ARTICLES

PRIVATE EQUITY'S THREE LESSONS FOR AGENCY THEORY

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Agency theory posits that separation of ownership and control opens up a governance deficit.[1] The shareholder principals, it says, have a collective action problem that leaves them without an economic incentive to monitor their manager agents.[2] The theory, in its original form, held out the hostile takeover as a cure.[3] Unfortunately for the theory, the hostile takeover went on to evolve as a transaction mode too costly to serve as a universal governance corrective.[4]

Still looking to make up the deficit, agency theorists turned to holders of large blocks of stock.[5] But this inquiry led to an intractable tradeoff. Separation of ownership and control holds out the benefit of liquidity and easy exit through the trading market even as it leaves the manager-shareholder incentive problem unsolved.[6] Meanwhile, the blockholder alternative reduces liquidity even as it ameliorates the manager-shareholder incentive problem.[7] As a result, blockholding poses its own incentive problem. A rational blockholder is unlikely to give up the benefits of liquidity in order to extract gains from improved governance if required to share those gains with the rest of a free-riding shareholder population.[8] A different sort of governance dysfunction follows—a rational blockholder will seek compensation for its governance contribution through self-dealing transactions, insider trading, or some other unshared mode of return.[9]

The blockholder inquiry having led to an impasse, agency theorists look for other means to circumvent the tradeoffs. This search returns again and again to the sleeping giant of corporate governance, the institutional investor community.[10] The giant, although fitfully wakeful, has not risen from its bed.

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1. Jean Tirole, *Corporate Governance,* 69 ECONOMETRICA 1, 1 (2001).
2. *See generally id.*
3. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 233–36 (2008).
4. *Id.*
5. *See* Frank Heflin & Kenneth W. Shaw, *Blockholder Ownership and Market Liquidity,* 35 J. FIN. & QUANTITATIVE ANALYSIS 621 (2000).
6. *See generally id.* at 622.
7. *Id.*
8. *See* Joseph A. McCahery & Erik P.M. Vermeulen, *Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda,* AMSTERDAM CENTER FOR CORPORATE FINANCE, *available at* http://www.accf.nl/uploads/corp%20gov%20crises%20and%20related%20party%20transactions.pdf.
9. *See* Heflin & Shaw, *supra* note 5, at 622.
10. Tirole, *supra* note 1, at 2.

Private equity buyouts occupy an anomalous but intriguing place in this unsettled governance picture. Buyouts carry blockholding out to its logical conclusion, completely removing the target firm from the equity trading market and, in so doing, making the ultimate liquidity sacrifice.[11] A given buyout is conducted by a limited partnership (the "buyout fund") that is organized and promoted by a private equity firm (the "buyout firm").[12] The buyout firm serves as the buyout fund's general partner, selecting the going private target, effecting the buyout, and undertaking the role of target firm monitor.[13] The buyout fund, which draws its risk capital from institutional investors who take the fund's limited partnership shares, is the purchasing entity.[14] The fund takes the majority equity stake in the target, with the target's managers as the only minority shareholders.[15] The buyout fund's limited partnership agreement, along with the transaction's other operative contracts, allocates the risks and returns between the buyout firm and the outside institutional investors.[16]

The buyout target emerges from the control transfer with a governance structure that approaches the agency ideal.[17] Its incumbent managers get high-powered incentives as minority shareholders.[18] Even better, the arrangements effected by the buyout fund's limited partnership agreement solve the blockholder incentive problem. The buyout firm, as general partner, has a high-powered incentive to monitor, and all matters respecting allocation of risk and returns between the monitor and the outside equity investors are determined ex ante, eliminating free rider and aggregation problems.[19]

Buyouts accordingly have a mesmerizing effect on some agency theorists, who propose ownership by buyout funds as a strong form solution to the problem of separated ownership and control.[20] But liquidity remains a problem that diminishes the buyout's plausibility as a universal governance solution. Investors readily sink capital into publicly traded equities on an indefinite durational basis, but only if given assurance of trading liquidity.[21] Private equity contracts finesse the problem by limiting

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11. Harry DeAngelo et al., *Going Private: Minority Freezeouts and Stockholder Wealth,* 27 J.L. & ECON. 367, 374 (1984).
12. *Id.* at 367.
13. *Id.*
14. *Id.* at 370.
15. *Id.* at 367.
16. *Id.*
17. DeAngelo et al., *supra* note 11, at 367.
18. *Id.*
19. *Id.*
20. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept.–Oct. 1989), revised 1997, *available at* http://ssrn.com/abstract=146149 [hereinafter *Eclipse of the Public Corporation*]; *see also* Gilson & Whitehead, *supra* note 3, at 233–236.
21. *See* Garry D. Bruton et al., *Corporate Restructuring and Performance: An Agency Perspective on the Complete Buyout Cycle*, 55 J. BUS. RES. 709, 710 (2002).

the buyout fund's duration, putting the buyout firm on a tight, ten-year leash, with liquidation and cash distribution at the end of the term.[22] Public markets loom large once the liquidation phase is reached. The most profitable subsets of buyout targets are liquidated through initial public offerings prior to the ten-year terms' expiration.[23] Many other targets are purchased by publicly traded companies. Buyouts accordingly do not trump trading markets; they coexist with them in a symbiotic relationship.[24] Even as buyouts pose a structural alternative to separated ownership and control, their business model exploits and depends on market liquidity.

Thus does the prevailing view about buyouts draw on the framework of agency theory and looks for lessons respecting the theory's unsolved problem, the separation of ownership and control. This Article, in contrast, changes the inquiry's direction. Where agency theory focuses on the buyout's implications for separated ownership and control, this Article considers the buyout's implications for agency theory. It points out, in its three parts, what the buyout tells us about agency.

Part I addresses agency theory's three-way association among control transfers, governance discipline, and hostile takeovers, suggesting that this triptych needs to be unbundled and reconsidered. Given the recent move to buyouts, we no longer need assume that hostility is the acquisition mode best-suited to post merger disciplinary governance. Today's disciplinary mergers are friendly. Part II considers agency theory's account of buyout motivations. The theory posits a transactional margin at which agency cost reduction determines control outcomes.[25] On first inspection, private equity buyouts neatly fit this picture. But a deeper examination shows that buyouts are driven by the economics of leverage, with agency cost reduction taking only a secondary motivational role. Part III looks at financial returns, showing that even as buyouts ameliorate the agency costs of separated ownership and control, buyout structures implicate their own agency costs in the form of fees paid to buyout firms. Studies show that buyout firms take so much of the transactional gain that the institutions investing in buyout funds would be better off investing in market indices.[26] There results question the line of agency theory that looks to institutional investors as agency cost reducing monitors. There also result questions respecting buyouts' incentive compatibility, questions raising doubts as to whether buyout governance structures hold out a template for improving corporate governance generally, even as a matter of agency theory.

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22. Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 UNIV. OF TORONTO L. J. 101, 160 (2008).
23. *See* Bruton et al., *supra* note 21, at 710.
24. *Id.*
25. *See* Tirole, *supra* note 1, at 2.
26. *See* discussion *infra* Part III.

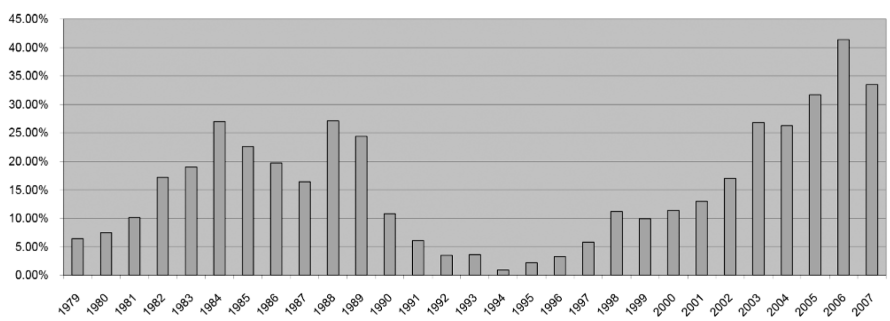
I. BOOM AND BUST: IMPLICATIONS FOR AGENCY THEORY

Private equity buyouts and hostile takeovers pursue different transactional routes to the common goal of governance discipline, the former cooperative and friendly and the latter uncooperative and unfriendly. This Part compares their records of occurrence across the past three decades to show the buyout's emergence as the more salient mode of disciplinary control transfer. The comparison suggests that agency theory needs to relax its categorical association between hostile transactions and disciplinary results.

