fending off Mesa's hostile takeover attempt.).

138. *See supra* note 76.

139. Several factors, such as different diversification needs and risk preferences, may influence a collaborator to purchase a TH when a bidder on its own would not.

140. *See* Floyd et al., *supra* note 13, at 7 ("The structure moreover mitigates the reputational stigma of a hostile takeover campaign because the bidder can use the activist for attacks on the target's board and management while maintaining—or at least purporting to maintain—the moral high ground.").

141. *See* Complaint at ¶ 119, Basile vs. Valeant Pharm. Int'l, No. 8:14-cv-02004-JLS-JCG (C.D. Cal. Dec. 16, 2014) ("Pershing Square agreed to forego

take over the target, since it has to pay less cash and, instead, can use its own stock. The discount the collaborator gives the bidder can be higher or lower than the control premium the acquirer is willing to pay for the remaining shares of the target.[142]

If the collaborator agrees to pay the bidder in the event it wins, then the collaboration agreement increases the expected benefit from winning and thus has the effect of making losing even less desirable. The collaboration agreement can have this same effect (of making losing less desirable to the bidder) by directly providing that losing will be costlier. For example, the agreement could state that if the bidder loses, then the collaborator's share of the profits from selling the TH will be larger.

The agreement can also have the reverse provision: the bidder, instead of the collaborator, agrees to pay the collaborator part of its share of the TH profits if it wins, and the bidder pays the collaborator more than the payment the other target's shareholders would receive. The Williams Act prohibits discrimination between shareholders, and all shareholders should be paid the same.[143] However, there is a risk that the payment will take an indirect form (such as consultant fees) rather than payment for the shares, de facto constituting a higher cost to the bidder in case of winning in a way that does not overtly violate the law.[144]

More generally, the provisions of the collaboration agreement can provide that each one of the parties may agree to pay the other a portion of its share in the TH if certain events

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all cash and accept 100% of its consideration in Valeant stock . . . . Pershing Square would receive $20.75 per share less consideration than other Allergan stockholders . . . .").

142. If, instead, the bidder had acquired a large TH directly, with no collaborators, then the bidder would have paid for the shares the lower pre-notice market price, which did not include the control premium.

143. *See* Rule 14d-10, *supra* note 103.

144. *See, e.g.*, *In re Luxottica Group S.p.A Sec. Litig.*, 293 F. Supp. 2d 224 (E.D.N.Y. 2003); *Field v. Trump*, 850 F.2d 938 (2d Cir. 1988); *Lerro v. Quaker Oats Co.*, 84 F.3d 239 (7th Cir. 1996); *cf.* Ganor, *supra* note 96 (executive payments and Perpetual Thrones given to target officers and directors). It should be noted that in 2006 the SEC amended the best price rule to exempt "compensatory arrangements from the rule so long as specific substantive standards are satisfied." Press Release, Sec. and Exch. Comm'n, SEC Amends Tender Offer Best-Price Rules to Benefit Investors (Oct. 18, 2006), https://www.sec.gov/news/press/2006/2006-177.htm.

come to pass. The collaborator can agree to pay the bidder. The collaboration agreement can also work in the reverse direction: the bidder can agree to pay the collaborator. The triggering event for paying can be the bidder winning and acquiring the target. Alternatively, the triggering event can be the bidder losing and a competing bidder buying the target along with the TH.

There are four possible contingent profit-sharing provisions: (a) The Collaborator agrees to pay the Bidder if a second bidder, a competitor, wins and acquires the target (thus sharing the collaborator's profits from selling the TH with the Bidder); (b) the Collaborator agrees to pay the Bidder if the Bidder acquires the target (such payment can take the form of the Collaborator accepting a lower-valued consideration for its TH shares); (c) the Bidder agrees to share with the Collaborator its profits from selling the TH to a second competing bidder if the competitor acquires the target; and (d) the bidder agrees to pay the Collaborator if it acquires the target.[145]

The collaboration agreement can include one or more of these contingent profit-sharing provisions. The combination of the provisions can work either in the same or in opposite directions. The total effect of the agreement depends on the cumulative direction of the provisions adopted in the agreement. The agreement can be symmetric in the sense that the provisions will balance each other out: in the aggregate, the same party to the agreement will receive the same amount of payment from the other party whether the bidder wins or loses the battle to acquire the target. Conversely, the total effect of the agreement can be asymmetrical. As long as there is asymmetry between the two effects, which means that the bidder's net gain from the provisions is higher in the case of one outcome rather than the other, then the TH may affect the decision of whether to go ahead with the acquisition of the target or let the competitor win.

For example, the collaborator agrees to pay or otherwise transfer equivalent value to the bidder both if the bidder wins

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145. This provision may be more difficult to achieve directly in case of a tender offer, since the Williams Act prohibits discrimination regarding a tender offer consideration, thus the price per share paid for the TH should be the same. However, there are other ways to achieve this result indirectly, such as payment for consultation. *See* Securities and Exchange Commission, *supra* note 144, at 1.

and if it loses. The effect of each of these two undertakings is balanced out: regardless of the result of the proposed acquisition the collaborator will transfer the same value to the bidder, and thus the bidder's incentives and the outcome of the bidding contest should not be affected. The agreement makes it less expensive for the bidder to acquire the target, because the collaborator will accept a lower consideration, and at the same time, it is more valuable for the Bidder to lose the bid because the collaborator will pay the Bidder if a competitor purchases the target.

On the other hand, if the agreement is not symmetrically balanced, then the asymmetry of the agreement will affect the incentives of the parties. This may result in changing the motivations of the Bidder and incentivizing it to either win or lose the bidding because of the added effect of the collaboration agreement. For example, the collaboration agreement may provide that the bidder will share part of its profits from its stake in the TH in case it loses the bidding war and ends up selling the TH to a competing bidder. This may serve as a penalty for losing, thereby minimizing the incentive to lose and encouraging overbidding. At the same time, since this agreement confers a benefit on the collaborator in the event of a competing bidder's win, it increases the Collaborator's incentive to support this outcome and vote its shares against the Bidder and in favor of the competing bid.[146] Alternatively, the agreement may provide for a payment to the collaborator when the acquisition of the target by the Bidder is finalized, thus making the deal less valuable to the Bidder and, at the same time, increasing the collaborator's incentive to support the deal.

In particular, an asymmetric collaboration agreement that penalizes the First Bidder for losing the bid for the target to a competitor may have a deterrent effect on potential competing bidders. Since the collaborators publicize their agreement (as the existence of such an agreement must be disclosed under the requirements of Rule 13d) following the purchase

146. This incentive to vote against the First Bidder and in favor of the Competing Bidder may explain voting agreements that require the Collaborator to vote its TH shares in favor of the First Bidder. [For example, the Allergan case included such a provision. . .] To be sure, an overt vote against the First Bidder entails reputational costs for the Collaborator.

of the TH,[147] potential bidders may realize that their chances of successfully bidding for the target are low even if the value of the target to them is higher than it is to the Bidder. The reason for the decrease in the likelihood of success is that the collaboration agreement creates a credible threat of overbidding by the Bidder. Thus, from an ex ante standpoint, initiating a competition may be economically rational only if the competitor values the target significantly more highly than the Bidder does, so that it will have a chance to overcome the collaboration agreement. One can think of this strategy of asymmetric TH collaboration as a strategy that openly and credibly makes losing worse for the bidder so that the bidder will be pushed to make an extra effort to win, virtually telling the potential competing bidders that it cannot afford to lose.

Thus, the asymmetric collaboration agreement may result in an inefficient outcome in the sense that a potential bidder who values the target for more will not enter the competition.[148] This raises the question of why the Bidder would create a credible threat ex ante when such a threat is likely to result in deterring an efficient competitor who would have bought the bidder's TH for more than it is worth to the Bidder. The answer lies in the fact that *without* the competition the bidder is likely to profit *more* than it would profit from selling its TH to a competing bidder, as the lack of competition will allow the bidder to profit from acquiring the target for a lower price.[149] While the asymmetric TH collaboration may look like shooting oneself in the foot (or rather, toehold), it may ultimately benefit the bidder.

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147. *See, e.g.*, THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 400 (7th ed. 2017) ("Disclosures also must be made with respect to contracts and other arrangements between the persons making the Schedule 13D filing and any other persons concerning the target securities of the issuer, including voting agreements options, and distributions of profits.").

148. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030 (1982) ("[F]acilitating competing tender offers is desirable both to targets' shareholders and to society.").

149. *Id.* (arguing that "facilitating competing tender offers is desirable both to targets' shareholders and to society" and that auctions increase shareholder value and social wealth); Sekhon & Kornfeld, *supra* note 76, at 288 (2016) ("A bidding competition is beneficial to shareholders' financial interests because of the potential for a higher price.").

IV.
THE EFFECT OF A TH WITH AN ASYMMETRIC TH COLLABORATION

A. *TH, Competition, and Collaboration*

As in Part II.B.2 above, the following analysis assumes that the First Bidder has identified a company for acquisition (the target) and that the Competing Bidder learns about the acquisition plans when the First Bidder publicly announces the acquisition of the TH and its plans to acquire the entire target. The Competing Bidder decides to attempt to acquire the target as well. This time the First Bidder enters into an agreement with a Collaborator. The Collaborator may take the form of an activist investor, a financial entity, or a general business partner. The agreement between the First Bidder and the Collaborator focuses on the purchase of the TH and on the profits from the TH in the event of an acquisition of the target. TH collaboration agreement may be asymmetric. It is an asymmetric agreement in the sense that the size of the payments that the parties to the collaboration agreement undertake to pay each other varies in relation to the First Bidder's success with the acquisition of the target. That is, the extent of the profit sharing is contingent upon the outcome of the bidding war between the First Bidder and the Competing Bidder. I will consider two alternative and converse asymmetric agreements: The first agreement will provide that the First Bidder will have to share in its profits from the TH it buys with the Collaborator *only in the event that* the First Bidder wins the bidding war with the Competitor and acquires the target.[150] The second agreement will provide that the First Bidder will share its profits from the TH with the Collaborator, but only if the First Bidder loses the bidding war with the competitor and does not acquire the target.[151]

The First Bidder and the Collaborator agree on a transfer of funds that is conditioned on the outcome of the contemplated acquisition of the target. The fate of the target and the

150. This agreement is similar to an agreement that provides that the collaborator will share in its profits from its part of the TH with the First Bidder if a competitor ultimately acquires the target rather than the first bidder.

151. This agreement is similar to an agreement that provides that the collaborator will share in its profits from its part of the TH with the First Bidder if the First Bidder acquires the target.

identity of its ultimate owner will determine the direction of the transfer—whether the First Bidder pays the collaborator or the collaborator pays the First Bidder. For example, the agreement may provide that should the First Bidder lose the bidding war and a Competing Bidder win and acquire the target, then the First Bidder may not retain all of the profits from the sale of the TH to the Competing Bidder[152]: rather, the first bidder shall share its profits with the Collaborator. However, should the First Bidder win the bidding war, it may retain all of its profits from the TH.[153] In other words, the asymmetric agreement may be drafted in ways that distort the incentives of the first bidder by penalizing a losing outcome.

Since the asymmetric agreement may motivate the First Bidder to win even if the price it has to pay in order to win is excessively high, the asymmetric agreement may affect potential competing bidders ex ante. An asymmetric agreement may credibly threaten a potential competing bidder and deter it from entering the bidding war since it lowers the competitors' chances of winning. Thus, the parties to such an agreement would prefer to make its contents public so that potential competition will become aware of the credible threat their collaboration poses. The securities laws help the parties achieve this goal by requiring the disclosure of such agreements and supplying a platform for the disclosure as part of Schedule 13D.[154] By eliminating the competition, the first bidder may be able to pay less for the target, which will directly hurt the target's shareholders.[155] Furthermore, the distorting incentive designed by contractually penalizing the first bidder in the event

152. In this example, I assume that the first bidder owns all of the TH. Alternatively, the collaboration agreement may provide for the co-purchase of the TH and the allocation of the profits thereof based on the outcome of the takeover.

153. The collaborator may still profit from the deal as it may provide the funds for the acquisition, or it may have purchased a part of the TH that increased in value once the Competing Bidder acquired the target.

154. *See* sources cited *supra* note 4.

155. *See, e.g.*, Bebchuk, *supra* note 148, at 1030.

of a loss will potentially deter competition even from a higher-value bidder, thus leading to an inefficient[156] outcome.[157]

An alternative design of the collaboration agreement, which nevertheless produces a similar outcome, could frame the agreement as a positive payment to the First Bidder in the event that it wins. For example, the collaborator buys part of the TH and agrees to share in the profits from subsequently selling the TH, but only if the First Bidder, rather than the Competing Bidder, ends up acquiring the target. Sharing in the profits from the TH in this case is tantamount to agreeing to sell the TH to the First Bidder for a lower price than the price the First Bidder will pay to the other target's shareholders. Similarly, agreeing to be paid in stock rather than cash (as occurred in the Valeant example[158]) may have the identical effect of agreeing to a lower consideration. The asymmetric part of the collaboration agreement may be structured as either a penalty or a reward: a penalty for losing the bidding war or a reward for winning. Either way, the result of such an asymmetric agreement is a shift in favor of winning. Conversely, the parties can enter into an agreement that has an asymmetric effect in the opposite direction: the First Bidder will be rewarded if, and only if, it loses the bid to a competing bidder.[159]

156. To be sure, claims about efficient outcomes should be qualified. For example, in this case it could be argued that the expected higher profit of the First Bidder caused by competition elimination may increase the level of searches and improve corporate government. However, this could also back fire by managers over reacting and entrenching themselves and thus reducing the incentive to search for targets. *See* Richard S. Markovits, *Monopoly and the Allocative Inefficiency of First-Best-Allocatively-Efficient Tort Law in Our Worse-Than-Second-Best World: The Whys and Some Therefores*, 46 CASE W. RES. L. REV. 313, 319–20 (1996) (discussing the general theory of Second Best, the deficiency of an isolated allocative efficiency analysis without a study of the aggregate effects, and the applications of this theory to the law).

157. As before, further transfer to a higher-value bidder is likely to be inhibited by transaction costs. *See* Bebchuk, *supra* note 120.

158. *See* Complaint at ¶ 119, Basile vs. Valeant Pharm. Int'l, No. 8:14-cv-02004-JLS-JCG (C.D. Cal. Dec. 16, 2014).

159. Drafting a similar agreement that provides that the First Bidder is penalized for winning by having to compensate the collaborator should avoid violating Williams Act, which requires that all shareholders of the target be paid the same higher consideration in a tender offer. Thus, the First Bidder cannot directly pay the Collaborator more for its TH, but it may enter into a financing agreement with a higher interest rate in case of the acquisition of the target, for example, which in fact will have the effect of

In the following Part, I outline a basic numerical example that illustrates the effect of a TH in the case of collaboration with an asymmetric agreement. The asymmetric collaboration can take one of two forms: I call the first form Forward Asymmetric Collaboration Agreement (FACA) and the second form Reverse Asymmetric Collaboration Agreement (RACA). The FACA penalizes the First Bidder for losing while the RACA penalizes the First Bidder for winning.

1. *Forward Asymmetric Collaboration Agreement*

The first bidder enters into a collaboration agreement. This agreement has an asymmetric effect: the first bidder agrees to pay its collaborator more if it loses than if it wins. Thus, it penalizes the first bidder for losing the bidding war. For example, the agreement may say that if, and only if, a competitor wins and buys the target, the First Bidder will have to share the profit from the TH with the collaborator. This asymmetric agreement reduces the effect of the TH on the First Bidder in the event that a competitor wins: the First Bidder agrees to share a portion of the profits from the TH with the collaborator but only if it loses the bid and sells the TH to the Competing Bidder. Thus, if it loses the war, it will retain less of the profit from buying a TH.

However, since this agreement treats winning and losing differently, its effect is not equivalent to merely reducing the size of the TH. Rather, it distorts the incentives of the first bidder, and may motivate it to offer a higher price, higher than the actual value it assigns the shares of the target, in order to win and avoid paying the Collaborator the penalty for losing. To be sure, this case of over-bidding is different from the overbidding that occurs in the strategic bidding discussed in Part II.B.3 above. While in both cases the First Bidder continues to bid beyond its reservation value, in the strategic bidding scenario the bidder overbids above its reservation price in order to induce the Competing Bidder to increase its bid, but not with an intention to win, but rather with a hope of losing the bidding war to the competitor.

To illustrate the possible effects of entering into an asymmetric agreement, I assume that the two collaborators agree

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penalizing the First Bidder for winning. *See supra* note 103 and accompanying text.

that the first bidder will be able to keep only 4% of the profit from the TH if it loses the bidding war. The Table below summarizes the collaboration agreement.

TABLE III

	Target stays independent	First Bidder buys target	Competing Bidder buys target
Payment to Collaborator	$0	$0	96% of TH profit

As before,[160] the First Bidder bought a TH in the open market, a 10% stake in the target, for $8. If the First Bidder owns the target, it will be worth $100 to it.

Suppose the competitor offers $1 per share, which is exactly how much the first bidder values the shares of the target to be worth. If the competitor's offer of $1 per share is accepted, the first bidder stands to profit $2 from the TH position (10 shares times $1 minus the cost of $8). According to the collaboration agreement, the first bidder will have to pay the collaborator 96% of the profit from selling the TH to the competitor, leaving it with a net profit of only $0.08 (4% x 2). However, if the first bidder counterbids and offers the shareholders of the target $1.01 per share, $0.01 more than it values the shares, it will have to pay a total of $90.9 for the remaining 90 shares. The total cost of purchasing the target will be $98.9, which includes the $8 it paid for the TH. Since the target is worth $100 to the first bidder, this leaves the first bidder with a profit of $1.1, all of which it may keep. This time, if it wins, the first bidder does not have to share its profit with the collaborator with whom it entered into the asymmetric collaboration agreement.

However, the competitor values the target at $102, and thus will be willing to offer up to $1.02 per share. If the First Bidder does not make a counteroffer and loses to the competitor following the asymmetric agreement with the collaborator, it will be allowed to keep only 4% of the profit on the TH. The first bidder will receive from the competitor $1.02 per each of the 10 shares constituting the TH for a total of $10.2, or 10%

160. See numerical example *supra* Part II.B.

of the $102. Since the cost of the TH was $8, the profit will be $2.2, and the first bidder's 4% share is $0.088.

If the first bidder increases its offer and bases its offer on a $102.1 valuation of the target, or $1.021 per share for the remaining 90 shares, then it will win the bidding war.[161] In this case, it will lose $0.021 for each of the 90 shares that it buys in the tender offer, which is the access payment it makes above its share valuation of $1. The first bidder will make a total overpayment to the holders of the 90 shares of $0.021 x 90= $1.89. It will make $2 on the TH (since it paid $8 for it and it will be worth $10 after it owns the entire target). As a result, the first bidder will profit from the transaction: its net gain will be $0.11.[162] Since it gets to keep only 4% of the profit from the TH if it loses but all of the profit if it wins, the first bidder will continue bidding past its own reservation value of $100 and even past $102 (the reservation value of the competitor), thus winning the bidding war with the competitor even though the competitor assigns a higher-value to the target than the First Bidder. The following Table IV summarizes the possible outcomes from the perspective of the First Bidder.

TABLE IV

	Profit from TH	Value of 90 shares	Cost of purchase of 90 shares	Total profit
Sale of TH for $1.02 per share	4%(10.2-8) =$0.088	0	0	$0.088
Purchase of Target for $1.021 per share	10-8 = $2	$90	90X1.021=$91.89	$0.11

Prima facie, this result seems favorable to the target's shareholders[163] because they receive a higher price for their shares than the value either one of the bidders attributes to the shares. Ex ante, however, since the collaboration agree-

161. This is because the offer is higher than the Competitor's value.

162. ($2 – $1.89).

163. To be sure, not the original shareholders who sold the shares of which the TH consists, these shareholders received the market price without a control premium, but rather a price close to the market price of the share at the time of the acquisition of the TH.

ment is made public and the asymmetric treatment of losing and winning in particular is disclosed, the competitor is made aware that it will face the possibility that the First Bidder will continue bidding above its reservation value. Given the lower chance of winning,[164] the competitor may well decide not to compete for the target at all, leaving the first bidder to negotiate with the target's shareholders alone. Without competition, the target's shareholders will be in a more difficult negotiating position and are likely to end up with less for their shares.[165] Thus, this result has both distributive and efficiency effects. The cumulative effect on efficiency is mixed. On the one hand, a lower-value bidder ends up owning the target and the shareholders receive a lower return on their investment, negatively affecting the incentives to invest in the market ex ante. On the other hand, bidders can expect to profit more from acquiring the target and thus may be encouraged to spend more in search costs and to increase the level of takeovers, potentially supporting the market for corporate control.[166]

2. *Collaboration in the Opposite Direction—Reverse Asymmetric Collaboration Agreements*

In this Subpart, I will consider an asymmetric collaboration in the opposite direction. Under this scenario, the collaboration agreement penalizes the First Bidder when it wins the bidding war and acquires the target. Suppose that the First Bidder and the Collaborator enter into an asymmetric agreement that takes the following form: the Collaborator agrees to buy the TH and promises to share equally (50/50) with the

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164. Including a lower chance of winning for a price below the competitor's reservation price.

165. *See, e.g.*, Bebchuk, *supra* note 148, at 1030 (for the benefit of having more than one bidder competing for the target); *see also* Peter Lattman, *Court Revives Financier's Fraud Suit Against Citigroup Over the Sale of EMI,* N.Y. TIMES, MAY 31, 2013, https://dealbook.nytimes.com/2013/05/31/appeals-court-revives-financiers-suit-against-citigroup/ (describing the suit brought by Terra Firma Capital Partners Ltd. against Citigroup for allegedly misrepresenting that another bidder was interested in acquiring EMI Group Ltd. In its complaint, Terra Firma argued it paid an inflated price for EMI because of Citigroup's alleged misrepresentation.).

166. Similarly, the effect of increasing the search level may not necessarily be efficient as it may be excessive, in addition to encouraging management to adopt anti-takeover mechanisms, which may likely affect social welfare negatively.

First Bidder its profit from the sale of the TH only if the First Bidder loses and a Competing Bidder purchases the target. In order to illustrate the possible distortive effects of such an asymmetric contract in the opposite direction, I consider the following example: this time the First Bidder is the efficient buyer in the sense that the value it assigns to the target is higher than the value that the Competing Bidder assigns to the target. The First Bidder values the target for $101 and the Competitor values it for only $100. As before, the TH is 10% of the target and the cost of purchasing the TH in the market before the proposed takeover announcement is $8, based on an $80 value. Should the Competitor offer $100 for the target, including $10 for the TH, then the total profit from the TH will be $2. The Collaborator will share half of the profit with the First Bidder, who will gain $1. Alternatively, The First Bidder could continue with the bidding war and make a counteroffer to the Competing Bidder's last and highest offer, since it values the target for $101. Nevertheless, any counteroffer that the First Bidder will propose above the $100 offered by the Competing Bidder will leave it with less than $1 profit.[167] Thus, in this case, winning is an inferior strategy to losing the bidding war and receiving half of the TH profit.

This simple example shows that an asymmetric TH collaboration agreement may cause the First Bidder to walk away from the target and allow a lower-valuing competitor to acquire the target.[168] Why would the parties, the collaborators, enter into such an agreement? An asymmetric agreement in the other direction may play an important role in deterring competition and allow the first bidder to acquire the target at a lower price. Conversely, at first glance, an asymmetric agreement in this direction may encourage potential bidders to compete for the target and prevent the first bidder from acquiring the target. However, such potential acquirers may wonder whether the initial TH acquisition is indeed a signal that the First Bidder has conducted a thorough study of the target and concluded that it is a worthy target for acquisition. The TH acquisition may look like a ploy to lure other buyers

167. If it bought the target for $100 it would have made a $1 profit. Any price above $100 will leave it with a lower profit.

168. Subsequent transfer may not be possible. *See* Bebchuk, *supra* note 120.

to acquire the target and leave the parties to the asymmetric agreement with an easy and quick gain from the TH with no sincere intent to follow through with a full takeover of the target. Such an agreement may indicate to potential competitors that the offer is not serious and that the collaborators are merely interested in profiting from the TH, not in acquiring the target itself. Thus, this may serve to weaken the free-rider opportunity since potential competing bidders may no longer rely on the first bidder's disclosed intentions. At the end of the day, this type of asymmetric agreement may also help to prevent the entrance of free-riders, who may be uncertain about the true intent of the parties to the agreement, and thus chill competition. To be sure, to the extent that the first bidder is a serial acquirer who repeatedly acquires targets despite such asymmetric agreements, such agreements are not likely to chill free-rider competition. Furthermore, management and shareholder advisory institutions may view this agreement as a signal of lack of seriousness and may make the target reluctant to negotiate with the first bidder.

It should be noted that a collaboration agreement could be drafted with either a penalty or an award and yet still have an identical economic effect, in that penalizing the bidder if it loses can be equivalent to rewarding it if it wins, (each has the effect of motivating winning and discouraging losing); and rewarding losing can substitute for penalizing winning (motivating losing and discouraging wining). However, the choice between the two, the carrot or the stick, may have behavioral psychological effects similar to the endowment effect[169] and to loss aversion,[170] as the estimation of a cost (as opposed to a benefit) may be skewed by the fact that it is framed as a cost.

CONCLUSION

The cooperation with a hedge fund or other business entity in takeover contests opens the door to new arrangements and alters the concept of a traditional TH. This Article has shown that with the new wolf packing practice, which fosters investor collaboration, a TH may affect the outcome of a take-

169. *See* Richard Thaler, *Toward a Positive Theory of Consumer Choice,* 1 J. ECON. BEHAV. & ORG. 39, 44 (1980).

170. *See* Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames,* 39 AM. PSYCHOLOGIST 341, 342 (1984).

over attempt and may negatively affect social welfare in ways that have previously gone unexplored. The collaboration in the acquisition of the TH itself presents an opportunity for potential bidders to create credible threats and deter competition from other potential acquirers including those who value the target for more.

Cooperation in the TH acquisition can include special agreements which will come into effect once a competing bidder enters the scene. The TH collaboration can include a profit sharing agreement that can either penalize or reward the bidder who is a party to the TH collaboration by increasing or decreasing the bidder's share of the profits from the TH based on the outcome of the bidding contest. The triggering event for these arrangements can be the competing bidder winning the contest and taking over the target.

Thus, the TH collaboration agreement can have a foothold effect, making it more profitable for the bidder to acquire the target rather than allowing a competing bidder, even a higher-use bidder, to acquire the target. Making the TH collaboration agreement public is likely to deter potential competing bidders ex ante, thus allowing the first bidder and its collaborator to increase their profits from the target at the expense of the shareholders and possibly at the expense of social welfare as well.[171]

While TH scholars have long recognized the potential benefits of acquiring a TH—particularly the ability to hedge against the possible loss of search costs in the event of a loss to a free-riding-higher-value bidder—the debate about TH acquisitions, including the timely disclosure of such acquisitions, persists. With enhanced collaboration among investors, public disclosure of TH collaboration agreements, specifically asymmetric agreements, may actually serve to strengthen the initial bidder and may well deter competition, dampening the market for corporate control. Thus, with collaboration, the complexity of the bidding game has increased and more aspects of the bidding game may affect the efficiency of the market. Appeals to the U.S. Securities and Exchange Commission to use

171. *Cf. supra* note 166 and accompanying text, discussing the effects on corporate governance: a potential increase in the level of target-searching activities on the one hand, followed by a likely increase in the level of defensive activities employed by incumbents on the other hand.

its authority under the Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") to amend the mandatory disclosure rule by shortening its window,[172] on the one hand, as well as apparent plans to repeal the Dodd-Frank Act on the other,[173] seem to be crude attempts to fix the market. Such solutions are excessively broad for the current level of complexity in the market and are unlikely to stop the tide of emboldened activist investors, who are seeking means of circumventing the rules—and should they succeed, (i) there may well be unintended consequences and (ii) the result would not necessarily lead to a smaller decrease in social welfare than under the current state of affairs.

172. *See supra* notes 3–4 and accompanying text.

173. *See, e.g.,* Ben Protess, *Republicans' Paths to Unraveling the Dodd-Frank Act*, N.Y. TIMES, Jan. 30, 2017, https://www.nytimes.com/2017/01/30/business/dealbook/republicans-unravel-dodd-frank-act.html?_r=0 and Bob Ehrlich & J.C. Boggs, *The Next Repeal and Replace: Dodd-Frank*, FORBES, Jan. 28. 2017, https://www.forbes.com/sites/realspin/2017/01/28/the-next-repeal-and-replace-dodd-frank/#5119b90f45cd.

APPENDIX

In this Appendix, I will use algebraic modeling to study TH collaborations. The basic framework, and especially the review of the basic TH theory in Appendix Part I below, will follow the work of Sandra Betton, et al.[174] In Appendix Part II, I will model TH collaboration agreements.

I. REVIEW OF THE BASIC TH THEORY

Consider the following scenario: Company A is interested in acquiring the target T. First, Company A purchases a toehold a in T. α is a fraction between 0 and 1 that represents the fraction of T that A owns. Subsequently, A discloses its acquisition plans to the public. After learning about A's plans to acquire T, Company B realizes that T is a good target for acquisition and that it, B, should acquire T instead of A, and thus decides to compete with A. I assume that B does not have an equity stake in T; nor does B start buying shares in the open market at this time. Following A's public announcement, the market adjusts the price of T's shares and includes a control premium to reflect A's acquisition plans.[175] A bidding war ensues: A and B incrementally raise their respective offer to T until one of the parties, the "losing" party, yields. B will stop bidding once the offer price has reached its own valuation of T, its reservation value, which I denote by V_B. A does not know what V_B is, but it does have a probability distribution for V_B, which means that it can estimate the likelihood of a range of values. A's own valuation of T is denoted by V_A. A has to decide when to stop bidding. I denote A's ceiling, above which it will stop bidding, by h. For simplicity, I assume that there are no termination fees, transaction costs, reputation costs, or other outside reasons that may influence each bidder to either leave the bidding contest or increase the offer price.

The main result of Betton, et al.,[176] who formulated an elaborate model for the basic, traditional, TH, is that the optimal h can be higher than A's valuation, V_A. A possible intuitive explanation to this mathematical result is that when the bid-

174. *See* Betton et al., *supra* note 6.
175. *See* Dyck & Zingales, *supra* note 92.
176. Betton et al., *supra* note 6.

ding has reached a level higher than V_A, A continues to bid even though it does not want to purchase T at the high price it now offers, which is higher than V_A, in fact this time A hopes to lose the bidding contest to B. A continues to bid past its reservation price because it is trying to lure B to make a higher offer. This will allow it to reap higher proceeds from the TH, which it wants B to buy from it for the highest possible price. B may indeed continue to match A's offer as long as it is below V_B.[177]

Specifically, the main result of Betton, et al. is that A's optimal bid is higher than V_A by an amount that equals the percentage of the target that the TH represents times a certain function *R(h)* of the optimal bid. Explicitly, h is given by the solution to the equation:

$$h = V_A + \propto R(h) \tag{1}$$

The factor *R(h)* is calculated from the probability distribution that A assigns to V_B. We first denote:

$G(x)$	Cumulative probability function, that is, the probability that $x > V_B$.
$F(x)$	$=1 - G(x)$ the probability that $x \leq V_B$.
$f(x)$	$=G'(x)$ Probability distribution function, that is, for small ε, $f(x)\varepsilon$ is the probability that $x < V_B < x + \varepsilon$.

Then, according to Betton et al.,

$$R(x) = \frac{F(x)}{f(x)}$$

To gain more insight into this formula, let us take a uniform probability distribution as an example. Suppose V_A=100, α=10%, and V_B is uniformly distributed in the range [100,200]. The range starts at 100, because if B values the target for less than 100 then it will stop bidding and A will win for a profitable price that will allow it to buy the target below its reservation price. Unlike A, B does not strategically bid higher than

177. *See* discussion of strategic overbidding, *supra* Part II.B.3.

its reservation price, because I assume that it does not own a TH in the target.[178] Then

$G(x)=(x\text{-}100)/100$, $F(x)=(200\text{-}x)/100$, $f(x)=0.01$, for $100 < x < 200$.

Plugging these values in formula (1) we get the following:

$$h = 100 + \propto \frac{\left(\frac{200-h}{100}\right)}{0.01} = 100 + \propto (200 - h)$$

For y=h-100, which is the amount that A bids above its V_A, this can be written as

$$y = \propto (100 - y)$$

with the solution of $y = \frac{100 \propto}{1 + \propto}$

To understand the logic behind this result we can look at A's decision process. In making the decision about what should be A's maximal bid, the mount that A will not bid above (not to be confused with the optimal bid), of $h=y+V_A$ $=y+100$, which is y over A's valuation, A's calculation is as follows:

Case	Outcome	Probability	A's Profit/Loss
$h > V_B$	A wins the bid	y/100	$-(1\text{-}\alpha)(V_B\text{-}100)$
$h < V_B$	B wins the bid	1-(y/100)	α y

In case $h > V_B$, I assume that V_B, the value that competitor B assigns to the target, is a random variable. If $h=100+y > V_B$ then V_B is a uniformly distributed random variable in the range [100,100+y] and therefore the expected value of V_B is 100+(y/2). So, plugging the expected value of V_B in A's profit in case it wins, that is when $h > V_B$, gives: $-(1\text{-}\alpha)(y/2)$.

Thus, A's expected profit is:

178. I also assume that B has no other reasons to want A to pay more for T. If A and B were competitors, in additional to competing for T, then B may have had an incentive to cause A to pay more for T even if B does not directly benefit from the acquisition.

$$\left(1-\frac{y}{100}\right) \propto y+\left(\frac{y}{100}\right)\left\{-(1-\propto) \frac{y}{2}\right\} =\propto y-\frac{(1+\propto) y^{2}}{200}$$

This is a quadratic function whose maximum is at y=100 $\alpha/(1+\alpha)$, the same as what formula (1) predicted.

For a uniform distribution, equation (1) has a simple interpretation. Suppose the bidding has reached a level that equals A's valuation V_A. A now has to consider a Bayesian distribution for $V_{B,}$ which is uniformly distributed in the range $[V_A, W]$, for some upper bound $W > V_A$ and then $f=1/(W - V_A)$. Equation (1) written as

$$h-V_{A}=\frac{\propto F(h)}{f}$$

can be expressed as

$$(h-V_{A}) f =\propto F(h)$$

The left hand side is the probability that A wins the bid (because V_B<h). On the other hand F(h) is the probability that B wins the bid (because V_B>h). Thus, the optimal h is when the ratio of Bayesian probabilities for A to win and for A to lose equals the toehold.

II.
TH Collaboration Agreements

In this Appendix Part, I first follow the scenario analyzed in Appendix Part I above, including its assumptions and notations. A (the First Bidder) and B (the Competing Bidder) engage in a bidding contest for the target. A can calculate its future wealth, which will include the value of its TH in the target and will depend on the outcome of the bidding contest - winning or losing to B. The following table[179] describes A's wealth:

179. Note that the table in Appendix Part I looks at A's profit or loss from bidding above V_A, rather than wealth, and thus I subtract the constant 100α, as the value of the TH. In this table, I look at the A's wealth instead of its profit, which includes its TH.

Case	Outcome	Probability	A's Wealth
$h > V_B$	A wins the bid	y/100	$100-(1-\alpha)V_B$
$h < V_B$	B wins the bid	1-(y/100)	α h

A, the First Bidder and owner of the TH, enters into an agreement with a third-party collaborator, which I denote by F. The collaboration agreement provides that A will transfer a portion γ of the TH value to F and will keep a portion $\eta=1-\gamma$ of the TH value if the Competitor B acquires the target including the TH. The following table describes A's wealth given the collaboration agreement:

Case	Outcome	Probability	A's Wealth
$h > V_B$	A wins the bid	y/100	$100-(1-\alpha)V_B$
$h < V_B$	B wins the bid	1-(y/100)	$\eta\ \alpha$ h

As in Appendix Part I above, I assume that V_B is a uniformly distributed random variable, and I plug the expected value of V_B, 100+(y/2), in A's wealth in case it wins, if h=100+y > V_B. I take the expected value of A's wealth:

$$\left(1-\frac{y}{100}\right)\eta \propto (100+y)+\left(\frac{y}{100}\right)\left\{100-(1-\propto)(100+\frac{y}{2})\right\}$$

Maximizing the expected wealth of A for y, the amount that A bids above its V_A, I find that the optimal y is:

$y_o=100\ \alpha/(1-\alpha+2\ \eta\ \alpha)$

which can be written as

$y_o =100\ \alpha/(1+\alpha-2\ \gamma\ \alpha)$. (2)

After setting $\gamma=0$, which means no collaboration, the optimal overbidding, y_o, reduces to the result of equation (1) in Appendix Part I above, which follows Betton, et al.'s results. However, as γ increases, the denominator $(1+\alpha-2\ \gamma\ \alpha)$ decreases, and the optimal y_o increases. Thus, equation (2) shows that the more that bidder A has agreed to share with the collaborator the higher the bid that A will be willing to make for the target. Since the collaboration increases A's optimal bid, it follows that collaboration increases the probability of A winning, despite the assumption that B values the target for more.

Thus, TH collaboration increases the probability of an inefficient outcome in which A wins even though B values the target for more.

It is interesting to note that when $\eta=0$, which is the maximal collaboration transfer, the overbidding is not strategic overbidding in the sense described in Part II.B.3 *supra*. In this event, the overbidding is not a strategy that attempts to cause B to pay more for the TH, because A will not gain from the sale of the TH to B, only its collaborator will. Rather, the overbidding is an attempt to prevent the loss from the transfer of the TH to the collaborator, which will take place in the event the competitor wins. A will bid more than its valuation of T, because in the event that A wins it will not have to pay for the TH, but will continue to own it, so A will be able to pay more for the remainder of the target than the value it assigns to it.

As an example, set $\alpha=10\%$. Then, for $\eta=0$ we find $y_o=100\alpha/(1-\alpha)=11.11...$, while for $\eta=1$ we find $y_o=100\alpha/(1+\alpha)=9.0909$. For $\eta=85\%$ we find $y_o=9.3457$. If we increase the TH, for example, set $\alpha=20\%$, the optimal bid increases as well. For $\eta=0$ we find $y_o=100a/(1-\alpha)=25$, while for $\eta=1$ we find $y_o=100a/(1+\alpha)=16.666$. And for $\eta=85\%$ we find $y_o=17.5439$.

To further explore the collaboration agreement, we can look at the effect of η, the portion of the TH that A may keep in case B wins, on A's expected wealth. Plugging the optimal y, A's expected wealth can be described as:

$$\Phi(\eta) = 50\alpha[\alpha +2(1-\alpha)\eta+4\alpha\eta^2] /[1+ (2\eta-1)\alpha] = 100\alpha\eta + 50\alpha^2/[1+ (2\eta-1)\alpha].$$

Note that the first derivate of $\Phi(\eta)$ is $\Phi'(\eta)=100\alpha - 100a^3/[1+(2\eta-1)\alpha]^2$

and the second derivative is $\Phi''(\eta)=400\alpha^4/[1+ (2\eta-1)\alpha]^3$

And $\Phi'(\eta)=0$ for $\eta=-1/(2\alpha)$ and $\eta=1-1/(2\alpha)$, and $\Phi'(\eta)<0$ for $-1/(2\alpha)<\eta<1-1/(2\alpha)$

Thus, $\Phi(\eta)$ increases for $\eta>1-1/(2\alpha)$. And since $\eta>0$, for $\alpha<0.5$, a TH that conveys less than full control of the target, it follows that $\Phi(\eta)$ is a monotonically increasing function of η. This result is intuitive, since a higher η means that A has to share less with the collaborator if it loses the bid.

For example, for $\eta=0$ (A has to give all the TH to the collaborator if B wins), we have $\Phi(0) = 50\alpha^2/(1-\alpha)$. For $\eta=1$ (no collaboration), we have $\Phi(1) = 50\alpha(2+3\alpha)/(1+\alpha)$.

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FREEDOM OF CONTRACT AND THE PUBLICLY TRADED UNCORPORATION

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Over the past decade, individual investors have poured hundreds of billions of dollars into publicly traded companies that have opted-out of traditional fiduciary duties. These publicly traded "uncorporations" are typically organized as limited partnerships (although they can take the form of a limited liability company), and most are governed by operating agreements that eliminate the fiduciary duties of managers and controlling equity holders. Advocates for this contractarian approach to fiduciary duties argue that parties should have the freedom opt-out of fiduciary duties and, instead, deploy contractual mechanisms for reducing agency costs. In 2004, Delaware fully integrated this contractarian approach to fiduciary duties into its alternative entity statutes, paving the way for today's growing population of fiduciary-free public companies. Many other states followed. Yet, over a decade later, Delaware judges and commentators have begun to call for reintroduction of a mandatory fiduciary duty of loyalty. While these advocates for a mandatory duty of loyalty acknowledge the contractarian paradigm of contracting for substitutions, they argue that in the context of publicly traded companies, robust contractual freedom leaves investors vulnerable to self-dealing and other misconduct and has also led to sub-optimal levels of standardization with regard to the terms that govern these entities.