A. BUYOUT CYCLES

Private equity buyouts occur in cycles.[27] Between 1979 and 2007, two cycles of buyouts occurred: the first peaked in the 1980s, and the second began in the late 1990s, peaked in 2006 (or, more precisely, in the first half of 2007) and then began to decline.[28] Between the two booms was a spectacular bust from 1990 to 1997.[29] Another bust appears to be in its early stage—preliminary figures for 2008 show the dollar volume of buyouts at less than one-third of the 2007 volume.[30]

Figure I: Buyouts as a Percentage of Total Public Acquisitions, 1979–2007[31]



27. *See* Figure I.

28. *See* Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 123 (2001).

29. *Id*. at 122–123.

30. *See* Amerbereen Choudhury, *Cerebus, Carlyle Profit From Sales in LBO Drought*, Aug. 13, 2008, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=aJGREa0y4Qvg.

31. Figure I presents Mergerstat's annual data on the number of "going private" transactions as a percentage of total public company acquisitions. Mergerstat defines "going private" as an acquisition of a publicly-traded company by a private investment group or individual where the buyer is not an operating business. The data thus picks up classic 1980s leveraged buyouts and their evolutionary successors, contemporary private equity transactions.

Figure I, which is based on a number of transactions, somewhat overstates the salience of buyouts in the wider merger market. A comparison based on transaction value rather than numbers of transactions would show a smaller percentage of total acquisitions for going private transactions, because buyouts tend to involve smaller firms.[32] The dollar amounts remain impressive, however. During the recent buyout boom, buyouts went from an aggregate $154 billion in 1999 to $907 billion in 2006, with a 29 percent cumulative annual growth rate.[33] Private equity's value-based share of merger activity increased in tandem, showing a cumulative annual growth rate of 27 percent from 1999 to 2006.[34] Dollar amounts of individual buyout deals rose as the cycle peaked: between 2005 and 2007, the average buyout tripled in size to weigh in at $1.3 billion.[35]

B. The First Boom and the Agency Account

A widely-accepted agency story accompanied the buyout's first rise during the 1980s. The story followed from Michael Jensen's account of suboptimal management performance and correction through capital market intervention.[36] For Jensen, the outbreak of manager-shareholder conflict stemmed from the managers' habit of reinvesting "free cash flow," defined as cash flows from operations in excess of those necessary to fund positive return investments.[37] The money, said Jensen, was being put into unproductive plant and value-reducing acquisitions when it should have been paid out to the shareholders.[38] Hostile takeovers and friendly leveraged buyouts were said to address the problem.[39] Both paid shareholders a premium over market, in effect making up for past deprivations of cash flow.[40] They also led to divestment of subpar acquisitions and to redirection of investment policy in productive directions.[41] Leverage also played a part in this disciplinary redirection of corporate focus.[42] A higher level of corporate borrowing raised the rate of return on equity, even as it lowered the corporation's overall cost of capital due to tax savings.[43] More debt also encouraged management discipline on

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32. A comparison of Mergerstat's annual record of total public company acquisitions and its annual record of going private transactions establishes this, showing that private equity dollar volume approximated its share of total acquisitions only at the peak of the recent cycle.
33. *See* Blackstone Group L.P., Registration Statement (Form S-1), at 115 (Mar. 22, 2007).
34. *Id.*
35. *Id.*
36. *See* Michael C. Jensen, *Agency Costs, Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (Papers & Proceedings 1986).
37. *Id.* at 324.
38. *Id.* at 328.
39. *Id.*
40. *Id.*
41. *Id.*
42. Jensen, *supra* note 36, at 328.
43. *Id.*

a going-concern basis.[44] Given the mandatory nature of the debt payments, they deterred ongoing waste of cash, thus returning the capital to the markets.[45]

Jensen took the governance and capital structure of buyouts as an agency solution to separated ownership and control, suggesting that the "LBO Association," with its combination of high leverage, control in the hands of market intermediaries, and high powered incentives for managers, amounted to a robust one-size-fits-all mode of governance.[46] But the buyout's disappearance in the early 1990s put an end to the claim of an early, levered disappearance of separated ownership and control. At no time since then has high leverage been seen as suited to a permanent place in corporate capital structures or as the *sine qua non* of shareholder value maximization. The rewards only intermittently outweigh the risks.

The buyout retained its prestige in agency theory even as new deals disappeared. This reputational persistence stemmed partly from the attribution of the early 1990s shift away from leverage to regulatory constraints.[47] The continued vitality of the shareholder value norm and its dispersion into management suites also played a role. The 1980s came to be seen as a period of shock therapy that redirected management priorities in a more productive direction, revitalizing managers normally slow to adapt to changed conditions.[48] Newly enabled capital markets imposed responsive strategies as management learned its lesson. In the 1990s, managers, incentivized by stock option compensation, voluntarily downsized their operations and unbundled conglomerates.[49] According to agency theorists, the shareholder value approach became dominant because the capital markets had a comparative advantage in initiating structural reforms necessitated by deregulation and technological change.[50] Buyouts were a means to that end.

The buyout's good reputation also found support in empirical studies. These looked at the 1980s' deals from various points of view and confirmed the story of governance improvement.[51] The increased leverage and incentive realignment was shown positively to affect operating performance

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44. *Id.*

45. *Id.* at 323–24.

46. *See generally Eclipse of the Public Corporation*, *supra* note 20 (modeling the LBO association and asserting its superiority as a governance structure).

47. *See, e.g.*, Federal Deposit Insurance Act, 12 U.S.C. § 1831e(d) (2000) (providing that thrift institutions may only invest in investment grade debt securities); 1991 Conn. Acts 91-262 §§ 3(c), 4(c) (limiting junk bonds to 10% of insurance company portfolios). This point had some validity as far as concerning risky lending by regulated institutions such as savings banks and insurance companies.

48. *See* Holmstrom & Kaplan, *supra* note 28, at 122.

49. *Id.*

50. *Id.*

51. *Id.*

and productivity.[52] There was also evidence of increased sales and cash flows, decreased expenditures, improved margins and reduced capital requirements.[53]

C. THE SECOND BOOM AND THE DISCIPLINARY MERGER

When buyouts reappeared in significant volume around the turn of the twenty-first century, questions about their place in agency theory returned. Some again asserted that the reappearance heralded the eclipse of separated ownership and control.[54] Others looked for explanations grounded in changes in the risk management environment.[55] Still others, looking at buyouts' historical track record, saw a cyclical phenomenon driven by secular conditions that lacked overarching theoretical significance.[56] Consider now a fourth suggestion: Private equity buyouts are the real world instantiation of the disciplinary merger predicted by agency theory. As such, they highlight some infirmities in the theory.

Agency theory makes the hostile takeover the lynchpin of an efficient, market-driven governance framework.[57] This follows in part from an economic theory of mergers, which assumes the strong version of the efficient market hypothesis (EMH): a firm's stock price accurately reflects its intrinsic value.[58] Given this assumption, a bidding firm will pay a premium over the market price of a target's stock only if the proposed combination creates new value sufficient to cover the price paid and to assure a profit.[59] A merger or takeover can create the necessary value in two cases. The first is the synergistic merger: a transaction where valuable synergies arise from combining the operations of the bidder and target firms, such as cost savings or technological advances.[60] The second case is the disciplinary merger: a transaction motivated by the target management's

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52. Bruton et al., *supra* note 21, at 710.

53. *See* Erkki Nikoskelainen & Mike Wright, *The Impact of Corporate Governance Mechanisms on Value Increase in Leveraged Buyouts*, 13 J. CORP. FIN. 511, 512 (2007) (surveying the empirical studies); *see also* Bruton et al., *supra* note 21, at 711 (same).

54. *See* Gilson & Whitehead, *supra* note 3, at 251–62.

55. *See* Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? 25–26, 28–34 (Aug. 10, 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1215188) (suggesting that the proliferation of derivative devices opens up new means of spreading risk and so makes public ownership less important, and that private ownership at the same time facilitates better risk management of complex derivative positions).

56. *See* Brian R. Cheffins & John Armour, *The Eclipse of Private Equity* (Eur. Corp. Governance Inst., Law Working Paper No. 082, 2007), *available at* http://ssrn.com/abstract=982114.

57. Gilson & Whitehead, *supra* note 3, at 233–36.

58. *See* Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics* (Princeton U. CEPS, Working Paper No. 91, 2001).

59. *See* NICHOLAS DIMSDALE & MARTHA PREVEZER, CAPITAL MARKETS AND CORPORATE GOVERNANCE 24 (1994).

60. *See* Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671 (1991).

failure to maximize value and the bidder's desire to create value by correcting the suboptimal conduct.[61]

This theory of mergers offers two descriptions of conditions that make a firm a candidate for a disciplinary merger, one open-ended and the other more particular. In the general description, incumbent management is either incapable of running the firm efficiently or firm governance has otherwise broken down.[62] A target might be hobbled by excessive perquisite consumption, excessive compensation, overpayment for supplies, labor, or raw materials, or self enriching or self-aggrandizing projects, or a combination of the foregoing.[63] The disciplinary acquirer creates value by cleaning house and replacing management.[64] The more specific description sets out three diagnoses of management failure along with three accompanying cures. Under the first, target management makes ill-advised diversifying acquisitions, so that the successful acquirer divests the unrelated lines of business.[65] Under the second, the target invests in excess productive capacity so the acquirer downsizes or otherwise constrains investment policy.[66] Under the third, the target's capital structure is underleveraged so the acquirer steps up borrowing.[67] Note that while all three acquirer correctives impose "discipline," broadly conceived, all three also implicate differences of opinion respecting the target firm's business plan rather than a diagnosis of poor governance practice, narrowly conceived.[68] Significantly, the agency story that accompanied the 1980s' boom posed the buyout as the cure to all three ailments.[69]

Agency theory underscores and elaborates on this theory of mergers when it posits that agents tend to slack off and behave opportunistically.[70] If a firm's internal governance mechanisms fail to check such a tendency, the firm's stock price will decline, attracting a hostile bid.[71] The hostile bidder thus performs a backstop governance role.[72] Expanding this theory, we can posit an ideal world in which all management groups are subject to hostile offers all the time by other managers who value the corporate assets more

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61. *Id.*
62. *Id.*
63. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 823 (5th ed. 1996).
64. *See generally* DIMSDALE & PREVEZER, *supra* note 59, at 25.
65. *See* Holmstrom & Kaplan, *supra* note 28, at 122.
66. *Id.* at 127–129.
67. *Id.*
68. *See* Julian Franks & Colin Mayer, *Hostile Takeovers and the Correction of Managerial Failure*, 40 J. FIN. ECON. 163, 166 (1996).
69. *Id.*
70. Gilson & Whitehead, *supra* note 3, at 233–236.
71. *Id.*
72. *See* R. Sinha, *The Role of Hostile Takeovers in Corporate Governance*, 14 APPLIED FIN. ECON. 1291 (2004).

highly.[73] In the ideal world, assets constantly move to the highest valuing user, maximizing shareholder value and economic welfare.[74]

The agency account goes on to link mergers' transactional postures to their economic motivations. Synergistic mergers are deemed likely to be friendly, negotiated transactions, while disciplinary mergers are likely to follow from hostile tender offers.[75] Because friendly mergers presuppose the agreement and participation of incumbent management, they do not necessarily implicate disciplinary motives or effects.[76] Indeed, pursuit of synergies from asset combinations sometimes improves the lot of all of the firm's stakeholders.[77] Hostiles, in contrast, are thought more single-mindedly to serve the target shareholder interests and to threaten target stakeholder interests.[78]

Thus does the hostile takeover emerge, playing a central role in the agency account. The record of incidence, however, triggers a question about the account's accuracy. Hostile takeovers have represented only a small portion of acquisitions, and their incidence has diminished over time.[79] Figure II[80] draws on the Mergerstat database to compare the total number of public company acquisitions completed during the period of 1974–2007 to numbers of formally registered tender offers and of registered tender offers formally opposed by target management. The merger waves of the 1980s and 1990s show up clearly, punctuated by a fall off in overall activity between 1989 and 1994. For present purposes, the most significant difference lies in the waning of hostility. Although absolute numbers of tender offers recovered in the mid-1990s, they did so as a much diminished proportion of overall merger activity. Moreover, the hostile tender offer did not reappear on a proportionate basis within the tender offer subset. Although it still exists, it has almost disappeared, relatively speaking. Meanwhile, as Figure I shows, buyouts returned.

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73. *See* Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988).

74. *See* G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599 (2000).

75. *Id.*

76. *Id.*

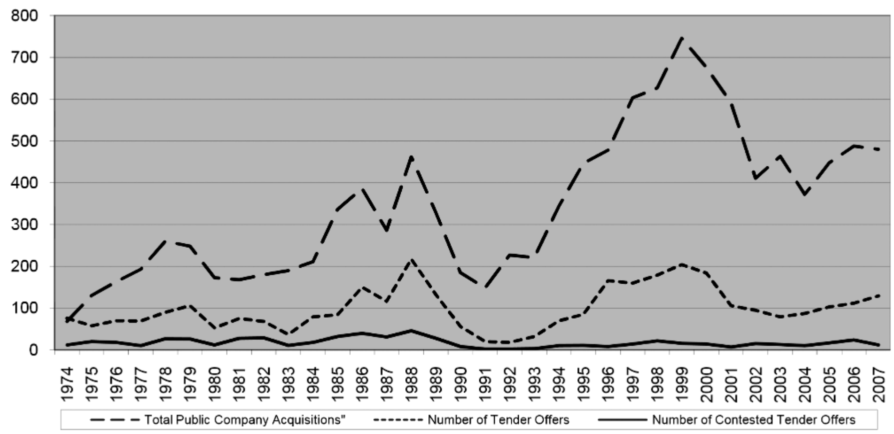
77. *See id.*

78. *Id.*

79. *See infra* Figure II.

80. *See* MERGERSTAT REVIEW (2007), *available at* https://www.mergerstat.com/bookstore/samp_mr.pdf.

Figure II: Total Number of Hostile Takeovers Relative to Total Public Company Acquisitions, 2004-2007[81]



Today, the private equity buyout stands as the sector of the mergers and acquisitions market most likely to present post closing incidences of governance discipline sought by agency theory. The buyout firm acts as an aggressive blockholder, closely monitoring performance and imposing performance targets.[82] Even as the private equity business model includes and depends on the participation of management incumbents and incentivizes them with a share of the equity, it also includes and depends on an active removal threat.[83] Leverage enhances the threat by interpolating the possibility of downside disaster, and magnifying the financial payoff for success.[84] Accordingly, discipline is built into the governance structure even as pre-closing hostility is avoided.[85]

The comparison has important implications for the theory of the disciplinary merger. The surge and sudden decline of hostile takeovers presents a causation question. Most ascribe the change to antitakeover regulation.[86] If they are right, there still arises an inference of a disciplinary deficit and concomitant opportunity cost. Others, however, ascribe the eclipse to a range of factors. In one such view, hostility is a negotiating position holding out high costs quite apart from antitakeover barriers.[87] If that is the case, then the disappearance of hostility does not imply significant opportunity costs. This account dovetails with both views. Even

81. *Id.*
82. Cheffins & Armour, *supra* note 56, at 9.
83. *Id.*
84. *Id.*
85. These are friendly combinations.
86. *See, e.g.*, Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 5 (1995).
87. *See* Schwert, *supra* note 74, at 2599.

if regulation, rather than value fundamentals, choked off the hostile tender offer, buyouts have picked up much of the slack.[88] While hostility has largely disappeared from the control market, discipline has not.[89] And, because discipline holds out value, it can be interpolated on a friendly basis.[90] Accordingly, agency theory and the related ideology of corporate legal theory need updating.

The recent emergence of activist hedge funds underscores such a need. In this still small sector, the sleeping institutional shareholder giant rises from its bed.[91] Here a new class of corporate raiders mounts hostile challenges to managers and business plans at publicly traded firms worldwide.[92] These are impatient shareholders, who look for value and want it realized in the near or intermediate term.[93] Their strategy is to tell managers how to realize that value and to challenge publicly those who resist their advice, using the proxy contest as a threat.[94] The strategy has proved successful.[95] Significantly, the strategy, while hostile, does not primarily aim for transfers of control.[96] Instead, the players act out a game of threat and resistance in which victory lies in either the insurgent's entry to the boardroom on a minority basis or the target's diffusion of the threat with a governance concession. The game leads to cooperative outcomes in a significant number of cases.[97] One once again notes the hostile tender offer's absence and apparent evolutionary adaptation by the capital markets.

Summing up, activist hedge fund interventions show that hostility survives with a disciplinary governance impact, but does so without a tie to control transfers. Disciplinary control transfers also survive, but only based on cooperative negotiations. Meanwhile, the market-driven control transfers on which agency theory has hung its hat for three decades are disappearing. It is time for a ground up reassessment of the theory's operative assumptions.

II. DISCIPLINE, LEVERAGE, AND VALUE

Part I took a look at buyout volume, noted the transactions' disciplinary aspect, and then associated discipline with transactional friendliness, casting doubt on agency theory's association between hostile initiation and

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88. Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1732 (2008).

89. *Id.*

90. *Id.*

91. *Id.*

92. *See generally id.*

93. *Id.*

94. Brav et al., *supra* note 88, at 1745.

95. *See, e.g.*, *id.* at 1739–45.