As argued in this Article, reintroduction of a mandatory duty of loyalty is not the only (or even best) way to address these issues. First, it is not clear that such potent medicine is necessary or desirable. There are other forces, such as investor expectations of cash distributions, that constrain the behavior of MLP management. And second, even if adoption of a mandatory duty of loyalty where the ideal solution, the forces that shape state business lawmaking, such as jurisdictional competition and internal interest group dynamics, make legislative adoption of a mandatory fiduciary duty of loyalty unlikely.

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This Article offers an alternative approach that reflects a new model for business lawmaking in the era of contractual freedom. With information available about commonly adopted governance structures and terms, their coherence in light of the circumstances under which these entities operate, and the ways that investors are routinely left vulnerable, it is possible to design a set of standardized terms that capture the benefits of "contractability" while also providing investors with additional protection where needed. Importantly, achieving widespread adoption of standardized terms would not require state lawmakers to negate their commitments to contractual freedom. Recent empirical and theoretical work on the role of statutory menus indicates that widespread adoption can be achieved even if the standardized terms are not mandatory.

INTRODUCTION

Since the early 2000s, investors have spent hundreds of billions of dollars purchasing the securities of publicly traded companies that have largely opted-out of the traditional fiduciary duties owed by management and controlling equityholders. These publicly traded alternative entities—or "uncorporations"[1]—are typically organized as limited partnerships (LPs) but can also take the form of limited liability companies (LLCs).[2] Most avail themselves of state statutes that allow them to modify and even eliminate fiduciary duties. In much of the business world, these entities are known as master limited partnerships (MLPs), and they have recently become a popular investment for yield-hungry retail investors.[3] MLP equity securities are called units rather than shares, and their current market capitalization exceeds $380 billion, a significant increase since 2000, when it was around $14 billion.[4] As with publicly traded corporations, most MLPs are organized in Delaware.

MLPs' popularity results from their tax treatment. Despite being publicly traded, MLPs are treated as partnerships for tax purposes.[5] Income is not taxed at the entity level; rather, income and losses "pass through" to the unitholders, which are responsible for paying taxes on their share of the MLP's earnings.[6] Thus, unlike corporate dividends (which are taxed at both the entity and investor levels) distributions to MLP inves-

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1. LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 1 (2010) [hereinafter RIBSTEIN, UNCORPORATION].

2. David N. Fleischer et al., *Master Limited Partnerships*, in THE HANDBOOK OF INFRASTRUCTURE INVESTING 83 (Michael D. Underhill, ed. 2010) (An MLP may be organized as either a limited partnership or as a limited liability company . . . .).

3. James Comtois, *Investors Not Swayed by MLP Flameout*, PENSIONS & INV. (Jan. 11, 2016), http://www.pionline.com/article/20160111/PRINT/ 301119977/investors-not-swayed-by-mlp-flameout (estimating that 75% of the MLP market has been comprised of retail investors and 25% has been comprised of institutional investors); Eric Rosenbaum, *Energy MLPs: Now There's Only Pain for Investors*, CNBC (Dec. 10, 2015), https://www.cnbc.com /2015/12/10/the-big-energy-investing-myth-now-hurting-investors.html (reporting that approximately 70% of MLP accounts belong to retail investors).

4. *Asset Class Overview*, YORKVILLE CAPITAL MGMT. (2017), http://www.yorkvillecapital.com/asset-class-overview.aspx

5. Fleischer, *supra* note 2, at 83 ("Because of the MLP's partnership tax status, MLP investors avoid the double taxation experienced by shareholders of regular corporations.").

6. John Goodgame, *New Developments in Master Limited Partnerships*, 68 BUS. LAW. 81, 82 (2012) [hereinafter Goodgame, *New Developments*] (noting that the reason for an MLP's existence is "its classification as a partnership for federal income tax purposes, which. . .provides 'tax-sheltered' income to its common unitholders.'"); LAURA E. CUNNINGHAM & NOËL CUNNINGHAM, THE LOGIC OF SUBCHAPTER K 1 (4th ed., 2011).

tors are taxed only once.[7] This feature makes MLPs a good fit for "firms with high levels of free cash flow" because it allows them "to distribute their excess cash in a tax-efficient manner."[8] Maintaining this privileged tax status depends on compliance with IRS restrictions on source of income: pursuant to Section 7704 of the Internal Revenue Code, at least 90% of an MLP's income must be "qualifying income" for it to maintain pass-through status.[9] Qualifying income can only be generated by particular types of assets, which include those related to energy and the exploration, extraction and transportation of natural resources, as well as certain real estate and investment assets.[10] For this reason, most MLPs are energy companies. Regular cash distributions have earned MLPs the reputation (and expectation) of being high yield investments.[11] It is the prospect of these cash distributions that attract investors and distinguish MLP units from shares in a traditional corporation.[12]

Publicly traded corporations and MLPs also differ significantly in their governance arrangements. Unlike corporations, alternative entities can modify and even eliminate the fiduci-

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7. In many instances, MLP investors are able to defer a significant portion of their tax liabilities until they sell their units. When the MLP distributes cash in excess of net income (as often happens as a result of non-cash expenses like depreciation and depletion), those distributions will count as return of capital, reducing the investor's basis in the investment. This is known as an MLP's tax shield.

8. Conrad S. Ciccotello & Chris J. Muscarella, *The Energy MLP Goes Institutional: Implications for Strategy and Governance*, 15 J. APPLIED CORP. FIN. 113 (2003); *see also* Larry E. Ribstein, Energy Infrastructure Investment and the Rise of the Uncorporation, 23 J. APPLIED CORP. FIN. 75, 83 (2011).

9. 26 U.S.C.S. § 7704 (2017).

10. *Id.*

11. Fleischer, *supra* note 2, at 83 (MLPs have consistently traded in the public market with distribution yields of 6 percent to 7 percent.").

12. Diana Liebman et al., *Recent Developments in United States and Texas Energy Law*, 4 TEX. J. OIL & GAS L. 363, 402 (2009) ("At this point, one might ask why anyone would ever become a unitholder in an MLP . . . . The answer lies in the cash distributions that unitholders receive."); Hillary Holmes & James Chenoweth, *Master Limited Partnerships – And Their Benefits and Risks*, LAW360 (March 10, 2016), http://www.law360.com/articles/769662/master-limited-partnerships-and-their-benefits-and-risks ("MLPs are typically valued off of their higher yield and, as a result, they tend to trade at a premium valuation to C corps. MLPs are also increasingly valued on an EBITDA (earnings before interest, taxes, depreciation and amortization.").

ary duties of management and controllers.[13] The *only* mandatory duty is the contractual duty of good faith and fair dealing, but it offers limited protection.[14] In the case of MLPs, eliminating the duty of loyalty is significant when (as is often the case) a publicly traded corporation responsible for organizing the MLP—its "sponsor"—retains control of the entity after it goes public[15] *and* continues to transact business with it regularly.[16]

Advocates for this contractual approach to fiduciary duties emphasize the costs associated with relying on mandatory duties as a mechanism for controlling agency costs.[17] They argue that fiduciary duties inject uncertainty into business activities and with it, risk, which may cause management to be overly conservative.[18] Fiduciary duty litigation is itself costly, and the primary beneficiaries often seem to be the lawyers involved. Contractarians argue that fiduciary duties may do more harm than good and parties should, therefore, be free to

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13. DEL. CODE ANN. tit. 6, § 18-1101(c) (2013) (allowing elimination of fiduciary duties owed by managers and members of an LLC); DEL. CODE ANN. tit. 6, § 17-1101(d) (2010) (allowing for elimination of duties owed by partners to limited partnership or other partners). *See also* DEL. CODE ANN. tit. 6, § 18-1101(b) (2013) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); DEL. CODE ANN. tit. 6, § 17-1101(c) (2010) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.").

14. Douglas M. Branson, *Alternative Entities in Delaware – Reintroduction of Fiduciary Concepts by the Backdoor?*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS, AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 55, 61 (Robert W. Hillman & Mark J. Loewenstein eds., 2015) (noting that an action for breach of the implied covenant not available for "conduct which is pursuant to some express term of the contract or express language in the contract."). Some commentators state that the Delaware courts are using the covenant "*arguably, in certain instances* to bring back into the picture duties very similar to fiduciary duties." *Id.* at 56 (emphasis added).

15. *See, e.g.*, Goodgame, *New Developments*, *supra* note 6, at 83.

16. *See, e.g.*, Brinckerhoff v. Enbridge Energy Co., 159 A.3d 242, 245 (Del. 2017) ("MLPs are typically families of entities that often engage in internal business transactions, referred to as dropdowns, rollups, insider financings, incentive distribution rights, and equity investments."); Goodgame, *New Developments*, *supra* note 6, at 83.

17. RIBSTEIN, UNCORPORATION, *supra* note 1, at 203–05.

18. RIBSTEIN, UNCORPORATION, *supra* note 1, at 204; Larry Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131 (2009).

substitute their own customized governance arrangements.[19] This line of argument certainly makes sense when parties of similar sophistication actually bargain over the terms of an LP or LLC operating agreement (e.g., a joint venture agreement between two real estate developers). In such a situation, an investor who is asked to relinquish the protection offered by fiduciary duties can seek contractual substitutions for those duties and likely has some bargaining power to do so.

Delaware (the home of most MLPs) adopted this strong contractarian approach to uncorporate fiduciary duties in 2004, when it enacted a statute declaring the state's commitment to contractual freedom and explicitly allowing elimination of fiduciary duties. Many other states followed suit, particularly with regard to their LLC statutes.[20] Yet, just over a decade later, two of the state's most renowned judges (Chief Justice Strine and Vice Chancellor Laster) alongside academic commentators have called for reinstitution of a mandatory duty of loyalty.[21] They argue that in the context of publicly traded entities, the contractarian paradigm fails. No bargaining takes place between MLP organizers and unitholders, and terms are offered on a "take-it-or-leave-it" basis.[22] Investors are systematically left vulnerable to self-dealing, for which Strine, Laster, and others prescribe a mandatory duty of loyalty. Advo-

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19. *See, e.g.*, Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 224 (2009) (arguing that "[c]ourts should favor the contracting parties ex ante calculation of the costs and benefits of fiduciary duties . . . .").

20. Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 225 n.190 (2011) [hereinafter Manesh, *Market for LLC Law*].

21. Leo E. Strine & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS, AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11, 12 (Robert W. Hillman & Mark J. Loewenstein eds., 2015). They recognize that, even within the corporate realm, Delaware law gives some latitude to modify the duty of loyalty and would extend this level of contractual freedom to publicly traded alternative entities as well. *See also* Sandra K. Miller & Karie Davis-Nozemack, *Toward Consistent Fiduciary Duties for Publicly Traded Entities*, 68 FLA. L. REV. 263 (2016); Michelle M. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879 (2012).

22. Strine & Laster, *supra* note 21, at 12; *see also* Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. CORP. L. 295 (2014).

cates for a new mandatory duty of loyalty also cite the lack of meaningful standardization in the terms that govern MLPs. Although they have begun to coalesce around certain types or categories of contractual terms (e.g., cash distribution provisions and conflict-of-interest provisions governing the approval of conflicted transactions, to name just two examples), the way in which those terms are drafted differs from one agreement to another.[23] This lack of standardization drives up investors' information costs[24] and diminishes the value of judicial opinions outside of the particular dispute being adjudicated.[25] Widespread variations in wording increase uncertainty and often lead to unexpected results, even for those responsible for the drafting.[26]

Recent studies of operating agreements indicate that there is at least some cause for concern, although precisely how much cause is unclear. Fiduciary duties are routinely eliminated, and the adopted contractual substitutions can leave investors vulnerable to misconduct, specifically self-dealing by management and the MLP sponsor.[27] Similarly, empirical studies[28] have identified at least one variety of term that is adopted almost across-the-board, but variations in implemen-

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23. Strine & Laster, *supra* note 21, at 18 ("A degree of surface-level standardization has begun to occur, with alternative entity agreements coalescing around particular features and concepts. At present, however, this superficial standardization is overwhelmed by diversity in implementation, which limits the efficacy of precedent and creates fertile opportunities for future litigation."); *see also* Brent J. Horton, *Modifying Fiduciary Duties in Delaware: Observing Ten Years of Decisional Law*, 40 DEL. J. CORP. L. 921, 922 (2016) [hereinafter Horton, *Modifying Fiduciary Duties in Delaware*] ("Successful uncorporations . . . appear to be coalescing around a standardized approach: approval by a special committee, coupled with a good faith standard.").

24. *See* Strine & Laster, *supra* note 21, at 18.

25. *Id.*

26. *Id.* at 12–13.

27. *See, e.g.*, Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53, 58 (2013) [hereinafter Horton, *Going-Private Freeze-Out*]; Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 562–63 (2012) [hereinafter Manesh, *Contractual Freedom*]; Strine & Laster, *supra* note 21, at 12.

28. *See, e.g.*, Horton, *Going-Private Freeze-Out*, *supra* note 27; Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies,* 40 DEL. J. CORP. L. 207, 257 (2015). These studies find routine elimination of the duty of loyalty and regular adoption of contractual, conflict-of-interest provisions. As discussed by Professor Horton, Chief Justice Strine and Vice Chancellor

tation inject uncertainty and limit the relevance of case law from one dispute to another. Although reliance on seemingly weak contractual rights to substitute for mandatory fiduciary duties is troubling, other forces, particularly market expectations related to cash distributions, *do* constrain MLP managers and sponsors to some degree. As discussed previously, investors in MLP units are primarily interested in cash distributions, and the ongoing payment of regular distributions is something that investors are capable of assessing easily. Although the MLP structure creates the opportunity for MLP sponsors and managers to engage in self-dealing, the need to meet investor expectations (or at least limit the extent to which those expectations will be disappointed) is one constraint, admittedly an imperfect one, on the degree to which sponsors and managers are actually able to do so. It is unclear, therefore, precisely how vulnerable investors really are as a class and how this compares to the risk presented by more traditional equity investments.

Reintroducing a mandatory duty of loyalty would certainly be a quick way both to increase the accountability mechanisms available to MLP investors and to impose some degree of standardization when it comes to certain recurring issues. However, a mandatory duty of loyalty is not the only, or even the most feasible, solution. It would require state lawmakers to act in opposition to the pressures created by jurisdictional competition for business entities, and would also threaten to chill beneficial transactions and business practices that allow MLPs to meet investor expectations of regular cash distributions.

Rather than move MLP governance toward corporate governance, state legislatures (mainly Delaware's) can look to statutory menus of standardized terms as a way of both increasing standardization and encouraging contracting outcomes that are more protective of investors' interests. Importantly, this terms-based approach does not require state lawmakers to act in opposition to the pressures created by state competition for business entities. Delaware is not the only state to offer alternative entities the contractual freedom to modify and eliminate fiduciary duties. Many other states followed Delaware's lead after it adopted the 2004 amendments, and these states would

Laster, these provisions can be utilized to insulate problematic transactions from any meaningful judicial review.

be available to MLP organizers in the event Delaware's legislature re-imposed a mandatory duty of loyalty. From a competitive perspective, Delaware's commitment to contractual freedom has become a double-edged sword. Although contractibility is part of what attracts uncorporate organizers to Delaware, it has also leveled the competitive playing field insofar as it is easy for other jurisdictions to commit to enforcing operating agreements as contracts.[29]

As against other states that allow modification and elimination of fiduciary duties, Delaware's competitive advantage seems to result from various Delaware-specific benefits that it offers, including its first-mover advantage, generally positive reputation, and high-quality legal infrastructure.[30] While these benefits would remain even after reintroduction of a mandatory duty of loyalty, whether they are sufficient to retain and attract alternative entities that also value the ability to avoid a mandatory duty of loyalty is anyone's guess. Alternative entities may simply value the ability to avoid mandatory fiduciary duties more than they value other Delaware-specific advantages, and there is reason to think that this is the case.[31] For state lawmakers, the prudent course of action is maintaining the state's commitment to contractual freedom.

In the past, concern over federal preemption of state corporate law has prompted state lawmakers to take actions that are not necessarily in the state's competitive interest vis-à-vis other states, but that threat is unlikely to play a similar role here. Federal intervention in state business law is sporadic and typically follows economic crisis. To the extent federal lawmakers have given any attention to MLPs recently, it has been in the course of efforts to expand the types of income that will qualify a publicly traded alternative entity for pass-through tax treatment.[32] Current conditions simply are not ripe for federal intervention.

29. *See, e.g.*, Manesh, *Contractual Freedom, supra* note 27, at 562–63.

30. *See, e.g.*, Franklin A. Gevurtz, *Why Delaware LLCs?*, 91 OR. L. REV. 57 (2012).

31. *See id.*; RIBSTEIN, UNCORPORATION, *supra* note 1; Manesh, *Market for LLC Law*, *supra* note 20, at 193 (noting that contractibility diminishes the value of Delaware's advantages).

32. *See* The Master Limited Partnership Parity Act, H.R. 2883, 114th Cong. (2015).

As mentioned above, this Article offers an alternative, terms-based approach to addressing these issues that would not require state lawmakers to buck the trend of increasing contractability. Given the information available about trends in MLP structure and governance (including the type of terms included in operating agreements) and the areas in which investors are left vulnerable, it is possible for state lawmakers to design a set of standardized terms that offer the types of structures and arrangements that MLPs need and routinely contract for, but in a way that does not leave investors systematically unprotected. This approach offers two advantages as compared to re-adoption of a mandatory duty of loyalty. First, successful implementation will not require state lawmakers to act in opposition to their state's competitive interests. Recent empirical and theoretical research demonstrates that these terms would not have to be mandatory to be effective.[33] State lawmakers can encourage the adoption of a term by making a state-sanctioned, standardized version of it available to firms that wish to adopt it. Among other things, such terms can become focal points around which standardization-related benefits grow, encouraging adoption.[34] Moreover, provided relevant market participants are aware of the terms' availability, a company that chooses not to adopt them can face reputational and market related consequences.[35] Provided the terms successfully capture the usefulness of the actual MLP terms on which they are based, the benefits of voluntarily adopting a standardized term can outweigh the benefits of adopting a bespoke version, even if that standardized term differs to some degree from the bespoke version that would have otherwise appeared in the operating agreement. Second, a terms-based approach based on actual contracting practices can offer MLPs, sponsors, and unitholders the advantages of both contractibility and standardization: If the standardized terms are based on the widely adopted bespoke versions that facilitate legitimate business needs, adopters will still enjoy terms that are more tailored than general fiduciary duty principles. If a

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33. Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Analysis*, 6 J. EMPIRICAL LEGAL. STUD. 279 (2009); Ian Ayres, *Menus Matter*, 73 U. Chi. L. Rev. 3 (2006).

34. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

35. *See* Ayres, *supra* note 33.

sufficient number of MLPs adopt them, these terms will also offer the full suite of standardization-related benefits.

Part I is an overview of MLPs, including common structure and IRS restrictions on income source for publicly traded pass through entities. Part I includes a discussion of the rise of alternative entities, the trend of extending them the freedom to limit and eliminate fiduciary duties, and recent calls to restrict the contractual freedom they currently enjoy under state law.

Part II explores the concerns raised by proponents of a new mandatory fiduciary duty as well as the literature examining the operating agreements of these entities and relevant case law. This literature demonstrates that there is some cause for concern: fiduciary duty eliminations are common, and the contractual substitutions adopted in their place leave investors vulnerable to malfeasance by the MLP's management and sponsor. The literature and case law also confirm that MLP operating agreements show little meaningful standardization. This increases information costs for investors, prevents the development of a coherent body of case law relevant to future disputes, and compromises the informational efficiency of the market for MLP units (as compared to the market for corporate securities). Nevertheless, there are countervailing forces that discipline MLP management and sponsors. First, there are strong market expectations of cash distributions, and failure to meet these expectations can lead to loss of investors and increased cost of capital. To the degree MLP operating agreements may permit self-dealing, it should be cabined by the degree to which it is does not prevent the MLP from meeting its investors' distribution expectations. Second, as recent cases have shown, there is a role for judicial oversight under frameworks provided by traditional contract enforcement as well as the contractual duty of good faith and fair dealing. It may not be as robust as the role of judicial oversight under a fiduciary duty regime, but it does exist.

Part III is a discussion of the role that state competition, interest group dynamics, and the threat of federal action to displace state law are likely to play in the capacity and willingness of state corporate lawmakers to reintroduce a mandatory duty of loyalty. It argues that state competition for business entities and the pressures created by interest group dynamics are likely to prevent Delaware's legislature from taking this step.

To the degree the federal government has paid any attention to MLPs recently, it has been in the course of efforts to expand their use—currently, there does not seem to be any threat of federal preemption strong enough to affect state lawmakers on this issue.

Part IV explores a terms–based approach to addressing the problems resulting from allowing publicly traded alternative entities to eliminate fiduciary duties. With information about the terms MLPs commonly utilize, the reason these terms are utilized regularly (i.e., *why* they are useful to MLPs), and the ways in which investors are routinely left vulnerable by the bespoke versions currently adopted, it should be possible to create a set of standardized terms that are designed to give MLPs the governance arrangements they need, but in a way that does not systematically disadvantage investors. Part IV uses the commonly adopted "conflict–of–interest" provision as an example of a term that can be standardized in a way that facilitates the legitimate business practices that have led almost all MLPs to adopt a version of it, but with increased protection against self-dealing. Recent empirical and theoretical research on the impact that statutory menus have on the content of corporate "contracts" indicate that these terms do not have to be mandatory to be effective. In other words, they can be implemented in way that is consistent with state lawmakers' commitments to contractual freedom. Additionally, as analysis of the "conflict-of-interest" provision demonstrates, a set of standardized terms can combine the benefits of contractability (*i.e.*, governance structures that have been tailored to the needs of particular types of firms) with increased investor protection and standardization.

I. OVERVIEW OF MLPS

A. *The Rise of Alternative Entities and the Move to Contractual Freedom*

American business law has entered the era of the uncorporation. Once a "backwater in the U.S. law of business associations," unincorporated business organizations are now "the cutting edge of U.S. entity law."[36] Recent years have seen more newly-formed alternative entities than corporations, and the trend seems likely to continue. LLCs have become especially popular. Internal Revenue Service data from 2013, for example, shows that 2,285,420 LLCs filed federal income tax returns that year, while corporations filed 5,887,804. Between 2000 (in which 718,704 LLCs filed federal income tax returns) and 2012, the number grew over 300%.[37] The success Delaware enjoys in attracting corporations holds true here as well, particularly with large uncorporations that organize outside of their "home" state.[38]

Alternative entities are attractive because they combine the pass-through tax treatment of partnerships with corporate-style limited liability.[39] Notably, they allow parties significant freedom to adopt individually tailored governance arrangements, including the modification and elimination of fiduciary duties. The duties of care and loyalty are treated as default rules subject to modification or even total elimination under the law of many states.[40] In the corporate context, parties have considerable flexibility with regard to the duty of care (an exculpatory charter provision can eliminate much of its bite),[41] but the duty of loyalty is mandatory.[42]

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36. Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 FORDHAM J. CORP. & FIN. L. 445, 445–46 (2009).

37. INTERNAL REVENUE SERVICE, Number of Returns, Total Receipts, Business Receipts, Net Income (less deficit), Net Income, and Deficit by Form of Business Tax Years 1980–2012, https://www.irs.gov/pub/irs-soi/12otidb1.xls.

38. *See, e.g.*, Franklin A. Gevurtz, *Why Delaware LLCs?*, 91 OR. L. REV. 57 (2012); Manesh, *Contractual Freedom, supra* note 27, at 562–63.

39. Limited partners enjoy limited liability, but limited partnerships must have a general partner, who can be held liable for the limited partnership's debts. This is easily addressed by having a corporation or LLC with minimal assets act as general partner. The LLC form includes corporate style limited liability – there is no LLC analogue to the general partner.

40. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(c) (2013); DEL. CODE ANN., tit. 6 § 17-1101(d) (2013).

41. DEL. CODE ANN., tit 8, § 102(b)(7).

42. Delaware does allow its corporations to adopt limited carve-outs from the corporate opportunity doctrine (a component of the duty of loyalty) with a charter provision "renounc[ing]. . .any interest or expectancy of the corporation in, or in being offered an opportunity to participate in specified business opportunities or specified classes or categories of business opportu-

The move toward contractual freedom reflects an acceptance, to some degree, of the arguments that contractarians have been making for decades.[43] They argue that fiduciary relationships are best understood as fundamentally contractual in nature. Fiduciary duties arise in contractual relationships that are "characterized by unusually high costs of specification and monitoring"[44] and they allow parties to forego the impossible task of negotiating a complete contractual relationship. When a party owed a fiduciary duty seeks to enforce it, the court both supplies and applies the applicable term *ex post*, according to the generalized fiduciary standard.[45] The contractarians' claim is not only descriptive, however. They also argue that mandatory fiduciary duties are often inefficient:[46] they increase uncertainty and risk, introduce considerable litigation costs, and do not appear to be all that effective at deterring bad behavior. Because the parties to these relationships are in the best position to determine the terms and arrangements that should govern their relationship, they should be able to rely on other mechanisms for ordering their relationship.[47]

Importantly, the contractarian outlook has made a difference. Various uniform alternative entity statutes and their state enactments reflect a contractual approach to these entities

nities that are presented to the corporation or 1 or more of its officers, directors or stockholders."). DEL. CODE. ANN., tit 8, § 122(17).

43. *See, e.g.*, Larry Ribstein, *Fiduciary Duty Contracts in Unincorporated Entities*, 54 WASH. & LEE L. REV. 537, 559 (1997) [hereinafter Ribstein, *Fiduciary Duty Contracts*]; Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

44. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425, 427 (1993).

45. *Id.* ("The duty of loyalty replaces detailed contractual terms, and courts flesh out the duty of loyalty by prescribing the actions the parties themselves would have preferred if bargaining were cheap and all promises fully enforced.").

46. *See, e.g.*, Butler & Ribstein, *supra* note 43, at 53–56 (arguing that mandatory terms are inefficient); Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009) (arguing that "default fiduciary duties add significant contracting and litigation costs and that therefore "[c]ourts should favor the contracting parties ex ante calculation of the costs and benefits of fiduciary duties").

47. *See, e.g.*, Ribstein, *Fiduciary Duty Contracts*, *supra* note 43, at 551; Butler & Ribstein, *supra* note 43.

and the fiduciary duties that they have traditionally incorporated.[48] For example, the Revised Uniform Partnership Act ("RUPA"), Uniform Limited Partnership Act (RULPA), and the Revised Uniform Limited Liability Company Act (RULLCA) all allow modification of the duty of loyalty (including the elimination of certain "aspects" of the duty) and require only that these changes to the traditional duty not be "manifestly unreasonable."[49]

Delaware's legislature has embraced a strong version of contractarianism and, in 2004, amended its alternative entity statutes to make this clear.[50] After disagreement in the Delaware courts over whether Delaware's limited partnership and limited liability company statutes authorized the elimination of fiduciary duties (rather than just limitations and modifications of those duties),[51] the Delaware Revised Uniform Partnership Act ("DRUPA"), Delaware Revised Uniform Limited Partnership Act ("DRULPA"), and the Delaware Limited Liability Company Act ("DLLCA") all expressly allow for total fiduciary duty elimination, with no limitation, aside from a non-waivable *contractual* duty of good faith and fair dealing.[52] Many other states have followed Delaware's lead, particularly with their LLC statutes.[53]

Notably, Delaware's alternative entities enjoy this degree of contractual freedom even when they are publicly traded.[54]

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48. *See, e.g.*, Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451, 453–56 (2006) (discussing contractarian view of fiduciary duties and its adoption in uniform statutes).

49. Revised Uniform Partnership Act § 105(d)(2);Revised Limited Partnership Act § 105(d)(2); Revised Uniform Limited Liability Company Act § 105(d)(3).

50. Branson, *supra* note 14 ("In Delaware alternative entities, then, contract, indeed, seems in all instances supreme, as the contractarians wished it to be.").

51. Gotham Partners LP v. Hallwood Realty Partners LP, 817 A.2d 160, 167–68 (Del. 2002).

52. DEL. CODE ANN. tit. 6, § 18-1101(c) (2013); DEL. CODE ANN. tit. 6 § 17-1101(d) (2010). *See also* DEL. CODE ANN. tit. 6, § 18-1101(b) (2013); DEL. CODE ANN., tit. 6 § 17-1101(c) (2010).

53. Manesh, *Market for LLC Law, supra* note 20, at 225 n.190 (listing states that have adopted Delaware approach to contractual freedom in LLC statutes).

54. *See, e.g.*, Hite Hedge LP v. El Paso Corp., 2012 WL 4788658 (Del. Ch. Oct. 9, 2012); *In re* Atlas Energy Res., LLC, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010).

Despite their diverse investor base and the absence of actual bargaining over the terms of their operating agreements, publicly traded uncorporations are just as capable of modifying and eliminating fiduciary duties as their closely-held siblings, and they typically do.[55]

B. *MLP Structure and Governance*

Publicly traded alternative entities typically operate in the energy sector. They are collectively referred to as "master limited partnerships" (MLPs),[56] but this name can be misleading because they can take (and have taken) the form of LLCs.[57] To further confuse things, although the term is typically used to refer to *all* publicly traded alternative entities taxed as partnerships, others use it only in reference to companies that operate in the energy sector. This article uses MLP in the broader sense.

MLP equity investors hold units instead of shares, and these units are sold on various public securities exchanges.[58] MLPs are governed according to the terms included in their organizational documents. Different state statutes assign these documents a variety of names; here they will be referred to collectively as operating agreements.[59] Operating agreements are bespoke documents, meaning they are individually drafted for each MLP.[60]

MLPs are structured in a variety of ways, but the sponsored model dominates.[61] Under this model, a corporation

55. Manesh, *Contractual Freedom, supra* note 27, at 562–63.

56. *In re* El Paso Pipeline Partners, LP, 2014 WL 2768782 (Del. Ch. June 12, 2014).

57. Tim Fenn, *Master Limited Partnerships (MLPs): A General Primer*, Latham & Watkins, LLP 2 (Apr. 2014), https://www.lw.com/admin/Upload/Documents/MLP/Resources/Latham-Master-Limited-Partnership-Primer-2014.pdf ("[M]ost commonly the MLP is formed as a Delaware limited partnership. Increasingly, the MLP may instead be a state law limited liability company—preferably a Delaware limited liability company (an LLC). . . .")

58. Goodgame, *New Developments, supra* note 6, at 82.

59. *See, e.g.*, Joan MacLeod Heminway, *The Ties that Bind: LLC Operating Agreements as Binding Commitments*, 68 S.M.U. L. REV. 812 (2015).

60. Strine & Laster, *supra* note 21, at 1.

61. *See, e.g.*, Miller & Davis-Nozemack, *supra* note 21; Deborah Fields et al., *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part I)*, TAXES - THE

(usually publicly traded) acts as a "sponsor" that organizes the MLP, typically under Delaware law.[62] The sponsor forms an affiliated entity, usually an LLC or a corporation, to serve as the general partner of the LP (or managing member if the LLC form is chosen).[63] The sponsor retains complete ownership over the general partner[64] and acts as the "ruler behind the throne."[65] The sponsor contributes qualifying assets to the MLP or otherwise arranges for the MLP to acquire them. Even after the MLP goes public, transactions in which the MLP acquires assets from its sponsor or an affiliate of the sponsor are common.[66] Individuals with actual management power over the MLP (*i.e.*, directors, managers, or employees of the general partner) are often affiliated with the sponsor in some capacity.

Other structures exist, but are less common. Some MLPs organized as LLCs have a board of directors and allow unitholders to participate in elections. These entities look very much like corporations,[67] and some opt for corporate-style fiduciary duties. Other arrangements known as "tuck-ins" still take the limited partnership form. However, in a tuck-in, the MLP (rather than the sponsor) owns the general partner, and the sponsor owns MLP units alongside public unitholders.[68] This tuck-in arrangement allows the public unitholders to participate in choosing the board of the general partner.[69]

TAX MAGAZINE, Dec. 2009, at 21, 28 [hereinafter Fields, *Triangles in a World of Squares (Part I)*] ("The 'sponsor' typically is the person or entity behind the formation and operation of the PTP. The sponsor typically structures the PTP with a goal of raising capital through the public markets to fund the acquisition, development and/or operation of property.").

62. Goodgame, *New Developments, supra* note 6, at 83.

63. Fields, *Triangles in a World of Squares (Part I), supra* note 61, at 21, 31.

64. Goodgame, *New Developments, supra* note 6, at 83.

65. Miller & Davis-Nozemack*, supra* note 21, at 269.

66. *See, e.g.*, Deborah Fields et al., *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part II – Property Acquisitions)*, TAXES: THE TAX MAGAZINE, Feb. 2010, at 73 ("Typically, the sponsor of a PTP transfers property to the PTP or otherwise arranges for the PTP to acquire property, while the PTP raises capital to acquire, develop or operate the property through an initial public offering (IPO).").

67. Goodgame, *New Developments, supra* note 6, at 88.

68. *Id.* at 91–93.

69. *Id.*

To qualify for pass-through tax treatment (which is the primary reason to form an MLP), at least 90% of an MLP's income must be qualifying passive income. Section 7704 of the Internal Revenue Code provides a list of assets that will generate qualifying income. Most Section 7704 assets are related to energy and the exploration, extraction and transportation of natural resources, but certain real estate and investment assets also qualify.[70] As a result, most MLPs operate in the energy and natural resources sector.[71]

The qualifying income requirement is intended to ensure that publicly traded entities that engage in "active business activities" which are usually conducted by corporations will be treated as such for tax purposes.[72]Pass–through treatment is reserved for those entities that "are engaged in activities commonly considered as essentially no more than investments" or which were historically organized in the partnership form.[73] As discussed above, any income earned by the MLP will be taxed only at the level of the unitholder[74] and not twice, as is the case with corporate dividends.

The tax benefits of MLP investing do not end with avoidance of an entity-level tax. Because MLPs typically recognize significant non-cash expenses (depreciation, amortization, and depletion), the cash distribution received by a unitholder

70. 26 U.S.C. § 7704.

71. Goodgame, *New Developments, supra* note 6, at 82.

72. HR REP. NO. 100-391(II), at 71, 282 (1987).

73. *Id.* Many energy MLPs do engage in "active business activities," such as the ongoing management of assets utilized in the development and transportation of natural resources. Presumably, their inclusion in Section 7704 resulted from the traditional use of the partnership form for these activities.

74. 26 U.S.C. § 701 ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."); John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 472 (2005) [hereinafter Goodgame, *Governance*] ("A dollar of income generated by such a partnership would only be taxed once ('passed-through'), at the marginal tax rate of the limited partner to whom that dollar of income was allocated. Accordingly, assuming that the relevant entity distributes all of its income to its equity holders and that the equity holder's marginal tax rate is thirty-five percent, an MLP must generate $1.54 of income for an equity holder to have one dollar of after-tax income, although a corporation must generate $2.20 of income for its equity holder to have one dollar of after-tax income." "This assumes a corporate tax rate of thirty percent." *Id.* at 472 n.9).

often exceeds the net income allocable to that unitholder.[75] Distributions in excess of the income allocable to that unitholder will qualify as return of capital and serve to reduce the unitholder's basis to the extent that the distribution exceeds net income allocable to that unitholder.[76] The effect is to delay any taxes owed on distributions until the units are sold. The prospect of regular distributions (the value of which are affected by the "tax shield" created by distributions that exceed net income) are the reason investors put their money into MLPs,[77] and for the most part, MLPs have delivered. As a class, they typically pay out more in cash distributions than stock holdings pay in dividends, and they regularly outperform the S&P 500.[78]

There is real money in MLPs. Since 2004, the market capitalization of MLPs has increased from $14 billion to almost $400 billion.[79] There is no reason to think the trend will re-

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75. *See, e.g.*, Fields, *Triangles in a World of Squares (Part I)*, *supra* note 61, at 30 ("Deductions for depreciation, depletion, and amortization (DD&A) can reduce the share of taxable income allocable to each unit.").

76. Goodgame, *Governance*, *supra* note 73, at 472.

77. *See, e.g.*, Fields, *Triangles in a World of Squares (Part I)*, *supra* note 61, at 30 ("From a market perspective, investors typically view a PTP unit as a yield-based security. To this end, the amount of 'tax shield' associated with a PTP can be relevant to potential buyers of a PTP's units. . . If an investor does not view the tax shield of the units of a particular PTP as adequate, he or she may choose to sell such units and to buy another investment, such as units in a different PTP that delivers a higher tax shield.").

78. Charles F. Beauchamp, *The Future of Master Limited Partnerships*, 30 J. APPLIED BUS. RES. 1493 (2014) (finding that "MLPs produce strong performance with lower risk and lower correlations" as compared to other asset classes); Fleischer, *supra* note 2 at 109 (reporting that "MLPs total return profile has historically averaged in the low to mid teens"). YORKVILLE PUBLICLY TRADED PARTNERSHIPS UNIVERSE INDICES: A COMPLETE STUDY OF RISK AND RETURN (1986–2011) (finding that "100% of MLP sectors have outperformed the S&P 500 on a total return basis over the past five years"); Chris Dieterich, *IPO Wave Kicks Off with Trio of MLPs*, WALL ST. J. (Jan. 13, 2013), http://www.wsj.com/articles/SB100001424127887324581504578236113296906792 (reporting that the average MLP had a "dividend yield of more than 6%, topping most dividend-paying stocks and rivaling high-yield bonds."); Maria Halmo, *Greatest Hits: The Periodic Table of Performance*, ALERIAN (Aug. 13, 2014), https://www.alerian.com/greatest-hits-the-chemistry-of-mlps-periodic-table-of-performance/. This does not mean that MLPs are all guaranteed winners. They are subject to market and firm-specific risk like any other company and have had periods of slower growth or losses.

79. YORKVILLE CAPITAL MGMT., *supra* note 4.

verse. In recent years, the IRS has experienced an increase in requests for private letter rulings related to Section 7704's qualifying income requirement, prompting it to instate a moratorium on issuing such rulings in early 2014.[80] It lifted the moratorium in 2015,[81] and has since promulgated regulations related to the assets that generate qualifying income.[82] Additionally, in recent years, members of Congress affiliated with both major parties have introduced various versions of the "Master Limited Partnerships Parity Act" to expand the definition of qualifying income (and with it, the availability of pass-through treatment), to new assets.[83]

MLPs are peculiar in another way. In an age dominated by institutional investors, MLP investors are primarily *individuals* looking for high yields.[84] Industry professionals estimate the MLP market to be around 70–75% retail,[85] raising ques-

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80. Amy S. Elliott, *IRS Has Stopped Ruling on Publicly Traded Partnership Qualifying Income*, TAX NOTES TODAY (March 31, 2014), 2014 TNT 61-4; Alison Sider, *Energy Spinoffs Are Moving Into Tax Limbo*, WALL ST. J. (Apr. 9, 2014), https://www.wsj.com/articles/energy-spinoffs-are-moving-into-tax-limbo-1397089584?tesla=y (reporting IRS moratorium given increased interest in MLP formation and requests for rulings as to the qualifying nature of various new asset classes).

81. Reuters Staff, *IRS Lifts 'Pause' on Rulings for Energy Partnerships*, REUTERS (Mar. 9, 2015, 1:10 PM), http://www.reuters.com/article/usa-irs-mlps-idUSL1N0WB19220150309 ("The Internal Revenue Service has lifted its temporary 'pause' on rulings about what businesses qualify for tax-free inclusion in energy master limited partnerships (MLPs), after about a year of study that held up some transactions.").

82. Treas. Reg. 1.7704-4, 82 Fed. Reg. 8338 (Jan. 19, 2017); 80 Fed. Reg. 25970 (May 6, 2015).

83. Versions of this bill were introduced in both 2013 and 2015. *See* S. 795, 113th Cong. (Apr. 24, 2013); H.R. 2883, 114th Cong. (June 24, 2015); S. 1656, 114th Cong. (June 24, 2015).