96. William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1422–27 (2007).

97. *Id.* at 1405–09.

post-closing discipline. This Part turns to agency theory's account of buyout motivations. Agency theory ascribes discipline, agency cost reduction and productivity improvement joint and primary roles as transactional motivators and depicts the buyout firm in a unique role as a value creator.[98] This Part asks how well buyout transactions sustain these theoretical aspirations, comparing governance improvement and leveraged gain as transactional motivations. It shows they both play a role in buyouts, but suggests leverage is better accorded the primary role in accounting for the recent boom.

As discussed earlier, the conventional wisdom of the 1980s was that buyouts prevent managers from reinvesting free cash flows.[99] One hears this free cash flow story less and less as time passes. Today, some doubt that the free cash flow account accurately described the profiles of 1980s buyout targets. If the story was true, the takeovers and buyouts of the era would have concentrated on firms that were overinvested relative to other firms in their industries. At least one study by Henri Servaes, has found no evidence of overinvestment compared with industry benchmarks, no relation between abnormal returns of the target firms and measures of overinvestment or industry investment, and no evidence of overinvestment in respect of a subclass of hostile targets.[100] There were two exceptions: larger firms and firms in the oil and gas industry.[101] When considering the core productivity claim made for 1980s buyouts, this is a devastating result. Subsequent studies provide confirmation, showing that expected reductions of free cash flows do not primarily motivate these deals.[102]

Cost cutting and situation-specific management improvement are the remaining possible disciplinary motivators for today's transactions. Such

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98. *See generally* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. REG. 119 (1992).

99. Jensen *supra* note 36, at 323.

100. Servaes's study looks for overinvestment in a class of 700 takeover and buyout targets during the period of 1972–87. *See* Henri Servaes, *Do Takeover Targets Overinvest?*, 7 REV. FIN. STUD. 253, 254 (1994).

101. *Id.* at 254. *See also* Boysn Jovanovic & Peter L. Rousseau, *The Q-Theory of Mergers* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 8740, Jan. 2002) (finding that the free cash flow account explains only a small number of mergers and asserting that a typical firm may waste cash on mergers but not on internal investment); Gerald T. Garvey & Gordon R. Hanka, The Management of Corporate Capital Structure: Theory and Evidence 520 (Jan. 13, 1997) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1501) (studying the effect of antitakeover provisions and finding that protection does not impact firm size or profitability).

102. *See* Douglas Cumming et al., *Private Equity, Leveraged Buyouts and Governance*, 13 J. CORP. FIN. 439, 441–42 (2007) (showing that targets are selected based on stock market valuation, undervalued companies being preferred, and the projected tax savings stemming from leveraged capital structure).

This does not go to say that today's managers always return free cash flow to their shareholders. They often horde cash, but they put it into short term liquid investments rather than safe businesses. *See* Bratton, *supra* note 96, at 1415–18. Such a cash account could indeed motivate a buyout offer, but as source of an immediate post-closing dividend rather than as a source of a disciplinary improvement.

factors are intuitively attractive, and there is empirical support for the proposition that buyouts involve both.[103] Even so, their explanatory traction has limits. For example, assume that Buyout Firm X is looking at two firms, A and B, as potential buyout candidates. Firm A has an excellent management team and low leverage, but is a value stock—its steady but dowdy industry does not enjoy investor favor. Firm B, also with low leverage, is an underperformer in a more glamorous industry due to a substandard management team and business plan. As between the two, which is the better buyout candidate? Agency theory, read together with the EMH, signals Firm B over Firm A. If the managers are good and the stock price is right, Firm A holds out no value. Meanwhile, Firm B holds out a disciplinary arbitrage profit. In the buyout world, in contrast, Firm A is the quintessential target. Private equity firms look for value, which exists in cases of pronounced inequality between market capitalization and fundamental value.[104] At the same time, because the control transfer comes on friendly terms and the managers take equity stakes, manifest problems with the top team make for value-reducing frictions. Finally, value enhancement does not necessarily imply basic changes in the business plan. The leverage can do the heavy lifting in generating positive returns.

To see the importance of leverage, assume a buyout target with $1 billion enterprise value and $700 million of debt in its post-buyout capital structure. If the company is sold in five years in a $1.3 billion public offering, the annual growth of the value of the firm is 6 percent over the initial $1 billion. Any number of factors can contribute to that 6 percent value enhancement. Certainly, firm-specific management improvements will help. Even so, a $1.3 billion IPO yield could be due entirely to growth in the economy, a stock market more inclined to favor the firm's industry, or the tax advantages attending the buyout debt. Whatever the source of the gain, the value of the equity investment will have doubled—as a result of the leverage, it will show a 15 percent annual rate of return rather than a 6 percent return. Such high returns imply high risks.[105] If the company gets into difficulty and has an enterprise value of $850 million at the end of the five year period and has not paid down any debt, that 15 percent decline implies a 50 percent loss on the private equity investment.[106]

Either way, the buyout firm has a high powered incentive to extract performance improvements during the five year period. For example, on the upside scenario, if the target manages to cut costs sufficiently to release

103. *See* Cumming et al., *supra* note 102, at 444–50 (summarizing the literature and discussing the empirical difficulties); Bruton et al., *supra* note 21, at 716–19 (showing performance improvements during the buyout period in a sample of buyout firms that later conducted reverse LBOs).

104. *See* Cumming et al., *supra* note 102, at 441 (confirming that buyout firms look for undervalued targets).

105. *See* Blackstone Group L.P., *supra* note 33, at 115.

106. *See id.*

enough operating cash flow to pay down $300 million of borrowing, the equity investment triples and the annual internal rate of return is 25 percent. The same performance improvement also reverses the downside result from a loss to a modest gain.

The question of whether the recent buyout surge was agency-driven or financially-driven remains. The answer is that, while both elements contributed, few observers would put primary weight on the agency side.[107] Readily available credit at low interest rates fills the bill better. In mid-2007, risk premium of junk bonds over U.S. Treasuries reached a historic low of 2.63 percent, compared to a 20-year average of 5.42 percent.[108] It is true that buyouts returned from their 1990s trough with less leverage in their capital structures than previously, but leverage remained salient. Assuming a target with an enterprise value of $1 billion, a typical transaction in the recent wave would entail an equity investment of $300 million and $700 million of debt.[109] This debt-to-equity goal of 30–70 is still much more conservative than the 1980s' rule of thumb of 20–80 or 10–90.[110] On the other hand, capital structures of restructured companies became riskier during the boom's late phase.[111] The average ratio of cash flow to interest cost was 3.4 in deals closing in 2004, 2.4 in 2006 deals and 1.7 in 2007 deals.

At the same time, lenders eased the terms of the debt, with some deals having terms resembling the deal terms of late 1980s. "Pay in kind toggle" bonds became common, giving the borrower an option to defer paying interest until maturity, with the deferred sums paying a higher rate. Such "PIK" terms were emblematic of the late 1980s leveraged capital structures that got into trouble after the economy faltered in 1989.[112] In addition, beginning in 2005, more and more private equity loans were "covenant

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107. For an empirical study of buyouts conducted in the 1990s that confirms the salience of financial and tax over performance motivations, see Shourun Guo, et al., Do Buyouts (Still) Create Value? 2–4 (June 3, 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1108808).

108. For empirical confirmation of this point, *see* Ulf Axelson, et al., Leverage and Pricing in Buyouts: An Empirical Analysis 4–5 (Aug. 2007) (unpublished Working Paper, *available at* http://ssrn.com/abstract=1027127) (showing that levels of debt in LBOs are unrelated to firm characteristics but highly sensitive to prevailing interest rates in the leveraged loan market).

At the same time, merger premiums in recent years generally have been lower than in the 1980s. Where the earlier rule of thumb was 30 to 50 percent premium, in recent years 20 percent deals have been common.

109. Blackstone Group L.P., *supra* note 33, at 115.

110. *See* Guo, *supra* note 107, at 6 (showing that 1990s buyouts entailed lower leverage and lower up front premiums).

111. *See id.* at 4–6.

112. Helen Power, *Credit crisis one year on: Risky debt notes could be a losing game*, THE DAILY TELEGRAPH, Sept. 22, 2008, at 5, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2794340/Credit-crisis-one-year-on-Risky-debt-notes-could-be-a-losing-game.html.

lite," omitting debt covenants and ratio tests.[113] In 2007, "covenant lite" loan volume reached $96.6 billion, compared with $23.6 billion recorded for the whole of 2006.[114] The current credit crisis has halted such extremely risky behavior.

The case for leverage as deal motivator also can be made negatively. As already noted, the buyout boom peaked in mid-2007, with activity falling precipitously thereafter.[115] After mid-2007, $144 billion of pending buyouts were abandoned or delayed.[116] Credit contraction is the reason for such a drop.[117] The easy credit that fueled the boom depended on exit by securitization as well as low rates. Buyout lenders sold their loans into securitized packages, with the repaid principal available to fund more and bigger buyouts. The credit crunch has choked off the securitization pipeline, leaving the investment banks holding an unexpected $200 billion of buyout paper and looking for someone to buy it.[118] Meanwhile, the value of buyout debt in circulation has dropped, precipitously in some cases, making sale of the paper in the pipeline more difficult still.[119] The "covenant lite" posture of recent deals has aggravated the price declines.[120] The banks have taken write-downs.[121] Market participants are already drawing parallels to the junk bond market collapse that began in 1989.[122]

To the extent the parallels to the 1989 collapse hold, a challenge will be posed for agency theory. Back then, agency theorists blamed the credit collapse on new regulation.[123] Today they have no such excuse[124] and will have to account for the boom-bust cycle. Their theory ill-equips them to do

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113. *See* W.Y. CAMPBELL & CO., SECOND QUARTER 2007 MIDDLE-MARKET TRANSACTION UPDATE 3–4 *available* at www.wycampbell.com/media/marketupdates/q2-07wycmarket update.pdf.

114. *See* INVESCO, MARKET COMMENTATOR: LEVERAGED LOAN MARKET REVIEW 4 (2007), *available at* http://www.institutional.invesco.com/portal/file/invescoinst/pdf/LeveragedLoan Overview.pdf.

115. *See* Bloomberg News, *Borrowing Costs Slowing Buyouts*, CHI. TRIB., Nov. 27, 2007, at 2.

116. Emily Thornton, *Done Deals in Distress: Debt Issued for Recent Buyouts is Fast Losing Value*, BUS. WK., Feb. 11, 2008, at 30. For critical analysis of the documentation at issue in these failed transactions, see Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1148178.

117. *See* Thornton, *supra* note 116, at 30; *see also* Davidoff, *supra* note 116, at 178.

118. Thornton, *supra* note 116, at 31.

119. Liz Rappaport & Peter Lattman, '*Anyone for Some Used Corporate Debt?' Why Leveraged Loans that Financed Buyouts are Causing Bottleneck*, WALL. ST. J. Feb. 6, 2008, at C1.

120. Thornton, *supra* note 116, at 30–31.

121. Carrick Mollenkamp, et al., *Leveraged Loans Inflict More Pain on Banks Globally*, WALL ST. J., Feb. 19, 2008, at C2.

122. Thornton, *supra* note 116, at 30.

123. *See supra* text accompanying notes 47–8.

124. It is, however, noted that Michael Jensen warns of unspecified new regulation in a posted PowerPoint slideshow. *See* Michael C. Jensen, *The Economic Case for Private Equity (and Some Concerns) – PDF of Key Note Slides* (Harvard NOM, Research Paper No. 07-02, 2007), *available at* http://ssrn.com/abstract=963530.

so. Agency theorists, very much in the Modigliani-Miller tradition, tend to assume that finance is irrelevant and look only to a firm's assets for valuation purposes.[125] Absent a specific tie between a particular capital structure and the incentives of the asset manager,[126] agency tends to assume that the mode of finance is irrelevant. Leverage figures into the agency buyout story only as a motivator in the context of the post-closing relationship between target managers and their buyout firm overseers;[127] it is not held to motivate deals independently.

But the real world is more complicated. Conditions conducive to buyouts coalesce only when targets can be outfitted with highly levered capital structures. Accordingly, buyouts thrive only when markets hold out ready credit on attractive terms. Because the credit markets only do this intermittently, the sector has cyclical character. And, even as the buyout firm has high-powered incentives to improve the target firm's performance, it is not clear that performance improvement by itself motivates buyouts. Leveraged gain motivates independently.

III. INVESTMENT RETURNS

Leverage, then, is the buyout's *sine qua non*. Even so, a completed buyout creates a high powered incentive for performance improvement and agency cost reduction. An empirical question arises respecting the quantum of improvement seen in practice. This Part takes up the question, turning from ex ante incentives to value generated ex post. We will see that value is indeed generated, but that all of it is allocated to the buyout firm. As a result, questions are raised for buyout structures and their incentive alignments.

A. BUYOUT RETURNS

Buyout data is hard to obtain. Once the target is taken private, its results disappear from the radar screen of public trading, the usual source of data for financial analysis. During a buyout fund's ten-year life, one must rely on the sponsor's self-serving reports. The most reliable data is generated at the end of the line when the buyout fund is terminated and its participants get their final distributions. Only then are there time-sensitive figures on amounts invested and returns thereon. Therefore, analyses of buyout returns appear on a time lag—recent studies cover buyout funds raised during the mid-1990s and earlier. It will be some time before there are reports on funds raised during the recent boom.

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125. Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958).

126. The suboptimal reinvestment of free cash flow story told in the 1980s affected such a tie. *See* Jensen, *supra* note 36, at 323.

127. *Eclipse of the Public Corporation*, *supra* note 20, at 11–13.

Meanwhile, analyses of past fund returns suggest that future returns may be low. Financial economists have been working from a database collected from voluntary reports by private equity firms and private equity investors. Sample bias is admitted, but if it is safe to assume that the worst performers are less likely to report voluntarily, any skew in the data lies on the side of over-reporting good results.[128]

The leading published study from the database comes from Kaplan and Schoar, who analyze the returns of 169 buyout funds that were close to fully liquidated during the period 1980 to 2001.[129] Their central analytical tool is the "public market equivalent" (PME). This is a ratio of the present value of all cash distributions by the fund (including undistributed assets taken at book value) over the present values of all of the fund's drawdowns using the year by year realized return of the S&P 500 as the discount rate.[130] A PME less than one means that the fund investor would have been better off putting the capital in a market index. The figures below are net fees retained by the fund.[131]

PME, 1980–2001	Equal weighted	Size weighted
Median	0.80	0.83
Average	0.97	0.93

Internal rates of return (IRR) were as follows:[132]

IRR, 1980–2001	Equal weighted	Size weighted
Median	0.13	0.15
Average	0.19	0.19

The picture is disappointing. The IRRs approximate those of the market. As for the PMEs, neither the equal-weighted nor size-weighted results beat the market. Kaplan and Schoar break the results into time periods to show that both PMEs and IRRs were better for funds raised in

128. Steven N. Kaplan & Annette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, J. FIN. 1791, 1794 (2005).
129. To be included in the sample, the fund must have distributed no returns for at least six quarters. Kaplan and Schoar assume that any undistributed residuals values on a fund's books are worth their book amount. *Id.* at 1794–98. It is noted that this assumption favors the funds.
130. *Id.* at 1797.
131. *Id.* at 1798.
132. *Id.*

the early 1980s and poorer for funds raised in the early 1990s.[133] More particularly, out of the funds raised between 1987 and 1994, the PME exceeds one for only those raised in 1990.[134] Because buyout funds are under-diversified and illiquid,[135] they would need to return PMEs somewhat greater than one to be investments with returns more attractive than those of the market.

Phalippou and Gottschalg update and extend these results, covering funds liquidated through 2003 and adding a sample comprised of additional liquidated funds.[136] They claim to cover 57 percent of the private equity universe in terms of size.[137] Grouping venture capital funds with buyout funds, they obtain an average PME of 1.01,[138] which compares with Kaplan and Schoar's combined aggregate PME of 1.05 for venture capital and buyout funds.[139] This poor result is magnified when Phalippou and Gottschalg adjust Kaplan and Schoar's assumptions so as to write down any unliquidated assets to zero.[140] This causes the aggregate venture and buyout PME to decline to 0.88. Finally, Phalippou and Gottschalg extend their analysis, separate the buyout funds from the venture funds, and substitute for the S&P 500 a discount rate derived from a risk adjusted cost of capital for industry comparables.[141] This reduces the buyout PME to 0.75.[142]

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133. *Id.*

134. Kaplan & Schoar, *supra* note 128, at 1801–02.

135. *See* Andrew Metrick & Ayako Yasuda, The Economics of Private Equity Funds 7 (Sept. 8, 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=996334).

136. Ludovic Phalippou & Oliver Gottschalg, The Performance of Private Equity Funds 7 (EFA Moscow Meetings, 2005) (unpublished Working Paper, *available at* http://ssrn.com/abstract=473221).

137. *Id. See also* OLIVER GOTTSCHALG, STUDY FOR THE EUROPEAN PARLIAMENT ECONOMIC AND SCIENTIFIC POLICY DEPARTMENT, PRIVATE EQUITY AND LEVERAGED BUY-OUTS 12–15 (2007), *available at* http://www.privateequitycouncil.org/wordpress/wp-content/uploads/gottschalg-eu-parliament-study.pdf (showing an average 3 percent above market per annum performance gross of fees and a negative 3 percent below market per annum performance net of fees).