84. WRITTEN STATEMENT OF THE NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS, Senate Committee on Finance Tax Reform Working Group (Apr. 15, 2015) ("According to surveys done by some of our members, the vast majority of the investors providing this capital are individual investors. Many of the investors are seniors—roughly 75 percent are over the age of 50. For the most part, they are individuals seeking a relatively secure income-oriented investment providing a reasonable return, something that is hard to come by in today's market."); Fleischer, *supra* note 2, at 94 (noting that MLP investors are "primarily motivated by the cash distributions").

85. James Comtois, *Investors not Swayed by MLP Flameout*, PENSIONS & INVESTMENTS (Jan. 11, 2016) (estimating that 75% of the MLP market has been comprised of retail investors); Eric Rosenbaum, *Energy MLPs: Now There's Only Pain for Investors*, CNBC (Dec. 10, 2015) (estimating that 70% of MLP

tions regarding the ability of most MLP investors to understand the way their rights differ from those of shareholders in a public corporation.[86]

C. *Contractual Freedom at Risk: Calls for A Mandatory Duty of Loyalty*

Just over a decade after Delaware's legislature adopted the strong version of contractarianism, two of its most prominent jurists, Chief Justice Strine and Vice Chancellor Laster, called for the reintroduction of a mandatory duty of loyalty for publicly traded alternative entities (and potentially for other entities with a diverse investor base).[87] In their provocatively titled book chapter, *The Siren Song of Unlimited Contractual Freedom*, Strine and Laster argue that the contractarian paradigm of "rational parties contracting efficiently to allocate risks is. . .an ideal."[88] Their criticisms of the current regime of contractual freedom focuses on inadequate investor protection and the negative consequences of decreased standardization.[89] According to Strine and Laster, investors have "no dependable protection against self-dealing and other conflicts of interest."[90] The lack of standardization contributes to investors' disadvantage (requiring them to either "become diligent and expert readers of alternative entity agreements, which may involve the expenditure of material costs for legal advice, or to blindly accept the risk"), but also subjects MLP management and sponsors to drafting-related uncertainty.[91] Strine and Laster also point out that decreased levels of standardization create systemic issues—it dilutes the value of case law, as deci-

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accounts belong to retail investors); Fleischer, *supra* note 2, at 94 ("[I]ndividual investors own approximately 75 percent of all MLP units . . . .").

86. Jim Cahn, *Don't be Seduced by Tax Benefits and High Yield: Beware the MLPs*, FORBES (Jul. 21, 2014), http://www.forbes.com/sites/ jamescahn/ 2014/07/21/dont-be-seduced-by-tax-benefits-and-high-yield-beware-the-mlps/#77d7ba092924.

87. Chief Justice Strine and Vice Chancellor Laster acknowledge that Delaware law extends to publicly traded corporations some latitude to limit aspects of the duty of loyalty, and they would extend similar leeway to publicly traded alternative entities.

88. Strine & Laster, *supra* note 21, at 11, 17.

89. *Id.*

90. *Id.* at 12.

91. *Id.*

sions interpreting one particular version of a contractual provision have little relevance to disputes over differing implementations of that type of term. Notably, Strine and Laster do not propose simply restoring Delaware law to its pre–2004 state, when fiduciary duties could be modified but not eliminated. Nor do they advocate for the approach taken by various uniform statutes which allow the duty of loyalty to be limited but not in a way that is "manifestly unreasonable."[92] Rather, they advocate for a mandatory duty of loyalty analogous to that applicable to publicly traded corporations.

This position appears to represent an evolution in Chief Justice Strine's views on fiduciary duty eliminations. When he was Vice Chancellor, his opinion in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*[93] stated that Delaware law allowed limited partnerships to eliminate fiduciary duties. On appeal, the Delaware Supreme Court repudiated this "dictum" as beyond the language of the statute.[94] This, in turn, prompted the Delaware legislature to amend its LP and LLC statutes to provide expressly for the elimination of fiduciary duties. Professors Sandra Miller and Karie Davis–Nozemack also argue for disallowing fiduciary duty eliminations and also advocate for application of certain stock exchange listing requirements from which MLPs are currently exempt.[95]

II.
CONTRACTUAL FREEDOM'S DOWNSIDES

This Part analyzes recent efforts to identify the effects of permitting fiduciary duty opt-outs in the context of publicly traded companies in light of the arguments made by Strine, Laster and others in favor of a mandatory fiduciary duty of loyalty. These commentators demonstrate that there is some cause for concern: fiduciary duties are regularly eliminated (or

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92. UNIFORM LIMITED PARTNERSHIP ACT § 110(b)(5) (2001) (UNIFORM LAW COMMUNICATION, amended 2013); UNIFORM PARTNERSHIP ACT § 103(b)3) (1997) (UNIFORM LAW COMMUNICATION, amended 2013); UNIFORM LIMITED LIABILITY COMPANY ACT § 110 (2006) (UNIFORM LAW COMMUNICATION, amended 2013).

93. Gotham Partners v. Hallwood Realty Partners, No. CIV.A.15754., 2000 WL 1476663, at *10 (Del. Ch. Sept. 27, 2000).

94. Gotham Partners v. Hallwood Realty Partners, 817 A.2d 160, 167 (Del. 2002).

95. *See* Miller & Davis-Nozemack, *supra* note 21, at 58.

weakened through exculpation provisions), and contractual substitutions appear to leave investors with no real means of holding MLP managers and controlling equity holders accountable for misconduct. This is not to say, however, that there is nothing that constrains the management and controllers of MLPs. Rather, other disciplinary forces, and in particular investor expectations related to cash distributions, act as one constraint on the degree to which management and sponsors can exploit the apparent vulnerability of unitholders. Additionally, in recent cases, the Delaware judiciary has indicated its willingness to utilize both the duty of good faith and fair dealing and the more traditional tools of contract enforcement and interpretation to police the behavior of MLP management with. Undoubtedly, these are not perfect replacements for fiduciary duties (and they do nothing to increase standardization), but they do place some constraint on the degree to which MLP management can exploit the gap when limited contractual substitutions are adopted for eliminated fiduciary duties.

A. *Contractual Freedom and Investor Protection*

The case for contractual freedom in business associations rests, in large part, on predictions about contracting behavior. According to contractarians, contractual freedom is good policy because parties who are permitted to eliminate fiduciary duties can "substitute other, possibly more cost-effective mechanisms for ensuring that fiduciaries act in the owners' interests."[96] Specifically, contractarians predict that mandatory cash distribution and liquidation provisions will be adopted when fiduciary duties are eliminated.[97] Mandating cash distributions limits management's discretion by both restricting their ability to control the entity's earnings and by forcing more frequent returns to capital markets for financing:[98] they "have a perpetual reliance on external equity and debt financing . . . ."[99] Provisions mandating liquidation on a specified future date disci-

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96. Ribstein, Uncorporation, *supra* note 1, at 221; Ribstein, *Fiduciary Duty Contracts*, *supra* note 43, at 559.

97. *See, e.g.*, Ribstein, Uncorporation, *supra* note 1, at 193–222.

98. Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. Chi. L. Rev. 289, 290–91 (2009)

99. Fleischer, *supra* note 2, at 86.

pline management by requiring them to take into account their return to the capital markets on a date certain in order to continue.

Efforts to determine the extent to which publicly traded alternative entities adopt contractual substitutes for eliminated fiduciary duties have employed a variety of methodologies and have reached differing conclusions. Nevertheless, when taken as a whole, this body of research shows that while MLP operating agreements often adopt contractual substitutions for eliminated fiduciary duties, investors are still vulnerable to management or the sponsor misconduct, particularly self–dealing. In a study of 85 publicly traded alternative entities, Professor Mohsen Manesh examined the extent to which publicly traded LPs and LLCs adopted cash distribution and liquidation provisions when fiduciary duties and other corporate governance features were eliminated. Of the 85 entities studied, 75 "fully waive[d] or exculpate[d] liability arising from the breach of fiduciary duties."[100] Out of these 75, 51 firms employed only mandatory cash distributions; 1 employed only mandatory liquidation; 14 employed both; and 9 employed neither.[101] Clearly, some level of substitution is taking place, and, mandatory cash distribution appears to be the more popular of the two mechanisms. However, these substitutions offer less protection than they appear to provide. Although cash distribution provisions often require distribution of all "available cash," they leave managers with wide latitude to determine how much cash is "available."[102] Similarly, the effect of mandatory liquidation provisions can be illusory when the liquidation will not occur until far into the future.[103]

Another common substitution is a provision designed to govern the treatment of conflicts-of-interest by specifying methods for the approval of conflicted transactions. These provisions typically provide a variety of procedures or conditions pursuant to which an action implicating a conflict of in-

100. Manesh, *Contractual Freedom, supra* note 27, at 574.
101. *Id.* at 578.
102. *Id.* at 579.
103. *Id.* at 580. Of the 20 firms in Professor Manesh's study that included a mandatory liquidation provision, 16 had liquidation dates in the year 2080 or beyond. Provisions with a liquidation date that occurs far past the point at which current management will have left the workforce can have no meaningful effect on their behavior.

terest will be deemed approved by all partners and, in doing so, substitute for the rubric supplied by the duty of loyalty. These conditions typically include: (1) approval by a committee appointed to evaluate conflicts (Special Approval); (2) approval by a majority of unitholders that are not affiliated with the general partner or its affiliates (which would include the sponsor); (3) transactions containing terms that are no less favorable than those available in an arm's length transaction; or (4) transactions that are fair on their terms.[104] In a study of 86 publicly traded alternative entities, Professor Brent Horton found that 84.88% included a conflict-of-interest provision in place of a fiduciary duty of loyalty.[105] As Professor Horton observes (and a variety of Chancery Court litigations show), Special Approval provisions may be utilized to insulate self-dealing transactions from any meaningful challenge by (1) allowing individuals of questionable independence to serve on the conflicts committee, and (2) requiring unitholders seeking to challenge the transaction to prove that the decision-makers acted in subjective bad faith.[106]

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104. Take, as an example, the provision at issue in *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400 (2013):

> Unless otherwise expressly provided in this Agreement, whenever a potential *conflict of interest* exists or arises between the General Partner or any of its Affiliates, on the one hand, and the Partnership or any Partner, on the other hand, *any resolution or course of action by the General Partner or its Affiliates* in respect of such conflict of interest shall be permitted and deemed approved by all Partners, and *shall not constitute a breach of this Agreement . . ., or of any duty stated or implied by law or equity, if* the resolution or course of action in respect of such conflict of interest is[:]
>
> (i) approved by Special Approval,
>
> (ii) approved by the vote of a majority of the Units excluding Units owned by the General Partner and its Affiliates,
>
> (iii) on terms no less favorable to the Partnership than those generally being provided to or available from unrelated third parties or
>
> (iv) fair and reasonable to the Partnership, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the Partnership).

Id. at 410 (emphasis added by the court).

105. Horton, *Going-Private Freeze-Out*, *supra* note 27, at 94.

106. Unitholder approval is also problematic. Because of the regular elimination of any duty to disclose (a component of fiduciary duties owed by managers in the corporate setting), voting unitholders are not entitled to receive all information material to the issue being decided. In other words,

In re: El Paso Pipeline Partners, L.P. Derivative Litigation provides an apt example of a Special Approval prong at work.[107] There, common unitholders in an MLP, El Paso, challenged a drop-down transaction between El Paso and its sponsor in which El Paso purchased various liquid-natural-gas-related assets from the sponsor. This transaction was approved by a conflicts committee comprised of three individuals, two of whom had past ties to the sponsor (both had been high-level executives of the sponsor in the past). Ultimately, El Paso paid approximately 22% above the price that the sponsor concluded was too expensive to pay for similar assets offered to the sponsor by a third party. Despite the obvious appearance of self-dealing (which would have almost certainly led to entire fairness review under Delaware corporate law), the Chancery Court granted summary judgment to the defendants because the plaintiffs could not show "subjective bad faith" on the part of the members of the conflicts committee.

However, in challenges to later drop-down transactions between El Paso and its sponsor, the investors *were* able to meet this subjective bad faith standard, in large part on account of (1) the committee member's knowledge as to just how poor the prior transactions (on which the company won summary judgment) turned out to be, and (2) an email record in which the committee members actually expressed their subjective belief that the transactions were not favorable to El Paso.[108] As this case demonstrates, conflict-of-interest transactions can be utilized to insulate self-dealing that is not accompanied by a record establishing a state of mind that most individuals serving in the relevant capacities will know not to memorialize in writing. Had it not been for the prior round of unfair transactions and the committee's sloppy email practices, the claims challenging the second round of drop-downs would likely have been resolved in favor of defendants on a summary judgment motion as well.

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their approval can be effective even if it was given without knowledge of material facts.

107. *In re* El Paso Pipeline Partners, 2014 WL 2768782.

108. *In re* El Paso Pipeline Partners Deriv. Litig., 132 A.3d 67 (2015). This judgment was subsequently reversed by the Delaware Supreme Court on standing grounds. *In re* El Paso Pipeline Partners Deriv. Litig., 152 A.3d 1248 (2016).

Conflict-of-interest provisions can also leave investors vulnerable to going-private freeze-outs.[109] The appraisal remedy (which, when triggered, allows a shareholder in a corporation to secure a judicial determination of the fair value of its shares) is not mandatory for alternative entities,[110] which makes it possible to leave minority investors without any real ability to challenge a merger between the MLP and another entity affiliated with its sponsor.

Concerns over investor protection have extra salience in the context of MLPs because of the market's primarily retail base.[111] Institutional investors have historically avoided these investments for tax reasons.[112] The federal unrelated business income tax that tax-exempt institutional investors must pay on income generated by MLP units[113] discourages their invest-

109. Horton, *Going Private Freeze-Out, supra* note 27, at 71 ("In short, because Delaware follows a contractarian approach to regulation of non-corporate business associations, investors in publicly traded LLCs and LPs are now uniquely susceptible to going-private freeze-outs.").

110. DEL. CODE ANN., tit. 6 § 17-212 ("A partnership agreement or an agreement of merger or consolidation or a plan of merger may provide that contractual appraisal rights with respect to a partnership interest or another interest in a limited partnership shall be available for any class or group or series of partners or partnerships interests. . ."); DEL. CODE ANN., tit. 6 § 18-210 ("A limited liability company agreement or an agreement of merger or consolidation or a plan of merger may provide that contractual appraisal rights with respect to a limited liability company interest or another interest in a limited liability company shall be available for any class or group or series of members or limited liability company interests. . .").

111. James Comtois, *Investors not swayed by MLP Flameout*, PENSIONS & INVESTMENTS (Jan. 11, 2016); Eric Rosenbaum, *Energy MLPs: Now There's Only Pain for Investors*, CNBC (December 10, 2015).

112. Goodgame, *New Developments*, *supra* note 6; Conrad S. Ciccotello & Chris J. Muscarella, *The Energy MLP Goes Institutional: Implications for Strategy and Governance*, 15 J. APPLIED CORP. FIN. 112 (2003).

113. 26 U.S.C. §§ 511–12. *See also* Christine Hurt, *The Private Ordering of Publicly Traded Partnerships*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2969175 ("This relatively low percentage of institutional ownership may be a product of the lack of dividends-received deduction in limited partnership investments, creating a preference for corporations to invest in other corporations; the added administrative burden of filing K-1 forms for distributions versus corporate dividends, or the imposition of Unrelated Business Interest [*sic*] Tax for 501(c)(3) investors who hold limited partnership interests."). Unaware individual investors have found themselves facing significant, unanticipated tax liabilities when they unknowingly hold MLP shares in their IRAs. *See* Laura Saunders, *Thousands Hit With Surprise Tax Bill on Income IRAs*, WALL ST. J. (Nov. 13, 2015).

ment in the MLP sector. Similarly, mutual funds must limit the number of MLP units they hold in order to maintain their status as regulated investment companies, and typically avoid them as a result.[114] Although more evidence is necessary to determine the profile of the typical MLP investor and the disclosures they receive,[115] anecdotal evidence indicates that unsophisticated investors purchase MLP units through brokers without understanding the risks involved.[116] The largely absent institutional investors are more likely than retail investors (even sophisticated ones) to have the resources required to assess the risks presented by a particular MLP investment, which raises questions about the informational efficiency of the market for MLP units[117] and the degree to which their prices reflect governance terms. In short, it appears that MLP units are often held by investors that do not have the resources or ability to assess the risks that MLP investments present,

114. 26 U.S.C. § 851(b)(3)(B).

115. Miller & Davis-Nozemack, *supra* note 21, at 317–18.

116. *See, e.g.*, Isaac Arnsdorf & Alex Nussbaum, *Master Limited Partnerships: Investors May Not See the Risks*, BLOOMBERG (Mar. 20, 2014), http://www.bloomberg.com/news/articles/2014-03-20/master-limited-partnerships-investors-may-not-see-the-risks. *See also* Miller & Davis-Nozemack, *supra* note 21, at 317–18. Professors Miller and Davis-Nozemack report that according to their "discussions with industry experts and unpublished data gathered from industry sources, individuals, estates, IRA/SEP/Keoghs, or Roth/Education IRAs comprise over 75% of investor accounts. The inclusion of tax-advantaged accounts on this list raises questions about the degree to which investors holding MLPs in such accounts actually understand them—the consequences of holding MLPs in a tax-advantaged investment account can destroy much of the investment's yield if the investment yields taxable net income. *See* Saunders, *supra* note 111.

117. *See, e.g.*, Ekkehart Boehmer & Eric K. Kelley, *Institutional Investors and the Informational Efficiency of Prices*, 22 REV. FIN. STUD. 3563 (2009). Unlike most retail investors, institutional investors can afford extensive research and analysis and benefit from advice given by governance advisors who analyze issues in order to make recommendations to their clients. Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. LAW 887 (2007). When traded upon, that information is incorporated into the market's valuation of the relevant shares, which ultimately benefits retail investors who never would have been able to generate such information on their own. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 694 (1984); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, (1984). *See generally* Mary Siegel, *Publicly-Traded LLCs: The New Kid on the Exchange*, 68 S.M.U. L. REV. 885, 895 (2015).

which can have negative effects on the informational efficiency of the market.

These studies of MLP governance alongside the information that has emerged about MLP investors raise questions about the current system of unrestrained contractual freedom. Nevertheless, this account—which focuses primarily on contractual and other legal accountability mechanisms—risks underemphasizing the role of other disciplinary forces, such as investor expectations related to cash distributions. Although contractual provisions requiring cash distributions may leave management with considerable discretion over distributions, regular distributions are the norm.[118] There are strong market expectations that distributions will occur, and in many instances other contractual mechanisms, such as Incentive Distribution Rights (which allocate additional distributions to the general partner after certain distribution benchmarks to public investors are reached) provide additional reasons for management to distribute cash regularly.[119] Common valuation metrics for MLPs focus on "yield, distributable cash flow, and EBITDA" rather than net income.[120] MLP units are yield investments, and whether or not a MLP makes cash distributions is something that even the most unsophisticated investor can assess. When MLPs stop distributing cash without a good reason for doing so, investors can flee quickly.[121]

Additionally, the need to maintain and regularly increase cash distributions likely acts as a constraint on the degree to which MLP sponsors can indulge in the misconduct that seems to be authorized by commonly adopted conflict-of-interest provisions. If the market expects increased cash distributions after drop downs and other similar going-concern transactions, self-dealing will be limited to that which will not have a

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118. *See* Beauchamp, *supra* note 77.

119. *See, e.g.*, Goodgame, *New Developments, supra* note 5 at 83–84. Gomtsian's study of LLC operating agreements confirms the role that market expectations of cash distributions can play. This study found that, despite the discretion retained by management over distributions, LLCs with a cash distribution provision distributed 76% of their cash. Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies,* 40 DEL. J. CORP. L. 207, 257 (2015).

120. Fleischer, *supra* note 2, at 98.

121. Alison Sider, *Linn Energy to Stop Making Dividend-Like Payments*, WALL ST. J. (July 30, 2015), http://www.wsj.com/articles/linn-energy-to-stop-making-dividend-like-payments-1438294871.

negative effect on the ability of the MLP to meet market expectations as to cash distributions. Thus, the importance of meeting investor expectations with regard to cash distributions also suggests that investors' likely inability to assess the details of governance arrangements is less important that it might appear to be. If those arrangements affect (either positively or negatively) the ability of the MLP to make ongoing cash distributions, then those arrangements will be at least partially reflected in price at which MLP units are valued. The recent appearance of variable distribution MLPs appears to confirm the relationship between cash distribution and fiduciary duties. These entities engage in activities that do not generate the regular cash flows that make predictable distributions possible, and they typically do not opt out of traditional fiduciary duties.[122]

An additional countervailing force is the role that the judiciary plays in policing the behavior of MLP management and sponsors under the frameworks provided by traditional contract enforcement[123] or the contractual duty of good faith and fair dealing.[124] Of course, good faith and fair dealing does not stand in the place of the duty of loyalty, but as recent cases demonstrate, it does provide a means of invalidating problematic actions that are incompatible with fundamental notions of fairness.[125]

B. *Lack of Standardization*

Another negative side effect resulting from state law commitments to contractual freedom is the decreased level of standardization across MLP operating agreements (as compared to other publicly traded companies organized as corporations). In the corporate law context, the largely positive effects of standardization are well documented.[126] When firms are subject to the same terms (e.g., mandatory fiduciary duties and widely-adopted default terms), they enjoy increased cer-

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122. Gomtsian, *supra* note 117.

123. *See, e.g.*, *In re* Energy Transfer Equity LP Unitholder Litig., No. 12197-VCG, 2017 WL 782495 (Del. Ch. Feb. 28, 2017).

124. *See, e.g.*, Dieckman v. Regency GP LP, 155 A.3d 358 (Del. 2017); Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400 (Del. 2013).

125. *See generally* Branson, *supra* note 14, at 61.

126. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

tainty resulting from development of case law relevant to those terms and business techniques that have been tested against that case law.[127] Lawyers and other advisors are able to offer their services more cheaply to more clients because they are able to transfer knowledge about standardized terms from one deal or case to another.[128] They also save firms negotiating and drafting costs by allowing them to adopt standardized terms "off–the–rack."[129] Even when state corporate statutes allow corporations to contract out of particular terms, they often opt for default terms, at least partially on account of these advantages.[130]

Advocates of a mandatory fiduciary duty of loyalty point out that uncorporate governance has coalesced around certain common features and types of terms,[131] but the use of individually drafted operating agreements allows each version to take a different form. Even in those areas where "a degree of surface-level standardization has begun to occur"[132] (e.g., the presence of a conflict–of–interest provision governing interested transactions[133]), variation in the wording used to implement them exists.[134] Poorly drafted and conflicting provisions confound courts tasked with interpreting operating agreements,[135] leading to results that the drafters were almost cer-

127. *Id.*

128. *Id.*

129. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34 (1996) [hereinafter EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE].

130. Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 4 (2006) ("While closely held business firms commonly have detailed, specifically tailored charters, the charters of publicly traded corporations are remarkably empty. . .They effectively defer to the default terms of the state corporation law in virtually all matters of significance.").

131. Goodgame, *New Developments, supra* note 6, at 81.

132. Strine & Laster, *supra* note 21, at 18.

133. Horton, *Modifying Fiduciary Duties in Delaware*, *supra* note 23.

134. *See, e.g.*, Allen v. Encore Energy Partners, LP, 72 A.3d 93, 100 (Del. 2013) ("Although the limited partnership agreements in these cases contain similar provisions, those facial similarities can conceal significant differences between the limited partnership agreements.").

135. *See, e.g.*, Kahn v. Portnoy, No. 3515-CC, 2008 WL 5197164, at *6 (Del. Ch. Dec. 11, 2008) ("I have been unable to explain these provisions as anything other than poor drafting or a strategy of 'if one exculpatory provision is good, then two must be better.'").

tainly intending to avoid.[136] Cases "turn on the unique and often seemingly contradictory terms of specific governing instruments,"[137] which "limits the efficacy of precedent and creates fertile opportunities for future litigation."[138] This state of affairs has led, in the words of the Delaware Supreme Court, to a body of "confusing precedent."[139] Empirical studies support these accounts of both inconsistent contractual provisions and variations in the way common contractual substitutions are implemented.[140] Alongside the largely retail investor base, the lack of standardization raises questions about the degree to which the market for MLP units accurately prices governance arrangements. Market efficiency is a function of information costs,[141] and standardization lowers those costs.[142] Without standardization, investors are faced with either investing blindly or spending considerable resources evaluating and understanding MLP operating agreements: they cannot rely on pre-existing experience of their own or of others. It is therefore not unreasonable to question the degree to which the market is able to incorporate information about MLP governance into the prices. However, the point should not be overstated: MLP units are yield investments and, as such, are subject to market expectations of regular distributions at particular levels. To the degree MLP governance features impact cash distributions, those features should have some effect on the market price of an MLP's publicly traded units.

136. *Id.*

137. Strine & Laster, *supra* note 21, at 24.

138. *Id.* at 18.

139. Brinckerhoff v. Enbridge Energy Co., 159 A.3d 242, 252 (Del. 2017).

140. Horton, *Going-Private Freeze-Out, supra* note 27; Horton, *Modifying Fiduciary Duties in Delaware*, *supra* note 23.

141. Gilson & Kraakman, *supra* note 115, at 593 ("Since efficiency in the capital market depends on the distribution of information, it is ultimately a function of the cost of information to traders. The lower the cost of particular information, the wider will be its distribution, the more effective will be the capital market mechanism operating to reflect it in prices, and the more efficient will be the market with respect to it.").

142. *See id.* at 615 (noting that "repeated use of the same form document will eliminate the costs of determining, for each issue, what alternative formulations mean and how effective they are."). *See also* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or the Economics of Boilerplate)*, 83 VA. L. REV. 713, 720–22 (1997).

III.
A MANDATORY DUTY OF LOYALTY AND THE FORCES THAT SHAPE STATE BUSINESS LAW

This Part addresses the likelihood that Delaware will re-adopt a mandatory duty of loyalty in this context in light of three forces that affect state business lawmaking: interstate (or horizontal) competition for entities, the influence of the Delaware bar, and the threat of federal preemption (or vertical competition). All three owe their influence to the forbearance of the federal government in the realm of business law: Congress has never enacted a comprehensive federal business association statute[143] despite almost certainly having Commerce Clause[144] power to do so. Instead, responsibility for American business lawmaking is split between the federal and state governments according to a blurry distinction between issues related to the internal affairs of business entities and those related to securities transactions and markets. Federal law generally focuses on the latter, primarily through disclosure requirements and anti-fraud rules.[145] State law provides the statutes and cases that govern "the powers, rights, and duties of the corporation, its shareholders, officers, and direc-

143. *See, e.g.*, STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 27 (2012) ("No one seriously doubts that Congress has the power under the Commerce Clause to preempt the field of corporate governance law."); Mark J. Roe, *Regulatory Competition in Making Corporate Law in the United States—and its Limits*, 21 OXFORD REV. ECON. POL'Y 232, 236 (2005) ("If Washington wanted to, it could take over all of corporate law from the states, obliterating Delaware as producer of state-made corporate law."). The federal government could also choose to relinquish control over certain corporate law areas, and Professor Romano has argued that the federal government should take this approach with regard to securities regulation. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361 (1998).

144. U.S. CONST. art. I, § 9, cl. 3.

145. *See, e.g.*, BAINBRIDGE, *supra* note 141, at 34 (2012) ("As a general rule of thumb, federal law appropriately is concerned mainly with disclosure obligations, as well as procedural and antifraud rules designed to make disclosure more effective."); Leo E. Strine, Jr., Vice Chancellor, Del. Court of Chancery, Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward, Address at Various Forums in Spring 2008, *in* 63 BUS. LAW, Aug. 2008 at 1079–80 (2008); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 3 (1993).

tors"[146]—its internal affairs. This power–sharing arrangement between state and federal governments has had significant impact on the content of state business law and the factors that impact it.

Primarily, business law federalism has created a lawmaking environment that allows states to compete for corporations and other business organizations. Generally, it will be in a state's interest to enact rules that will maximize the number of entities that choose to organize in that state. Of course, Delaware has been the dominant player in this competition for decades with regard to corporations, and it has recently established a similarly dominant position with regard to large alternative entities.

This interstate, or horizontal, competition is not the only force that affects the content of state business law. Rather, because Congress has left internal affairs to state governments, intrastate interest groups, and in particular the Delaware bar, are able to influence the content of state business law. If their interests are aligned with the more generalized state interest in maximizing entity formations, intrastate interest groups will tend to encourage adoption of rules that will maintain or enhance a state's competitive position. When they diverge, however, these groups are in a position to push for rules that will benefit them, even if they will compromise the State's competitive advantage.

Another force that impacts state business lawmaking (and which results from corporate federalism) is the threat of federal preemption, or vertical competition. Again, federalism in the business law context is voluntary. The federal government *could* step in and preempt state business law at any time, and this forces state lawmakers to pay attention to federal preferences and policies for fear of losing jurisdiction over parts or all of business law.[147]

Together, these three forces—all of which result from the power-sharing arrangement between state and federal governments—interact to impact the content of state business law. Interstate competition pushes states to adopt rules that will

146. Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1607 (2005).

147. *See, e.g.*, Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600–01 (2003).

maximize the number of entities that organize there. Pressures created by internal interest group dynamics will often be consistent with the competitive pressures that favor formation-maximizing rules, but this is not necessarily the case. At times, the interests of groups like the Delaware bar will not be advanced by adoption of formation-maximizing rules, and in these instances, the pressures created by internal interest groups will work in opposition to those created by interstate competition. Above the state-level fray sits the federal government, which can preempt aspects of state business law and has done so in the past. State lawmakers—whether acting in response to competitive pressures or those created by the Delaware bar—must also pay attention to this threat of federal preemption if they are to maintain their power over important aspects of business law. Delaware, of course, has the most to lose from federal preemption, and the state's responsiveness to the threat is well-documented.

In this Part, I evaluate the prospect of reinstating a mandatory duty of loyalty in light of the pressures created by state competition, the influence and likely preferences of the Delaware bar, as well as the threat of federal preemption. As I argue below, they are unlikely to lead to legislative reintroduction of a mandatory duty of loyalty in this context.

A. *Interstate Competition*

1. *Overview of Interstate Competition*

Despite periodic calls for a federal incorporation statute, Congress has yet to adopt one.[148] Its forbearance has allowed states to compete for corporate charters (and other business entities) and the tax revenue they generate. Delaware currently enjoys tremendous success in attracting these entities and has done so for several decades.[149] It is the state of incor-

148. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Daniel Schwartz, *Towards New Corporate Goals: Co-existence with Society*, 60 GEO. L.J. 57 (1971); Harold G. Reuschlein, *Federalization—Design for Corporate Reform in a National Economy*, 91 U. PA. L. REV. 91, 106–07 (1942).

149. Delaware first started to compete for corporate charters in the late nineteenth and early twentieth centuries, when New Jersey dominated. Charles M. Yablon, *The Historical Race Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880–1910*, 32 J. CORP. L. 323, 358–59 (2007). It has since enjoyed considerable success.

poration of over 50% of publicly traded corporations and approximately 65% of the Fortune 500.[150] This is a lucrative business for Delaware. It collected approximately $677 million in corporate franchise taxes during its 2014–2015 fiscal year and approximately $700 million during its 2015-2016 fiscal year.[151]

The reason for Delaware's success has been a primary focus of corporate law scholarship for decades. Some argue that the competition for corporate charters is a race to the bottom. Because managers are responsible for making decisions about where to incorporate or reincorporate, state lawmakers have an incentive to offer corporate law that elevates interests of management over those of shareholders.[152] According to race-to-the-bottom theorists, this is exactly what Delaware has done. Its success represents an orientation that privileges management at the expense of investors.

Other scholars, however, argue that the race is to the top. Proponents of this position argue that the costs of a jurisdiction's corporate law regime will be reflected in the price of securities issued by corporations organized there.[153] If a state's corporate law is overly friendly to management (or otherwise negatively impacts shareholder value), it will be reflected in price of securities issued by corporations that are organized there.[154] The state will eventually lose incorporations to states with "better" legal regimes.[155] According to this take on the charter competition, Delaware has won because it provides efficient corporate law that effectively balances the interests of management and shareholders.[156] For both race-to-the-top and race–to–the–bottom theorists, state competition exerts pressures on states vis-à-vis the content of their corporate law.

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150. Jeffrey W. Bullock, Delaware Division of Corporations 2016 Annual Report, https://corp.delaware.gov/2016AnnualReport.pdf.

151. Delaware Dep't of Fin., Div. of Acct., 2016 Delaware Comprehensive Annual Financial Report (Dec. 30, 2015), https://auditor.delaware.gov/wp-content/uploads/sites/40/2017/01/State-of-Delaware-Fiscal-Year-2016-Comprehensive-Annual-Financial-Report-CAFR.pdf

152. *See, e.g.*, Cary, *supra* note 146.

153. EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 127, at 17.

154. This, of course, assumes that the securities are traded in a market of sufficient efficiency for prices to reflect jurisdictional variations in corporate law.

155. ROMANO, *supra* note 143 at 14–15.

156. *See, e.g.*, Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUDIES 251 (1977).

They differ, however, as to "whose demand schedule for corporate charters is driving the system."[157]

Explorations of Delaware's success in this jurisdictional competition have focused on a variety of explanations for Delaware's competitive advantage and have identified its prestigious and specialized courts,[158] its first-mover advantage,[159] the network effects that result from the widespread adoption of the standardized terms that appear in the state's corporate statute,[160] the state's credible commitment to updating its statute, path dependence,[161] and its generally favorable legal environment and infrastructure[162] as possibilities. Given the convergence of relevant factors, it is impossible to identify conclusively the reasons for Delaware's success at attracting corporations. As is often the case with reality, the situation is too complicated for a single explanation.[163]

The following Part analyzes jurisdictional competition in the context of publicly traded alternative entities and argues that state competitive pressures will discourage Delaware's lawmakers from readoption of a mandatory duty of loyalty.

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157. ROMANO, *supra* note 143, at 15.

158. *See, e.g.*, Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1068 (2000).

159. ROMANO, *supra* note 143 at 44.

160. Klausner, *supra* note 34.

161. *See* Brian J. Broughman & Darian M. Ibrahim, *Delaware's Familiarity*, 52 SAN DIEGO L. REV. 273, 304–05 (2015).

162. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) ("[D]elaware, over time, has developed an important capital asset in the form of a legal environment that is highly desired by consumers of its corporate law both for the present structure of its rules, and—perhaps more importantly—for the reliable promise it makes that rules adopted in the future will also be highly desired.").

163. There is empirical evidence tending to show that horizontal competition has had a positive effect on the content of state law. *See, e.g.*, Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II – Empirical Studies and Corporate Law*, 4 AM. L. ECON. REV. 380, 384 (2002) ("[T]he event study literature suggests that Winter's core insight is accurate: competition for corporate charters benefits investors."). However, the presence of state corporate law features that clearly favor management, such as anti-takeover statutes, raise legitimate questions about both the direction of the race and whether the race even has an overall direction or if, instead, jurisdictional competition pushes states in different directions with regard to different issues.

2. *State Competition for Alternative Entities*

As is the case with publicly traded corporations, most publicly traded alternative entities are organized as Delaware[164] LPs or LLCs.[165] Nevertheless, Delaware's success may imply that the state has more market power than it actually does.

Although Delaware's decision to grant alternative entities significant contractual freedom "likely enhance[s] the value" of its law, other states have made similar commitments, and this has the same effect of the value of the law products they offer.[166] All of these states, including Delaware, are simply offering themselves as jurisdictions committed to enforcing contracts. For firms that value the contractual freedom to modify or waive fiduciary duties, ready substitutes for Delaware law are available. As against these other states that have adopted a con-

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164. It is important to acknowledge up front that regulatory competition in the context of alternative entities has received too little scholarly attention. The work that has been done focuses primarily on LLCs and usually includes data relating to closely-held firms alongside that relating to publicly traded firms. Nevertheless, it is possible to draw some conclusions as to whether or not state competition is likely to prompt reintroduction of a mandatory duty of loyalty.

165. Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 476 (2009); Goodgame, *New Developments, supra* note 6, at 81–83; Tim Fenn, *Master Limited Partnerships (MLPs): A General Primer* 2 (2014) https://www.lw.com/admin/Upload/Documents /Latham-Master-Limited-Partnership-Primer-2014.pdf ("[M]ost commonly the MLP is formed as a Delaware limited partnership. Increasingly, the MLP may instead be a state law limited liability company—preferably a Delaware limited liability company (an LLC). . .").

166. Sandra K. Miller & Yvonne L. Antonucci, *Default Rules and Fiduciary Duty Waivers in Alternative Entities: Policy Issues and Empirical Insights*, 42 J. CORP. L. 147 (2016); Manesh, *Market for LLC Law, supra* note 20, at 225 n.190. Significantly fewer states have amended their LP statutes to allow for total elimination of fiduciary duties. *See, e.g.*, ALA. CODE § 10A-9-1.10(a)(2)(LexisNexis 2017) (repealed 2017). On January 1, 2017, recent amendments to Alabama's limited partnership law will go into effect, and the provision allowing for elimination of fiduciary duties will be Section 10A-9A-1.08(b)(1). Even statutes that do not allow for total elimination of the duty of loyalty regularly allow for restrictions on it. *See, e.g.*, UNIFORM LIMITED PARTNERSHIP ACT § 110(b)(5) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2001); UNIFORM PARTNERSHIP ACT § 103(b)(3) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 1997). In any event, the ability of MLPs to take the LLC form (and increasing regularity with which this is occurring) makes it possible for states to compete against Delaware with their LLC statutes, even if they do not amend their LP statutes to provide for the same level of contractual freedom to eliminate duties.

tractual approach to alternative entities, Delaware's primary competitive advantages seem to be other, Delaware-specific benefits (such as its generally superior legal infrastructure)[167] rather than ways in which the content of its law differs from that of other states.

As Professor Manesh has argued, these Delaware-specific advantages may be less valuable in this context on account of commitments to contractual freedom. Reliance on operating agreement provisions rather than on fiduciary principles may render some of the expertise of Delaware judges and lawyers less relevant.[168] This is not to say that these other advantages are rendered totally valueless: operating agreements are long and complex documents, and there is an obvious advantage to calling upon commercially-savvy, experienced legal professionals when issues arise.

Delaware's tax schedule is consistent with this account of its competitive position in the market for alternative entities. Delaware LPs and LLCs pay a flat annual tax of $300,[169] which is comparable to the tax other states impose.[170] In the corporate realm, however, corporations pay an initial filing fee as

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167. Efforts to determine Delaware's success at attracting alternative entities have focused on LLCs and have utilized a variety of methodologies. Two correlation studies have reached differing effects. *Compare* Jens Damman & Matthias Schündeln, *Where are Limited Liability Companies Formed? An Empirical Analysis,* 55 J. LAW & ECON. 741 (2012) *with* Bruce H. Kobayashi & Larry Ribstein, *Delaware for Small Fry*: *Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91 (2011). Damman and Schündeln find that LLCs flee their home state (usually to Delaware) if it offers lax protection for minority investors or creditor-friendly veil piercing rules. Kobayashi and Ribstein interpret their data as indicating that Delaware's success is largely attributable to Delaware's legal system and general reputation. On the other hand, Professor Franklin Gevurtz has questioned exclusive reliance on correlation studies in this context and, instead, has conducted surveys of practitioners. Franklin A. Gevurtz, *Why Delaware LLCs?*, 91 OR. L. REV. 57 (2012). He concluded that "the top two reasons for forming LLCs in Delaware were the freedom of contract (including the ability to waive fiduciary duties) . . . and Delaware's judicial infrastructure." *Id.* at 105. These results are consistent with those reached by Ribsten and Kobayashi. *See,* Kobayashi & Ribstein at 135–36.

168. Manesh, *Market for LLC Law, supra* note 20, at 234–35 (2011).

169. DEL. CODE ANN. TIT. 6, § 17-1109 (2017) (for LPs); DEL. CODE ANN. TIT. 6, § 18-1107 (2017) (for LLCs).

170. *See* Manesh, *Market for LLC Law, supra* note 20, at 198–200 (2011).

well as an annual franchise tax calibrated according to size.[171] For publicly traded corporations (those that likely place the most value on organizing in Delaware), this amount can be quite high—the Delaware General Corporation Law sets a ceiling of $180,000 on the annual franchise tax.[172] Other states charge significantly less to incorporate and remain organized there.[173] Assuming that Delaware would charge a similar premium for alternative entities if it were possible to do so, its pricing approach to alternative entities implies that it enjoys less power in the market for alternative entities than it does in the market for corporate charters.[174]

For Delaware lawmakers evaluating a departure from the state's commitment to contractual freedom, the relevant question appears to be whether other aspects of organizing in Delaware, like its judicial infrastructure, are enough on their own to attract the lion's share of large, out-of-state alternative entities. They might be, but not necessarily. After all, "[o]ther states have shown that they can take over submarkets for specific types of publicly held firms."[175] Maryland, for example, has had overwhelming success in attracting real estate invest-

171. *See* 1 Balotti & Finkelstein, DEL. L. OF CORP. AND BUS. ORG. § 18.7 (2017).