138. *See* GOTTSCHALG, *supra* note 137, at 12–15. *See also* Phalippou & Gottschalg, *supra* note 136, at 11.

139. Kaplan & Schoar, *supra* note 128, at 1798 tbl. 2.

140. GOTTSCHALG, *supra* note 137; *see also* Phalippou & Gottschalg, *supra* note 136, at 3.

141. Phalippou & Gottschalg, *supra* note 136, at 19.

142. *Id.* at 19–20. Christian Diller & Christoph Kaserer, *What Drives Private Equity Returns? – Fund Inflows, Skilled GPs, and/or Risk?* (CEFS Working Paper No. 2004-2, 2004), *available at* httpbu://ssrn.com/abstract=590124, calculates PME for 200 European buyout funds to get similar results – the average is 0.90 and the median 0.89. For a set of contrary results, see Alexander Ljungqvist & Matthew Richardson, *The Cash Flow, Return and Risk Characteristics of Private Equity* (NYU Finance Working Paper No. 03-001, 2003), *available at* http://ssrn.com/abstract=369600. They get an IRR for buyouts of 21.83 which compares favorably to the S&P 500's 14.1. On the other hand, their sample dates from the early 1980s, the period that shows the most favorable results in Kaplan and Schoar's larger sample. For a set of mixed results, see Matthias M. Ick, Performance Measurement and Appraisal of Private Equity Investments Relative to Public Equity Markets (May 2005) (unpublished Working Paper, *available at* http://ssrn.com/abstract=871931).

None of this falsifies the general point that buyouts mean monitoring, and monitoring means productivity gains. Significantly, the PME results discussed above are net of the buyout firm's fees.[143] From an efficiency point of view, the net does not matter because it follows from an internal distributional agreement. What matters is the gross—the total return to the fund and its outside investors. The database, which depends on reporting by investment institutions with limited partnership stakes in the buyout funds, does not directly yield a gross. But Phalippou and Gottschalg, making some assumptions based on buyout fund fee practices, have extrapolated a gross PME of 1.12 for the aggregated venture capital and buyout funds.[144] From an efficiency point of view, the most relevant figure is 0.11, the distributional portion of that 1.12 that goes to the buyout funds.

The question remains as to how impressive a PME of 1.12 is. The figure aggregates results from the database's venture capital and buyout funds. As venture returns tend to be higher, the gross PME for buyout funds is presumably somewhat lower than 1.12. Moreover, even on a gross basis, some of the return over market compensates for illiquidity. Even more importantly, some of the return also compensates for the risk attached to the target firms' levered capital structures. Note also that the 1.12 figure covers twenty-three years of fund liquidations stretching back to 1980. It thus incorporates the first boom and the period's levels of debt in the 85 to 90 percent range. Given these extreme capital structures, even a modest increase in the value of the firm meant a substantial gain for the equity held by the buyout fund.[145] Unfortunately, the data does not tell us just how much of the positive PME stems from productivity gains. Nevertheless, the inference still arises that it is not much.

B. MODES OF EXIT

These overall buyout returns may seem surprising in relation to studies of reverse LBOs. In the standard depiction of a buyout, the transaction goes forward with a view to a subsequent public offering, termed a reverse LBO (RLBO). The RLBO returns the target equity to liquidity and enables the buyout fund to make cash distributions to its limited partners.[146] The buyout fund accordingly has every incentive to engage an RLBO as soon as possible—one study finds that the median time in which a target stays

143. Phalippou & Gottschalg, *supra* note 136, at 14–17; *see also* Kaplan & Schoar, *supra* note 128, at 1799.
144. Phalippou & Gottschalg, *supra* note 136, at 4.
145. Jerry X. Cao & Josh Lerner, The Performance of Reverse Leveraged Buyouts 4 (Oct. 15, 2006) (unpublished Working Paper, *available at* http://ssrn.com/abstract=937801).
146. *See* Bruton et al., *supra* note 21, at 711.

private is only three years.[147] RLBO firms have been analyzed extensively and have good track records.[148]

The wider implication is that public trading market opportunities motivate buyouts, with a big payoff occurring as a result of the public to private to public round trip. And such is the case, but with a catch: the big payoff round trip occurs only in a minority of cases. Kaplan, working with a sample of 183 large buyouts completed between 1979 and 1986, found that by August 1990, 62 percent of the targets remained privately owned, 24 percent were owned by other public companies, and only 14 percent were independent public companies.[149] Cao and Lerner, with a sample of RLBOs from 1981 to 2003, have shown that the average annual percentage of new LBOs to RLBOs is only 13 percent.[150] The going private movement thus nets out on the private side over time, with round trips being the exception. Phalippou and Gottschalg report a similar figure respecting mode of exit in their sample: only 11 percent of the targets in the liquidated funds were the subject of an RLBO.[151] How then do the buyout firms liquidate their investments?

Negotiated sales to publicly traded companies provide a second exit route, accounting for 24 percent of the targets in Kaplan's sample.[152] If we now add the RLBOs in Kaplan's sample to the negotiated sales, we will have accounted for only 38 percent of the targets. Similarly, Phalippou and Gottschalg, with their bigger database covering a longer period, add (1) asset and stock sales to publicly traded companies to (2) RLBO exits to account for 31 percent of the targets.[153] It again follows that going private means staying private in the majority of cases.

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147. *See id.*

148. Cao & Lerner, *supra* note 145, shows performance superior to peers on both market and accounting bases for a sample of 526 RLBOs during the period 1981 to 2003. *See also* Chris J. Muscarella & Michael R. Vetsuypens, *Efficiency and Organizational Structure: A Study of Reverse LBOs*, 45 J. FIN. 1389 (1990) (studying 72 RLBOs in the period 1983–87 and showing substantial increases in profitability in comparison to the firm's pre-LBO results); Francois Degeorge & Richard Zeckhauser, *The Reverse LBO Decision and Firm Performance: Theory and Evidence*, 48 J. FIN. 1323 (1993) (studying 62 RLBOs in the period 1983–87 and showing their accounting performance exceeds peer group performance prior to going public and then deteriorates after the public offering with no evidence of post RLBO underperformance in the stock market); Shehzad Mian & James Rosenfeld, *Takeover Activity and the Long-run Performance of Reverse Leverage Buyouts*, 22 FIN MGT. 46 (1993) (showing slight outperformance of stock market peers with a 1980s sample); Robert W. Holthausen & David F. Larcker, *The Financial Performance of Reverse Leverage Buyouts*, 42 J. FIN. ECON. 293 (1996) (studying 90 RLBOs in the period 1983–88 and showing no evidence of poor performance based on accounting or stock price).

149. Steven N. Kaplan, *The Staying Power of Leveraged Buyouts* 29 J. FIN. ECON. 297 (1991).

150. Cao & Lerner, *supra* note 145, at 7.

151. Phalippou & Gottschalg, *supra* note 136, at tbl 3.

152. Kaplan, *supra* note 149, at 287.

153. Phalippou & Gottschalg, *supra* note 136, at tbl 3.

It is difficult to determine what happens to these still-private targets in light of the fact that each fund is liquidated after ten years.[154] The study results are thin, and the resulting picture murky. A sample of 321 exits in the United Kingdom between 1995 and 2004 yields the following: on the public side, 16 percent exited through RLBO and 29 percent exited through trade sale (for a total of 45 percent); and on the private side, 38 percent exited through receivership and 17 percent exited through secondary buyout (for a total of 55 percent).[155] In other words, roughly two-thirds of the still-private targets ended up in financial distress, with the rest going out as "secondary buyouts": refinancings in which a second buyout firm takes out the original buyout firm.[156] Buyout firms, then, pass off their junk targets to one another. Third and even fourth time transfers have occurred in the UK.[157] There are also partial liquidations, in which pieces of targets are sold, often to another buyout fund.[158] Alternatively, the target increases its borrowing or does a sale and leaseback of an asset and then makes a dividend of the proceeds.[159] The less hospitable the IPO market, the more likely the resort to these expedients.

Buyout exit, then, is a tricky, sticky business. Big payoffs come from RLBOs and negotiated sales to operating companies, even as most targets are disposed of in the low-return back room. As such, the sector's disappointing aggregate returns become less surprising.

C. Money Chasing Deals

Studies of buyout returns that fully cover the sector's first boom and bust teach us some structural points about buyout cycles. Funds floated early in the cycle do well.[160] As good results come in and the cycle moves up the curve, the established players float new funds.[161] Successful buyout firms add a new fund every three to five years.[162] Since the fee structures of buyout funds remain relatively stable over time, a buyout firm that wishes to maximize returns on its invested human and reputational capital will seek to float a bigger fund.[163] New players also enter and float their own funds.