172. DEL. CODE ANN. TIT. 8, § 503(C) (2017).

173. *See, e.g.*, Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1219–21 (2001).

174. Manesh, *Market for LLC Law*, *supra* note 20, at 198–200. Professor Manesh raises the possibility that, in light of the meager amounts at stake, states are simply not competing for LLCs. *Id.* at 256–57. This is an interesting possibility, and may very well be true with regard to small, closely-held entities. With regard to larger entities and certainly publicly traded ones, franchise tax revenue is only part of what is at stake. These firms are more likely to require extensive legal services at the formation stage, need legal advice on an ongoing basis, and face litigation brought by their investors. All of these provide valuable economic benefits to Delaware and its citizens and provide the state's lawmakers with a reason to compete for such entities. *See, e.g.*, Kahan & Kamar, *Price Discrimination*, *supra* note 171. The low, flat LLC and LP tax may also indicate that the organizers of these entities are more price sensitive than those of corporations. Again, this may be true with regard to small, closely held LPs and LLCs. With regard to publicly traded firms (which are organized by sponsors who are themselves publicly traded corporations), this seems less likely to be the case. Companies holding hundreds of millions worth of natural resource related assets can most likely afford significantly more than a $300 annual tax.

175. Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 705 (2008)

ment trusts (REITs),[176] in large part by offering a statute designed specifically for them.[177] For Delaware lawmakers who want to maintain the state's success in attracting publicly traded LPs and LLCs, the prudent course of action, at least from a state competition perspective, appears to be continuing to offer contractual freedom.

B. *The Delaware Bar's Influence*

Of course, jurisdictional competition is not the only force that shapes the content of state business law. Particularly in Delaware, interest group dynamics play a significant role in determining the content of the state's business law, and many features of the state's corporate law appear to protect and facilitate the politically powerful corporate bar's interest in maximizing the demand for their services.[178] Perhaps this is unsurprising given the bar's outsized influence over regular amendments to the statutes that govern business entities organized in the state. Committees comprised of members of the Delaware bar are responsible for drafting amendments,[179] which are routinely adopted by the legislature, often unanimously. The bar's influence is not limited to legislation; even a cursory analysis of the interest dynamics at play in Delaware corporate lawmaking point out that many of the state's judicial decisions advance the interests of the state's bar.[180]

Typically, it will be in the interest of the Delaware bar to "go with the flow" created by jurisdictional competition: whether the race is to the top or bottom, attracting business entities is the best way for the Delaware bar to maintain demand for their services.[181] In this regard, the incentives of the

176. *Id.*; *see also* David M. Einhorn et al., *REIT M&A Transactions—Peculiarities and Complications*, 55 BUS. LAW. 693 (2000).

177. MD. CODE, CORPS. & ASS'NS §§ 8-101-801 (2013). Maryland enacted its first statute to govern REITS in 1967.

178. Macey Miller, *supra* note 160 (offering interest group theory of Delaware law and arguing that the "bar is the most important interest group within this equilibrium").

179. Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006).

180. Macey & Miller, *supra* note 160.

181. Macey & Miller, *supra* note 160, at 503 ("All groups prefer, other things being equal, that the state provide a legal regime that is highly desired by corporate managers. Accordingly, the groups will tend to support the kinds of provisions that appeal to corporate managers and those that

bar and the state government are generally aligned.[182] Both benefit from attracting additional entities and retaining the ones that have already opted for Delaware. There are, however, instances in which the interests of the bar and those of the state diverge.[183] A legal rule or framework that will lead to fewer business entities may nevertheless be in the best interests of the bar if it would lead to an increase in legal fees sufficient to offset any loss resulting from fewer entity formations in the state.[184] Indeterminacy, such as that created by reliance on judges' *ex post* application of fiduciary principles to generate many of the applicable legal rules,[185] benefits the Delaware bar by generating additional legal work even though indeterminate law may negatively impact the value of organizing in Delaware.[186] While litigators have incentives to prefer

influence them: rules promoting economic efficiency; safeguards of incumbent managers; and provisions favored by lawyers, investment bankers, or others with influence on the incorporation decision.").

182. *See, e.g.*, Stephen M. Bainbridge, *Fee-Shifting: Delaware's Self-Inflicted Wound*, 40 DEL. J. CORP. L. 851, 874 (2016) ("In most cases, the interests of Delaware lawyers and those of the state government are aligned. Just as the State wants to maximize the number of firms incorporated in Delaware, so as to maximize franchise and other tax revenues, Delaware lawyers also want to maximize in-state incorporations, because all else being equal, an equal number of firms will generate an increasing volume of legal work.").

183. This divergence results from the bar's ability to capture a large proportion of the indirect costs that are paid by Delaware entities. Macey & Miller, *supra* note 160, at 492 ("the fees paid to lawyers, accountants investment bankers, and corporation services companies . . . .").

184. Macey & Miller, *supra* note 160, at 504 ("[T]he bar could also benefit from legal rules that increase the amount of expected legal fees per corporation, even if such rules, by imposing additional costs on Delaware corporations, reduced the absolute number of firms chartered in the state. If the legal fees gained exceed the fees lost by deterring Delaware incorporation, the bar would prefer to adopt rules that did not serve the interests of the other interest groups within the state. In this respect, the bar's interests are opposed to the interests of all other groups."). At least one prominent commentator has argued that Delaware's recent prohibition of fee-shifting bylaws is an example. Bainbridge, *Fee-Shifting*, *supra* note 180.

185. *See* Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 87 (1990) (arguing that "indeterminacy describes the state of corporate law generally").

186. Macey & Miller, *supra* note 167, at 504 (Advisory work and litigation "are also functions of the clarity of the applicable legal rules, because an unclear rule is likely to generate both a greater need for legal advice and a greater likelihood of litigation"); William W. Bratton, *Delaware Law As Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-Five Years*,

mandatory indeterminacy (i.e., indeterminacy out of which parties cannot contract) because it increases demand for their services, transactional attorneys have strong reasons to favor indeterminacy that is contractible,[187] (i.e., indeterminacy that can be reduced or eliminated through private ordering). The possibility of implementing private ordering to escape indeterminacy creates demand for legal services related to planning, drafting, and providing advice relating to obligations created by private ordering.[188] Delaware's current approach to uncorporate fiduciary duties is one of contractible indeterminacy: fiduciary duties apply as default rules, but parties are free to contract out of them. Thus, reintroduction of a mandatory duty of loyalty would represent a shift in the portion of the Delaware bar whose interests are served by the species of indeterminacy present in uncorporate entity law. This would, of course, require legislative action, and in the past, legislative changes have often reflected the interests of the transactional bar in this regard.[189]

Furthermore, it is not clear that Delaware litigators would even benefit from this shift. Although there may not be as much MLP-related litigation now as there would be under a mandatory fiduciary duty regime, Delaware's litigators *do* experience some demand for their services under the current regime of contractible indeterminacy.[190] There is at least some demand for litigation over compliance with the contractual provisions (which courts can interpret to incorporate fiduciary

34 GA. L. REV. 447, 469 (2000) ("[I]ndeterminate law triggers more litigation . . . ."). Other explanations of indeterminacy exist. *See, e.g.*, Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 Colum. L. Rev. 1908 (1998).

187. Stephen Bainbridge, *Interest Group Analysis of Delaware Law: The Corporate Opportunity Doctrine As Case Study*, (UCLA School of Law, Law-Econ Research Paper No. 17-01, 2017).

188. *Id.*

189. *Id.* As Professor Bainbridge points out, the Delaware judiciary is often hostile toward private ordering and therefore appears to favor the litigation bar. *Id.* Strine & Laster's proposal to reintroduce a mandatory duty of loyalty is another example of what may be a judicial tendency to advance the interests of litigators. Nevertheless, as Professor Bainbridge points out, reputational considerations, rather than sympathy with a particular segment of the Delaware bar, may be the reason. *Id.*

190. Three major MLP opinions released in 2017 so far.

standards),[191] and the Delaware courts have recently looked to the covenant of good faith and fair dealing to police the behavior of MLP management.[192] Reintroduction of a mandatory fiduciary duty of loyalty would benefit Delaware's litigators only if increased litigation is not offset by the consequences resulting from having fewer entities formed in the state. If reintroduction of a mandatory fiduciary duty were to prompt MLPs to leave or avoid Delaware (and there are strong reasons to think that this is a real risk), the litigators themselves would not ultimately benefit from reintroduction of mandatory indeterminacy. This does not appear to be a situation in which the losses caused by fewer entity formations will be offset by the increased demand for legal services.

C. *The Federal Threat and Its Effect on Delaware Lawmaking*

In addition to facilitating interstate competition for corporate charters, the current balance of corporate federalism empowers the federal government to act as a constraint on the content of state law. The federal government has utilized legislative, regulatory, and more informal, but no less effective, methods to displace state corporate law, and state lawmakers have indicated both an awareness of this threat and a willingness to act in ways that are inconsistent with the pressures of state competition on account of it. As the state of incorporation for the majority of publicly traded companies, Delaware has the most to lose from federal displacement of state corporate law. The state's lawmakers are aware of the threat posed by the federal government and expressly acknowledge the need to be cognizant of federal preferences.[193] In the words of Chief Justice Strine (then-Vice Chancellor), "the capacious constitutional authority of Congress over interstate commerce is something that Delaware and other state corporate lawmakers have constantly had to take into account ."[194]

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191. *See, e.g.*, Brinckerhoff v. Enbridge Energy Co., Inc., 2017 WL 1046224 (Del. 2017).

192. Dieckman v. Regency GP LP, 2017 WL 243361 (Del. Sup. Jan. 20, 2017); Gerber v. Enterprise Holdings, LLC, 67 A.3d 400 (Del. 2013).

193. *See, e.g.*, William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 958–59 (2003).

194. Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW.

Although Congress has refrained from total preemption of state law, it has reached into the traditional realm of state corporate law on a piecemeal basis.[195] Recent examples include both the Sarbanes-Oxley Act of 2002 ("SOX") and the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Both pieces of legislation include a variety of provisions that reach into areas traditionally within the purview of state law. Some examples include requiring certain board committees and compositions,[196] authorizing a new category of derivative suit,[197] and creating new rules applicable to executive compensation.[198]

In addition to congressional action, the SEC also takes steps to override problematic aspects of state law. It has wielded its rulemaking authority in the past to "overrule" decisions by state courts on important corporate topics: Rule 14d-10, for example, requires that bidders open their tender offers to all holders of the securities subject to the offer,[199] and was adopted in response to a Delaware Supreme Court case upholding a corporation's decision to exclude a large shareholder from its offer to buy back shares of the corporation's stock.[200] The SEC also has authority under Section 19(c) of the 1934 Act to compel exchanges to change their rules so as to achieve particular aims,[201] and even when limits on its statu-

1079, 1081 (2008). After passage of SOX, two members of the Chancery Court explained that the legislation represented a federal determination that state law placed insufficient constraints on executive compensation and predicted that state lawmakers would "be responsive to this expression of concern and . . . use it as an opportunity to reflect more deeply on whether their own policies need adaptation to better protect stockholders." William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 1001 (2003).

195. *See, e.g.*, BAINBRIDGE, *supra* note 141.

196. 15 U.S.C. § 78j-1(m); 17 C.F.R. § 240.10A-3; *see also* 15 U.S.C. § 78j-3 (Dodd–Frank provision requiring a fully independent compensation committee).

197. 15 U.S.C. § 7244(a)(2)(B) (authorizing derivative cause of action to recover profits received by directors and officers who violate the statute's prohibition on trading in the corporation's securities when its pension plan participants cannot).

198. 15 U.S.C. § 78n-1; 15 U.S.C. § 78j-4.

199. 17 C.F.R. § 240.14d-10.

200. Unocal Corp. v. Mesa Petroleum Corp., 193 A.2d 946 (Del. 1985).

201. 15 U.S.C. § 78s(c) (2010).

tory power bar the SEC from compelling a change in listing standards, its "raised eyebrow power" can prompt cooperating exchanges into voluntary compliance.[202]

Importantly, this threat has caused Delaware's judges and legislators, as well as the Corporation Law Section of the Delaware State Bar Association and its Council[203] to take into account federal preferences, even when they are incompatible with the pressures of interstate competition.[204] Delaware's adoption of a moderate anti-takeover statute in the late 1980s was, at least in part, an attempt to avoid provoking the federal government into pre-empting the field with its own statute.[205] Given the horizontal competitive pressures created by other states' passage of more management-protective anti-takeover

202. Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 571 (1984). For example, after Delaware and other states upheld the validity of dual class recapitalizations, Williams v. Geier, 671 A.2d 1368 (Del. 1996), the SEC promulgated a rule pursuant to Section 19(c) to prohibit dual class recapitalizations by companies listed on a public exchange. 17 C.F.R. § 240.19c–4 (2005). The D.C. Circuit, however invalidated this rule as beyond the scope of the SEC's Section 19(c) authority. Bus. Roundtable v. Sec. and Exch. Comm'n, 905 F.2d 406 (D.C. Cir. 1990). Nevertheless, within a few years, the stock exchanges adopted listing standards prohibiting dual class recapitalizations under pressure from the SEC. *See* Stephen M. Bainbridge, *Revisiting the One Share/One Vote Controversy: The Exchanges' Uniform Voting Rights Policy*, 22 SEC. REG. L.J. 175, 176 (1994) ("Chairman Levitt has asked the three principal domestic securities exchanges—the New York Stock Exchange (NYSE), the American Stock Exchange (Amex), and the National Association of Securities Dealers (NASD)—to adopt a uniform voting policy that essentially tracks Rule 19c-4.").

203. Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1754 (2006).

204. *See, e.g.*, *Id.* at 1768 ("At the most basic level, Roe is absolutely right . . . . All we can do is hope that paroxysms of populist pressure for such federal intervention are few and far between, and try not to make law that will induce such paroxysms, so that the not unimportant role of Delaware's courts and legislature in the making of corporate law can continue to be played and so that our state can continue to enjoy the resulting benefits.").

205. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 625 (2003) ("Other states were producing one pro-managerial anti-takeover law after another . . . . Delaware, meanwhile, waited and passed only a mild anti-takeover law late in the decade."); Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1 (2009); Hamermesh, *supra* note 201, at 1764.

legislation at the time, the drafters of Delaware's statute must have seen federal preemption as a significant threat.[206]

At first glance, a threat of federal action seems like a potential reason for state lawmakers to consider reintroducing a mandatory duty of loyalty into the governance of publicly traded uncorporate entities. Until recently, federal securities laws have operated alongside the state law governing internal affairs. If state lawmakers allow themselves to be taken out of the regulatory framework applicable to a segment of publicly traded firms, the federal government may perceive a good reason to expand its activities.

Nevertheless, there is no real indication that Congress or the SEC is paying much attention to MLPs and their investors. If anything, federal lawmakers have shown an interest in expanding the use of this structure by attempting to broaden the definition of qualifying income. Furthermore, past federal actions to displace state corporate law have usually been in response to populist outcry following some sort of large-scale financial crisis or scandal.[207] Currently, these conditions do not exist with regard to MLPs. The federal threat does not seem to be a significant one.

Thus, Delaware's lawmakers are unlikely to perceive a federal threat that is significant enough to justify moving against the pressures of state competition. In fact, even if Delaware lawmakers did perceive some threat, they might have a reason to prefer federal action, provided they do not anticipate complete preemption of state law. Some narrow, mandatory, federal duty or governance requirement imposed by the SEC or stock exchanges would apply without regard to an entity's state of formation and might even take the form of a requirement that all publicly traded entities be subject to some sort of state

206. Dale Arthur Oesterle, *Delaware's Takeover Statute: Of Chills, Pills, Standstills, and Who Gets Iced*, 13 DEL. J. CORP. L. 879, 889 n.51 (1988). One SEC Commissioner, Joseph Grundfest, testified against the statute before the House Judiciary Committee of the Delaware State Legislature.

207. *See, e.g.*, STEPHEN BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 37 (2012) ("[F]ederal interventions tend to be episodic. The most important almost always follow some major economic crisis."). For example, Securities Act of 1933, Securities Exchange Act of 1934, Sarbanes–Oxley Act of 2002, and the Dodd–Frank Wall Street Accountability and Consumer Protection Act of 2010 were all enacted in response to major financial crises.

law governance feature. In sum, any threat of federal action is presently insufficient to force state lawmakers to act in opposition to the pressures of state competition.

IV. A TERMS-BASED APPROACH

Given the inconsistency between the reintroduction of a mandatory duty of loyalty and the forces that shape state business lawmaking, this Part explores an alternative approach. In short, it demonstrates that state lawmakers can use a statutory menu of standardized terms to encourage adoption of measures that are intended to provide investors with additional protection where it is needed and achieve higher degrees of standardization with regard to MLP governance. By looking at trends and patterns in the governance arrangements adopted by these entities (*e.g.*, the nearly universal adoption of conflict-of-interest provisions), state lawmakers can identify the terms that would benefit from standardization. In designing the terms, however, state lawmakers can also take into account the need to provide investors with additional protection in the areas where sponsors and organizers are able to impose one-sided terms.

This approach offers two advantages over reinstatement of a mandatory fiduciary duty. First, with standardized terms that are based on actual contracting practices (but which have been adjusted to incorporate increased levels of investor protection), states can offer terms that are tailored more appropriately to the needs of these firms than a mandatory duty of loyalty while facilitating increased standardization and investor protection. Importantly, this approach can be implemented in a way that is consistent with the pressures created by jurisdictional competition. Recent empirical and theoretical work indicates that standardized terms, such as those being proposed by this Article, do not have to be mandatory to be adopted.

Part A is a short discussion of considerations relevant to designing these terms and uses the recently enacted Dodd-Frank regime for swap trading as a model of standardization based on data about actual contracting practices. Part B provides an illustration using the commonly adopted conflict-of-interest provision as an example. Finally, Part C argues that standardized terms do not have to be mandatory for MLPs to adopt them.

A. *Devising the Terms*

Both empirical research as well as the observations of judges who regularly hear cases involving large, publicly traded uncorporations indicate that their operating agreements have begun to coalesce around certain types or categories of terms and governance arrangements.[208] This is unsurprising, particularly in light of the favorable tax treatment that motivates the creation of these entities and the conditions that must be met to secure that status.[209] MLPs operate in the same set of industries, hold the same general types of assets, and were organized by their sponsor to achieve the same financial objectives.

Terms which have become common, like conflict-of-interest provisions as well as cash distribution and mandatory liquidation provisions, are the most obvious candidates for standardization.[210] Presumably, their regular adoption indicates their usefulness. The ubiquity of conflict-of-interest provisions, for example, is unsurprising given the regularity (and desirability) of transactions between the MLP and its sponsor. With information about these contracting practices, state lawmakers are able to design standardized versions of these terms in a way that captures their usefulness to MLPs and facilitates the common business practices that led to widespread adoption of particular types or varieties of terms.

In devising standardized terms, state lawmakers should also take into account the need for increased investor protection in the areas where MLP sponsors and organizers impose one-sided terms. In this regard, the terms will depart to some degree from actual contracting practices, and their viability will depend on the degree to which they can incorporate additional investor protection without destroying the usefulness of the bespoke versions on which they are based. Again, the con-

208. *See supra* Part II.

209. I.R.C. § 7704 (2008).

210. Specific mention of these terms is not intended to imply that they are the only ones that are suitable for standardization. Indemnification and exculpation provisions may also be good candidates for standardization, as might other common arrangements like incentive distribution rights.

flict-of-interest provision is relevant. In designing a standardized conflict-of-interest term, state lawmakers can preserve the overall structure, intent, and utility of the conflict-of-interest provisions by providing a streamlined method for sanitizing interested transactions through committee approval, but also build in protection for investors in the areas where it is needed. In other words, there is a need for balance—measures intended to increase investor protection should be included in a way that does not destroy the usefulness of the bespoke terms on which the standardized terms are based. If this is not the case (*i.e.*, investor protection is incorporated in a way that destroys the usefulness of the standardized term such that adoption would overly inhibit the legitimate business practices of MLPs), they will not be adopted.

This "bottom-up" approach to devising standardized terms is similar to the Dodd-Frank regime for regulating swap contracts and pushing them toward increased standardization. Prior to the 2008 financial crisis, these financial instruments were bought and sold in a virtually unregulated and untracked over-the-counter market.[211] Dodd-Frank requires many swap transactions to go through an authorized exchange (in the parlance of Dodd-Frank, a "swap execution facility" (SEF) or designated contract market (DCM)),[212] provided one of these facilities has issued a determination that the particular type of swap has been "made-available-to-trade" (MAT).[213] MAT determinations identify categories of swaps based on their terms: in

211. Sec. Indus. and Fin. Markets Ass'n v. U.S. Commodity Futures Trading Comm'n, 67 F.Supp.3d 373, 385 (D.D.C. 2014); Reed T. Schuster, *Sacrificing Functionality for Transparency: The Regulation of Swap Agreements in the Wake of the Financial Crisis*, 62 SYRACUSE L. REV. 385, 391 (2012) ("Swaps in the OTC market . . . are negotiated bilaterally in a largely confidential, decentralized system that includes many instruments that are non-standardized.").

212. 7 U.S.C. § 2(h)(8)(A). Determining which swaps are subject to mandatory exchange trading is a convoluted process. Dodd–Frank imposes a broad requirement that swaps undergo clearing, unless they fall within an exception. 7 U.S.C. §§ 2(h)(1), (7). This clearing requirement is not relevant here, but at a high-level, it operates to reduce counterparty risk by dividing a swap into two transactions and substituting the clearinghouse for one of the parties in each of the two transactions. All swaps that must be cleared are subject to mandatory trading on an SEF or DCF as long as they have been "made-available-to-trade."

213. 17 C.F.R. § 37.10; 17 C.F.R. § 38.12.

the case of an interest rate swap, for example, the MAT determination describes the interest rate to which a swap is tied, the tenor, the payment schedule, etc.[214] Swaps that exhibit these attributes are subject to the mandatory exchange trading requirement. The MAT process is relevant here because it represents an attempt to look at actual contracting behavior and, *based on that behavior*, identify contractual arrangements that occur regularly enough to allow for standardization.[215] In making MAT determinations, SEFs/DCMs are required to consider various factors which lead them to identify categories of swaps with common characteristics and which, therefore, lend themselves to exchange trading.[216] The benefits of exchange trading (easier clearing, more liquidity, transparent and competitive pricing, and lower transaction costs) provide market participants with an incentive to fit their desired transaction into a standardized swap that is subject to an MAT determination.[217] Obviously, units in publicly traded alternative entities

214. Bloomberg SEF LLC - Made Available to Trade ("MAT") Submission of Certain Credit Default Swaps ("CDS") and Interest Rate Swaps ("IRS") Pursuant to Commodity Futures Trading Commission Regulation 40.6 (submission #2013-R-9), (Dec. 5, 2013), http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/bsefmatdetermltr120513.pdf.

215. In making MAT determinations, SEFs/DCMs are required to consider various factors, most of which are liquidity related. 17 C.F.R. § 37.10; 17 C.F.R. § 38.12. These factors are (1) whether there are ready and willing buyers and sellers; (2) the frequency or size of transactions; (3) the trading volume; (4) the number and types of market participants; (5) the bid/ask spread; and (6) the usual number of resting firm or indicative bids and offers.

216. See, for example, a MAT determination submitted by Bloomberg SEF LLC in which they explain that they are making MAT determinations with respect to "those swaps that are the most standardized . . . ." Bloomberg SEF LLC - Made Available to Trade ("MAT") Submission of Certain Credit Default Swaps ("CDS") and Interest Rate Swaps ("IRS") Pursuant to Commodity Futures Trading Commission Regulation 40.6 (submission #2013-R-9), (Dec. 5, 2013) at 3, http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/bsefmatdetermltr120513.pdf.

217. Annette Nazareth & Gabriel Rosenberg, *Swap Reporting Clearing & Trading: A Timing Guide*, FUTURES INDUSTRY 34, 36 (June 2012) ("Market participants will also need to monitor which swaps are 'made available to trade' and choose whether to use these standardized swaps or, instead, opt for more customized bilateral swaps *that do not need to be traded on SEFs or DCMs but may be subject to higher margin and capital requirements.*") (emphasis added). In response to this new regulatory landscape, Market Agreed Coupon (MAC) swaps have begun to trade on SEFs. These are recently developed,

are not swaps and cannot be regulated as such. Nevertheless, the Dodd-Frank model is instructive insofar as it illustrates a "bottom-up" approach in which actual transactions form the basis of efforts to standardize terms, and parties have a strong incentive to fit their transactions into a particular form.

B. *An Example: A Standardized Conflict of Interest Provision*

The vast majority of MLP operating agreements include a conflict-of-interest provision specifying both how conflicted transactions (usually between the MLP and its sponsor or an affiliate of the sponsor) can be approved and the standard of review under which the provision will be evaluated if challenged.[218] Usually, these provisions specify that a conflicted transaction is deemed to be approved by all partners if it is fair to the MLP, was made on terms equivalent to those available in an arm's length transaction, received "Special Approval" (which means that the transaction was approved by a conflicts committee acting in good faith) or was approved by a majority of public unitholders.[219]

The almost universal adoption of conflict-of-interest provisions that include a Special Approval prong makes sense in light of the regularity with which MLPs enter into transactions with their sponsors or other entities in the same group.[220] In a

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"fully standardized swap contract[s]" that have pre-set terms which are designed to make exchange trading easier for market participants. Terry Flanagan, *Bloomberg's SEF Executes Electronic MAC Trade*, MARKETSMEDIA, Nov. 25, 2013, http://marketsmedia.com/bloombergs-sef-executes-electronic-mac-trade.

218. Strine & Laster, *supra* note 21, at 21; *see also* Horton, *Modifying Fiduciary Duties in Delaware, supra* note 23, at 922 ("Successful uncorporations . . . appear to be coalescing around a standardized approach: approval by a special committee, coupled with a good faith standard."); Miller & Davis-Nozemack, *supra* note 21, at 280.

219. Strine & Laster, *supra* note 21, at 17; Lonergan v. Epe Holdings, LLC, 5 A.3d 1008 (Del. Ch. 2010); Brinckerhoff v. Enbridge Energy Co., 2011 WL 4599654 (Del. Ch. Sept. 30, 2011); *In re* Encore Energy Partners LP Unitholder Litig., 2012 WL 3792997 (Del. Ch. Aug. 31, 2012); Norton v. K-Sea Transp. Partners, L.P., 67 A.3d 354 (Del. 2013).

220. *See, e.g.*, Brinckerhoff v. Enbridge Energy Co., 159 A.3d 242, 245 (Del. 2017) ("MLPs are typically families of entities that often engage in internal business transactions, referred to as dropdowns, rollups, insider financings, incentive distribution rights, and equity investments."); *In re* El Paso Pipeline Partners, L.P. Derivative Litig., No. 7141-VCL, 2014 WL 2768782 (Del. Ch. June 12, 2014) (recounting history of eight drop downs between MLP and

drop-down transaction, for example, the sponsor sells additional Section 7704 qualifying assets to the MLP.[221] These transactions are a common growth tool for MLPs and, in many instances, are accretive, meaning that they increase cash flow to investors.[222] For the sponsor, they provide the opportunity to monetize additional assets beyond those which were sold to the MLP at its formation. When it comes to drop-downs, everyone can win. Thus, while MLP unitholders certainly do not want transactions to unfairly benefit the sponsor or the sponsor's affiliate at the expense of the MLP, they also do not want a rule that makes these transactions prohibitively risky or excessively expensive to undertake.

The usefulness of conflict-of-interest provisions and, in particular, special approval prongs becomes evident after consideration of how these transactions would be treated if evaluated under Delaware's current duty of loyalty framework. The contractarian criticism of mandatory fiduciary duties as potentially chilling legitimate business practices carries some weight here. As self-dealing transactions with a de facto controller,[223] drop-downs would be presumptively subject to entire fairness review.[224] This entails judicial review of both substantive and procedural aspects of the transaction, and significantly, places the burden of proving fairness on the defendant.[225] The de-

sponsor over four years); Eduardo Gallardo et al., *Implications of Recent Delaware Court of Chancery Decisions on MLP-Related Party Transactions,* 18 M&A Law. 7 (2014) ("Drop-down transactions are inherently conflict transactions, but are not uncommon in the life of an MLP.").

221. Matthew J. McCabe, Comment, *Master Limited Partnerships' Cost of Capital Conundrum,* 17 U. Pa. J. Bus. L. 319, 325 (2014).

222. Even the "bad" deals at issue in *El Paso* were accretive. *In* re *El Paso Pipeline Partners,* 2014 WL 2768782. The Court, however, rejected the proposition that subjective good faith was demonstrated by the fact that the drop-down would be accretive. *Id.* Other aspects of the deal were not in the best interests of the partnership. *Id.*

223. *See, e.g.*, Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1114 (1994) (finding that shareholder had de facto control notwithstanding the fact that its holding was less than 50%).

224. Solar Cells, Inc. v. True North Partners, LLC, No. Civ.A. 19447, 2002 WL 749163, at 3–4 (Del. Ch. Apr. 25, 2002); *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194, 1204 (Del. Ch. 1995); *see also* Stroud v. Grace, 606 A.2d 75 (1992).

225. J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny,* 40 Wm. Mitchell L. Rev. 1443, 1447 (2014) ("Under entire fairness, the defendant directors have the burden to demonstrate that the challenged act

fendant can, however, utilize procedural protections to "sanitize" the transaction: if the transaction is negotiated and approved by a disinterested special committee *or* if the transaction is approved by a majority of the minority shareholders after disclosure of all material information, the burden is shifted within the entire fairness review. The plaintiff will have to prove that the transaction was unfair.[226]

However, after a recent Delaware Supreme Court case, controlling shareholders and their advisors can structure the transaction in a way that will activate the business judgment rule, thereby foreclosing meaningful substantive review.[227] If the transaction is conditioned on both procedural protections—(1) negotiation and approval by a special committee *and* (2) the approval by a majority of minority shareholders after disclosure of all material facts—the business judgment rule will apply.[228] Delaware's duty of loyalty approach to controlling shareholder transactions can be conceived of as striking a balance between procedural fairness and substantive review at various points along a spectrum. On one end exists "naked" self-dealing transactions (those which are not subject to any procedural protections), which are subject to entire fairness review with the burden on the defendant to prove fairness. On the other end of the spectrum exists the fully pro-

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or transaction was entirely fair to the corporation and its shareholders. To meet this test, they must show that the action they took was both procedurally and substantively fair by establishing to the court's satisfaction that the transaction was the product of both fair dealing and fair price.") (internal citations and quotations omitted).

226. *In re Wheelabrator*, 663 A.2d 1194; *see also Stroud*, 606 A.2d 75, at 90; Laster, *supra* note 223, at 1462. Some commentators have questioned applicability of this framework outside of the freeze-out context. *See, e.g.*,Claire Hill & Brett McDonnell, *Sanitizing Interested Transactions*, 36 DEL. J. CORP. L. 903 (2011).

227. *See, e.g.*, *In re* Books-A-Million, Inc. Stockholders Litig., No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), *aff'd*, No. 515, 2017 WL 2290066 (Del. May 22, 2017).

228. Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014); *Books-a-Million*, 2016 WL 5874974; J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443, 1463 (2014). This standard was first announced in the context of a controlling shareholder merger, but Delaware courts have since indicated that it applies more generally to any transaction involving a controlling shareholder. *In re* Ezcorp. Consulting Agreement Derivative Litigation, No. 9962-VCL, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016).

tected transaction that is conditioned on both special committee participation and on shareholder approval. These transactions receive the protection of the business judgment rule, which effectively forecloses any meaningful substantive review. This framework sets up an inverse relationship between procedural protection and substantive review.

It is particularly important for MLPs that, under the framework discussed above Delaware's corporate law approach, escaping entire fairness completely requires a shareholder vote.[229] Under this paradigm, an MLP seeking to enter into a drop down or other transaction with its sponsor or an affiliate would either have to activate the notoriously expensive investor voting machinery or potentially face entire fairness review of the transaction. Subjecting each transaction between MLPs and their sponsors or affiliates to either an expensive and cumbersome unitholder vote or the possibility of litigation involving entire fairness review[230] would make these transactions a less attractive option for MLP sponsors and affiliates looking to sell accretive assets. Either scenario (regular entire fairness review resulting from litigation or holding a shareholder vote to bring these transactions into the business judgment rule) would likely lead to fewer drop down transactions and potentially cause the drop downs that do take place to be less valuable. With conflict-of-interest provisions that include special approval language, MLPs are adopting a mechanism that allows them to insulate transactions with controllers from substantive review with fewer procedural protections than those currently required under Delaware corporate law. In other words, they are adopting a balance between procedural protection and substantive review that is currently unavailable under Delaware corporate law.

A problem appears to lie, however, in the ability of management to seek approval of such transactions from committees comprised of individuals whose independence is question-

229. Under the framework announced in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), escaping entire fairness review requires both approval from a committee of independent directors and a majority of the minority shareholders.

230. Vice Chancellor Laster has described Delaware's entire fairness standard as existing on the top tier of a "pyramid of narrowing deference to corporate decision making and increasing judicial intrusiveness." Laster, *supra* note 226, at 1446–47.

able,[231] utilize opinion letters issued by repeat-player financial advisors to conclusively establish good faith, and secure unitholder approval without disclosing material facts to unitholders (in the event unitholder approval is needed or otherwise sought).[232] When challenging Special Approval by a committee, unitholders are usually required by language found in the operating agreement to show that the committee members failed to act in subjective good faith.[233] Operating agreements often include a provision specifying that if the committee obtains a fairness opinion from a financial advisor, it will conclusively establish "good faith," making challenge effectively impossible.[234]

A standardized version of this term should reflect both the need for additional protection against self-dealing and the fact that MLPs and their controllers have a legitimate need for a streamlined and reliable way to secure approval for transactions between them. It can do this by recognizing that holding a unitholder vote to sanitize each drop down is impractical, but requiring that the Special Approval process include greater procedural protections. For example, a Special Approval provision could still incorporate a good faith standard[235] (making challenge difficult after the transaction is approved, functioning similarly to the business judgment rule in corporate law), but increase the protection offered through the negotiation and approval process by requiring (1) that the committee be comprised of independent, disinterested individuals who remain independent throughout the negotiation

231. *See, e.g.*, Dieckman v. Regency GP LP, No. 11130-CB, 2016 WL 1223348 (Del. Ch. Mar. 29, 2016); *In re* El Paso Pipeline Partners, L.P. Derivative Litigation, No. 7141-VCL, 2014 WL 2768782 (Del. Ch. June 12, 2014).

232. *Dieckman*, 2016 WL 1223348, at *8.

233. *See, e.g.*, Allen v. Encore Energy Partners, L.P., 72 A.3d 93, 106 (Del. 2013) ("Therefore, to plead a breach of the LPA's contractual duty of subjective good faith, Allen must plead facts that enable a court reasonably to infer that the Conflicts Committee members did not subjectively believe that the Merger was in Encore's best interests. Allen can meet this standard by showing that the Conflicts Committee believed that it was acting against Encore's best interests when approving the Merger. He can also do that by showing that the Conflicts Committee consciously disregarded its duty to form a subjective belief that the Merger was in Encore's best interests."); *El Paso Pipeline Partners*, 2014 WL 2768782, at *11–12.

234. Norton v. K-Sea Transp. Partners L.P., 67 A.3d 354, 366 (Del. 2013).

235. Either subjective or objective bad faith.

of the transaction, and (2) that the committee be empowered to negotiate with the sponsor, retain relevant advisors, and walk away from the deal.[236] There is no doubt that unitholders would be more vulnerable to self-dealing than they would be if activation of a deferential standard of review required approval by an informed majority of the minority unitholders, but this may be where market expectations related to cash distribution play a role in disciplining sponsors and other affiliates. If such transaction are generally expected to lead to an increase in cash distributions, any self-dealing will be limited to the extent that it does not disappoint market expectations related to cash distributions.

Similarly, additional procedural protection should be included in any prong allowing sanitization by a vote of the minority unitholders by requiring disclosure of all material information for a vote to be effective. Again, this requirement appears in the corporate context and is meant to ensure that the shareholder votes that activate a more deferential standard will be informed. The standardized term should also specify that no action will create a conclusive presumption of "good faith" (e.g., opinion letters). With this approach, MLPs and their sponsors would still be able to take advantage of a faster and less risky means of entering into what are oftentimes advantageous transactions, but unitholders would receive additional protection in the form of more robust procedural safeguards.

If a standardized version of this term is adopted on a widespread basis, the benefits of standardization will follow. A body of case law will develop interpreting it. Attorneys and other advisors will be better able to translate their experiences on one deal or litigation to others that are subject to the standardized term. Drafting costs and uncertainty would decrease. Investors will have an easier time understanding their investments, likely leading to an increase in the informational efficiency of the market for MLP units.

Thus, by offering to publicly traded uncorporations standardized terms that have been drafted to reflect the common

236. This is not the only possible balance of available review and procedural protection. A case could be made for utilization of a standard that allows for more review than that allowed by the subjective good faith standard (still less than entire fairness) but less stringent procedural protections than those outlined above.

contracting practices, state lawmakers may be able to offer the best of both worlds: the benefits of contractability *and* the advantages of standardization. Provided the benefits of standardization or other pressures outweigh any perceived costs created by the incorporation of measures intended to increase investor protection (and are, therefore, departures from current contracting practices), organizers of these entities will have a reason to adopt the standardized forms. The following Part addresses the likelihood of adoption if the terms are not mandatory, *i.e.*, whether this solution can be implemented effectively in a manner that is consistent with the pressures of interstate competition.

C. *Statutory Menus – A Viable Implementation*

Many of the benefits promised by standardized MLP terms require widespread adoption. MLP investors, as a class, can only enjoy the benefits of these terms if adopted by a large number of MLPs; similarly, the standardization-related advantages, such as increased certainty and a body of well-developed case law, are a function of the degree to which the terms are adopted. The easiest way to ensure widespread adoption is by making the terms mandatory for publicly traded alternative entities that opt out of governance features traditionally associated with publicly traded corporations, like fiduciary duties. A state legislature adopting this approach would be offering its alternative entities a "close-ended" menu—they could either adopt traditional, corporate style fiduciary duties or the standardized terms, but not some other option. Because this entails a limitation on contractual freedom,[237] a closed menu is unlikely to gain much traction.

This does not mean that widespread adoption is impossible. Instead, non-mandatory implementations, such as including the terms as an option on an "open-ended menu" (i.e., a statutory menu that provides terms designed for these entities but does not prohibit adoption of bespoke terms), can lead to widespread adoption. In the corporate context, many firms voluntarily adopt non-mandatory standardized terms[238] on ac-

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237. Ayres, *supra* note 33, at 10.

238. *See, e.g.*, Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006); Hansmann, *supra* note 128, at 4 ("While closely held business firms commonly have detailed, specifically tai-

count of lowered "transaction costs of drafting and negotiating, the high salience or presumptive legitimacy of governmentally provided terms, [and] the need for standardization."[239] For MLPs, adopting the standardized terms would likely lower the costs faced by organizers at the formation stage. Over time, as more firms adopt them and case law construing the standardized terms develops, adopting firms would be able to minimize uncertainty and much of the potential for the surprising results managers and sponsors now face when litigating over the interpretation of customized provisions.[240]

Furthermore, adoption of the standardized terms would serve as an inexpensive and credible way for MLPs to send signals to investors about the quality of the investment they offer. The current lack of standardization leaves investors without any straightforward way to sort these entities according to their governance terms. Currently, even if an MLP offers favorable governance terms and attempts to signal this to investors, those investors have no way to confirm whether those terms are indeed favorable without undertaking a similarly expensive and time-consuming verification effort. However, the availability of government-endorsed, standardized terms that have been designed to protect investors' interests in the areas where other forces are insufficient to do so would provide investors with a virtually costless way to evaluate investment opportunities—whether or not that MLP has adopted the standardized terms. A decision by an MLP not to adopt the terms would send investors a strong signal of "buyer-beware."[241] The creation of a reliable and inexpensive sorting mechanism could easily lead to lower capital costs for adopting MLPs, which would provide another reason for firms to consider their adoption notwithstanding their ability to contract out of them. Ad-

lored charters, the charters of publicly traded corporations are remarkably empty. . . . They effectively defer to the default terms of the state corporation law in virtually all matters of significance.").

239. Hansmann, *supra* note 128, at 4.

240. Strine & Laster, *supra* note 21, at 12; Horton, *Modifying Fiduciary Duties in Delaware, supra* note 23, at 922.

241. Ayres, *supra* note 33, at 6–7. Professor Ayres argues persuasively that the use of statutory menus can have a significant impact in a variety of areas, including civil rights. According to Professor Ayres, companies offered a statutory option to extend their employees additional protection against discrimination in the workplace would make it difficult for many employers to refrain from opting in.

ditionally, an increased institutional investor presence in the future may also lead to increased pressure for adoption of standardized terms if they are perceived as offering investors additional protection. Widespread adoption will ultimately come down to whether the benefits of adopting the standardized terms (whether on account of network benefits or the signaling power of the terms) outweigh any perceived costs imposed by the inclusion of additional measures to further investor protection.

A recent study conducted by Professor Yair Listokin provides empirical support for the feasibility of this approach. Listokin compared the adoption of fair-price protection by publicly traded companies organized in states in which (1) fair-price protection *could* be included in the corporate charter but was not included in the state's corporate statute; (2) fair-price protection was included as an item on a statutory menu (opt-in statute); (3) fair protection was the default rule (requiring companies to opt-out).[242] He found that a company organized in a state with an opt-in fair-price protection statute has a 22% greater chance of including it than a company organized in a state without a statutory provision (i.e., a state in which fair price protection can be implemented, but only through adoption of a bespoke term). Companies organized in states whose statutes establish fair price protection as a default rule (requiring opt-out) have a 67% greater chance of including fair price protection over companies organized in a state with no fair price statute and a 45% greater chance than corporations formed in states that have opt-in statutes.[243] Listokin's findings suggest that the inclusion of terms on a statutory menu will lead more firms to adopt those terms because they "provid[e] imprimatur of the state, facilitate[e] network effects, and reduc[e] the cost of continually updating corporate charters to reflect changes in the law and the economy."[244] In the words of Professor Ian Ayres, "menus matter."[245]

Thus, Listokin's findings indicate that standardized MLP terms do not have to be a *mandatory* alternative to corporate

242. Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Analysis*, 6 J. EMPIRICAL L. STUD. 279 (2009).
243. *Id.* at 300–02.
244. *Id.* at 307.
245. Ayres, *supra* note 33.

style fiduciary duties to enjoy widespread adoption. Rather, state legislatures could maintain their commitment to contractual freedom and still facilitate adoption of standardized MLP terms by including them as part of a statutory menu.[246] Listokin's findings suggest that merely making them available and requiring opt-in can encourage adoption, but they also indicate that state legislatures can choose to put a thumb on the scale in favor of adoption by implementing the standardized terms as defaults that automatically apply to MLPs that eliminate fiduciary duties. This implementation would require MLP organizers to opt-out, and Listokin's research suggests that requiring opt-out is a particularly effective way of encouraging the adoption of terms that management may prefer to avoid.[247]

As the state of almost all publicly traded alternative entities, Delaware is the obvious state for implementation of these terms. But this does not mean that other states do not have something to gain from implementation of standardized terms for MLPs. Maryland has long enjoyed a competitive advantage over Delaware in attracting real estate investment trusts (REITs),[248] in large part on account of the menu option of specially-tailored terms that has been available to REITS under Maryland law for several decades.[249] It is not implausible that a state wishing to compete with Delaware for MLPs could do so with a well-designed set of standardized terms.

D. *Why the Legislature and Not a Private Party*

Thus far, this Article has assumed that the standardized terms should be promulgated by a state legislature (most likely Delaware's) rather than some private party or organization. Of course, private-sector organizations also offer menus of standardized terms, and it would be completely plausible for a

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246. For many of the same reasons, Professor Brian JM Quinn has advocated in favor of including a standardized in forum selection provision as a statutory menu option for corporate charters. He argues that "opt-in menus are . . . a valuable mechanism for overcoming contractual inertia and assisting contracting parties reach more optimal results." Brian J. M. Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. Davis L. Rev. 137, 190 (2011).

247. Listokin, *supra* note 241.

248. Ribstein & O'Hara, *supra* note 173, at 705–06.

249. Maryland first passed a statute specifically for REITs in the 1960s.

trade organization, such as the Master Limited Partnerships Association, to offer standardized MLP terms that can be adopted by MLPs or their organizers. While it is not possible to rule out the possibility that such terms would be frequently adopted, legislative production of these terms is preferable and more likely to lead to widespread adoption. As discussed above in Part IV.C, one of the likely motivations for adopting the standardized terms will be the market and reputational consequences that will flow from an MLP's failing to adopt the terms when investors know that they are available. These consequences, of course, will depend on the market's perception of the terms as offering investors a more appropriate degree of protection than is likely to be offered by individually drafted versions of the standardized terms. As discussed above in Part I, MLP operating agreements are not the subject of negotiation. Investors will be looking to the drafter of the terms to represent their interests, and for this reason, the provenance of the terms will matter. Terms that have government imprimatur are more likely to be viewed as striking a balance between the relevant parties than terms which have been promulgated by a private party (particularly one that is associated specifically with MLPs, their sponsors, and their organizers) and for this reason, are more likely to lead to market pressures in favor of adoption.[250] This is especially the case with regard to terms adopted by the Delaware legislature in light of the process by which Delaware legislates business law – legislation is drafted by members of the Corporate Council of the Delaware Bar Association and must be approved by the Corporate Council prior to being submitted to the legislature.[251] These groups will typically include both transactional attorneys and litigators as well as members of both the plaintiffs' and defense bars. Accordingly, terms that have been drafted and approved by this group are likely to have a veneer of legitimacy and even-handedness that terms generated by the private sector will not have.

250. *See, e.g.*, Ayres, *supra* note 33, at 8 (arguing that "privatized menu option[s] do not have nearly the same salience as a legislative menu option").
251. Hamermesh, *supra* note 201, at 1756.

CONCLUSION: CONTRACTUAL FREEDOM, NOW WHAT?

With the rise of uncorporations, American business law has entered an era of contractual freedom. In increasing numbers, state legislatures are committing to this principle and extending the ability to waive and eliminate traditional fiduciary duties to unincorporated entities, even ones that are publicly traded. But what are state lawmakers to do if they perceive a need to address problems that result from this degree of contractual freedom? Are their only options either to reinstate mandatory terms (something that would require them to buck the trend of increasing contractabiltiy in this context) or to sit on the sidelines? This Article suggests that there is a robust role for the state legislature to play in jurisdictions that have made commitments to contractual freedom, and that this role does not require them to readopt mandatory terms. Instead, well-designed enabling menus present the opportunity for state lawmakers to combine the benefits of contractual freedom with the advantages of standardization, while also steering contracting outcomes toward increased levels of investor protection. Contractarians have long maintained that state business law statutes are best understood as off-the-rack contracts. As this Article argues, in an era of virtually unlimited contractibility, state lawmakers can go a long way toward addressing the negative consequences of unrestrained contractual freedom by offering a wider variety of off-the-rack contracting products which have been carefully calibrated to serve the needs of particular types of firms and their investors. This suggests an ongoing role for the state legislative in corporate lawmaking, even in jurisdictions that have committed to contractual freedom. Once contracting trends emerge, state lawmakers can implement standardized versions and, in doing so, take into account the need (if any) to accommodate other interests, such as the need for increased investor protection.

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A PAYOFF TO SECOND BEST PRAGMATISM: RETHINKING ENTITY CLASSIFICATION FOR FOREIGN COMPANIES

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Whether it is an attempt by the Obama administration to curb corporate inversions or a strategy by the Trump administration to make U.S. businesses more competitive abroad, the world of international taxation seems primed to occupy policy conversations for the foreseeable future.

Yet few areas of law are as contentious while remaining so abstruse. Indeed, international taxation—while enormously important for global commerce and domestic companies alike—is extraordinarily complex. Consequently, companies with the resources to dream up sophisticated tax shelters are better positioned to take advantage of U.S. tax laws when operating transnationally.

The following example of this is illustrative. Suppose two companies (one domiciled in the United States and one domiciled overseas) sold the exact same products in both the United States and overseas. The U.S. company would be treated differently under U.S. tax law—and would have to pay higher taxes by consequence—solely because of its status as a U.S. domiciliary. While the foreign company would be exempt from U.S. taxation on all of its foreign revenue, the U.S. company would merely get a tax credit against its U.S. taxes on any income earned overseas. This reality has led companies to come up with tax strategies (including inversions) that enable them to avoid this competitive disadvantage in the global marketplace.

The status quo is untenable, but it remains frustratingly difficult to reach a consensus on how to solve the problem. Many countries—including the United Kingdom and Japan—have followed a global trend towards a territorial system, or taxing companies only on revenue earned in that particular country. With the current state of political affairs, bipartisan comprehensive tax overhaul legislation remains elusive, even if the Republican-

* J.D., 2016, Yale Law School; Associate, Covington & Burling, LLP. Special thanks to Anne Alstott, the Jacquin D. Bierman Professor in Taxation at Yale Law School, who provided support and valuable ideas for this paper.

backed Tax Cuts and Jobs Act of 2017 becomes law. This paper argues for an elegant "second best" solution that could help crack down on corporate tax games while providing a road map towards a territorial system, bringing the United States into alignment with global trends.

Namely, this proposal suggests that in the same vein as the corporate check-the-box regulations promulgated during the Clinton administration, companies could simply elect whether they wish to be treated as a foreign or a domestic entity. While this would leave the vast majority of the tax code largely intact, it would have wide-reaching implications for tax law and corporate structuring (without upsetting the legal form of current structures), provide a pathway towards a true territorial system, and potentially help uncover abusive tax shelters in the process.

INTRODUCTION

On April 4, 2016, the Treasury Department, under the leadership of President Obama and his Secretary of the Treasury, Jacob Lew, announced new regulations tightening the rules regarding corporate inversions.[1] This move led Pfizer (domiciled in the United States[2]) and Allergan (domiciled in Ireland[3]) to call off their planned merger, as the companies viewed the new regulations as an "adverse tax law change."[4] While the new rules set the battle lines in the Obama administration's attempts to prevent companies from moving their place of incorporation offshore, they help illuminate an enormous problem in tax policy today. The U.S. taxes domestic companies on all of their worldwide income, but it taxes foreign companies on only their U.S.-source income. This disparate treatment, coupled with one of the highest corporate tax rates in the world, has created a strong incentive for companies to figure out ways to move their place of incorporation overseas.

Perhaps the most straightforward way to address this problem would be to treat U.S. and foreign companies the same. This would mean, in effect, a transition to a territorial system. However, despite wide acknowledgement of the need to overhaul the tax code, particularly with respect to international taxation,[5] there seems to be little appetite for moving to a true

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1. Press Release, U.S. Dep't of Treasury, Treasury Announces Additional Action to Curb Inversions, Address Earnings Stripping, JL-405 (Apr. 4, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0405.aspx.

2. Pfizer, Inc., Current Report (Form 8-K) (Apr. 6, 2016) [hereinafter Pfizer 8-K], http://www.sec.gov/Archives/edgar/data/78003/000119312516531559/d175229d8k.htm.

3. Allergan plc, Current Report (Form 8-K) (Apr. 6, 2016), http://www.sec.gov/Archives/edgar/data/1578845/000119312516531600/d177691d8k.htm.

4. Pfizer 8-K, *supra* note 2; *accord* Jonathan D. Rockoff, Liz Hoffman, & Richard Rubin, *Pfizer Walks Away from Allergan Deal*, WALL ST. J. (Apr. 6, 2016), http://www.wsj.com/articles/pfizer-walks-away-from-allergan-deal-1459939739.

5. *See* House Republican Members of the Ways and Means Comm., *A Better Way: Our Vision for a Confident America – Tax* 27 (June 24, 2016) [hereinafter House Republican Members], http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf ("Taken together, a 20 percent corporate rate, a switch to a territorial system, and border adjustments will cause the recent wave of inversions to come to a halt."); REUVEN AVI-YONAH, THE CENTURY FOUND. PROPOSALS FOR INTERNATIONAL TAX REFORM: IS THERE A MIDDLE ROAD? (Nov. 17, 2016), https://s3-us-west-2.amazonaws.com/production.tcf.org/app/uploads/2016/11/17084930/proposals-for-international-tax-reform-is-there-a-middle-road.pdf.

territorial system by Congress.[6] While the Tax Cuts and Jobs Act of 2017 ostensibly moves to a territorial system by virtue of granting a deduction to U.S. shareholders for dividends received from controlled foreign corporations with respect to such a subsidiary's foreign earnings, it does so while retaining complicated provisions intended on preventing base erosion. It might be a laudable effort in the abstract, but does not address the issue of a U.S. corporation being taxed on its overseas earnings; it merely tries to allow earnings from foreign subsidiaries to be repatriated without any tax cost. In light of that reality, perhaps a different strategy would be worthwhile. Building on the success of the Treasury's check-the-box regulations in the mid-1990s, which allowed companies to elect to be treated as either a corporation or as a partnership for tax purposes, this Article suggests a "second best" strategy for accomplishing a similar end in the realm of international tax. Rather than fixing a company's status under the tax code by place of incorporation, this Article suggests allowing business entities the ability to elect treatment as either a domestic or foreign entity. This small change would leave the rest of the Internal Revenue Code ("Code") intact (including transfer pricing rules and Subpart F, which governs foreign entities controlled by U.S. persons) while giving companies the flexibility to both retain their place of incorporation here in the United States and avoid U.S. taxation of their foreign income.

I.
THE TAXATION OF INTERNATIONAL TRANSACTIONS BY THE UNITED STATES

The current tax regime employed by the United States with respect to international transactions is commonly referred to as a worldwide tax system, meaning that U.S. persons are taxed on all of their worldwide income.[7] By contrast, non-U.S. corporations are taxed only on certain types of invest-

6. Richard Rubin, *U.S. Crackdown on Inversions Renews Calls for Tax Code Overhaul*, WALL ST. J. (Apr. 6, 2016) ("[T]here are few signs that the parade of companies attempting to flee the U.S. tax net or the administration's increasingly ambitious regulatory attempts to stop them will prompt Congress to act."), http://www.wsj.com/articles/u-s-crackdown-on-inversions-renews-calls-for-tax-code-overhaul-1459982348.

7. I.R.C. § 61 (2012).

ment income from U.S. sources[8] or income effectively connected with the conduct of a U.S. trade or business.[9] Because foreign corporations are not subject to U.S. corporate tax on their non-U.S. income, there is a discrepancy in how foreign persons are treated compared with how U.S. persons are treated.

In the context of corporate law, this system of worldwide taxation ultimately incentivizes multinational corporations to minimize their overall tax liability through the use of offshore corporations, including the use of shell entities. These tax games are not illegal, and though often hidden by layers of offshore holding companies and tax strategies, they are used regularly by many multinational companies. According to the Citizens for Tax Justice, 73 percent of Fortune 500 companies use subsidiaries in tax haven jurisdictions.[10] Multinationals do not limit themselves to incorporating in tax havens, either. Repeated waves of "corporate inversions" have dominated tax planning for decades, meaning that dozens of companies formerly domiciled in the United States are now considered to be located in a foreign country for tax purposes.[11]

While a boon to lawyers and investment bankers, this reincorporating, inverting, and creating offshore subsidiaries serves little purpose for corporations other than aiding in tax planning. In short, they are taking advantage of a system that penalizes American companies for being American, because it is only American companies that are required to pay taxes on their worldwide income.

For the purposes of U.S. taxation, foreign companies are liable to be taxed on two different types of income. The first, Effectively Connected Income (ECI), refers to income that is effectively connected with a U.S. trade or business.[12] Thus, when a foreign company operates its business within the United States, that income will be subject to taxation under

8. I.R.C. § 881 (2012).

9. I.R.C. § 882 (West 2014).

10. Robert S. McIntyre et al., Citizens for Tax Justice & U.S. PIRG Ed. Fund, Offshore Shell Games 1 (2015), http://ctj.org/pdf/offshoreshell2015.pdf.

11. Cathy Hwang, *The New Corporate Migration: Tax Diversion Through Inversion*, 80 Brook. L. Rev. 807, 821–833 (2015) (providing a survey of four generations of tax-driven corporate inversions).

12. I.R.C. § 864(c) (2012).

the normal tax regime.[13] In order to prevent companies from manipulating the source of income to avoid U.S. taxation, certain types of income (such as royalties or interest payments to a financial institution) are considered ECI if the company "has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable."[14]

The second type of income is known as Fixed or Determinable Annual or Periodical income (FDAP income), which refers to income from U.S. sources that is not ECI.[15] Such income is subject to a withholding tax of 30 percent (often reduced if the offshore company's home country has a relevant treaty with the United States[16]) and reflects the interest in preventing certain types of highly mobile income (e.g., interest, dividends, rents, royalties, etc.) from going untaxed.[17] What remains clear, however, is that the sourcing rules are designed to ensure that companies treated as foreign corporations by the tax code are still taxed on income earned within the United States.

This system tends to benefit companies with the resources to either reincorporate offshore or set up offshore subsidiaries. For those companies with the resources to map out even more complex and ingenious tax strategies, the benefits of gaming the international tax system are even larger.[18] For example, lawyers for technology companies notoriously developed the "Double Irish with a Dutch Sandwich," which ulti-

13. *See* I.R.C. § 882 (West 2014).

14. I.R.C. § 864(c)(4)(B) (2012).

15. I.R.C. § 881(a) (2012).

16. *See, e.g.*, Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.K.–U.S., art. XI(1), July 24, 2001, T.I.A.S. No. 13161 (reducing withholding tax on interest income to 0 percent), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/uktreaty.pdf.

17. *See* Howell H. Zee, *Taxation of Financial Capital in a Globalized Environment: The Role of Withholding Taxes*, 51 NAT'L TAX J. 587, 587 (1998).

18. *See* Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 TAX L. REV. 375, 383 (2012) (showing that the largest U.S. multinationals pay an effective tax rate far lower than their statutory rate).

mately enables companies using the structure to legally pay a near-zero tax rate on much of its foreign income.[19]

This system is also problematic because it creates a system ripe for *illegal* tax abuse and tax evasion. By shielding their balance sheets in foreign jurisdictions, foreign subsidiaries are able to operate in a world with little oversight from the governments of the countries in which they do most of their business.[20] Of particular concern to many is the fact that money held in offshore jurisdictions is far in excess of those countries' GDPs. For example, Bermuda's GDP was $6 billion in 2010, but U.S.-controlled subsidiaries reported $94 billion in

19. Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 712–13 (2011). The "Double Irish with a Dutch Sandwich" is a technique by which a company incorporated in Ireland (IrishCoOne) wholly owns a company wholly owned in the Netherlands (DutchCo), which in turn wholly owns a company that is incorporated in Ireland but has its principal place of business in an offshore tax haven such as the Cayman Islands (IrishCoTwo). IrishCoOne, wholly owned by the U.S. parent, elects to be treated as a corporation for U.S. tax purposes, and DutchCo and IrishCoTwo elect to be treated as disregarded entities such that from the perspective of U.S. tax law, the U.S. parent only has an Irish subsidiary, thereby avoiding potential issues with regards to Subpart F income. The U.S. parent incorporates the companies by successively contributing its non-U.S. intellectual property (IP) assets (such as certain European IP assets) and setting up license agreements between the companies. IrishCoOne receives profits generated pursuant to the use of the IP, but pursuant to the license agreement with DutchCo, gets a deduction for royalties paid such that it can nearly eliminated any Irish tax liability. Because both the Netherlands and Ireland are not subject to certain withholding taxes by virtue of both being in the European Union (EU), there is no tax leakage on the transfer of royalty payments to DutchCo. DutchCo then sends the revenue received from IrishCoOne (and thereby receiving a deduction roughly equal to its profit, thereby negating any Dutch tax) to IrishCoTwo pursuant to its own license agreement, again with no tax leakage on withholding taxes by virtue of the fact that from the perspective of the Netherlands, IrishCoTwo is an Irish (and therefore, EU) company. However, under Irish tax law, IrishCoTwo is actually a *foreign* company because its principal place of business is located offshore. Therefore, because all of IrishCoTwo's revenue is from the Netherlands and is therefore foreign earnings to a foreign company, no Irish tax is levied on the company. The bottom line is that because of the offsetting revenues and deductions on royalties paid, none of the entities end up paying a significant level of tax, thereby reducing each entity's tax to near zero such that the entire European operation of the company is essentially done tax-free.

20. *See* ALAIN DENEAULT, OFFSHORE: TAX HAVENS AND THE RULE OF GLOBAL CRIME 51 (George Holoch trans., The New Press) (2011).

profits there; for the Cayman Islands, those figures were $3 billion and $51 billion, respectively.[21]

From an economic perspective, scholars have debated the effect that international tax laws have had on the allocation of capital. This debate is often framed as a tension between favoring either neutrality of capital exports or capital imports. Capital export neutrality (CEN) is the position that an individual or company should be agnostic as to where it places its assets.[22] To put it another way, if a person is choosing between Country A and Country B as to where to invest her capital, according to CEN, tax considerations should not play a role in that choice. Consequently, the tax rate on the company will be the same irrespective of the choice of where to invest. In terms of tax policy, pure CEN is applied as a tax by the country of residency only.[23] Capital import neutrality (CIN), by contrast, states that the effective tax rate should be agnostic as to where capital is derived.[24] In other words, all capital investment within a particular jurisdiction would be taxed at the same rate. Pure CIN is applied as a tax by the country of the income's source only.[25]

The tension between CEN and CIN comes from the fact that without a global government or tax rates that are uniformly applied worldwide, it is impossible to have both.[26] Therefore, companies seeking to minimize their tax burden will seek to arbitrage their tax liability based on the type of neutrality sought. Under CEN, companies will seek the country which imposes the lowest tax rate on its residents. Under CIN, companies will place their investments in countries with the lowest tax rates.

The decision between CIN and CEN is complicated by several factors. For example, while the theoretical goal of CEN is for countries to forgo taxation on any non-residents, in practice CEN is interpreted as residence countries using a foreign tax credit to account for taxes paid to source countries.[27] Be-

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21. MCINTYRE ET AL, *supra* note 10, at 14.
22. Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 270 (2001).
23. *Id.* at 270–71.
24. *Id.* at 270.
25. *Id.* at 270–71.
26. *Id.* at 272.
27. *Id.* at 271.

yond that, however, the question comes down to how policymakers want to orient their goals. From the perspective of promoting worldwide tax efficiency and minimizing the ability of companies to arbitrage their way to artificially lowered tax burdens, the question becomes whether it is easier to move corporate residency or to move capital.

There is significant debate over which of these two norms provides the ideal system for moving forward. Among economists and academics, CEN earns the most support, in part due to the fact that "distortions in the location of investments are thought to be more costly than distortions in the allocations of savings."[28] However, that conclusion is not universally shared, as some argue that taxing foreign income would have a detrimental effect on business competitiveness.[29]

While the academic debate between CIN and CEN will undoubtedly continue, countries around the world have shifted their tax policy toward CIN. Japan and the United Kingdom both switched to territorial systems in 2009.[30] In fact, "[e]very country that is the residence of major multinational enterprises, other than the United States, has adopted some form of territorial tax system."[31] Corporations seem to favor territorial systems, and while bowing to corporate interests need hardly be the sole motivation for a tax system, it is not hard to imagine companies "speaking with their feet" and setting up operations offshore.[32] By contrast, the current system employed by the United States is one that tends towards CEN (the United States currently taxes all worldwide income of *its*

28. *Id.* at 272. *See also* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 1010 (1997).

29. Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 ARIZ. L. REV. 835, 843–44 (2000).

30. JOINT COMM. ON TAX'N, BACKGROUND AND SELECTED ISSUES RELATED TO THE U.S. INTERNATIONAL TAX SYSTEM AND SYSTEMS THAT EXEMPT FOREIGN BUSINESS INCOME 28, 42 (2011).

31. Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99, 135 (2011).

32. The use of corporate inversions, where companies are simply moving their corporate residency, and subsequent attempts by Congress and the executive to curb such corporate expatriation provides ample evidence of this. *See* Joshua Simpson, *Analyzing Corporate Inversions and Proposed Changes to the Repatriation Rule*, 68 N.Y.U. ANN. SURVEY OF AM. L. 673, 695–99 (2013) (providing an overview of corporate inversion transactions).

residents), but involves elements of CIN as well (the United States generally taxes *foreign* persons on their U.S.-sourced income only). Because U.S. law respects the corporate form, a company can keep its offshore active income in a foreign subsidiary indefinitely; but once it brings it home in the form of dividends, it is subject to taxation. In popular news articles, this is often described as a situation in which earnings are "trapped offshore."[33]

One of the particular problems associated with the tax planning strategies is the two-pronged issue of base erosion and profit shifting. OECD countries are concerned that the tax systems currently in place create incentives for companies to shift their profits to untaxed jurisdictions, thereby avoiding any significant taxes on them. This has led to the phenomenon of "stateless income," which Edward Kleinbard describes as follows:

> Stateless income comprises income derived for tax purposes by a multinational group from business activities in a country other than the domicile of the group's ultimate parent company, but which is subject to tax only in a jurisdiction that is not the location of the customers or the factors of production through which the income was derived, and is not the domicile of the group's parent company.[34]

This allows certain companies to find jurisdictions with very low tax rates to park their income, preventing it from being subject to U.S. taxation.[35] The OECD has responded with its Base Erosion and Profit Shifting (BEPS) Project, aimed at combatting "tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity."[36]

Most of all, however, the problem with this mixture of tax planning strategies is that they are almost entirely tax-driven. It is generally recognized that a well-designed tax system should

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33. *See* Victor Fleischer, *How Obama's Tax Plan May Not Work as Intended*, N.Y. TIMES: DEALBOOK (Feb. 6, 2015 10:22 AM), http://dealbook.nytimes.com/2015/02/06/obama-proposal-to-tax-offshore-earnings-may-have-unintended-effects/.

34. Kleinbard, *supra* note 19, at 700.

35. Kleinbard, *supra* note 31, at 135.

36. *About the Inclusive Framework on BEPS*, OECD, http://www.oecd.org/ctp/beps-about.htm (last visited May 6, 2016).

minimize the distortions and inefficiencies caused by the system itself.[37] Yet companies spend billions of dollars every year to devise tax strategies to ensure that they minimize their tax burden, and one of the chief ways in which companies do this is by reincorporating overseas to avoid the liability caused by the worldwide system of taxation.

Despite all of the problems that result from the worldwide system of taxation employed by the United States, what is often overlooked are the beneficial ways in which companies utilize foreign subsidiaries to compete in the global marketplace. In short, the existence of offshore jurisdictions that levy no corporate income tax provides an invaluable service to the U.S. economy that is often overlooked. Because the United States remains somewhat of an outlier in terms of its tax policy regarding worldwide income, tax shelters in low tax jurisdictions help bring the United States into alignment with international norms of taxation. The fact is, therefore, that the United States relies on low tax jurisdictions to accomplish what the rest of the world has already accomplished through substantive change to their tax codes. This is an exceedingly bizarre result, for the only benefit the U.S. system provides over the international system is to tax advisors and tax planners—a "benefit" usually described as deadweight loss.[38] To modify the words of Michael Graetz, we have a system set up by very smart people that, but for the tax considerations, would otherwise be very stupid.[39]

Tax shelters—among them the use of offshore subsidiaries—are strategies used by people to lower their tax burden. While tax shelters generally take advantage of loopholes in the tax code, this Article will avoid making a normative claim about them. Tax *havens*, in contrast, are jurisdictions (generally offshore) that provide a tax benefit to companies that incorporate there—usually by virtue of favorable rates or gener-

37. Reuven S. Avi-Yonah, *The Three Goals of Taxation*, 60 TAX L. REV. 1, 1 (2006).

38. Kleinbard, *supra* note 19, at 713.

39. Graetz was referring to tax shelters, which he describes as "a deal done by very smart people that, absent tax considerations, would be very stupid." Lynnley Browning, *How to Know When a Tax Deal Isn't a Good Deal*, N.Y. TIMES (Sept. 10, 2008), http://www.nytimes.com/2008/09/10/business/businessspecial3/10TAX.html.

ous corporate laws.[40] The offshore tax economy refers to the use of tax havens and tax shelters—particularly by multinational corporations—as a method by which entities and individuals navigate complex international tax laws in an effort to minimize their overall tax burden.

II.
THE ROLE OF THE OFFSHORE TAX ECONOMY IN U.S. AND GLOBAL MARKETS

It seems a common sport among commentators and politicians to rail against the use of tax havens in our economy. Alain Deneault describes how the powerful have "set up custom-made political jurisdictions—tax havens—that enable them to exercise decisive influence on the historical course of events without having to comply with any democratic principle."[41] Tax shelters became a campaign issue in 2012 when President Obama criticized Mitt Romney's investments in Bermuda and the Cayman Islands.[42] They remain a point of criticism for Cabinet-level nominees during Senate confirmation hearings.[43] Certainly not all uses of tax havens are legitimate, yet these criticisms fail to recognize the positive role that offshore tax havens and shelters may play.

A. *Facilitation of Inbound Foreign Investment*

For many companies that are seeking to do business in the United States or to gain access to American capital markets, U.S. tax law presents a formidable obstacle. While many politicians have recognized this as a problem and have sought to unravel the challenges to better allow inbound capital to come into the United States,[44] companies still use the offshore tax economy to facilitate their investment.

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40. *See* Calvin H. Johnson, *Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters*, 71 TAX NOTES 377, 380 (Apr. 15, 1996).

41. DENEAULT, *supra* note 20, at viii.

42. Michael D. Shear, *Obama Ad Continues Effort to Tie Romney to Outsourcing*, N.Y. TIMES: THE CAUCUS (July 14, 2012), http://thecaucus.blogs.nytimes.com/2012/07/14/obama-ad-features-a-singing-romney.

43. *See, e.g.*, Alan Rappeport, *Issues of Riches Trip Up Steven Mnuchin and Other Nominees*, N.Y. TIMES (Jan. 19, 2017), https://www.nytimes.com/2017/01/19/us/politics/steven-mnuchin-treasury-confirmation-hearing.html.

44. *See* Invest in Transportation Act, S. 981, 114th Cong. (2015) (providing for a repatriation holiday of overseas profits).

Effective tax planning involves trying to use the tax law to accomplish several ends: (1) achieving temporary tax savings by accelerating deductions and deferring income, (2) permanently reclassifying income to achieve a lower tax rate, and (3) avoiding the complexity of U.S. tax law altogether.[45] Tax minimization strategies—including those that use the offshore tax economy—are not in themselves any less legal than an individual taking the standard deduction on her annual tax return. In the words of Judge Learned Hand, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[46] Of course, that does not imply that the policies that make tax minimization strategies legal are good policies,[47] but it is important to take a closer look at how the offshore tax economy facilitates inbound investment.

In recent years, Chinese companies have sought access to American capital markets by listing on a U.S. stock exchange.[48] The advantage to Chinese companies is that American capital markets give access to deep reservoirs of capital that would otherwise be unavailable in China. It also gives American investors the chance to take advantage of a growing Chinese economy. Until recently, American investors were unable to even access Chinese stock markets—and it remains cumbersome to purchase those shares.[49]

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45. Mark J. Cowan, *A GAAP Critic's Guide to Corporate Income Taxes*, 66 TAX LAW. 209, 232 (2012).

46. Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

47. In an open letter published on May 9, 2016, a group of notable economists declared that "[t]here is no economic justification for allowing the continuation of tax havens." This paper is not an attempt to refute this view, but an attempt to reshape the legal architecture such that tax havens are obsolete and the problems these economists identified can be dealt with directly. Letter from Economists to World Leaders (May 9, 2016), https://www.oxfam.org/en/pressroom/pressreleases/2016-05-09/tax-havens-serve-no-useful-economic-purpose-300-economists-tell.

48. *See* Sophie Song, *Chinese Companies Consider Listing in US Stock Exchanges Again Following Accounting Woes of 2011*, INT'L BUS. TIMES (Aug. 6, 2013), http://www.ibtimes.com/chinese-companies-consider-listing-us-stock-exchanges-again-following-accounting-woes-1373269.

49. Gregor Stuart Hunter, *China Opens Door Wider to Foreign Investors*, WALL ST. J. (Nov. 10, 2014), http://www.wsj.com/articles/china-opens-doors-to-foreign-investment-in-stocks-1415604267.

Today, well over a hundred Chinese companies have gone public in the United States—nearly all of which were first listed in the last decade.[50] However, listing on a U.S. exchange can prove challenging for a Chinese company for several reasons. First, these companies are often highly regulated, which frequently means a requirement that their shares are owned by Chinese nationals.[51] Second, the rules of U.S. stock exchanges regarding corporate governance often contain exemptions for foreign issuers, giving greater flexibility to companies domiciled offshore.[52]

To help facilitate this trade, many Chinese companies have employed a variable interest entity (VIE) structure, which generally involves three different entities. The first is the company operating in China, the second is a wholly foreign-owned entity (WFOE), also domiciled in China, and the third is the company being listed on the U.S. exchange (the VIE) and usually domiciled in the Cayman Islands or another offshore jurisdiction (presumably to avoid an entity-level tax). The VIE owns 100 percent of the WFOE, and the WFOE enters into contractual agreements that allow foreign investors effective control over the Chinese company without having a direct stake in the company itself.[53]

The Chinese government has typically turned a blind eye to these structures, which have proven to be enormously successful for the companies that have made use of them.[54] Because there is no direct ownership between the Chinese com-

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50. The website www.TopForeignStocks.com keeps a list of Chinese companies listed on U.S. exchanges; as of March 2016, it listed 111 companies. *The Full List of Chinese ADRs*, TOPFOREIGNSTOCKS.COM, http://topforeignstocks.com/foreign-adrs-list/the-full-list-of-chinese-adrs (last visited May 7, 2016).

51. Gregory J. Millman, *Foreign Companies at Risk from Proposed Chinese Law*, WALL ST. J. (Apr. 19, 2015), http://www.wsj.com/articles/foreign-companies-at-risk-from-proposed-chinese-law-1429474352. Certain U.S. industries maintain similar regulations; commercial aviation, for example, has limits on the ownership of airlines by non-U.S. persons. *See* 49 U.S.C. § 40102 (2012).

52. ROBERT ELLISON ET AL., SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE FOR FOREIGN PRIVATE ISSUERS: OVERVIEW 1 (2009), http://us-corporate.practicallaw.com/2-386-6205.

53. Serena Y. Shi, *Dragon's House of Cards: Perils of Investing in Variable Interest Entities Domiciled in the People's Republic of China and Listed in the United States*, 37 FORDHAM INT'L L.J. 1265, 1277 (2014).

54. Millman, *supra* note 51.

pany and the WFOE, they cannot be consolidated for tax purposes.[55] Thus, if the VIE were to be domiciled in the United States without an intervening offshore entity, it would be liable to pay a tax on any income—including income earned from China. Thus, setting up the VIE offshore allows this structure to function in a way that largely limits its tax burden to the country in which it earns most of its income—i.e., China.

Another way in which the offshore tax economy helps catalyze the movement of capital in the U.S. economy is through investment funds. Investment funds (which include everything from mutual funds to hedge funds to private equity funds) represent an increasingly large sector of American capital markets and are well known for their use of extensive tax planning.[56] While some investment fund tax planning is centered around domestic tax issues (e.g., treating income as long term capital gains via the carried interest provision[57]), other planning strategies help protect investors from unwanted tax liabilities, particularly for foreign and tax-exempt investors. Tax-exempt investors, which include university endowments and pension funds, play an important role in capital markets.[58] Yet for such tax-exempts, unrelated business taxable income (UBTI) can often prove very costly, since it becomes taxable at the corporate rate.[59] UBTI is defined as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it."[60] Normally, income earned by a tax-exempt entity—such as dividends and interest—is not taxable, but UBTI is an exception to the rule.[61] Sometimes investment funds will purchase controlling shares in a partnership or other pass-through entity, which does not qualify as such a UBTI exclusion under Section 512. In order to transform this "bad" UBTI income into "good" dividend income, fund man-

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55. *See* I.R.C. § 1504 (West 2014).

56. *See generally* Emily Cauble, *Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities*, 29 VA. TAX REV. 695 (2010).

57. Note, *Taxing Partnership Profits Interests: The Carried Interest Problem*, 124 HARV. L. REV. 1773 (2011).

58. Willard B. Taylor, *"Blockers," "Stoppers," and the Entity Classification Rules*, 64 TAX LAW. 1, 6 (2010).

59. I.R.C. § 511 (1988).

60. I.R.C. § 512(a)(1) (2015).

61. I.R.C. § 512(b) (2015).

agers will set up an offshore blocker corporation.[62] While the Code is set up to help prevent abuses of offshore entities, the IRS has explicitly sanctioned investments involving offshore blocker corporations.[63] The reality is that tax-exempt investors are so allergic to the risk of UBTI that they will sometimes accept a *less favorable* result (from a tax perspective) by utilizing the offshore tax economy.[64]

Foreign investors in U.S. investment funds have their own desires when structuring a fund. Like tax-exempt investors, they too will often pool their investment into an offshore corporation, for several reasons. The first reason is a tax minimization strategy. By placing their funds in an offshore entity, any foreign investments made by the fund can be shielded from U.S. income tax liability.[65] Additionally, for onshore investments, having a blocker corporation can help minimize a foreign person's exposure to ECI, which is withheld at the foreign person's highest rate.[66] Finally, while offshore corporations will still have to file U.S. tax returns with respect to U.S. source income, their shareholders (i.e., foreign persons in an investment fund) will not.[67] The desire to avoid the need to file a U.S. tax return should be apparent to any American taxpayer familiar with April 15, and the offshore tax economy provides a vehicle for doing so.

Thus, tax planning allows companies to keep foreign income from being taxed in the United States. Unlike most of the rest of the world, the United States has attempted to tax

62. Taylor, *supra* note 58, at 1.

63. *See* I.R.S. Priv. Ltr. Rul. 2002-51-016 (Dec. 20, 2002); I.R.S. Priv. Ltr. Rul. 2002-51-018 (Dec. 20, 2002); *see also* Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 NW. U. L. REV. 225, 241 (2012); Taylor, *supra* note 58, at 21.

64. JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURES AND OPERATIONS § 5.04[1] (2016) ("The net effect of this structure is that the entire gain of the Tax-Exempt Partners derived from the investment is subject to corporate level tax in the hands of the Alternative Investment Vehicle. This result may be less favorable to a Tax-Exempt Partner than if it decides to make its capital contribution directly to the Fund and suffer the consequences of debt-financed income, particularly if the Tax-Exempt Partner is making a capital contribution to fund part of the investment and, thus, not all the gain from the investment would be UBTI.").

65. *Id.* at § 5.05[2].

66. *Id.* at § 5.05[1].

67. *Id.* at § 5.05[2].

foreign income; as a practical matter, investors have found legal ways to avoid this result—often through the offshore tax economy. The offshore tax economy also provides a safety valve for domestic organizations that would otherwise incur adverse tax consequences (such as tax-exempt organizations receiving UBTI). Yet perhaps contrary to popular belief,[68] the existence of a company headquartered offshore does not mean that the company is avoiding taxes altogether. Indeed, if the offshore company is operating legally, it will still be paying taxes at the normal statutory rate on any ECI and at a withholding rate of 30 percent on any FDAP income.

B. *The Desire to Keep "American" Companies Competitive Abroad*

To illustrate, consider two hypothetical companies, Color Corp. (incorporated in the United States) and Colour Corp. (incorporated in the United Kingdom). If both companies maintain identical businesses such that they earn precisely the same amount of revenue from each country, Color Corp. will still pay more in taxes than Colour Corp.[69] It is no small wonder, then, that Color Corp. will look for ways to level the playing field, such as by creating a British subsidiary or reincorporating to the United Kingdom entirely. Some have questioned the patriotism of companies that have decided to

68. *See* Cauble, *supra* note 56, at 707 (2010) ("Because the types of income earned by hedge funds (predominantly capital gain income and interest income) are generally not the types of income that are subject to U.S. federal income tax when earned by a non-U.S. corporation, the TE Investor Parallel Fund will generally not be subject to corporate-level U.S. federal income tax."). It is true that capital gain and interest income will not be taxed as ECI for a non-U.S. corporation. However, such income—assuming it comes from U.S. sources—*will* be subject to a withholding tax of 30 percent as FDAP income if not reduced by a treaty. The United States does not currently have treaties with common hedge fund domiciles such as the British Virgin Islands, Bermuda, and the Cayman Islands.