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154. *Id.* at 2.
155. Nikoskelainen & Wright, *supra* note 53, at 513.
156. *Id.* at 514.
157. Cumming et al., *supra* note 102, at 456.
158. *Id.*
159. *Id.*
160. Kaplan & Schoar, *supra* note 128, at 1792.
161. *Id.*
162. *See* Metrick & Yasuda, *supra* note 135. Note that the institutions offered the limited partnership interest in the new funds accordingly must make their appraisals based only on the previous fund's interim results.
163. *Id.*

But these late entrants are less likely to form follow-up funds, implying lower levels of success.[164]

The cyclical flow of cash into the sector correlates positively with target valuations—as more money comes in, buyout funds pay more to acquire targets.[165] Therefore, two inferences can be drawn. First, increases in target values could be attracting the inflows into buyout funds, with money following opportunity. Second, assuming a limited number of good targets, increased inflows have the demand side effect of increasing the bids, with the added money chasing deals. Studies support the latter inference, showing that fund returns are negatively correlated with capital inflows.[166]

If buyout returns to outside investors do not beat the market, on average, and buyout cycles have perverse effects on valuations as they approach their peaks, why do investment institutions clamor to participate in new buyout funds as the cycle rises? Some argue that participation in the sector has a portfolio effect and thus makes sense for well-diversified institutions.[167] There also is at least one value-based explanation: buyout returns tend to persist. A buyout firm that does well with a given fund in a given industry is likely to repeat the result with its next fund.[168] This distinguishes the sector from mutual funds, where success (famously) does not tend to be replicated over time.[169] The persistence phenomenon implies that some buyout firms are better than others, both in selecting and in monitoring their targets. The sector has winners, and an institution invested in a winner will benefit from above market returns.

Therefore, a minority of institutional investors likely do well with buyouts, given the aggregate results.[170] Overconfidence is a standard behavioral explanation for this sort of investment pattern—although only one-quarter of investors will make abnormally positive returns, the capital still pours in because 100 percent of investors believe themselves able to pick the winners.[171] Business practices in the sector encourage such

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164. Kaplan & Schoar, *supra* note 128, at 1791–93, 1816–19.

165. Paul Gompers & Josh Lerner, *Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations*, 55 J. FIN ECON. 281 (2000) (analyzing venture capital only).

166. *Id.*; Ljungqvist & Richardson, *supra* note 142, at 16. For a confirming industry study, see BOSTON CONSULTING GROUP & IESE BUSINESS SCHOOL, THE ADVANTAGE OF PERSISTENCE: HOW THE BEST PRIVATE EQUITY FIRMS "BEAT THE FADE", *available at* http://www.bcg.com/impact_expertise/publications/files/Private_Equity_Feb_2008.pdf.

167. *See Do PE buyouts create value?*, ECON. TIMES, Opinion, Aug. 24, 2007, *available at* http://economictimes.indiatimes.com/Do_PE_buyouts_create_value/articleshow/2305470.cms.

168. Kalpan & Schoar, *supra* note 128, at 1792.

169. *Id.* at 1791–93. For a critical follow on finding that accounts for the higher returns at experienced funds in terms of higher risk, see Joost Driessen, Tse-Chun Lin & Ludovic Phalippou, A New Method to Estimate Risk and Return of Non-Traded Assets from Aggregate Cash Flows: The Case of Private Equity Funds (June 2008) (unpublished Working Paper, *available at* http://ssrn.com/abstract=965917).

170. Kaplan & Schoar, *supra* note 128, at 1791–93.

171. Ludovic Phalippou, *Caveats When Venturing into the Buyout World*, 23 J. ECON. PERSP. (forthcoming 2009), *available at* http://ssrn.com/abstract=999910.

delusions. Buyout firms and their industry associations issue selective and skewed reports of historical results.[172] At the same time, it appears that institutional investors bring to bear unsophisticated analytical yardsticks. They use a payback model, looking to double their money across the ten-year buyout fund term.[173] In so doing, they ignore the cautionary advice of elementary finance textbooks. Finally, selective incentives could be motivating some of these institutions—maybe they seek service relationships with the buyout firm and maybe their salary structures reward their managers for the buyout fund's interim results.[174]

Fundraising by buyout firms was 37 times greater in 1998 than it was in 1985, and by 2006 was more than 100 times greater than in 1985, suggesting the end may be near.[175] If money chases deals into this sector and returns from funds raised near a cyclical peak tend to come in on the low end of the scale, the future could be bleak.

D. FEES

If we accept Kaplan and Schoar's buyout PME of 0.93 and concede that the implicit result, gross of fees, is greater than one, the implication is that the buyout firm takes all the gain it creates. Financial economists do not find this result surprising, having already concluded as a theoretical proposition that, in equilibrium, fund managers take all the rents.[176] Still, further inquiry into the private equity fee structure is warranted. If, as agency theory suggests, buyout governance structures approach the ideal in part because an arm's length contract distributes the rents, the distributional particulars hold out extraordinary interest. Here at last we see capitalism allocate risk and return in respect of large operating companies in a high-incentive context free of regulatory distortions.

Private equity firms take fees on a number of bases. Most of their yield is asset (rather than profit) based.[177] Historically, buyout firms took asset fees of two percent of the capital committed to the buyout funds per fund year.[178] Assuming a ten-year duration and actual investment of all capital committed by the funds' institutional limited partners, an archetypical buyout firm took twenty cents on the dollar off the top, actually investing only eighty cents on the dollar.[179] But the practice has evolved so as to scale back the two percent asset fee. Some funds reduce the annual two percent

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172. *Id.* at 7, 13–14.
173. Phalippou & Gottschalg, *supra* note 136, at 23–24.
174. Phalippou, *supra* note 171, at 4.
175. Cao & Lerner, *supra* note 145, at 4.
176. Richard C. Green & Jonathan B. Berk, *Mutual Fund Flows and Performance in Rational Markets* (Nat'l Bureau of Econ. Research, Working Paper No. W9275, 2004), *available at* http://ssrn.com/abstract=338881.
177. *See* Metrick & Yasuda, *supra* note 135.
178. *Id.*
179. *Id.* at 8–9.

by 25 basis points per year starting in the sixth year; other funds leave the two percent in place but shift to invested (as opposed to committed) capital beginning in the sixth year; and other funds combine both reductions, shifting to invested capital on a declining percentage basis in the sixth year.[180] As a result of all this, the buyout firm's current median off-the-top draw of committed capital decreases to 12 percent.[181]

Private equity firms also charge carried interest.[182] This is 20 percent of profits, with 83 percent of the funds measuring profits against committed (as opposed to invested) capital.[183] In addition, in 93 percent of the funds, the buyout firm must surmount a hurdle before drawing down the carry.[184] For example, the investors must have received 8 percent on their committed capital before the buyout firm may draw down, with the buyout firm taking all of the next profit tranche until the carry is fully paid. There also are claw backs for cases where later distributions prove insufficient to support the full carry basis.[185] Metrick and Yasuda usefully describe this compensation device as a fractional (20 percent) call option on the proceeds of investment, with the strike price equal to the carry basis.[186]

Finally, the buyout fund imposes charges on the target company.[187] A transaction fee is charged upon both the sale and purchase of a target.[188] In between, the target pays an annual monitoring fee based on its EBITDA.[189] The range in practice is one to five percent with smaller targets paying the higher rate.[190] Both of these fee streams are shared between the buyout firms and the outside investors.[191]

The yield to a buyout firm on a given target will vary depending on the particular contract terms. Metrick and Yasuda construct a simulation that yields the buyout firm a median of $19.36 for every $100 invested by the limited partners.[192] The breakdown is as follows—the asset fee yields $11.78 (61 percent), the carry yields $5.35 (28 percent) and the fixed fees yield $ 2.11 (11 percent).[193] In other words, the package's high incentive component accounts for only 28 percent of the buyout fund's returns.

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180. *Id.*
181. *Id.* at 9.
182. *Id.* at 10.
183. Metrick & Yasuda, *supra* note 135, at 10.
184. *Id.*
185. *Id.* at 9–12.
186. *Id.* at 16.
187. *Id.* at 16–18.
188. *Id.*
189. *See* Metrick & Yasuda, *supra* note 135, at 16–18. EBITDA is earnings before interest, taxes, depreciation, and amortization.
190. *Id.*
191. *Id.*
192. *Id.* at 30.
193. *Id.* at 31–34. *See also* Phalippou & Gottschalg, *supra* note 136, at 17 (showing that compensation comes from mainly large management fees and not the carry).