69. If the U.S. rate is 35 percent and the British rate is 20 percent, both Color Corp. and Colour Corp. will pay a 35 percent rate on their U.S. source income. However, Color Corp. will pay 15¢ more in taxes on every dollar of U.K.-source income than its British counterpart. Both Color Corp. and Colour Corp. will pay 20 percent of their British-source income to the United Kingdom, but while Color Corp. can credit those taxes paid against its U.S. tax burden, the United States will still impose its 35 percent rate on Color Corp.'s U.K.-source income.

reincorporate overseas.[70] The real question, however—particularly when taking into account a manager's fiduciary duty to maximize shareholder wealth[71]—is why any company would want to be domiciled in the United States in the first place. Clearly, many companies are and will continue to be domiciled in the United States, but this simple example should illustrate how the Code currently places a thumb on the scales in favor of keeping one's domicile outside of the United States.[72]

Setting up an offshore subsidiary allows American business owners to pay local taxes on foreign active income and defer U.S. taxes on most of that income indefinitely, enabling them to remain competitive with competitors who also only pay local taxes.[73] Of course, once foreign income is repatriated, it will immediately be subject to U.S. taxation,[74] so companies prefer to leave that money offshore for as long as possible and defer its tax burden, until either such a time as it needs the money or the U.S. government decides to implement a one-time tax holiday.[75] This practice is widely used, and according to the Citizens for Tax Justice, Fortune 500

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70. In the words of President Obama, a corporate inversion is "when big corporations acquire small companies, and then change their address to another country on paper in order to get out of paying their fair share of taxes here at home." President Barack Obama, Remarks by the President on the Economy (Apr. 6, 2016).

71. Brian M. McCall, *The Corporation as Imperfect Society*, 36 DEL. J. CORP. L. 509, 511 (2011) ("Conceptualizing corporate law as an area of law facilitating private ordering has led to the entrenchment of the principle of shareholder wealth maximization. Corporations exist to maximize shareholder wealth.").

72. This is particularly true for companies with large cash reserves held overseas, such as pharmaceutical companies. Jonathan D. Rockoff, *Why Pharma Is Flocking to Inversions*, WALL ST. J. (July 14, 2014), http://www.wsj.com/articles/why-pharma-is-flocking-to-inversions-1405360384.

73. In the example of Color Corp. and Colour Corp., Colour Corp. will have an extra 15¢ for every dollar earned in the United Kingdom to distribute to shareholders or reinvest in its business.

74. Graetz, *supra* note 22, at 323.

75. The advantage of tax deferral is, of course, in measuring the net present value of a deferred obligation. In a case that examined a 999-year lease, "The Commissioner asserts, and the taxpayer does not dispute, that the present value of this obligation to pay $23 million at the end of the 950-year period the lease still has to run, using an interest rate of six percent, is two quadrillionths of a cent." *Carolina Clinchfield & Ohio R. Co. v. Comm'r*, 823 F.2d 33, 34 (2d Cir. 1987).

companies alone are holding $2.4 trillion offshore.[76] The righteous anger levied at this practice resulted in the Cayman Islands Financial Services Association issuing the following open letter to President Obama regarding tax deferral:

> Tax deferral arises, as you know, from current provisions of U.S. tax law that were designed to provide a competitive advantage to American companies in global trade. But this is not fraud, evasion or artificial avoidance. Historically, deferral has been used by some U.S. companies to boost the capital they have available for reinvestment, expansion and job creation.[77]

There is, of course, an ugly side to this too. Large multinational companies hire armies of lawyers to minimize their tax burdens, giving an advantage to companies with the resources to generate the most stateless income.[78] One of the more well-known strategies is the "Double Irish with a Dutch Sandwich," employed by technology companies to minimize their tax burdens.[79] Utilizing multiple corporate entities and discrepancies in Irish and Dutch tax laws, a company is able to attribute its income for much of Europe to Bermuda, lowering its effective tax rate to near zero.[80]

Nevertheless, there are at least some reasons why the current global economy benefits from low- or no-tax jurisdictions. In the words of Michael Burns and James McConvill, "[o]ffshore entities (typically companies, but occasionally also limited partnerships) are commonly used as joint venture vehicles when there are investors from different jurisdictions coming together to fund a project."[81] Additionally, they argue, "[o]ffshore entities are also used regularly to raise financing

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76. CITIZENS FOR TAX JUSTICE, FORTUNE 500 COMPANIES HOLD A RECORD $2.4 TRILLION OFFSHORE 1 (2016), http://ctj.org/pdf/pre0316.pdf.

77. Letter from Anthony Travers, Chairman, Cayman Is. Fin. Servs. Ass'n to President Barack Obama (May 5, 2009).

78. *See* Kleinbard, *supra* note 19, at 702.

79. This "sandwich" found its way into a cartoon. SCOTT ADAMS, DILBERT (Dec. 28, 2010), http://dilbert.com/strip/2010-12-28.

80. For the details of how this strategy is implemented, *see* Kleinbard, *supra* note 19, at 706–13.

81. Michael J. Burns & James McConvill, *An Unstoppable Force: The Offshore World in A Modern Global Economy*, 7 HASTINGS BUS. L.J. 205, 208 (2011).

through their listing on a major stock exchange."[82] Places like the British Virgin Islands or the Cayman Islands are obviously havens for tax abuse, but before we deride them as cancerous lesions on the global tax system, we should acknowledge their positive role in facilitating the global economy as well.

To put it another way, the problem with the generation of stateless income is not that Bermuda imposes no income tax. Rather, Irish and Dutch tax laws (along with high-tax jurisdictions) exhibit flaws that use Bermuda (and other low-tax jurisdictions) to reduce effective rates far below marginal rates. This problem of tax rent-seeking by multinational companies is one that will likely become increasingly relevant and will require solutions well beyond the scope of this paper.

III.
PROPOSING A "SECOND BEST" ALTERNATIVE TO THE CURRENT SYSTEM

It is clear that the current system of taxation of international transactions has enormous structural flaws and is in desperate need of revision. The system of international taxation has the same basic framework as it did in the 1920s.[83] However, political reforms are usually centered around trying to shore up the current system of worldwide taxation, not moving from a worldwide system to a territorial system.[84] So while a territorial system would be preferable as a practical matter, lawmakers have thus far been loath to move in that direction. While the Tax Cuts and Jobs Act of 2017 offers a gesture towards territoriality, every version of the bill has retained some sort of tax on certain classes overseas earnings not connected to the United States that are ostensibly directed at preventing base erosion.[85]

In light of that, I offer a second best alternative: allowing companies to remain domiciled in the United States but "check the box" and elect to be treated as an offshore entity

82. *Id.* at 213.

83. *See* Graetz, *supra* note 22, at 261.

84. Recent efforts by the Treasury under the Obama administration to disregard certain inversion transactions is a perfect example of this. *See* Burns & McConvill, *supra* note 81 at 205.

85. *See, e.g.*, Tax Cuts and Jobs Act of 2017, H.R. 1 § 14401 (establishing a "base erosion minimum tax" on high-return foreign income) (as passed by the Senate on December 2, 2017).

for tax purposes. To put it another way, this is an *elective territorial system* that gives companies a self-help mechanism that limits their U.S. tax liability on foreign income. While such a system fails to move the country entirely to a worldwide system, it would achieve two main objectives. First, it would remove the charade of setting up offshore companies for tax purposes, helping isolate companies with legitimate offshore businesses from those who use the offshore tax economy for tax evasion and other nefarious purposes. Second, it would allow our tax code to simulate some of the benefits of a territorial system—while still retaining the anti-abuse provisions of transfer pricing and Subpart F—and thus move our system closer to optimal efficiency.

A. *The Theory of the Second Best*

In order to achieve a Pareto optimal solution, each of the necessary conditions for that solution must also be satisfied. A Pareto optimal solution is one in which no changes can be made to the system to make someone better off without making another worse off.[86] While in simple in theory, the application of this to the design of a tax system is not trivial and has been the subject of considerable academic debate.[87] For the purposes of this Article, however, an optimal solution can be understood as one that balances the interest of the U.S. government in raising revenues and implementing policy objectives in a way that is easily administered, the interests of taxpayers in paying an amount of tax corresponding to their relative economic contribution, and in the international context, the interest of countries in maximizing the allocation of located in their respective jurisdictions.

However, that may not be possible in all circumstances. The *theory of the second best* says that if one condition cannot be optimized, departure from the optimal condition for all of the conditions can produce a "second best" solution.[88] Suppose a given market is failing to achieve optimal efficiency because

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86. *See* Joseph E. Stiglitz, *Pareto Optimality and Competition*, 36 J. FIN. 235, 235 (1981).

87. *See* A.B. Atkinson & J.E. Stiglitz, *The Design of Tax Structure: Direct Versus Indirect Taxation*, 6 J. PUB. ECON. 55, 56 (1976).

88. R.G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUDIES 11, 11 (1956).

one market segment is failing. The best solution would be, of course, to fix the underlying failure. But supposing that failure could not be corrected, the theory of the second best suggests that an overall greater efficiency can be attained by departing from the ideal for other market segments. One might refer to this as the "one step back, two steps forward" approach. So when lawmakers are unable to improve one inefficient condition through policy changes, it may be that the best option available is to depart from the ideal on other conditions.[89]

However, while the theory demonstrates that the second best solution is not always achieved by optimizing all controllable conditions, it gives no indication as to *which* controllable conditions ought to depart from the optimum.[90] Indeed, Lipsey and Lancaster acknowledge "[t]he extraordinary difficulty of making *a priori* judgments about the types of policy likely to be required in situations where the Paretian optimum is unattainable, and the second best must be aimed at."[91]

B. *The First Best Solution for International Tax Law*

Scholars debate the relative merits of territorial versus worldwide tax systems, usually an extension of the debate over the competing goals of CIN and CEN.[92] Some have also argued that discussions about the nature of an international tax system ought to be broader than the dichotomy posed by CIN and CEN.[93] This continues to be an area of robust academic debate. Regardless of how this debate ends, however, most countries have moved away from the U.S.-style worldwide system and towards a territorial system. The United States is now the only G7 country with a worldwide system for active business income, and only 8 out of 34 OECD countries still have a

89. For an example of how this has been applied in the international tax regime, *see* Alexander Wu, *U.S. International Taxation in Comparison with Other Regulatory Regimes*, 33 VA. TAX REV. 101, 125 n.96 (2013) (explaining the international tax regime that we have in terms of the theory of the second best by recognizing the twin roles played by both regulation and tax policy in determining allocation of capital).

90. *See* Paul Krugman, Opinion, *The Big Green Test*, N.Y. TIMES (June 22, 2014), http://www.nytimes.com/2014/06/23/opinion/paul-krugman-conservatives-and-climate-change.html.

91. Lipsey & Lancaster, *supra* note 88, at 28.

92. *See supra* Part I.

93. Graetz, *supra* note 22, at 276.

worldwide system.[94] Thus, irrespective of *academic* consensus on the issue, there is increasing *political* consensus in favor of the territorial system. U.S. international income taxation currently stands firmly in opposition to international norms on these issues.[95]

The fact that companies move offshore does not mean that they will not do business here, nor does it mean that they will no longer pay U.S. taxes. It *does* mean, though, that large and sophisticated companies are able to figure out ways to move offshore and bring their effective tax rates in line with global competitors, irrespective of domicile.[96] The companies that suffer the most are those with overseas operations, yet limited resources to set up sophisticated tax avoidance schemes. This becomes particularly problematic as corporate tax rates around the world continue to decline while the United States maintains a top marginal corporate rate of 35 percent.[97]

There have been some recommendations within the U.S. government to move to a territorial system for corporations. The National Commission on Fiscal Responsibility and Reform recommended moving the United States to a territorial system in order to "bring the U.S. system more in line with our inter-

94. Thornton Matheson, Victoria Perry, & Chandara Veung, *Territorial vs. Worldwide Corporate Taxation: Implications for Developing Countries* (Int'l Monetary Fund, Working Paper No. 205, 2013), https://www.imf.org/external/pubs/ft/wp/2013/wp13205.pdf.

95. Nearly all tax systems have elements of both territorial and worldwide systems. MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 13 (2003). A true worldwide tax system, for example, would reject a foreign tax credit. The United States maintains a foreign tax credit, allowing people to at least partially offset their U.S. taxes by taxes paid to foreign governments. That said, in common parlance worldwide systems are defined as those which impose a tax (before credits and deductions) on a corporation's worldwide income; territorial systems are defined as those which impose a tax only on income earned within the country imposing the taxation.

96. Kleinbard, *supra* note 19, at 713.

97. Avi-Yonah & Lahav, *supra* note 18, at 375 ("The United States has the second highest statutory corporate tax rate in the Organization for Economic Co-Operation and Development (OECD) (after Japan)."). Note that Japan lowered its corporate tax rate to below that of the United States in 2015. Takashi Nakamichi & Toko Sekiguchi, *Japan to Lower Corporate Tax Rate*, WALL ST. J. (Dec. 30, 2014), http://www.wsj.com/articles/japan-to-lower-corporate-tax-rate-1419935308.

national trading partners."[98] In 2010, the President's Economic Recovery Advisory Board recommended moving to a territorial system to fix the distortion caused by "[t]he tax disincentive to repatriating foreign earnings."[99] Republican House Members, led by Speaker Paul Ryan, have advocated for a move to a territorial system as part of their blueprint for Republican policy reform.[100] And, as discussed *supra*, the Republican-backed Tax Cuts and Reform Act of 2017 attempts to move towards a territorial system.[101]

Perhaps politicians will yet implement a move to the territorial system. After all, groups on both sides of the aisle during at least the last two presidential administrations have advocated repeatedly for a move to a territorial system. I suggest four reasons why this move has not yet happened. First, there simply has not been enough political will or bipartisan consensus at the right moment in time to move the needle. Second, much of the frustration with U.S. international taxation has been misdirected. Rather than focusing on a system that taxes non-U.S. income, politicians malign companies inverting and expatriating as "unpatriotic" or as not "paying their fair share."[102] Thus, in focusing on companies and not on the broken system, politicians obscure the real problem. Third, unlike in countries like the United Kingdom and Japan, which were seeking to become more competitive in the global marketplace and repatriate foreign earnings[103]—including a move to a territorial system—the United States has not experienced large scale capital flight. Lastly, moving to a territorial system means giving up the right to revenue gleaned from taxing the

98. NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH (2010).

99. ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION (2010), https://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf.

100. *See* House Republican Members, *supra* note 5.

101. *See supra* note 85 and accompanying text.

102. President Barack Obama, Weekly Address (July 26, 2014) ("[S]topping companies from renouncing their citizenship just to get out of paying their fair share of taxes is something that cannot wait. That's why, in my budget earlier this year, I proposed closing this unpatriotic tax loophole for good.").

103. Barbara Angus, et al., *The U.S. International Tax System at a Crossroads*, 30 NW. J. INT'L L. & BUS. 517, 531 (2010).

overseas operations of U.S. companies. In other words, it will cost more. In 2010 (the last year statistics were available), American corporations reported $470.4 billion in foreign-source income.[104] While the resulting tax liability was reduced by $118.1 billion in foreign tax credits, the United States still gained substantial revenue on taxing the foreign income of U.S. corporations. While that is comparatively little in the overall federal budget, it also is large enough that some groups have suggested that the move to a territorial system would impose an unnecessary cost on U.S. government coffers.[105]

Regardless of the reasons for why the United States has not followed its trading partners and moved towards a territorial system, the fact remains that the worldwide system of taxation stubbornly remains in place. This is so despite significant pushes from members of both parties and numerous think tanks to overhaul in the direction of a territorial system. Thus, our country's tax system does not meet Pareto optimal efficiency because we have failed to generate the political will necessary for major overhaul of the portion of the tax code dealing with international taxation.[106]

C. *A "Deemed Foreign Entity"—Second Best Solution?*

While it is difficult to identify all of the conditions that need to be satisfied for Pareto optimal efficiency, we can at least identify some of the key components. The overall goals for evaluating a tax system are widely recognized as equity (or fairness), simplicity, and efficiency.[107]

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104. IRS, CORPORATE FOREIGN TAX CREDIT, TAX YEAR 2010, https://www.irs.gov/pub/irs-soi/10corporateforeigntaxcredits.pdf.

105. CHYE-CHING HUANG, CHUCK MARR, & JOEL FRIEDMAN, CTR. ON BUDGET AND POLICY PRIORITIES, THE FISCAL AND ECONOMIC RISKS OF TERRITORIAL TAXATION 9 (2013), http://www.cbpp.org/sites/default/files/atoms/files/1-31-13tax.pdf (estimating $130 billion in lost revenue over ten years by switching to a territorial system).

106. *See* I.R.C. §§ 861-1000 (Subchapter N, "Tax Based on Income from Sources Within or Without the United States").

107. *See, e.g.*, Malcolm Gillis et. al., *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 728 (1996); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 153 (1999). *But cf.* Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 652 (2003) ("This argument . . . goes against the consensus among scholars that the three most important criteria

Achieving equity in the world of international tax would require that those with the greatest ability to pay will pay the most in taxes. Our current regime achieves precisely the opposite result.[108] Large companies with armies of tax lawyers are able to artificially lower their rates through various tax-saving measures, whether through offshore subsidiaries, corporate inversions, or simply careful tax planning.[109] A system of greater equity would focus on working to ensure that companies—regardless of place of incorporation—are not able to manipulate the offshore tax economy to lower their tax rate.

Simplicity—perhaps the top priority for many politicians[110] and the one that elicits the most skepticism among experts[111]—is clearly lacking in the current system, and the problem is made worse by the fact that the system of international taxation is a 1920s era framework that last saw major overhaul in 1986.[112]

As Graetz noted, the question of efficiency—particularly in the international tax context—is neither simple nor clear. Gratez argued that "[w]e should minimize the costs of compliance and administration and acknowledge that an unenforceable tax can be neither efficient nor fair."[113] While the current international tax regime is something of a compromise between capital export neutrality and capital import neutrality, an ideal system ought to do at least two things. First, it ought to minimize economic activity done primarily "for tax rea-

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for evaluating any tax system (or a particular rule or set of rules within a tax system) are equity, efficiency, and simplicity.").

108. *See* Kleinbard, *supra* note 19, at 714.

109. *See* Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions*, 55 NAT. TAX J. 409, 415 (2002); Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. TIMES (Apr. 28, 2012), http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html.

110. *See, e.g.*, Ted Cruz, Opinion, *A Simple Flat Tax for Economic Growth*, WALL ST. J. (Oct. 28, 2015), http://www.wsj.com/articles/a-simple-flat-tax-for-economic-growth-1446076134.

111. Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 652 (2003).

112. Graetz, *supra* note 22, at 263–64. ("Along with its complexity, the importance of the regime for taxing international income has also increased dramatically since the 1920's, even since it was last reexamined in the 1980's.").

113. *Id.* at 324–25.

sons." Second, it ought to recognize how the system affects the movement of capital across international borders.

Efficiency is a key part of the debate between territorial and worldwide systems. While territorial systems are not themselves immune from inefficiencies,[114] taxing overseas income creates a set of nontrivial distortions. James Hines argues, "Whereas some forms of international taxation, such as subjecting U.S. firms to U.S. excise taxes on their foreign sales, are transparently inefficient and self-defeating, others, such as the current U.S. regime of taxing foreign income, are no less inefficient, only somewhat subtler in their appearance."[115]

Currently, U.S. tax policy leads to gross inefficiencies. One such inefficiency is the outsized role that the offshore tax economy (which is beyond the juridical reach of the United States government) plays in tax planning. This is at least partially a consequence of the U.S. system of trying to tax worldwide income. In practice, though, the worldwide system operates as a trap for the unwary. Kleinbard argues that "[i]n practice the U.S. tax rules do not operate, as many presentations suggest, as a 'worldwide' system of taxation, but rather as an ersatz variant on territorial systems, with hidden benefits and costs when compared to standard territorial regimes."[116] One way (and indeed, perhaps the best way) of removing these distortions would be moving to a territorial system. Yet, with a move to a territorial system gaining little traction at this time, perhaps there is a second best way forward—allowing companies to elect into a territorial system by "checking the box," thereby making them a "deemed foreign entity."

1. *Check-the-Box in Corporate Taxation*

Scholars and economists are largely in agreement that the corporate tax is a bad tax,[117] and all else being equal, integrating the corporate tax would reduce economic distortions im-

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114. *See* Kleinbard, *supra* note 19, at 714.
115. James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269, 298 (2009).
116. Kleinbard, *supra* note 19, at 714.
117. Noël B. Cunningham & Mitchell L. Engler, *Prescription for Corporate Income Tax Reform: A Corporate Consumption Tax*, 66 TAX L. REV. 445 (2013) ("Even in the current polarized political times, there is an emerging consensus on two tax reform issues. First, there is a widely-shared bipartisan view that the corporate income tax is a 'bad' tax that is desperately in need of

posed by the two-level corporate tax.[118] The corporate tax has, however, proven extraordinarily difficult to remove. Yet even while the corporate tax remains in place for public companies and most older corporations, the United States took a significant step towards corporate tax integration in 1996 by removing burdensome regulations on entity choice and allowing businesses to simply "check the box" and therefore elect to be treated as either a corporation or a partnership.

The Code defines corporations to include "associations, joint-stock companies, and insurance companies."[119] The regulations further clarify the definition by including business entities "organized under a Federal or State statute" and "[a]n association."[120] The challenge for the Service has long been in properly defining what constitutes an "association," particularly with the advent of limited liability companies.[121] Before 1996, the Treasury had promulgated rules outlining four factors that determined whether a business association was subject to the two-level corporate tax: continuity of existence, centralization of management, limited liability, and free transferability of interests.[122] These four factors were drawn from *United States v. Kintner*, which also outlined two others: the presence of associates and a business objective.[123] However, with a knowledgeable financial planner, companies could figure out how to "become" the desired entity by attaining the foregoing characteristics,[124] notwithstanding attempts from the IRS to

reform or repeal. The corporate income tax is complicated, inefficient, and is strewn with tax expenditures.").

118. Emil M. Sunley, *Corporate Integration: An Economic Perspective*, 47 TAX L. REV. 621, 635 (1992) ("The various proposals for corporate integration can reduce, eliminate or even reverse these distortions, and most tax policy experts agree that, all other things being equal, a tax system free of these distortions would be superior to current law.").

119. I.R.C. § 7701(a)(3) (West 2014).

120. Treas. Reg. § 301.7701-2(b).

121. *See, e.g.*, Rev. Rul. 94-51, 1994-2 C.B. 407 (1994); Rev. Rul. 94-79, 1994-2 C.B. 409 (1994); Rev. Rul. 94-6, 1994-1 C.B. 314 (1994).

122. *See* Larson v. Comm'r, 66 T.C. 159, 172 (1976), *acq.*, *IRS Announcement Relating to: Am. Precision Metals, Larson*, 1979-2 C.B. 1 (Dec. 31, 1979).

123. United States v. Klintner, 216 F.2d 418 (9th Cir. 1954).

124. Victor E. Fleischer, Note, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 527 (1996).

impose some sort of order on the definition of a corporation.[125]

In response to growing pressure, in 1996 the IRS promulgated revisions to the regulations that simplified the entity classification rules.[126] In its decision, the Treasury said that "[a]ny business entity that is not required to be treated as a corporation for federal tax purposes (referred to in the regulation as an eligible entity) may choose its classification under the rules of 301.7701-3."[127] Non-eligible entities are those that are otherwise classified as corporations under the regulations, such as companies organized as corporations under state law, banks, and certain foreign entities.[128] For eligible entities, the regulations now allow a business to choose whether to be treated as a corporation (thereby imposing the two-level tax) or as a partnership.[129]

When the IRS first announced "check-the-box," it was widely praised for reducing complexity.[130] An additional benefit provided by check-the-box, however, is that it removes the two-level tax for many non-public companies.[131] In effect, therefore, check-the-box is partial corporate tax integration. Full-scale corporate tax integration has proved to be a nearly intractable problem, and while most scholars agree that the first-best solution to the problems associated with a two-level tax is, of course, removing the second level of tax, check-the-box represents a second best solution.

2. *A Deemed Foreign Entity*

Currently, Section 7701 and the accompanying regulations define whether an entity is foreign or domestic.[132] The Code provides that, "[t]he term 'domestic' when applied to a

125. *See id.* at 522–32.

126. For an in-depth overview of the history behind check-the-box, see Steven A. Dean, *Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 447 (2005).

127. T.D. 8697, 1997-1 C.B. 215.

128. Treas. Reg. § 301.7701-2(b) (as amended in 2016).

129. Treas. Reg. § 301.7701-3(c)(1)(i) (2006).

130. *See, e.g.*, Dean, *supra* note 126, at 438; George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 125 (1998).

131. Public companies are generally taxed as corporations, regardless of choice of form. I.R.C. § 7701 (2014).

132. I.R.C. § 7701(a) (2014); Treas. Reg. § 301.7701-5 (2006).

corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations."[133] Mirroring this, the Code provides that, "[t]he term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic."[134] While this is certainly straightforward, it does not reflect economic reality. Ugland House in the Cayman Islands is famous for serving as the place of incorporation for thousands of companies—companies that are therefore classified as foreign for tax purposes.[135] U.S. companies reported $51 billion in offshore income from the Cayman Islands alone in 2010.[136] The only problem is that the Cayman Islands' entire GDP is only about $2.5 billion.[137] Thus, the tax story and the economic story show very different pictures of what is happening, meaning that something is awry with our tax code.

The notion that a company's locus is its place of incorporation is mere fiction. Decisions about where to incorporate are made with little, if any, reference to where the business is operated or whether the business even has any presence in the jurisdiction of choice. There is no reason why that fiction cannot simply be extended to allow companies to elect their tax status as either a foreign or a domestic company. This movement would have little substantive effect on an entity's tax status (as companies currently domiciled offshore would be more likely to be domiciled onshore with this change in law), but would allow companies to avoid having their place of incorporation be dictated by tax law. Such a regulation could mirror the check-the-box regulations, because while foreign domiciled companies would still be classified as foreign companies, U.S.-domiciled companies could elect to be treated as foreign companies for tax purposes. The current system is already an

133. I.R.C. § 7701(a)(4) (2014).

134. I.R.C. § 7701(a)(5) (2014).

135. Robert M. Morgenthau, Opinion, *These Islands Aren't Just a Shelter from Taxes*, N.Y. TIMES (May 5, 2012), http://www.nytimes.com/2012/05/06/opinion/sunday/these-islands-arent-just-a-shelter-from-taxes.html.

136. MCINTYRE ET AL., *supra* note 10, at 14.

137. CIA, CAYMAN ISLANDS, THE WORLD FACTBOOK (last updated May 5, 2016), https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html.

elective system for all intents and purposes—so long as an entity has the resources to structure their tax position properly.[138]

3. *Getting from Here to There*

The original check-the-box was accomplished via regulations, but there remains significantly greater clarity in the Code regarding the distinction between foreign and domestic companies compared with the Code's definition of a corporation. Section 7701 defines a corporation to include associations, but does not define the term;[139] by contrast, the Code clearly defines domestic entities as those "created or organized in the United States or under the law of the United States or of any State."[140] Thus, it may prove more difficult to redefine whether a corporation is domestic or foreign without legislative change. The Treasury Department is limited in its ability to issue regulations in instances where the meaning of a statute is plain.[141] In reviewing an agency's interpretation of a statute, courts use a two-step process (known as the *Chevron* analysis) whereby they first analyze "whether Congress has directly spoken to the precise question at issue."[142] The definitions of domestic and foreign corporations are quite clear, which makes the second step of the *Chevron* analysis a nullity: "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[143]

Making a regulatory change would be very aggressive—almost certainly too aggressive to be feasible—but it is worth thinking about what such regulations might look like. Such a regulation would be similar to check-the-box and would in-

138. Kleinbard, *supra* note 19, at 714 ("[T]he current U.S. tax system, which purports to tax the worldwide income of U.S.-resident multinational firms, in fact, affords those firms the opportunity to operate in a quasi-territorial tax environment and to earn stateless income in the same manner that their territorial-based competitors do.").

139. I.R.C. § 7701(a)(3) (2014).

140. I.R.C. § 7701(a)(4) (2014).

141. Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984).

142. *Id.* at 842.

143. *Id.* at 843.

clude several different points.[144] First, it would establish a default rule in the statute—absent election, domestic or foreign business entities would be defined by their place of incorporation. Second, it would establish that business entities organized under the laws of the United States can elect to be treated as foreign entities. Third, it would specify that any business electing to be treated as a foreign entity would be treated as "a United States person transfer[ing] property to a foreign corporation," making it subject to the rules and associated regulations of Section 367. Among other things, this could require the domestic company to recognize all gains before expatriating.[145] This would accomplish two things: (a) it would prevent *all* domestic entities from seeking foreign treatment; (b) it would dissuade companies from switching back and forth between foreign and domestic status for different tax years. Fourth, the regulation would require companies to elect their domestic or foreign status prior to the taxable year, thereby preventing companies from choosing whether they want to be treated as a domestic or foreign company solely based on their annual tax burden for the year in question.

In order to keep the regulation in line with the words of the statute, only companies eligible to be treated as partnerships could elect to be treated as foreign entities.[146] Of course, some offshore entities would still want to be treated as corporations for tax purposes, so election for either corporate or partnership tax treatment would be made subsequent to the election to be treated as a foreign or domestic entity. Thus, the new system would allow eligible domestic entities a double election: first, they would elect whether or not to be treated as a foreign entity; second, they would elect whether or not to be treated as a corporation.

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144. *See* Treas. Reg. § 301.7701-5 (2006) (giving regulatory guidance on the definition of domestic and foreign business entities).

145. I.R.C. § 367 (2004); *see also* Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 494 (2005).

146. The reason for this is that the statute defines domestic entities as those "created or organized in the United States or under the law of the United States or of any State *unless, in the case of a partnership, the Secretary provides otherwise by regulations*." I.R.C. § 7701(a)(4) (2014) (emphasis added). Thus, the law provides the ability for Treasury to define domestic entities independent of the statute—but only for partnerships.

This proposal may indeed be both overly aggressive and too cute by half, but such a regulation may still have interesting consequences worth considering. Unlike the original check-the-box, there is no apparent need to require a lock-in,[147] as expatriation rules provide sufficient penalty for companies electing to switch from domestic to foreign status. Additionally, it is not entirely clear who would have the legal standing to challenge these regulations. In order to challenge regulations, a plaintiff must first establish Article III standing, which, among other things, requires a plaintiff to demonstrate "an injury in fact—an invasion of a legally protected interest which is (a) concrete and particularized and (b) actual or imminent, not conjectural or hypothetical."[148] Since the goal of this regulation is taxpayer friendly and designed to allow taxpayers to elect the classification that would minimize their tax burden, it is not clear how a plaintiff could establish this injury in fact. That said, it was not clear that anyone would have standing to challenge the original check-the-box regulations.[149] It took ten years, but eventually those regulations were challenged in *Littriello v. United States* as an invalid exercise of the Treasury's authority.[150]

The plaintiff in *Littriello* had organized an LLC and had apparently forgotten to elect treatment as a corporation—making him personally liable for the LLC's unpaid taxes.[151] The court went through the *Chevron* analysis and found that the Treasury had not in fact abused its discretion.[152] It is hard to imagine an analogous situation under the election system proposed here, because at the heart of Littriello's argument is the notion that he was liable for a tax that he would not have had to pay prior to check-the-box. This would not be an issue in electing between either a foreign or domestic entity because

147. Once an entity elects to be treated as either a partnership or a corporation, it generally cannot change its election for five years. Treas. Reg. § 301.7701-3(c)(1)(iv) (2006). Without such an election, businesses could change their election without penalty to take advantage of the form best suited for that year's financial statement.

148. Lujan v. Defs. of Wildlife, 504 U.S. 555, 560 (1992) (internal quotations omitted).

149. *See* Fleischer, *supra* note 124, at 550 n.157.

150. Littriello v. United States, No. CIV.A.3:04CV-143-H, 2005 WL 1173277 (W.D. Ky. May 18, 2005), *aff'd,* 484 F.3d 372 (6th Cir. 2007).

151. *Littriello*, 484 F.3d at 374.

152. *Id.* at 380.

the default rule in this proposed regulation would remain the same as it is today: it would look to the place of incorporation. Still, ingenious litigants may still find a way to challenge the rules, and given the aggressive nature of such a rule, it is not clear that such a challenge would withstand scrutiny under the *Chevron* doctrine.[153] Furthermore, as a matter of public policy it may not be advisable for a presidential administration to pursue policies that are in contravention of the duly enacted laws of Congress, even if such policies are immune from challenge on the basis of a standing argument.

Thus, the far more plausible fix would be through legislative change, which would either empower the Treasury to apply rules to define domestic and foreign corporations or would place the regulations described above directly into law. Given the level of public scrutiny that corporate inversions receive, the proposal above may be able to gain some political traction. This would be a small change and would therefore not require wholesale overhaul of the tax code. For that reason, it may be more palatable to legislators than moving entirely to a territorial system. It would, in fact, represent Congress' first move towards a territorial system, thereby following the international trend away from worldwide taxation.

IV. THE COMPLICATIONS AND ADVANTAGES OF BEING A "DEEMED FOREIGN ENTITY"

The theory of the second best suggests that when one condition cannot be optimized, a second best solution deviating from the Pareto optimal solution can be achieved by making other conditions suboptimal.[154] The consequence of this, of course, is that while the overall result becomes more efficient,

153. In reviewing whether or not Treasury could index capital gains for inflation under its regulatory authority, Lawrence Zelenak concludes that such a regulation would be invalid. Despite that, "indexing would probably be immune from judicial challenge," so "there would almost certainly be no one with standing to challenge the new regulation." Nevertheless, he argues that "[a]s tempting as that course may be, the administration should remember that an illegal activity is still an illegal activity, even when you are sure you will not be caught." Such an analysis would be appropriate in this circumstance as well. Lawrence Zelenak, *Does Treasury Have Authority to Index Basis for Inflation*, 55 TAX NOTES 841, 841–42 (1992).

154. *See* Lipsey & Lancaster, *supra* note 88.

it comes at the cost of making other conditions *less* efficient. Therefore, if allowing the election of either foreign or domestic classification is indeed a second best solution, we should expect *overall* benefits, while at the same time sacrificing some efficiency.

A. *Potential Complications of the Second Best*

Perhaps the most obvious potential disadvantage is the fact that once a company is treated as a foreign entity, its foreign source income becomes, with some exceptions, immune from U.S. taxation. Not only that, but generating income not taxable to the United States could very well become stateless income, or income not attributable to a multinational's natural locale (that is, the domicile of its parent, residence of its customers, or location of its production facilities).[155] One could therefore imagine a business domiciled in the United States declaring itself as a foreign entity for tax purposes. Under current law, this move would free such a business from paying anything on its foreign source income. However, while its U.S. source income would be taxed at normal U.S. rates, its foreign source income may not be attributed to any particular country if no other country claimed that income under its own source rules.[156]

This is an existing problem, however, and not a problem that either this proposal or the status quo purports to solve. Indeed, identifying the "source" of income has become something of a Sisyphean task and requires international cooperation well beyond the debate over moving to a territorial system. As it currently stands, the offshore tax economy already provides the framework for companies to claim income without paying tax to any jurisdiction on that income. The problem of untaxed foreign income (i.e., stateless income) is a problem more generally in a world without unified tax principles.[157] This proposal would merely extend to U.S. companies what foreign companies operating in the United States already

155. Kleinbard, *supra* note 19, at 701.

156. Sourcing rules vary from country to country, and the friction between different countries in how various types of income are defined as well as how income is sourced are what give rise to stateless income. *See id.* at 706.

157. *See* OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), http://dx.doi.org/10.1787/9789264202719-en.

have: the right to have foreign-source income exempt from U.S. income tax. Most countries have already granted this right via a territorial tax system, and it is time for the United States to provide that right as well.

Another potential concern is that domestic companies would rush to elect foreign treatment, in much the same way that we currently see companies trying to invert. However, very few companies have substantial foreign revenue to report, and many current multinationals have already structured their overseas operations into separate legal entities.[158] Thus, there would be almost no advantage for most companies in avoiding paying U.S. tax on foreign income.[159]

Additionally, while foreign companies have the benefit of non-U.S.-sourced income avoiding U.S. taxation, the companies are also subject to additional regulations and withholding taxes under current tax law.[160] The overarching goal of U.S. tax policy with regards to foreign entities would remain the same, ensuring both that income connected with U.S. activity remains taxed and that foreign income remains untaxed.

If this proposal were to be implemented—particularly via regulation—the temptation for Congress or a future administration to revert to present-day policy could be very high. Currently, if Congress wanted to tax offshore companies, it would be limited in its ability to enforce such a tax beyond U.S. borders. By definition, however, this proposal would involve companies domiciled in the United States that are treated as foreign for tax purposes. Thus, the only thing preventing Congress from "flipping the switch" and reclassifying these entities as domestic (thereby opening these businesses up to massive

158. As of 2010, the IRS reported that just 6,922 corporations reduced their taxable income using the foreign tax credit. While these companies generate substantial revenue, this illustrates the fact that companies have either domiciled overseas and taken advantage of tax deferral using CFCs or do not have significant overseas operations. IRS, *supra* note 104.

159. Note also that U.S. companies are given a foreign tax credit on taxes paid to foreign countries, meaning that being taxed by the United States on foreign income ultimately matters only for companies that maintain significant activities abroad. Because most countries have a lower corporate tax rate than the United States, the foreign tax credit generally does not eliminate U.S. tax liability for foreign source income. I.R.C. § 901(a) (2010).

160. *See, e.g.*, I.R.C. § 897 (2015) (imposing a withholding tax on the sale of any U.S. real property interest); I.R.C. § 1441 (2014) (imposing a withholding tax on various forms of income for foreign persons).

tax liabilities unexpectedly) would be the reputational hazard imposed by such a move. Congress would, in effect, have lured businesses to organize in the United States with the promise of not having their foreign income taxed—only to do an about-face. For this reason alone it may be wise to allow Congress—and not the Treasury—to implement this proposal, because it would immunize the policy from the criticism of administrative overreach.

The real disadvantage to this system is that it inserts a legal fiction where one may not be required. Put another way, it is an encumbrance that imposes regulations on companies for which the regulations were not designed. The easiest way to deal with this potential problem would be, of course, to simply move to a territorial system. So introducing the option to elect whether an entity will be treated as foreign or domestic would inject a level of unnecessary complexity—at least with respect to the Paretian optimal solution. It may also open the doors for companies to use the framework for tax planning strategies in similar ways to how companies currently take advantage of generous tax rules in other countries to avoid taxes. This would make the United States *more* complicit in the tax charades that the international community is trying to thwart.[161]

B. *Advantages of a Second Best Election*

Achieving a second best solution can require deviation from the optimum for certain conditions in order to achieve an more efficient solution overall. Despite the sacrifices in efficiency described above, this proposal does deliver net benefits over the status quo. First, U.S. companies gain the benefit—already granted to foreign companies—of avoiding U.S. income tax on their foreign income. Not all companies may be able to benefit immediately, but eventually, U.S.-domiciled Color Corp. from the example above in Part II.B, would be taxed in the same way as its British competitor, Colour Corp.[162]

Second, it would eliminate certain sham transactions made solely for tax purposes. Ideally, people who were formerly setting up entities in tax havens such as the Cayman Islands for legitimate purposes would set them up domestically.

161. *See generally* OECD, *supra* note 157.
162. *See supra* Part II.B.

This would give these companies predictability by being subject to U.S. laws in a way that may be unavailable when setting up the entities overseas. Second, it would limit tax haven incorporation to companies that either have non-tax reasons[163] or illegitimate tax reasons for setting up overseas. Not all companies use tax havens for legitimate purposes; some use them to hide money beyond the reach of the U.S. government. It is no secret that trillions of dollars are stored offshore in tax havens, with much of that sum illegally avoiding taxation.[164] While tax information exchange agreements with various tax havens have proliferated in the last decade,[165] the United States does not maintain formal tax treaties with most of those countries.[166] Thus, even while tax treaties and tax information exchange agreements have sought to prevent tax evasion, offshore tax havens and associated shell companies remain widely used by the wealthy and powerful both to avoid taxes and also to skirt sanctions.[167]

The final benefit is that it would provide guidance for future changes in law. It would reveal flaws in how we currently treat foreign entities from a tax perspective, since it would help isolate techniques used to generate stateless income. Additionally, it would pave the way for a true territorial system of taxation—the first best solution. This mechanism rejects the notion that a company moving its place of incorporation overseas via inversion or other means is doing anything other than saving money on its *foreign* taxes. Of course, when quintessentially "American" companies move their domicile overseas, it

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163. For example, recall that Chinese companies listing on U.S. markets will use an offshore VIE as the company going public. *See supra* Part II.A.

164. *Special Report: Storm Survivors*, THE ECONOMIST (Feb. 16, 2013), http://www.economist.com/news/special-report/21571549-offshore-financial-centres-have-taken-battering-recently-they-have-shown-remarkable.

165. *See, e.g.*, *U.S. - Netherlands Antilles Tax Info. Exch. Agreement Enters into Force*, Treas. HP-336 (Mar. 29, 2007).

166. The United States maintains tax treaties with a number of countries, which generally exist "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income." United States Model Income Tax Convention, Nov. 15, 2006.

167. *The Panama Papers: A Torrential Leak*, THE ECONOMIST (Apr. 9, 2016), http://www.economist.com/news/international/21696497-huge-trove-documents-has-revealed-secrets-offshore-business-presaging-tougher (describing the so-called "Panama Papers"). Ironically, the first major inversion transaction, McDermott Inc., moved its domicile to Panama in 1982.

often strikes taxpayers as being unfair.[168] And in a way, it *is* unfair, particularly for small-to-medium sized companies unable to afford an army of tax lawyers to build complicated inversion structures. So let's democratize the ability for companies to become foreign entities. Let's allow domestic companies the choice to be treated as a foreign company for tax purposes so that they can compete on equal footing with competitors from around the globe.

Conclusion

The narrative among the media and politicians regarding international tax tends to focus on companies leaving the United States, thereby getting out of paying their taxes. The narrative has some truth to it, but ultimately misstates the problem. Large multinational companies are able to manipulate the worldwide system of taxation such that they compete on a level playing field with businesses in countries that have a territorial system—and yet the United States insists on trying to capture the worldwide income of any company with the misfortune of having a U.S. mailing address.

Despite recommendations from both sides of the aisle and a consensus among America's major trading partners, Congress has made no move to overhaul the tax code in favor of a territorial system of taxation. Thus, with the first best solution unavailable, I propose a second best solution that allows companies the chance to elect their tax treatment. This would allow companies without the resources to structure themselves into a territorial regime to nevertheless acquire the benefits of a territorial system. This does not obviate the need for large-scale overhaul of an outdated system of taxation; nevertheless, such a move would prove to be a step forward in improving the United States tax code.

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168. *See* Danielle Douglas-Gabriel, *These Are the Companies Abandoning the U.S. to Dodge Taxes*, WASH. POST (Aug. 6, 2014), https://www.washingtonpost.com/news/wonk/wp/2014/08/06/these-are-the-companies-abandoning-the-u-s-to-dodge-taxes/.

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SCREENING OUT THE LOSERS: HOW DELAWARE CORPORATIONS CAN IMPLEMENT FEE-SHIFTING TO DETER FRIVOLOUS STRIKE SUITS

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 J.D., 2018, New York University School of Law; B.A., 2013, Haverford College. This note began as a paper for Professor Catherine Sharkey's seminar on torts and the administrative state. I am grateful to Professor Sharkey and Professor Choi for their thoughtful advice and comments. Many thanks to Ariella Pultman and the members of the N.Y.U. Journal of Law and Business for their helpful critique and feedback. I thank my family for their and support.

INTRODUCTION

The principal U.S. securities anti-fraud provision—Rule 10b-5—has unassuming origins. In 1943, two lawyers at the Securities and Exchange Commission ("Commission" or "SEC") heard about the president of a company buying up company shares under suspicious circumstances from shareholders, and proposed a rule to bring him to justice.[1] What would become known as Rule 10b-5 was presented to the Commission, with all the commissioners quickly and silently indicating their approval. Only one—Sumner Pike—remarked, "Well, we are against fraud, aren't we?"[2] From these humble beginnings, 10b-5 securities fraud regulation has grown enormously in doctrinal complexity. As Justice Rehnquist observed about Rule 10b-5, "we deal with a judicial oak which has grown from little more than a legislative acorn."[3] A line of Supreme Court cases, drawing heavily on the common law of deceit and fraud, read several doctrinal elements into 10b-5 securities fraud.[4] But the most consequential Supreme Court decision in the evolution of modern securities fraud rules was *Basic v. Levinson*.[5] In *Basic*, the Court adopted the controversial Fraud-on-the-Market (FOTM) presumption of reliance.[6] Twenty-two years earlier, the Federal Rules of Civil Procedure had been

1. *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).
2. *Id.*
3. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).
4. *See* John C.P. Goldberg & Benjamin C. Zipursky, *The Fraud-on-the-Market Tort*, 66 VAND. L. REV. 1755 (2013).
5. Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988). The FOTM theory assumes that, in a well-functioning securities market, "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.*
6. *Id.* at 244.

revised to allow class actions for monetary damages under Federal Rule 23. If the Federal Rules revision set the stage for plaintiff shareholder class actions, *Basic* drew back the curtain.

The decades following *Basic* saw a dramatic rise in securities class action lawsuits. In the 1980s, class action settlements in the millions and sometimes billions of dollars started making headlines.[7] Opposition to increased corporate liability to plaintiff shareholder classes predictably mounted. Advocates for reform argued that the federal securities laws left corporate defendants vulnerable to meritless suits by enterprising plaintiffs' attorneys. In their view, private enforcement of the securities regime incentivized strike suits—effectively imposing a tax on common shareholders.[8] By 1995, efforts to curb the rise of 10b-5 class actions culminated in the passage of the Private Securities Litigation Reform Act (PSLRA).[9] The PSLRA directly targets frivolous lawsuits, instituting various procedural and substantive reforms to the securities class action regime. Concisely stated, the goal of the PSLRA was to make it easier for defendants to win. Some two decades later, however, the PSLRA's success in screening out strike suits is questionable.[10]

The latest installment in the doctrinal evolution of Rule 10b-5 came in 2014, when the Supreme Court decided *Halliburton Co. v. Erica P. John Fund, Inc.* (*Halliburton II*).[11] Many advocates for reform hoped—indeed, expected—that the Court would use the occasion to jettison the fraud-on-the-market presumption of reliance. The defense marshalled fairly compelling evidence to demonstrate the falsity of FOTM. Some Justices were persuaded by that evidence; however, a majority of the Court ultimately declined to overturn *Basic.* Although the Court preserved the FOTM presumption of reliance, it also held that defendants may rebut the presumption

7. Robert Klonoff, *The Decline of Class Actions,* 90 WASH. U. L. REV. 729, 737–39 (2013).

8. Strike suits refer to meritless securities fraud claims that are brought merely for their settlement value. *See infra* notes 15–18 and accompanying text.

9. Victor Schwartz & Christopher Appel, *Rebutting the Fraud on the Market Presumption in Securities Fraud Class Actions: Halliburton II Opens the Door,* 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 33, 40 (2016).

10. *Id.* at 41.

11. Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014).

at the class certification stage. Like the PSLRA, *Halliburton II* makes it easier, at least in theory, for defendants to prevail in securities class actions. Also like the PSLRA, however, the practical impact of *Haliburton II* on the amount of frivolous suits is doubtful.[12] Finally, *Halliburton II* preserves, for better or worse, the class action apparatus as the principal means of private enforcement of Rule 10b-5.

As of this writing, the size of settlements paid by corporate defendants in securities class actions remains staggering.[13] Meanwhile, the debate over reform continues. Against this backdrop, the aim of this Note is twofold. First, I identify evidence of frivolous 10b-5 class actions, arguing that these strike suits have survived repeated reform efforts. I then introduce fee-shifting as a device to optimally screen out frivolous securities fraud suits. Second, this Note argues that Delaware corporations can now, as a matter of U.S. law, adopt valid fee-shifting bylaws and charter provisions. That argument turns on my construction of Delaware's recently passed law, Senate Bill No. 75.[14] As we shall see, there is considerable diversity among commentators in their interpretations of how S.B. No. 75 constrains corporate fee-shifting. I argue that Delaware's new law, properly construed, permits corporations to adopt fee-shifting provisions in their bylaws or charters. This Note then anticipates likely challenges to the implementation of fee-shifting bylaws or charter amendments, including challenges based on Delaware legislation and federal preemption grounds, arguing that these objections are ultimately surmountable. Indeed, as I argue in this Note, far from impeding the federal securities

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12. Robert L. Hickok & Gay Parks Rainville, *Defendants Look for Broader Interpretation of "Halliburton II"*, PEPPER HAMILTON LLP (2016), http://www.pepperlaw.com/publications/defendants-look-for-broader-interpretation-of-halliburton-ii-2016-06-07/ ("Despite the significance of *Halliburton II*, a majority of district courts have applied a narrow interpretation of its holding, rendering toothless defendants' right to rebut the *Basic* presumption.").

13. By one measure, aggregate investor losses on all filed cases in 2015 were $183 billion, and the average settlement value was $52 million. *See* SVETLANA STARYKH & STEFAN BOETTRICH, *Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review*, NERA Econ. Consulting 1, 7, (2016), http://www.nera.com/content/dam/nera/publications/2016/2015_Securities_Trends_Report_NERA.pdf.

14. *See* DEL. CODE ANN. tit. 8, §§ 102(f), 109(b) (West 2015) [hereinafter S.B. NO. 75].

regulation scheme, corporate fee-shifting promises to further its purpose.

Finally, this Note considers how courts are likely to review challenges to fee-shifting based on implied preemption. As we shall see, the judicial track record is historically inconsistent in this area. To remedy that trend, I propose a framework for judicial review built on three core ingredients: the presumption against preemption, consideration of the underlying regulator's views, and a careful judicial scrutiny of the regulator's reasoning. This analytical framework incentivizes agencies to use transparent and inclusive rulemaking procedures to support assertions of preemptive power. The framework also prompts courts to accord deference in proportion to evidence that agencies brought their expertise to bear on questions of implied preemption.

This Note is organized as follows: Part I introduces fee-shifting, and argues that the current level of frivolous lawsuits justifies its implementation. Part II discusses the Delaware legal environment leading to the passage of S.B. No. 75, and interprets the law to allow for fee-shifting. Part III addresses the principal challenges to implementation of loser-pays regimes by corporations, and proposes a framework for judicial review.

I.
Fee-Shifting: Creating the Incentives to Litigate Meritorious Claims and Deter Frivolous Strike Suits

A. *There Are Persuasive Reasons to Believe that Many Rule 10b-5 Securities Class Actions Are Frivolous, Imposing an Unjustifiable Tax on Shareholders*

The prevalence of frivolous class action lawsuits generally, and frivolous securities class actions in particular, is by now a familiar refrain.[15] Critics of the class action apparatus evoke a broad range of abusive practices unfairly targeting corporate defendants.[16] But for all the complaints of widespread abusive

15. *See, e.g.*, A. C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 Va. L. Rev. 925, 926–27 (1999).

16. *See* Richard H. Walker, David M. Levin & Adam C. Pritchard, *The New Securities Class Action: Federal Obstacles, State Detours*, 39 Ariz. L. Rev. 641 (1997).

litigation, the definition of frivolous lawsuits is sometimes taken for granted. What, after all, distinguishes a frivolous claim from a meritorious one? The only definitive response is that a meritorious claim achieves a judgment after trial.[17] However, virtually all securities class actions that survive the motion to dismiss stage are settled. The most conclusive way to judge a complaint's merit is therefore usually unavailable. A more practicable distinction might identify frivolous suits as those dismissed, and meritorious ones as those settled. This approach, however, fails to distinguish truly meritorious suits from lawsuits settled merely for their nuisance value.[18] Ultimately, we cannot observe a claim's merit conclusively prior to judgment.

That said, there are other reasons to believe that securities class actions are not always in shareholders' best interests. The 104th Congress certainly reached that conclusion before adopting the PSLRA: "today certain lawyers file frivolous 'strike' suits alleging violations of the Federal securities laws in the hope that defendants will quickly settle to avoid the expense of litigation."[19] Congress did not reach this view lightly; numerous distinguished experts testified at hearings, and dozens of relevant cases were referenced to support the conclusion that abusive strike suits exist. Granted, strong private interests backed a concerted lobbying effort to convince Congress of the existence of widespread abusive litigation. Nonetheless, staggering plaintiffs' attorney fee awards, the high volume of complaints filed, often at the slightest hint of corporate misconduct, and the consistent opinions of many experts all lend support to Congress' conclusion that frivolous strike suits unfairly afflict corporate defendants. Therefore, even though we do not directly observe frivolous claims, there are strong reasons to conclude, as Congress did, that frivolous securities class actions are a widespread phenomenon.

To be sure, the evidence of strike suits discussed above all pertains to the time before the PSLRA's enactment. One must ask, then, whether any of the phenomena undergirding Con-

17. S. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act* 2, (U. Mich. L. Sch. Law & Economics Working Papers Archive: 2003–2009, Art. 69, 2007), http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1070&context=law_econ_archive.

18. *See id.*

19. S. REP. NO. 104-98, at 4, 6, 11 (1995).

gress' finding of widespread abusive litigation are still present. In other words, did the PSLRA, which sought to root out frivolous Rule 10b-5 claims, achieve its purpose? In answering this question we should again keep in mind that no precisely accurate measurement of the level of frivolous lawsuits can be made. Notwithstanding, several empirical studies have analyzed the impact of the PSLRA on securities class actions.[20] There is broad consensus that the PSLRA, at least initially, was beneficial to shareholders. Choi et. al, for example, found that the PSLRA indeed had a screening effect.[21]

Unfortunately, however, by all indications the PSLRA's welfare-enhancing effect for shareholders was short-lived. As one commentator observed, "[t]he plaintiff's bar has found ways to circumvent these reforms, and reinstitute the old abusive practices in new form."[22] One way in which plaintiff lawyers have reasserted their pre-PSLRA control over Rule 10b-5 lead plaintiffs is through so-called "pay to play" contributions to institutional funds.[23] Other observers have noted that despite an initial dip following the PSLRA's passage, the filing of meritless lawsuits quickly rebounded.[24] More recently, the Supreme Court's decision in *Halliburton II* promised an avenue for Rule 10b-5 defendants to dispose of baseless lawsuits earlier on. By allowing defendants to rebut the FOTM presumption at the class certification stage, corporations can theoretically defeat meritless claims in court instead of settling them for their nuisance value. However, in the three years since the decision, there is little indication that Rule 10b-5 defendants can succeed in rebutting the FOTM presumption.[25] Finally, the chorus of complaints about abusive securities class action lawsuits is as audible now as it was in the early 1990s.[26] In sum, there is robust evidence to support an inference that frivolous securi-

20. *See, e.g.,* Ashiq Ali & Sanjay Kallapur, *Securities Price Consequences of the Private Securities Litigation Reform Act of 1995 and Related Events*, 76 ACCT. REV. 431 (2001).

21. S. Choi et al., *supra* note 17, at 3.

22. ANDREW J. PINCUS, *What's Wrong with Securities Class Action Lawsuits?*, U.S. CHAMBER INST. FOR LEGAL REFORM 10 (2014).

23. *Id.* at 11 (citing John C. Coffee, Jr., *Nobody Asked Me, But. . .*, Nat'l L.J., Jan. 18, 2007).

24. *See, e.g.,* S. Choi et al., *supra* note 17, at 3.

25. *See* Hickok and Rainville, *supra* note 12.

26. *See, e.g.*, MUKESH BAJAJ ET AL., *Economic Consequences: The Real Cost of U.S. Securities Class Action Litigation?*, U.S. Chamber Inst. for Legal Reform, at

ties class actions presently exist and impose an unjustifiable burden on shareholders.

B. *Fee-Shifting, Properly Configured, Promises to Screen Out More Frivolous Lawsuits*

As we saw, the problem of frivolous lawsuits in the securities industry persists. The burden imposed by abusive litigation, however, is hardly unique to the securities industry. Opponents of allegedly baseless lawsuits targeting businesses have long proposed reforms to root out strike suits. These include caps on damages awarded after trial, mandatory arbitration clauses, and, of particular relevance to this Note, fee-shifting. This Part considers fee-shifting as a method to reduce strike suits specifically in the context of securities fraud. I argue that a particular form of fee-shifting—namely, symmetric shifting—optimally screens out frivolous securities class actions against corporations. Before arriving at that more nuanced conclusion, a discussion of the basic economics of fee-shifting is necessary.

Concisely stated, fee-shifting (also referred to as "loser pays") provides that the prevailing party to a lawsuit does not pay its legal fees. Instead, those fees are shifted to that party's adversary—the losing party. There are several theoretical justifications for the loser pays principle. Foremost of those is a concern for fairness. Indeed, most contemporary legal systems feature some form of fee-shifting, considering this rule as dictated by notions of fundamental fairness.[27] The U.S. principle that each party finances its own lawsuit (hereinafter "the American Rule") is the outlier here.

A corollary justification to the notion of fairness is the screening function. Fee-shifting affects the incentives of parties to litigate disputes in court.[28] Consider how the loser pays principle impacts a plaintiff's decision to bring suit in the first place. Intuitively, the stronger a plaintiff's claim, the more likely she is to sue under fee-shifting. A numerical example illustrates the point: Suppose the probability of her winning at

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10 (2014), http://www.instituteforlegalreform.com/uploads/sites/1/EconomicConsequences_Web.pdf.

27. *See, e.g.,* Germany.

28. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 429 (Harvard Univ. Press 2004).

trial is 80%, and the amount she stands to win at judgment is $10,000. Her expected return under the American Rule is therefore $8000. Assume also that the plaintiff's and the defendant's legal fees for litigating the suit until judgment are $9000 each. In this scenario, the plaintiff has a negative expected return under the American Rule ($8000 - $9000 = -$1000), and hence would not bring suit.

Now consider how introducing fee-shifting changes the expected return on litigating the suit. Under loser pays, the plaintiff's expected cost of litigating the suit is no longer $9000, but instead the legal fees for both parties, weighted by her probability of losing: 20% × $18,000 = $3600. Her expected return on bringing the suit is now positive ($8000 - $3600 = $4400), and she would therefore choose to bring the suit in the first place. In these circumstances, the availability of fee-shifting increases the plaintiff's incentive to bring suit where her claim is strong.[29] Importantly, the converse is also true: fee-shifting disincentivizes a plaintiff from bringing suit when her claim is weak (because the expected cost of the suit is now greater than it would be under the American Rule).[30] Fee-shifting thus magnifies the relative strength or weakness of a claim, making frivolous suits more costly and less likely to be litigated, while strong claims become more profitable and more likely to be litigated.

Nonetheless, an important caveat is necessary for the foregoing conclusion to hold. Thus far, I have taken for granted that fee-shifting is symmetrical. Symmetry in this context means that a court shifts fees after judgment in *either* direction. In other words, both the plaintiff and the defendant—whoever loses—stands to foot the bill for the legal expenses of the triumphant party. As we shall see, fee-shifting does not necessarily exhibit symmetry. And the precise mechanics of the applicable fee-shifting rule (i.e., whether it is symmetrical) in turn affect the expected return on a claim.

Having reviewed the basic economics underlying the loser pays principle, this Note next considers actual fee-shifting provisions adopted by corporations. Consider the fee-shifting provision at issue in *ATP Tour, Inc. v. Deutscher Tennis Bund*.[31] *ATP*

29. *Id.* at 428–432.
30. *Id.*
31. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014).

Tour is also of particular importance to recent developments in Delaware law discussed in Part II *infra*; for now, however, the focus is on the fee-shifting provision at issue in the case.

ATP Tour, Inc. is a Delaware non-stock membership corporation, comprised of tennis tournament operators.[32] A dispute arose between two of ATP Tour's members (Deutscher Tennis Bund and Qatar Tennis Federation) and the corporation when ATP Tour's board implemented a change to the tour schedule resulting in the downgrade of the tournament in Hamburg from the highest to the second-highest tournament tier.[33] The plaintiffs alleged federal antitrust violations and breach of fiduciary duties against the corporation and its directors. Following a ten-day jury trial, the United States District Court for the District of Delaware granted defendants' motion for judgment as a matter of law on all claims against the corporation and its directors.

The matter was not yet at an end. ATP Tour next moved to recover its legal fees pursuant to Rule 54 of the Federal Rules of Civil Procedure and Article 23.3(a) of ATP's bylaws. In 2006, one year prior to the dispute, the board had amended ATP Tour's corporate bylaws and added Article 23, which provides, in relevant part, as follows: "(a) In the event that [any member] initiates [any claim or counterclaim], and (ii) the Claiming Party . . . does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought, then each Claiming Party shall be obligated jointly and severally to reimburse the League . . . for all fees, costs and expenses . . . that the parties may incur in connection with such Claim".[34] The district court certified the question of whether Article 23 is enforceable to the Delaware Supreme Court, which upheld the fee-shifting provision. A plain reading of Article 23.3(a) makes clear that fee-shifting in only one direction is contemplated by the bylaw: from the "League" to the "Claiming Party." There is no mention of shifting legal fees and expenses in the event that "Claiming Parties" succeed against the "League." Article 23 of ATP's bylaws, then, is an example of asymmetric fee-shifting, where legal fees are only

32. *Id.* at 555.
33. *Id.* at 556.
34. *Id.*

shifted in one direction (from the successful defendant to the unsuccessful plaintiff).

As suggested above, fee-shifting does not always achieve the desired outcome of encouraging meritorious suits while deterring frivolous ones. How, then, does an asymmetric loser pays regime like Article 23 in *ATP Tour* measure up? Albert Choi addresses this question in his recent paper on fee-shifting bylaws.[35] Choi demonstrates algebraically that the ATP Tour fee-shifting provision decreases the expected return on frivolous claims, but also the expected return on meritorious claims. In his words, "compared to the traditional, no-fee-shifting rule, the symmetric fee-shifting rule encourages more meritorious lawsuits while discouraging frivolous ones, while the ATP Tour Rule discourages all types of lawsuits."[36]

Put differently, the ATP Tour bylaw does function as a screen against frivolous lawsuits, but it also screens out meritorious ones. Choi argues convincingly that the optimal fee-shifting rule exhibits symmetry, providing for reimbursement of legal fees in both directions.[37] I concur with Choi's reasoning, and add that symmetric fee-shifting, in addition to producing more economically efficient outcomes, has the added benefit of fairness. Unlike the ATP Tour provision that only shifts fees to a losing plaintiff, symmetric fee-shifting does not appear to be designed to keep plaintiffs out of court.

In conclusion, we saw that there is strong evidence of frivolous strike suits encumbering the securities industry. We then examined fee-shifting and its ability to screen out baseless claims, finding that symmetric fee shifting ideally performs that screening function. The discussion of fee-shifting thus far was largely theoretical, however, and did not account for the particularities of class action lawsuits. The next question, then, is how loser pays provisions work specifically in the context of Rule 10b-5 securities fraud class actions, and how those provisions can be implemented.

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35. Albert Choi, *Optimal Fee-Shifting Bylaws*, 103 VA. L. REV. (forthcoming 2017).

36. *Id.* at 15.

37. *Id.* at 28–31.

II. FEE-SHIFTING IN DELAWARE: HOW CORPORATIONS CAN IMPLEMENT LOSER PAYS PROVISIONS GOVERNING SECURITIES FRAUD CLASS ACTIONS

Part II proposes Delaware as a jurisdiction where fee-shifting is, as a positive matter, a feasible option for corporations to reduce their exposure to frivolous securities fraud claims. To that end, the decision in *ATP Tour* does double duty for this Note. In Part I we examined the fee-shifting provision in *ATP Tour* to illustrate why the optimal fee-shifting provision is symmetrical, and as an example of corporate bylaws implementing a loser pays regime. The decision is also important for an understanding of Delaware law governing corporate fee-shifting provisions. *ATP Tour* ignited a debate between the supporters and opponents of fee-shifting, recently culminating in the enactment of Senate Bill No. 75 in 2015. As we shall see, that bill has profound implications for corporations and directors: their ability to adopt fee-shifting provisions applicable to suits against the corporation depends on the limits to the new law's reach.

Before analyzing Delaware's approach to fee-shifting, it is worth pausing at a threshold question. Because this Note proposes an antidote to frivolous securities class actions, which are, of course, federal causes of action, why focus on state corporate law, and why Delaware in particular? In the United States, corporate law has traditionally been a concern of the states. While large, publicly traded companies are incorporated in diverse jurisdictions across the nation, Delaware has long been a leader in corporate law. Many of the nation's largest corporations are incorporated there.[38] Therefore, if Delaware law were to permit fee-shifting bylaws, the scope of corporations standing to benefit is vast. The other reason why this Note focuses on Delaware in particular is more by happenstance than design. As the following sections elaborate, the last two years have brought the issue of fee-shifting to center stage in Delaware corporate law. Nonetheless, there have been rele-

38. Per the state's Division of Corporations, 64% of Fortune 500 companies are incorporated in Delaware, and more than 1,000,000 entities in total have their seat in Delaware. *Why Businesses Choose Delaware*, DEL. DIV. CORP., https://corplaw.delaware.gov/why-businesses-choose-delaware (last visited Oct. 4, 2017).

vant developments in other jurisdictions. For example, Oklahoma and New Jersey have both also recently adopted legislation regarding fee-shifting.[39] For the reasons just outlined, however, the focus of the following sections is Delaware state law.

A. *From ATP Tour to Delaware Senate Bill No. 75: Fee-Shifting's Circuitous Path Through Delaware's Legal System*

The Delaware Supreme Court decision in *ATP Tour* sparked vigorous reactions from the corporate community. To fully explicate the import of *ATP Tour*, a more detailed account of the procedural history and holding of the case is necessary. As discussed above, the dispute arose when two plaintiff tournament owners sued the defendant non-stock member corporation, ATP Tour, Inc., and various of its directors and officers (hereinafter "ATP") for breach of fiduciary duties and antitrust violations. The plaintiffs filed suit in the Delaware District Court in 2008. Following a ten-day jury trial, the court granted ATP's motion for judgment as a matter of law for the state law claims, and the jury then found for defendants on the antitrust law claims.[40] Defendants then moved to recover attorney's fees and other costs amounting to just under $18,000,000, pursuant to Federal Rule of Civil Procedure 54(d)(2). Defendants relied on Article 23, the corporation's fee-shifting bylaw, as the basis for their claim for attorney's fees.

The district court acknowledged, in principle, a contractual exception to the American Rule that each party finances its own lawsuit.[41] However, the court found that awarding ATP its legal fees would conflict with federal antitrust law, and declined ATP's motion. The court "reasoned that federal law preempts the enforcement of fee-shifting agreements when antitrust claims are involved."[42] On appeal, the Third Circuit remanded for further consideration, finding that a preliminary issue to the preemption question needed resolution. Spe-

39. *See* N.J. Rev. Stat. § 14A:3-6.7 (2013); Okla. Stat. tit. 18, § 1126 (2016).

40. Bund v. ATP Tour, Inc., No. 07-178, 2009 U.S. Dist. LEXIS 97851, at *2 (D. Del. Oct. 19, 2009).

41. *Id.* at *6.

42. Deutscher Tennis Bund v. ATP Tour Inc., 480 F. App'x 124, 126 (3d Cir. 2012).

cifically, the appellate court held that "the by-law validity issue needs to be addressed, and a finding of validity must be made, before the constitutional issue of preemption can be considered."[43]

The question of the fee-shifting bylaw's validity eventually made its way to the Delaware Supreme Court after the circuit court certified four questions of state law. In 2014, the court issued a short en banc opinion in response to the certified questions. The court unanimously held that fee-shifting bylaws like ATP's Article 23 are facially valid under Delaware statutory and common law, and are therefore enforceable so long as they are adopted for equitable purposes and pursuant to applicable procedural requirements.[44] The Delaware Supreme Court thus sanctioned utilization of corporate bylaws to contract around the default American Rule and implement fee-shifting provisions.

Broadly read, the *ATP Tour* decision is a significant endorsement of corporate fee-shifting provisions in Delaware. Nonetheless, the Delaware Supreme Court was careful to qualify its holding. First, the opinion emphasizes that whether a fee-shifting bylaw is enforceable depends on the manner in which it is adopted. Since ATP Tour's board of directors had

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43. *Id.* at 127.

44. The court elaborates that in principle fee-shifting provisions like Article 23 are not inconsistent with the DGCL and Delaware common law:

> A fee-shifting bylaw, like the one described in the first certified question, is facially valid. Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws. A bylaw that allocates risk among parties in intra-corporate litigation would also appear to satisfy the DGCL's requirement that bylaws must "relat[e] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." The corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence. Moreover, no principle of common law prohibits directors from enacting fee-shifting bylaws.
>
> Delaware follows the American Rule, under which parties to litigation generally must pay their own attorneys' fees and costs. But it is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party's fees. Because corporate bylaws are "contracts among a corporation's shareholders," a fee-shifting provision contained in a non-stock corporation's validly-enacted bylaw would fall within the contractual exception to the American Rule. Therefore, a fee-shifting bylaw would not be prohibited under Delaware common law.

ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 558 (Del. 2014).

the power pursuant to the corporation's charter to amend the bylaws, Article 23 was adopted in proper manner.[45] Second, the Delaware court observed that otherwise facially valid bylaws will be unenforceable if adopted for inequitable purposes.[46] The court did not, however, elaborate on which purposes might be deemed inequitable. Most importantly, the decision leaves unanswered the question of how broadly the court's holding applies, or whether the ruling is more narrowly cabined to the facts of the case.[47] As noted above, the dispute in *ATP Tour* involved a non-stock member corporation. This leaves open the question of whether the court's sanctioning of ATP Tour's bylaw applies equally to fee-shifting provisions of public corporations.

Despite the uncertainty over the precise reach of *ATP Tour*'s holding (i.e., what bylaws pass muster, and which kind of corporations the holding covers), several commentators have advanced a broad construction of the court's opinion. One prolific commentator, Kevin LaCroix, suggested that *ATP Tour* may reach not only non-stock corporations like ATP Tour, Inc., but also public corporations incorporated in Delaware.[48] Others have gone even further in their assessment of how broadly *ATP Tour* applies. Consider the memorandum of one law firm to its clients following the decision: "The practical effect of this decision, along with the Court of Chancery's earlier decision in *Chevron* (written by then-Chancellor and now Chief Justice Strine), is that many boards of directors of private and public Delaware corporations should seriously consider adopting fee-shifting bylaws of their own."[49] That advice

45. *Id.* (citing Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437 (Del. 1971) for the applicable legal standard).

46. *Id.*

47. *Accord* Gregory DiCiancia, *Limiting Frivolous Shareholder Lawsuits Via Fee-Shifting Bylaws: A Call for Delaware to Overturn and Revise Its Fee-Shifting Bylaw Statute*, 56 B.C. L. REV. 1537, 1559 (2015).

48. In a panel following publication of the decision, Lacroix commented: "So this idea that by bylaw, an unsuccessful litigant would bear the adversary's cost, is really radical—it could be transformative of the way shareholder litigation goes forward in our litigious environment." Yin Wilczek, *Litigation Reform Through Bylaws So Far a Success Story, Panelist Says*, Corporate Law & Accountability Report (BNA), 12 CARE Issue No. 31.

49. Wilson Sonsini Godrich & Rosati, *Delaware Supreme Court Endorses "Fee-Shifting" Bylaw in Certified Question of Law* (2014), https://www.wsgr.com/publications/PDFSearch/wsgralert-fee-shifting.pdf.

is given to public and private companies alike, advancing a broad construction of *ATP Tour* that reaches non-stock as well as stock corporations. And indeed, the opinion certainly leaves room for a plausible reading that the court sanctioned the use of fee-shifting bylaws for corporations irrespective of their status as public or private.[50]

As the months immediately following the Delaware Supreme Court's decision would show, the proponents of fee-shifting provisions for public corporations initially carried the day. Delaware companies, both public and private, began adopting loser-pays provisions into their bylaws or certificates of incorporation in short order.[51] Fee-shifting provisions, with the apparent blessing of Delaware's highest court, gained momentum. But then, just as rapidly as companies had begun to adopt loser-pays provisions, the pendulum swung back toward the American Rule. Two of the largest and most influential proxy advisory services (Glass-Lewis and Institutional Shareholder Services) spoke out against fee-shifting provisions, indicating in voting guidelines that they would not recommend reelecting boards that unilaterally acted to adopt loser-pays re-

50. The court bases its decision in part on its reading of Delaware corporate statutory law: "Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws." *ATP Tour, Inc.*, 91 A.3d at 558. The DGCL applies to public and private Delaware corporations alike. Further, in its discussion of enforceability of fee-shifting bylaws in Delaware, the court cites *Schnell v. Chris-Craft Industries*—a decision involving a public Delaware corporation. *See supra* text accompanying note 45. Taken together, the court's discussion is amenable to a reading that its holding reaches stock corporations seated in Delaware too. *Accord* Ronald Mueller et al., *Gibson Dunn Discusses Supreme Court of Delaware Case Upholding Fee-Shifting Bylaws*, CLS Blue Sky Blog (May 16, 2014), http://clsbluesky.law.columbia.edu/2014/05/16/gibson-dunn-discussessupreme-court-of-delaware-case-upholding-fee-shifting-bylaws/.

51. John Coffee Jr. recounts the reaction to *ATP Tour* as follows: "Corporations and other business entities began to adopt such board-approved bylaws or, in the case of issuers preparing for an initial public offering, to insert "loser-pays" provisions into their certificates of incorporation. Between May 29, 2014 and September 29, 2014, some twenty-four companies (including some limited liability companies and limited partnerships that were planning a public offering) adopted such a provision, either by a board-passed bylaw or a charter provision (in the case of a firm planning an initial public offering (or "IPO")." John C. Coffee, Jr., *"Loser Pays": The Latest Installment in the Battle-Scarred, Cliff-Hanging Survival of the Rule 10b-5 Class Action*, 68 SMU L. REV. 689, 692 (2015).

gimes.[52] These objections to unilaterally adopted fee-shifting bylaws and charter amendments have had an understandably chilling effect on Delaware's corporate boards and decisions to adopt such provisions.[53]

Besides the shareholder advisory services, there were other formidable sources of opposition to the trend toward fee-shifting. Large institutional investors also opposed the proliferation of fee-shifting provisions in Delaware.[54] The institutional investors brought their influence to bear on the Delaware fee-shifting reformation in two-fold fashion. First, the vocal opposition of large shareholders resonates in corporate boardrooms responsive to shareholder concerns.[55] Relatedly, as we have seen, proxy advisory services responded to pressure from institutional investors to oppose corporate fee-shifting provisions.[56] Second, institutional investors used their clout to lobby Delaware lawmakers—a campaign that included sending letters to the Governor Jack Markell urging him to help stem the tide of new fee-shifting provisions.

One important caveat should be kept in mind here: the resistance by investor groups was not necessarily an indictment of fee-shifting per se. As discussed in Part I above, ATP Tour's loser-pays bylaw was asymmetric, providing for recovery of legal fees only in favor of the corporation and not the plaintiff-shareholders. As we saw, the effect of an asymmetric fee-shifting provision like ATP Tour's is to reduce the expected return

52. *See* Stephen Bainbridge, *Fee Shifting: Delaware's Self-Inflicted Wound*, 40 DEL. J. CORP. L. 851 (2016); *see also* Teri E. O'Brien et al., *Key Changes to ISS and Glass Lewis Voting Guidelines,* Law360 (Dec. 16, 2014, 4:37 P.M.), https://www.law360.com/articles/602947/key-changes-to-iss-and-glass-lewis-voting-guidelines.

53. Shareholder proxy advisory services have strong influence on shareholder voting behavior. When the services recommend against reelection of incumbent boards, this creates a significant risk for incumbent directors that shareholders will vote in favor of other candidates. The voting guidelines of the most influential proxy advisory services therefore have considerable weight in how corporate boards decide to act.

54. Institutional investors wield increased clout over public corporations, as their assets under management and consequent share ownership have experienced sustained growth. Sarah Krouse, David Benoit & Tom McGinty, *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), http://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101.

55. *See supra* text accompanying notes 50 and 51.

56. DiCiancia, *supra* note 47, at 1561.

on litigating even meritorious claims. The institutional investors may therefore oppose asymmetric loser-pays provisions without necessarily objecting to fee-shifting bylaws generally.

Finally, the Delaware State Bar Association also took a strong position against corporate fee-shifting provisions. The economic interests of the Delaware plaintiff's and defense bars were aligned here: the proliferation of fee-shifting provisions imposing steep costs on plaintiffs who fail to recover all or substantially all of the remedy sought would likely effect a dramatic reduction in litigation. And every suit deterred by the new loser-pays provisions represents foregone legal fees for attorneys on both sides of the dispute.[57] Sure enough, following the *ATP Tour* decision, the bar association promptly began drafting a bill to undo the Delaware Supreme Court's ruling. However, opposite the institutional investors and Delaware State Bar Association, there were powerful interests lobbying against legislation that would curtail fee-shifting. Specifically, the U.S. Chamber of Commerce, a strong business lobbying group, voiced its support for the *ATP Tour* ruling and opposition to legislation overturning it.[58] The battle lines in the struggle over loser-pays regimes in Delaware were drawn.

The Delaware legislature, confronted with pressure from the opposing interest groups, declined to vote on the draft bill in 2014, and delayed the decision to overturn *ATP Tour*[59] to the next legislative session.[60] The 2015 legislative session began with a new draft bill put forward by the Corporate Law Council.[61] This time, the legislature approved the bill and the

57. As Coffee remarks, the bar association would not make the case against fee-shifting by reference to their own foregone legal fees. Nonetheless, the economic incentives here are undeniable. *See* Coffee, *supra* note 51, at n.20.

58. *See* Jonathan Starkey, *Chamber Forces Delay on Fee-shifting Legislation*, DELAWARE ONLINE (Jun. 10, 2014, 1:00 PM), http://www.delawareonline.com/story/firststatepolitics/2014/06/10/fee-shiftingbill/10280791/.

59. S.B. No. 75 would eventually overturn *ATP Tour*, but only with regard to public Delaware companies (as opposed to non-stock corporations too). As the Synopsis of the law explains, "In combination with the amendments to Sections 109(b) and 114(b)(2), new subsection (f) does not disturb that ruling in relation to nonstock corporations." S.B. 75, 148th Gen. Assemb., First Reg. Sess. (Del. 2015).

60. Coffee, *supra* note 51, at 693.

61. The Council, appointed by the Delaware State Bar association, is responsible for proposing changes to the DGCL. *See* COUNCIL OF THE CORPORA-

opponents of corporate fee-shifting emerged victorious. The Delaware Senate adopted Bill No. 75 by an overwhelming margin of sixteen votes in favor and five opposed.[62] It passed the Delaware House the following month, and Governor Markell signed the bill into law on June 24, 2015.

What ultimately tipped the scales in favor of the fee-shifting opponents in Delaware? Albert Choi suggests that the Delaware legislature "possibly . . . acced[ed] to the influence of the Delaware plaintiffs' bar."[63] Coffee invokes a concern over reduced "Gross Domestic Product of the State," imposing a significant cost both economically and politically.[64] The bill itself states that the law was passed "[i]n order to preserve the efficacy of the enforcement of fiduciary duties in stock corporations."[65] It is unclear which of these reasons underlay the legislation, but whatever the motivation for S.B. No. 75's passage, it was a significant victory for the interest groups opposing loser-pays provisions, and a defeat for the corporations supporting them.[66]

The struggle over fee-shifting in the context of Delaware corporations seemed to be, at least for the time being, at an end with the enactment of S.B. No. 75. As we have seen, the momentum toward adoption of loser-pays provisions by corporations in the wake of *ATP Tour* first slowed, and finally stopped. In turn, this might suggest that the struggle over fee-shifting has ended with a blanket prohibition against fee-shifting bylaws and charter provisions. But this paints the picture in overly broad strokes. What, then, does the new Delaware law mean exactly for corporations and their ability to implement loser-pays provisions? To answer that question, a closer look at the text of the statute and the accompanying synopsis is called for. As the following section describes, the law leaves room for fee-shifting provisions governing certain claims against corporate defendants.

TION LAW SECTION, https://www.delawarecounselgroup.com/dsba-corporate-council/.

62. DiCiancia, *supra* note 47, at 1563.

63. A. Choi, *supra* note 35.

64. Coffee, *supra* note 51, at 693.

65. S.B. 75, *supra* note 14.

66. *See, e.g.*, Anthony Rickey, *Fee Shifting May Disrupt Delaware's Dominance,* Law360 (Mar. 13, 2015), http://www.law360.com/articles/631222/fee-shifting-may-disrupt-delaware-s-dominance.

B. *Interpreting the New DGCL: An Avenue to Implementation of Fee-Shifting Provisions in Corporate Bylaws and Charters to Curtail Frivolous Strike Suits*

The law enacted by the Delaware legislature amends existing sections of the DGCL to incorporate express prohibitions against fee-shifting. Specifically, the law amends Sections 102 and 109 of the DGCL, among others. Those sections govern the contents of the certificate of incorporation and the bylaws, respectively. A precise understanding of the amendments is important for purposes of this Note, and we therefore review them in some detail.

The Act added an entirely new subsection (f) to Section 102 of the DGCL, reading as follows: "The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title."[67] The Act also amends Section 109(b), adding the following: "The bylaws may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim, as defined in § 115 of this title."[68]

Reading the amendments in conjunction, what stands out is that both prohibit "provision[s] that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation." This language thus targets fee-shifting regimes in the two most important contractual foundations of the Delaware corporation: the charter and the bylaws (in that order). One should note, however, that the amendments—applicable only to corporate charters and bylaws—do not entirely foreclose adoption of provisions imposing liability on shareholders for attorneys' fees or expenses.[69] Both amendments also focus the prohibition of fee-shifting provisions on "internal corporate claims," referencing DGCL Section 115 for definition.

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67. S.B. No. 75, *supra* note 14, at 2.

68. *Id.*

69. Specifically, shareholders are still free to enter contractual agreements amongst themselves (shareholder agreements), or with the corporation. Both of these contracts would fall outside the purview of the charter and the bylaws, and consequently outside of the prohibitions in §§ 102 and 109. *Accord* A. Choi, *supra* note 35.

Pursuant to Section 115, another new section of the Act adds to the Delaware Code, "'Internal corporate claims' means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery."[70] Section 15(i) defines internal corporate claims as those alleging breaches of duties by directors and officers of a corporation. Section 15(i) thus interacts with Sections 102 and 109 of the DGCL to prohibit loser-pays provisions that would hold plaintiff-shareholders liable for defendants' legal fees. Finally, DGCL Section 15(ii) covers appraisal actions, over which the Delaware Chancery Court is explicitly given jurisdiction under the DGCL.

Thus, the new amendments to the DGCL limit corporate fee-shifting provisions. But exactly what claims by plaintiff-shareholders are preempted? Section 15(i) defines internal corporate claims as those "based upon the violation of a duty," specifically contemplating breaches of fiduciary duties owed by directors to their corporations and shareholders. The Delaware Corporate Council defined intra-corporate claims in part by reference to fiduciary duties, recognizing that plaintiff-shareholder lawsuits alleging breaches of fiduciary duties make up a vast proportion of shareholder litigation in Delaware state courts. Indeed, in the memorandum explaining and advocating for the law, the Council describes its intent to preserve the availability of shareholder litigation:

> "Most litigation testing the propriety of conduct under either the DGCL or the common law of fiduciary duty is initiated by stockholders. The Council believes that absent legislation, many Delaware corporations will eventually adopt *ATP*-type provisions."[71]

And further:

> "It is no exaggeration to say that the Court of Chancery is an invisible presence in every boardroom where a public company deal is being considered, si-

70. S.B. No. 75, *supra* note 14, at 3.

71. *See* Delaware Corporate Law Council, *Explanation of Council Legislative Proposal* 3 (2015), http://www. delawarelitigation.com/files/2015/03/COUNCIL-SECOND-PROPOSAL-EXPLANATORY-PAPER-3-6-15-U0124513.docx.Memo.

> lently promoting compliance with its refined standards of fiduciary conduct. This constitutes a remarkable regulatory achievement. It should be recognized and protected by confiding to Chancery the prerogative to manage the docket and ultimately the destiny of Delaware-law fiduciary duty litigation."[72]

As the memorandum in support of S.B. No. 75 demonstrates, the Corporate Council sought to preserve fiduciary duty claims as an avenue for recourse for shareholders exposed to losses from corporate misconduct. The Council's memorandum, by describing the law's intended purpose, also suggests the limits of Section 102 and Section 109's reach. Conspicuously missing from the text of the statute and the Council's explanatory memorandum is any mention of claims brought under the federal securities regime.

Although there is scope for debate, this Note submits that the newly amended DGCL permits implementation of corporate fee-shifting provisions governing shareholder litigation over violations of the federal securities laws. The plain language of Sections 102 and 109, as we saw, define intra-corporate claims by reference to Section 115. And Section 115 defines intra-corporate claims as those alleging breaches of duties and appraisal actions. A loser-pays provision that by its terms applies to lawsuits brought under Section 10 and Rule 10b-5 of the Exchange Act, but not to appraisal or fiduciary duty-based claims, would not violate the DGCL. The purpose of the Act further supports this conclusion. Recall the Delaware Corporate Council's stated purpose for amending the General Law: to ensure the de facto availability of fiduciary duty lawsuits, and the continued involvement of the Chancery Court in the development of Delaware corporate law.[73] The adoption of fee-shifting regimes applicable to securities fraud lawsuits—brought under federal, not state law—would not impede either of those goals. In sum, loser-pays provisions contemplated by this Note would violate neither the letter nor the spirit of the newly-amended DGCL.

This reading of the Act is consistent with the commentary of some other observers. As Coffee concludes, the "language [of the newly adopted prohibitions against fee-shifting] did

72. *Id.* at 12.
73. *See* DiCiancia, *supra* note 47, at n.182.

not reach the securities class action."[74] DiCiancia advances a similar, though more guarded, reading of the new law: "Despite passage of Delaware's fee-shifting bylaw prohibition, uncertainty still remains as to the scope of the prohibition, specifically whether the prohibition applies to securities class action lawsuits."[75] As DiCiancia points out, some observers have taken the opposite position—reading the amended DGCL's prohibition of loser-pays provisions to include securities fraud claims.[76] Notably, Neil Cohen argues that the wording of Section 115 represents a deliberate choice of the Delaware legislature to encompass securities fraud claims in the Act's reach:

> If Sec. 115 were designed to excludes [sic.] securities fraud lawsuits it would define internal corporate claims as exclusively "claims in the right of the corporation"—instead, the definition says "*including* claims in the right of the corporation," leaving room for individual securities fraud claims.
>
> Similarly, the language of the section is not restricted to claims alleging "a violation of a duty"; rather, it includes claims "*based on* a violation of a duty." Securities fraud claims fit because they are based on a violation of a corporate officer's duty to loyally obey the law on behalf of his employer. Finally, the section does not limit coverage to claims under Delaware law. Section 115 could have been deliberately worded

74. Coffee, *supra* note 51, at 694. Coffee reasons as follows: "the Corporation Law Council defined 'intracorporate claim' to mean "claims, including claims in the right of the corporation, (I) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (II) as to which this title confers jurisdiction upon the Court of Chancery. This language reaches derivative actions, class actions based on a breach of fiduciary duty (such as the standard merger class action asserting that the directors sold the firm too cheaply), and appraisal actions." *Accord* A. Choi, *supra* note 35 ("Finally, since fee-shifting bylaws relate to the issues based on Delaware corporate law, they do not apply in the cases where shareholders bring a non-corporate claim, such as a claim based on federal securities laws that does not allege a violation of duty.").

75. DiCiancia, *supra* note 57, at 1564.

76. *See id.* at n.182 (describing commentators arguing that the statute should not be read so narrowly as to exclude federal securities fraud claims from its purview).

> to leave enough room for the Delaware courts to find that securities fraud cases are covered.[77]

Several arguments militate against Cohen's construction of the Delaware statute. First, Cohen argues that the legislature's choice to define internal corporate claims broadly (using "including" instead of a more exclusive and narrow term) evidences the intent to include securities claims in the definition. But there are different reasons why the legislature might prefer a broad definition over a narrower one; importantly, it may have wanted to include other causes of action without enumerating each one. Claims alleging corporate waste are one obvious example. The second reason why the definition of intra-corporate claims should not be read to include securities fraud claims relates back to the *ATP Tour* decision. Although S.B. No. 75 was initially perceived as overruling *ATP Tour*, the legislature went out of its way to explain that this was not the intended effect of the law's enactment.[78] The Delaware Supreme Court decision is therefore still binding precedent and a Delaware corporation could adopt a fee-shifting provision governing securities fraud claims without running afoul of the 2015 DGCL amendments, as long as it follows *ATP Tour*'s requirement of using proper procedure. Indeed, the legislature's decision not to overrule *ATP Tour* makes sense when viewed in this light: it allows the legislature to achieve its goal of keeping fiduciary duty-based claims in Delaware courts while preserving a way for corporations to screen out harmful strike suits through fee-shifting. Finally, Cohen's argument—that the legislature would have defined internal corporate claims to exclude securities fraud claims if it intended that definition—works at least as well in the opposite direction. If the corporate council had truly intended to prohibit fee-shifting after securities fraud litigation, it could have easily referenced the securities laws and Rule 10b-5 in the definition of internal corporate claims in Section 115.[79]

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77. Neil Cohen, *Does Pending Delaware Legislation Cover Fee-Shifting in Securities cases?* (June 15, 2015), https://corpgov.law.harvard.edu/2015/06/15/does-pending-delaware-legislation-cover-fee-shifting-in-securities-cases/.

78. *See* S.B. No. 75, *supra* note 14.

79. Indeed, it is hardly plausible that the legislature would choose to include securities fraud claims in the definition so vaguely and indirectly. Federal securities fraud is, after all, a statutory offense. To define securities fraud claims as "based on a violation of a duty" would be circuitous and

As we have seen, Delaware corporations and the shareholders who own their shares continue to suffer unjustified losses in value through legal costs from frivolous securities class actions. Based on a careful review of the recent decision in *ATP Tour*, and the language and purpose of the 2015 Delaware law, this Note argues that corporations have a viable defense against those strike suits. The adoption of fee-shifting provisions holds the promise of reduced meritless claims (as demonstrated in Part I), and Delaware provides its corporations with the legal basis for implementation. A note on what procedure corporations intending to implement loser-pays regimes should follow is in order here. As discussed in this Part, the two principal documents in which a Delaware corporation specifies its governing rules are the charter and the bylaws. Corporations should consider amending their charters, or adopting new bylaws, as ATP Tour did. How best to navigate the internal corporate politics (i.e., how the board should frame the proposal to its shareholders, or how the shareholders should signal interest to the board) are beyond the scope of this Note; it suffices here to point out the bylaws and charter as the main avenues of implementation.[80]

This section has also addressed some objections to my proposal. As DiCiancia and Cohen's articles demonstrate, other interpretations of Delaware law are certainly possible. Probably the greatest hurdle to corporate fee-shifting provisions, however, has yet to be addressed. The following Part takes on the issue of federal preemption, making the argument that loser-pays regimes do not conflict with the federal securities regime.

III.
Defending the Proposal

A. *The Case Against Federal Preemption*

If one accepts the arguments in the foregoing Parts, Delaware corporations and their shareholders stand to gain by implementing loser-pays provisions, and Delaware law does not

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inaccurate—in fact, a 10b-5 claim need not include any allegations of breached fiduciary duties.

80. Of course, shareholders are still free to enter contractual agreements with each other and with the corporation. This could be another, probably more costly method of adopting fee-shifting provisions.

prohibit their implementation. Unfortunately, the matter does not quite end there. The opponents of fee-shifting, particularly plaintiff lawyers, are likely to challenge the validity of fee-shifting provisions governing securities fraud claims under Rule 10b-5 and the federal securities laws. Given the novelty of Delaware's law, it is unclear how courts will construe its applicability to securities fraud class actions.[81] The issue, however, is bound to be raised in court—either in a direct challenge to a fee-shifting provision or by plaintiffs seeking a declaratory judgment to that end.[82] This Part anticipates and responds to arguments that are likely to be made against the validity of fee-shifting provisions, specifically, federal preemption.[83] Ultimately, I conclude that fee-shifting under Delaware law is not explicitly preempted by the federal securities regime and poses no obstacle to implementation of the securities laws.

Courts have recognized several flavors of preemption. First, a brief note on the general principles underlying preemption, before considering the different species of preemption in turn. The constitutional principle of federalism establishes the coexistence of two sovereigns—the republic and the states. The Supremacy Clause provides that federal law "shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."[84] As the Supreme Court held, "(u)nder this principle, Congress has the power to preempt state law."[85] There are three distinct categories of preemption. First, Congress may expressly preempt state law through explicit preemption clauses. Courts have also recognized two additional doctrines under the larger category of implied preemption: "field" (or impossibility) and "conflict" (or obstacle) preemption. The first category of preemption—express—is also the easiest to dispose of here. While there are

81. As of this writing, there are no decisions or complaints in Delaware courts that address this issue of corporate fee-shifting provisions. *Accord* DiCiancia, *supra* note 47, at 1571.

82. *Id.*; Coffee, *supra* note 51, at 701.

83. In Part II *supra* we saw how a plaintiff can argue the invalidity of a fee-shifting provision under Delaware law without reaching the issue of preemption. Part III therefore does not revisit those arguments and focuses instead on the issue of preemption.

84. U.S. CONST. art. VI, cl. 2.

85. Arizona v. United States, 132 S. Ct. 2492, 2500 (2012).

several express preemption clauses in the federal securities laws (e.g., exemptions from state securities registration requirements under Section 18 of the Securities Act), none of them preempts fee-shifting.[86]

Courts infer field preemption when, despite the absence of express preemption clauses, federal regulation has so completely dominated a field that it implicitly preempts concomitant state regulation. "The intent to displace state law altogether can be inferred from a framework of regulation so pervasive . . . that Congress left no room for the States to supplement it or where there is a federal interest . . . so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject."[87] The case for field preemption is stronger than for express preemption, but, ultimately, unconvincing. In its regulation of the securities industry, Congress has long been sensitive to preexisting state laws. For instance, Congress initially allowed the coexistence of state "Blue sky" laws with the federal securities regime, expressing its intent to not upset state regulatory efforts. This demonstrates a deliberate effort by the federal legislature to not entirely dominate the field of securities regulation, but instead to preserve state regulations.

More importantly, the U.S. Supreme Court held in a line of decisions that there is a distinction between state corporate law and the federal securities laws. In *Santa Fe Indus. v. Green*, the Court reviewed Rule 10b-5 fraud claims brought by minority shareholders following a short-form merger. The plaintiffs, however, did not allege material omissions or misstatements, a required element of that federal antifraud provision. Instead, the minority shareholders argued that the federal securities fraud rules applied to breaches of fiduciary duty.[88] The Court, however, rejected this argument, emphasizing the distinction between state corporate and federal securities laws:

> Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of

86. *Accord* Coffee, *supra* note 51, at 698.

87. Arizona v. United States, 132 S. Ct. at 2501 (internal citations omitted).

88. *See* Roberta Karmel, *Reconciling Federal and State Interest in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 504 (2003).

> the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in *Court v. Ash*, *supra*: "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[89]

The Court's reasoning demonstrates its concern for preserving state corporate law as an area of regulation distinct from the federal securities laws. It follows that, to the extent fee-shifting provisions can be framed as instruments of corporate governance, they are not preempted by the national securities regime. I submit that fee-shifting provisions fit under the umbrella of corporate state law, and are therefore not preempted by the federal securities regime.

Opponents of fee-shifting might counter that this conceives of the field too narrowly. In their view, the relevant field is not corporate law generally, but rather fee-shifting provisions governing securities fraud claims against corporate defendants. Under this conception of the field, implied preemption seems more likely.

Indeed, the federal securities regime arguably provides for a fee-shifting mechanism of its own.[90] Section 21D(c) of the Exchange Act, enacted as part of the PSLRA, instructs courts to, upon final judgment, rule on whether either party violated Federal Rule of Civil Procedure 11(b).[91] If a court finds violations of Rule 11, Section 21D(c)(3) creates a presumption that the appropriate sanction is to shift the non-violating party's legal fees to the opposing party. The federal se-

89. Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977).

90. *See* Coffee, *supra* note 51, at 700 (Coffee invokes Section 21D in his discussion of obstacle preemption).

91. Securities Exchange Act of 1934 § 21D(c), 15 U.S.C. § 78u-4 (2017) ("In any private action arising under this title, upon final adjudication of the action, the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion.").

curities regime thus arguably overlaps here with corporate fee-shifting, giving rise to field preemption concerns.

Importantly, however, the analogy between fee-shifting bylaws and Section 21D(c) should not be overstated. Section 21D(c)(3)(A)(ii) provides that a court must find a "substantial failure" to comply with Rule 11(b). Further, the sanction for abusive litigation under Section 21D merely starts with the presumption of fee-shifting—but it need not end there. That is, courts may decide to fashion a different sanction than fee-shifting. The federal securities laws thus leave ample space for shareholders to adopt provisions triggered by a lower standard than "substantial failure," and providing for their desired remedy (i.e., fee-shifting) with certainty and definitude.[92] I therefore submit that Congress has not so thoroughly regulated this field—even if we define it narrowly as fee-shifting applicable to securities fraud claims—as to preempt state law.

Finally, a court may find fee-shifting provisions in corporate bylaws or charters preempted for conflicting with federal securities laws. Obstacle preemption is likely the strongest basis for finding implied preemption of state law here. Coffee makes the argument that corporate loser pays regimes would frustrate "important federal policies" enacted by the PSLRA.[93] As discussed in Part I above, Congress enacted the PSLRA to limit frivolous litigation. One of the goals of that end was ensuring that adequate plaintiffs be made lead plaintiff in class actions. Specifically, the PSLRA creates a rebuttable presumption that the lead plaintiff in a class action is the stakeholder with the largest financial stake in the litigation.[94] The effect of the law was that institutional investors, particularly pension funds, are now the most frequently chosen lead plaintiffs in securities fraud class actions. The reasoning behind this reform was that a lead plaintiff with significant financial interest

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92. Indeed, this point bears repeating: by many accounts, and as I argue in Part I, the PSLRA was at best moderately successful in decreasing abusive litigation. Especially with regard to judicial involvement in fee-shifting, the evidence suggests the PSLRA has failed to create a reliable and consistent outcome. Baker, Perion, and Silver, for example, find "judges appear to cut fees randomly, typically with very little explanation for why they did so." Lynn Baker, Michael Perion & Charles Silver, *Is The Price Right? An Empirical Study of Fee-Setting In Securities Class Actions*, 115 COLUM. L. REV. 1371 (2015).

93. Coffee, *supra* note 51, at 698.

94. *See* A. Choi, *supra* note 35; *accord* S. Choi, *supra* note 17, at 204.

in the dispute would have stronger incentives to monitor class counsel, and thereby reduce the likelihood of abusive litigation.

The PSLRA thus overhauled the prior practice in securities class action litigation, where plaintiff lawyers would draw on so-called "stable" plaintiffs—nominal shareholders who own mere fractions of the corporation—to be plaintiffs repeatedly in class actions.[95] The concern over fee-shifting provisions here is that public pension funds might be deterred from being lead counsel in a class action, because their expected return on the lawsuit declines with fee-shifting. Specifically, in Coffee's words, "there is a substantial asymmetry between the pension fund's likely gains and losses."[96] The lead plaintiff pension fund can only recover in proportion to its ownership (when the case settles or returns a favorable verdict), but stands to foot the whole bill if the plaintiff loses. According to that theory, institutional investors will decline to act as lead plaintiffs, thereby restoring the previous status quo of "stable" lead plaintiffs in securities class action litigation. Thus, Coffee: "If this happened, Congress's intent would have been frustrated."[97]

The argument for obstacle preemption certainly has merit. I submit, however, that fee-shifting ultimately does not create an obstacle to the federal securities regime: quite the opposite, it affirmatively furthers its purpose. As with field preemption, a reviewing court's analysis is guided by "the purpose of Congress, [which] is the ultimate touchstone in every preemption case."[98] Further, in the absence of express preemption courts follow a presumption against implied preemption.[99] This raises the bar for a finding that fee-shifting frustrates congressional purpose underlying the securities regime.

95. *See* Schwartz & Appel, *supra* note 9, at 40.

96. Coffee, *supra* note 51, at 609.

97. *Id.* at 699.

98. Medtronic, Inc. v. Lohr, 518 U.S. 470, 485 (1996) (internal quotation marks omitted).

99. "[I]n all pre-emption cases, and particularly in those in which Congress has legislated in a field which the States have traditionally occupied, we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." (internal citations omitted) Wyeth v. Levine, 555 U.S. 555, 565 (2009).

But courts will rebut the presumption if the federal policies are shown to be frustrated by state law. Let us then probe the arguments in favor of obstacle preemption more deeply.

First, for the theory espoused by Coffee—that fee-shifting deters institutional plaintiffs from taking the lead—to hold, institutional investors must have a net expected loss from being lead plaintiff.[100] However, there are reasons to question the conclusion that institutional investors will indeed have negative expected returns on leading the class in a securities class action. For one, shareholder concentration has been on a steady rise for many years now. This trend is driven by the growth in institutional investors, who now hold vast proportions of publicly traded corporations' securities.[101] As the institutional investors' ownership increases, so does their share in the recovery from the settlements. More importantly, Coffee's estimation of an investor's return on becoming lead plaintiff does not account for the change in strength of claims brought after introduction of fee-shifting.[102] The great benefit of fee-shifting, after all, is screening out frivolous claims. Therefore, under fee-shifting we expect that the most meritorious claims—those with admission of corporate wrongdoing, gov-

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100. Recall from the discussion in Part I that plaintiffs will be deterred from bringing suit if their expected return from the lawsuit is negative. The same intuition applies here regarding an institutional investor's decision to be lead plaintiff as it does to plaintiffs' incentives to bring suit generally. See *supra* Part I for the discussion of how expected return on a claim affects a plaintiff's decision to litigate.

101. MATTEO TONELLO & STEPHAN RABIMOV, THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 27 tbl.13 (2010) (Conference Board Research Report, No. R-1468-10-RR, 2010), http://ssrn.com/abstract=1707512 (describing how institutional ownership in U.S. public corporations grew to 73% in 2009).

102. Specifically, Coffee assumes a 50% chance of success (i.e., settlement), 1–3% recovery of investor losses, and cost of failure of at least $10 million. *See* Coffee, *supra* note 51, at 699. Coffee concludes that these figures lead to an "asymmetry between the pension fund's likely gains and losses," making it hard for the fund to justify being lead plaintiff to its pensioners. Coffee is right to point out that some claims will have a negative expected return, and pension funds will be deterred from being lead plaintiff in class actions based on those claims. However, this paints the picture in strokes too broad. The beauty of fee-shifting, as we saw, is that it incentivizes meritorious claims—those with high likelihood of success (and higher than 50%). As the strength of the claim increases, so does the pension fund's (or other institutional investor's) expected return on litigating the claim and being lead plaintiff.

ernment sanctions, etc.[103]—will still be brought.[104] Therefore, under a loser-pays regime, institutional investors will still have the incentive to be lead plaintiff, but only in class actions based on claims exhibiting the factors we associate with merit.[105]

A related but distinct point also raises doubt over the supposed deterrent effect of fee-shifting on institutional investor lead plaintiffs. As we saw in Part I, the incentives of plaintiffs to bring suit are sensitive to the design of the fee-shifting regime. In particular, whether the provision exhibits symmetry, or is asymmetric as in *ATP Tour*, is essential to how the provision affects plaintiffs' incentives to litigate. The argument for obstacle preemption seems to assume asymmetric fee-shifting to the detriment of plaintiffs à la *ATP Tour*.[106] However, as we saw, symmetric fee-shifting actually incentivizes litigation of meritorious suits while also screening out frivolous ones.

Finally, even assuming that fee-shifting deters institutional investors from becoming lead plaintiffs, this does not make implied preemption a forgone conclusion. Coffee identifies the goal of the federal securities laws, for purposes of the preemp-

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103. *See* STARYKH & BOETTRICH, *supra* note 13, at 35. Examples of these factors are admitted accounting irregularities and being sanctioned by the government or a regulatory agency. The effect of fee-shifting is to increase the cost of litigating claims with the smallest likelihood of success. And these are precisely the frivolous claims that ought to be deterred. At the same time, once these claims fall away, the median settlement value increases.

104. Let's assume the defendant corporation has been sanctioned by the SEC, and admitted to accounting irregularities. If the lead plaintiff then reasonably has a 90% probability of achieving settlement for alleged investor losses in the order of several billions of dollars, a pension fund could surely justify being lead plaintiff to its pensioners.

105. Ultimately, this assertion can be tested empirically by estimating settlement amounts, percentage recovery by the lead plaintiff of the settlement amount, and the likelihood of settling. That estimation is beyond the purview of this Note; it does point to a future area for research in evaluating the desirability of corporate fee-shifting. For now, it suffices to emphasize the larger point that fee-shifting theoretically incentivizes the lead plaintiff to litigate stronger claims which also have higher expected settlement amounts. How well are these lead plaintiffs positioned to assess the merit of securities fraud claims? Very well. Years of experience as lead plaintiffs and the publicly available body of research by firms like Cornerstone Research and NERA make clear what factors distinguish meritorious from frivolous claims.

106. *See* Coffee, *supra* note 51, at 698–99. He only mentions shifting in the direction of plaintiffs, and invokes the "substantially all" recovery standard used in the ATP Tour provision.

tion analysis, as the lead plaintiff presumption enacted by the PSLRA. However, a better view is that the relevant goal of the PSLRA (and, more broadly, the federal securities regime) is the overarching objective to reduce frivolous litigation. The presumption in favor of more invested plaintiffs taking the lead is just a means to achieve that overarching goal, rather than an end in itself. Framed this way, the goal of the federal securities laws is hardly obstructed by corporate fee-shifting.

Indeed, it is likely that even with a reduction in institutional investors acting as lead plaintiffs, fee-shifting will achieve a net decrease in frivolous litigation. Recall that the objective of the PSLRA's presumption in favor of plaintiffs with the biggest financial interest as lead plaintiffs was to enhance the incentives of lead plaintiffs to monitor class counsel. This in turn was thought to enhance restraint by lead plaintiffs over plaintiff lawyers' inclination to frivolously litigate. One important point should allay any concern that fee-shifting will frustrate the goal of reducing strike suits: once fee-shifting is introduced, lead plaintiffs actually stand to lose money if they litigate frivolous claims. Therefore, fee-shifting provisions promoted by this Note would enhance a plaintiff's incentive to monitor class counsel, and disincentivize litigation of frivolous claims.[107]

The preemption challenge to corporate fee-shifting certainly has force. Ultimately, however, for the foregoing reasons, I submit that the federal securities regime does not preempt—explicitly or implicitly—fee-shifting bylaws or charter provisions. Indeed, for the reasons we observed, symmetric fee-shifting furthers the purpose of the federal securities laws by screening out frivolous claims.

B. *A Framework for Judicial Review*

By now my position—in favor of fee-shifting, and against preemption—should be clear. The foregoing makes the case that fee-shifting bylaws are consistent with, and in furtherance of, the federal securities regime. The analysis would end here, if no relevant agency had taken a position on the preemption

107. Perhaps lead plaintiffs in securities class actions would even negotiate for indemnity from lead counsel to act as lead plaintiff. In that case, lead counsel would be especially interested in pursuing only meritorious claims, and the need to monitor would diminish accordingly.

question. Where a federal agency expresses a view on preemption, however, courts may acknowledge the agency's view. To what extent courts defer to agency positions on implied preemption is an important and unresolved question. Relatedly, there is also uncertainty about what role the presumption against preemption plays in the context of securities fraud.

This Part addresses these questions about how courts should resolve implied preemption challenges to loser-pays bylaws.[108] The doctrinal approach by a reviewing court turns largely on three issues: the import of the presumption against preemption, whether to consult the underlying regulator, and how much deference the regulator's position receives. In what follows, I propose an analytical framework to guide courts in their assessment of these issues to resolve implied preemption questions. Finally, I apply that framework to the question of implied preemption of fee-shifting bylaws, concluding that they are not preempted.

Recall my earlier assertion that courts apply a substantive canon—the presumption against preemption—to cases of implied preemption.[109] While any advocate arguing against preemption would surely invoke the presumption, the reality is that courts have not applied the doctrine straightforwardly. Indeed, as one observer puts it, the field is a "muddle" of confusion.[110] The Supreme Court's inconsistent application of the doctrine is well-documented.[111] Given the Court's apparent ambivalence toward the presumption, how are judges to decide whether to apply the canon?

There is limited case law on preemption of state law by the federal securities regime.[112] Nonetheless, I submit that relevant Supreme Court jurisprudence favors application of the anti-preemption presumption to a challenge of fee-shifting by-

108. *See* Coffee, *supra* note 51 (observing that the preemption question will eventually take "center stage").

109. *Supra* notes 98–99 and accompanying text.

110. Ernest A. Young, *The Ordinary Diet of the Law: The Presumption Against Preemption in the Roberts Court*, 2011 SUP. CT. REV. 253, 256 (2012).

111. *See* William W. Buzbee, *Preemption Hard Look Review, Regulatory Interaction, and the Quest for Stewardship and Intergenerational Equity*, 77 GEO. WASH. L. REV. 1521, 1563 (2009). *Accord* Young, *supra* note 110, at 277–78 (describing how the Supreme Court sometimes mentions the presumption, other times ignores it, but insists on its continued relevance).

112. *See* Anthony E. Szydlowski, *Preemption in the Securities Industry: A Diminished Standard?*, 74 ST. JOHN'S L. REV. 259, 266 (2012).

laws based on implied preemption. Several Supreme Court decisions, albeit from contexts outside of securities law, demonstrate a pronounced reluctance to find preemption in the absence of clear congressional intent to that effect.[113] As Facciolo notes, the decisions in *O'Melveny*, *Freightliner*, and *Cipollone* suggest that the Court would not find congressional intent to preempt state securities laws without express statutory language to that effect. Facciolo argues, "If the securities industry wants to be subject exclusively or primarily to uniform federal law, at least in certain business lines, there is a clear need to lobby Congress in the legislative process and the SEC in the rulemaking process to clearly enunciate the preemptive scope of the federal securities laws and SEC rules and regulations."[114] So, while my research indicates no case law directly on preemption of fee-shifting provisions by the federal securities laws, the Court's use of the presumption against preemption in analogous contexts recommends its application here too.

However, one might fairly ask, does the Supreme Court's historically inconsistent application of the presumption against preemption disfavor its application here? After all, the cases cited by Facciolo are all from before 1995, and the federal laws at issue, as well as the composition of the Court, have changed. In *Geier v. Am. Honda Motor Co.*, a more recently decided preemption case, the Court did not even mention the presumption against preemption.[115] And in *Wyeth v. Levine*, the latest Supreme Court decision in this area, Wyeth argued that the presumption is entirely inapplicable to implied preemption analyses.[116] However, the Court firmly rejected this line of argument, affirming its commitment to the presumption against preemption in the absence of clear congressional intent to preempt.[117] Courts deciding implied preemption

113. Francis J. Facciolo and Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934,* 1995 COLUM. BUS. L. REV. 525, 534–38 (1995) (discussing the holdings in *O'Melveny*, *Freightliner*, and *Cipollone*).

114. *Id.* at 538.

115. Mary J. Davis, *The "New" Presumption Against Preemption*, 61 HASTINGS L.J. 1217, 1235 (2010).

116. Wyeth v. Levine, 555 U.S. 555, 565, n.3 (2009).

117. *Id.*

challenges to fee-shifting bylaws would therefore do well to apply the presumption against preemption—the doctrine most consistent with federalism values and Supreme Court precedent.

Besides applying the presumption against preemption, courts must also decide whether to consult the underlying regulator—here the SEC—in adjudication of preemption challenges. The reasons for deferring to agencies on questions of implied preemption are familiar justifications for the administrative state: agencies can bring to bear their institutional expertise, and are comparatively less prone to political influence. Indeed, some commentators have argued that agencies are uniquely well-positioned to assess preemption challenges.[118] It stands to reason, then, that courts adjudicating preemption challenges in the securities industry should consider the position of the SEC on questions of implied preemption. However, this raises a final, related question: How much deference should courts accord the underlying regulator's view?

To provide a preliminary answer, in lawyerly fashion: it depends. A more substantive response requires a deeper dive into relevant administrative law, particularly, into judicial review of agency decisions. Under the *Chevron* framework, courts defer to agency interpretations of ambiguous organic statutes so long as those interpretations are reasonable.[119] After the Supreme Court decision in *Mead*, agencies only receive *Chevron* deference to the extent that they use rules that have the "force of law."[120] To the extent agency interpretations do not have the "force of law," courts still accord them *Skidmore* respect if they persuade the court.[121] How much deference courts accord the SEC's view on preemption of fee-shifting

118. Catherine M. Sharkey, *Products Liability Preemption: An Institutional Approach*, 76 GEO. WASH. L. REV. 449, 477 (2008) ("With respect to answering the key regulatory policy issue at the heart of the preemption query—namely, whether there in fact should be a uniform federal regulatory policy—federal agencies emerge as the institutional actor best equipped to provide the answer").

119. *Chevron, U.S.A., Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 844 (1984).

120. *United States* v. *Mead Corp.*, 533 U.S. 218, 226–27 (2001) (holding that *Chevron* deference to agency rules is only appropriate where Congress delegated authority to make rules carrying the force of law—for instance, by giving the agency adjudication or notice-and-comment rulemaking power).

121. *Id.* at 228.

provisions by the Exchange Act ostensibly turns on how the agency reached its interpretation.

My research indicates that the SEC weighed in on preemption of fee-shifting bylaws just once. In a speech at Tulane University Law School, former Commission Chair Mary Jo White commented, "I am concerned about any provision in the bylaws of a company that could inappropriately stifle shareholders' ability to seek redress under the federal securities laws."[122] Chair White's speech reflects her concern that corporate fee-shifting provisions may interfere with private enforcement of the securities regime. Evidently, the SEC views Delaware fee-shifting bylaws as conflicting with—and hence preempted by—the federal securities laws.

Let us assume that a loser-pays bylaw is challenged on implied preemption grounds, and the reviewing court considers the regulator's position. At least in theory, the court would apply the *Chevron* framework described above. As of now, the court would have nothing more to draw on than Mary Jo White's remarks from her speech. Those remarks clearly do not carry the "force of law," and therefore do not pass Step Zero en route to *Chevron* deference.[123] Nor would the court defer to the agency's position under *Skidmore*, because the relatively informal remarks are unlikely to "persuade" the court.

However, when the issue gets litigated the SEC could advise the court on its views of preemption in a more formal manner—for instance, by submitting an amicus curiae brief.[124] If the SEC spells out its position in an amicus brief, this brings us to a more nebulous area of administrative law. Again, the *Chevron* framework theoretically applies: agency amicus briefs do not carry the force of law, but they may persuade the court and receive *Skidmore* deference. In practice, however, the judicial record of deferring to agency views on implied preemption is hardly transparent or systematic. Schol-

122. Stephanie Russell-Kraft, *SEC's White 'Concerned' About Some Fee-Shifting Bylaws*, LAW360 (Mar. 19, 2015, 5:30 PM), https://www.law360. com/securities/articles/633617/sec-s-white-concerned-about-some-fee-shifting-bylaws.

123. That is to say, the SEC did not employ its notice-and-comment rulemaking power to issue a fee-shifting prohibition.

124. This scenario is not purely hypothetical. Indeed, the former chair suggested in her speech that the agency is closely following the fee-shifting debate and might submit an amicus brief when the opportunity arises. *See* Russell-Kraft, *supra* note 122.

ars have documented the Supreme Court's consideration of agency interpretations without resort to the *Chevron* framework—a phenomenon Sharkey calls "cryptic reliance" on agency positions.[125]

To summarize, agencies are well-positioned to assess the merits of preempting state laws. In theory, courts follow the *Chevron* framework to evaluate an agency's position, however, in practice, they sometimes defer to an agency's position without explicitly following *Chevron* or otherwise explaining their deference to the agency. In light of this reality, the normative question posed earlier sounds especially urgent: How much deference should courts accord agency views on implied preemption? Several commentators have suggested doctrinal frameworks to guide judicial review in these cases. William Buzbee, for instance, suggests that the Supreme Court apply a "Hard Look" review to agency assertions of preemptive effect.[126] Sharkey has proposed an "agency reference model" for courts to elicit agency views on preemption in products liability cases.[127] She concludes that the *Skidmore* level of deference to agency interpretations is desirable here.[128] Buzbee and Sharkey advance different standards of review, but they share an important characteristic: both call on the reviewing court to carefully scrutinize the agency's basis for asserting preemptive effect.

In my view, how we name the doctrinal framework for courts to follow is of secondary importance. To be sure, consistent adherence by the judiciary to one doctrine—whether it be hard look review or *Skidmore* deference—is desirable for obvious reasons. But if past is prologue the Supreme Court is in no rush to formally adopt a doctrinal framework for reviewing agency assertions of preemptive effect.[129] Here is where I part

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125. Catherine M. Sharkey, *What Riegel Portends for FDA Preemption of State Law Products Liability Claims*, 103 Nw. U. L. Rev. 437, 431 (2009).

126. Buzbee, *supra* note 111, at 1558, 1572–73 (arguing that a "Hard Look" standard of review, adopted by the Court in *State Farm*, should apply to agency assertions of preemptive effect; Buzbee argues this review will incentivize agencies to engage in an "open and deliberative process" before claiming preemptive power).

127. Sharkey, *supra* note 118, at 485.

128. *Id.* at 492–93, 498.

129. As we saw, there have been numerous analytical frameworks proposed for adoption by the Supreme Court. Sharkey advanced her agency reference model in two separate articles predating the *Wyeth* decision, yet

ways with Sharkey and Buzbee: I argue that it is less important that the Court categorize its analytical framework as either Hard Look review or *Skidmore* deference. The more important objective is that courts apply a searching, careful scrutiny to agency interpretations regarding implied preemption—whether they call it Hard Look review, *Skidmore* deference, or supply no label whatsoever. This incentivizes agencies to do (and show) their work: using their most inclusive and deliberative rulemaking procedures promises *Chevron* deference, but unfounded claims of preemptive power will not pass careful judicial scrutiny.

Finally, consider how this prescription for judicial review applies to the context of fee-shifting provisions. Assume again that a loser-pays bylaw is challenged in court on implied preemption grounds. A reviewing court would be ill-advised to put much stock in the informal remarks of the SEC's former chair. If the SEC submits an amicus brief arguing in favor of implied preemption, the court should then probe the record for evidence showing that the agency brought its expertise to bear on the question of preemption. Deference to the SEC's assertion of preemptive effect then turns on the robustness of the agency's reasoning—ideally supported by calculations demonstrating net benefits from preemption. The onus is therefore on the agency to convince the court that—contrary to the arguments I make in this Note—fee-shifting bylaws frustrate the federal securities regime. This framework thus incentivizes agencies to apply their expertise to preemption questions, and directs courts to subject agency interpretations to careful, searching review.

Conclusion

The debate over corporate fee-shifting in Delaware goes on. This Note advances the position that fee-shifting, in furtherance of the federal regulatory design, offers shareholders the opportunity to reduce frivolous litigation by raising the costs of litigating meritless claims. At the same time, shareholders and directors should be sensitive to the importance of calibrating the fee-shifting provision for optimal results. Loser-pays rules have the potential to work as blunt tools in circum-

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the Court declined to adopt it or otherwise clarify its framework for determining the appropriate level of deference.

stances where more focused instruments—like scalpels rather than sledgehammers—are needed. But as new research like Choi's demonstrates, by implementing symmetrical fee-shifting provisions, one can achieve the desired result of deterring frivolous lawsuits while retaining the incentives to pursue meritorious claims.

The legal challenges to the widespread adoption of fee-shifting in Delaware are not insignificant. Courts are bound to weigh in on the challenges to fee-shifting, particularly federal preemption concerns. This Note makes a proactive attempt at demonstrating how corporate loser-pays bylaws and charter provisions not only avoid running afoul of congressional intent but also further the achievement of the federal securities regime's goals. The Note therefore both urges fee-shifting as a desirable policy instrument, and suggests a line of argumentation to rebut legal challenges to its implementation.

Finally, we considered how courts should adjudicate legal challenges based on implied preemption. This Note advances a framework for judicial review that includes three major ingredients. First, courts deciding preemption challenges in the securities context should follow the presumption against preemption—a doctrine that promotes federalism values and is firmly grounded in Supreme Court precedent. Second, courts should draw on the expertise of the underlying regulator to resolve questions of implied preemption. The *Chevron* and *Skidmore* doctrines theoretically apply to judicial review of agency interpretations. However, the historical record shows that courts sometimes defer to agencies without invoking these doctrines. The third component of the analytical framework seeks to remedy that trend: courts should carefully scrutinize an agency's assertion of preemptive effect. If a reviewing court finds that the agency brought its expertise to bear on the question of preemption, it may conscientiously defer to the regulator. Lastly, we saw how this analytical framework applies to corporate fee-shifting provisions in Delaware. The SEC has not used its notice-and-comment rulemaking authority to regulate loser-pays bylaws; Mary Jo White did however articulate the agency's position that corporate fee-shifting conflicts with the federal securities regime. If a loser-pays provision is challenged on implied preemption grounds and the SEC submits an amicus brief, the reviewing court, following the framework outlined above, should accord deference in proportion to evidence that the agency exercised its expertise. Until that time, this Note sets out the reasoning why fee-shifting provisions stand to weed out strike suits and maximize shareholder value.