E. SUMMARY

The lure of asset fees on committed capital assures us that buyout firms will remain incented to raise capital and find targets. Once they do, the carry will keep them incentivized to monitor their targets. Whether institutional investors will continue to view the sector with favor, given the track record of below-market returns, presents more of a question. Much will depend on the results of funds presently in existence. If the past is a guide to the future, the results will not be good. Superior performance will be there only for a small number of astute institutions.

This unsatisfactory picture holds out a lesson for agency theory. Recall that agency theory, as it grapples to solve the problem of separated ownership and control in publicly-held firms, turns again and again to the institutional investor community to look for some way to energize it into a productive governance role. Here, after a look at the one sector agency theory praises for incentive compatibility, it becomes hard to envision what such a productive governance role might be. All institutions have been able to do in thirty years in the buyout sector is bargain for modification in the governing limited partnership agreements' distributional terms.[194] Although the terms have improved, they are still insufficient to allow the institutions to escape the trap of below-market results. Actors such as these do not come forth as plausible candidates to solve collective action problems and create value.

Other lessons for agency theory lie in the financial structure that places the buyout firm in the position of incentivized monitor. Recall that agency theory also looks at blockholding shareholders as potential active principals, but that the analysis runs into incentive problems.[195] So let us now consider the buyout as a form of blockholding. The buyout fund takes the blockholder position, but the motivating governance incentives do not, strictly speaking, lie in the fund as blockholder entity. They instead lie in the buyout firm acting as the general partner of the blockholding limited partnership. Accordingly, the equity interest can be viewed in the target through the buyout firm's lens. How patient is this equity stake? The fund's ten year duration gives the arrangement a patient appearance. But appearances can deceive. Given the bonus held out by carried interest, the buyout firm has every incentive to shorten the duration of the fund's ownership. The fact that target firms held for the full ten years tend to be losers[196] attests to this incentive's real world effects. At the same time, the limited partnership arrangement does solve the blockholder incentive

194. *See* Metrick & Yasuda, *supra* note 135, at 31–34; *see also* Phalippou & Gottschalg, *supra* note 136, at 17.

195. *See* Heflin & Shaw, *supra* note 5, at 621.

196. This follows from the results of RLBO studies, which show a duration of 3.8 years for RLBO firms. *See* Cao & Lerner, *supra* note 145, at 10. When the public markets are receptive, the buyout firm liquidates its winners quickly.

problem. But, it does so by assuring that the party doing the actual monitoring (1) is not the blockholder itself, (2) is not required to make a significant equity capital investment ex ante,[197] and (3) is compensated on an assured, priority basis through the combination of an asset-based charge to the blockholder's outside investors and a cut of the target's annual cash flow. The performance improvement incentive, in turn, is structured as an option, which means that the holder takes a profit share on the upside but suffers no loss on the downside.[198] Thus, while the buyout firm has a strong incentive to make improvements to the target, loss aversion does not figure directly into the mix.

Now to the bottom-line question of whether this arrangement holds out lessons for operating companies burdened with agency costs. The analytical exercise of collapsing the limited partnership (and its general and limited partners) into the target firm to see what the unitary entity looks like helps provide an answer. From this point of view, the buyout firm's participation resembles a majority voting preferred stock with a high fixed dividend and an added pro rata participation. Only an operating company desperate for capital would issue stock on such terms. In any event, the analogy fails on a key point: the buyout firm has not necessarily contributed significant capital and so may not risk significant capital loss. We accordingly might look for an analogy elsewhere, comparing the buyout firm to an outside CEO, who brings only reputational capital to the table. This analogy also fails on a key point—unlike the CEO, the buyout firm owes no duty of loyalty. In any event, this deal does not make business sense either. Today's properly incentivized CEO is not supposed to receive a fixed salary equal to eight percent of the equity value of the firm. Nor would we expect a stock option plan to divert to the CEO twenty percent of the gain on the stock, at least on a rule of thumb basis.

In the end, the buyout super monitor bears no familial relationship whatsoever to a long-term equityholder, block or otherwise.

IV. CONCLUSION

The private equity buyout overcomes the problems of separated ownership and control by combining a debt-heavy, risky capital structure with a transfer of control to a temporary super-monitor who makes no significant capital contribution but takes all of the monitoring gain. High powered incentives result. The structure appears to work within its own limited durational framework, subject to a question concerning the distribution of gain between the super-monitor and the outside equity

197. Private equity firms contribute only a small fraction of the limited partnership equity, typically one percent. *See* GEORGE W. FENN, ET AL., FED. RESERVE THE ECONOMICS OF THE PRIVATE EQUITY MARKET 28 (1995) *available at* www.federalreserve.gov/pubs/staffstudies/1990-99/ss168.pdf.

198. Metrick & Yasuda, *supra* note 135, at 16.

investors. At the same time, the structure does not appear to hold out an all purpose replacement for the still-potent combination of unlimited duration equity capital and market liquidity.

THE ROLE OF FINANCIAL REGULATION IN PRIVATE FINANCIAL FIRMS: RISK MANAGEMENT AND THE LIMITATIONS OF THE MARKET MODEL

James A. Fanto[*]

I. INTRODUCTION: THE OLD VERSUS THE NEW IN FINANCE

Remember the former world of finance? There were easily identifiable financial institutions that operated primarily in their allotted spheres, with their designated regulators and with most of their activity in the public eye. Firms registered as broker-dealers specialized in either investment banking (corporate finance and merger advice) or retail brokerage;[1] banks took in deposits and made mainly commercial loans;[2] and insurance companies underwrote policies, hedged their insurance risk in the reinsurance market, and were major buyers of company debt in private placements.[3] The upstart was the private equity firm, which shook up the corporate and financial establishment in the 1990s, as it essentially reintroduced merchant banking into the United States and provided a new kind of investment for institutions and wealthy individuals.[4] Stock exchanges, with a few rare exceptions, were quasi-public, essentially national organizations with a characteristic clientele, such as large capitalization firms for the New York Stock Exchange.[5] This is, of course, an idealized portrait; the last twenty years of the 20th century also saw the beginning of an intense competition between, and a blending of, the different kinds of financial institutions, as each one encroached upon the territory of the others by offering similar products and services. Now there exists a very different financial world, where it is not always easy to categorize a particular financial institution,

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1. *See generally* Arthur B. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U.L. REV. 75, 83–84 (2004) ("The activities of many financial firms can be divided roughly into two categories, investment banking and retail brokerage . . . .").

2. *See* Independent Bankers Ass'n of America v. C.T. Conover, 1985 U.S. Dist. LEXIS 22529, at *2 (M.D. Fla. Feb. 24, 1985) ("Section 2(c) of the BHCA as amended in 1970, defines the term 'bank' for purposes of that act as 'any institution . . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.'").

3. *See generally*, Emeric Fischer, *Banking and Insurance – Should Ever the Twain Meet?*, 71 NEB. L. REV. 726 (1992).

4. *See generally* GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE (1998) [hereinafter NEW FINANCIAL CAPITALISTS].

5. *See generally* Jaclyn Braunstein, *Pound Foolish: Challenging Executive Compensation in the U.S. and the U.K.*, 29 BROOK. J. INT'L L. 747, 766 (2004) ("[T]he NYSE is not a publicly traded entity and, as the world's largest stock exchange, serves as a 'quasi-public institution with an important regulatory function.'") (internal citation omitted).

there has been a growth of private financial institutions,[6] and financial regulators appear to be constantly trying to catch up with financial developments.

The Gramm-Leach-Bliley Act of 1999 (Gramm-Leach-Bliley) officially created the financial conglomerate, allowing diverse financial institutions to operate together under a single financial holding company.[7] In this structure, the separate identities and functions of the financial institutions are nominally maintained.[8] Commercial banks still conduct "banking," while their investment bank, futures commission merchant, and insurance company affiliates focus on their traditional tasks.[9] However, the financial institutions often supply overlapping products[10] and are ultimately operated together in the financial conglomerate as the group's services are offered to clients in combination.[11]

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6. *See generally* NEW FINANCIAL CAPITALISTS, *supra* note 4; Peter J. Wallison, *For Financial Regulation, Era of Big Government Really is Over*, STATE NEWS SERVICE, June 17, 2008, at 2–4 ("One of the most significant unremarked trends of the last twenty-five years has been the growth of private financial markets and private financial institutions . . . . From 1996 to 2006, the real assets of the ten largest private-sector banks in the world grew in nominal terms from $4.6 trillion to $17.4 trillion, a growth rate of 277 percent.").

7. *See* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12, 15, 16, 18 U.S.C.).

8. *See generally* F. Jean Wells & William D. Jackson, *Major Financial Services Legislation: The Gramm-Leach-Bliley Act (P.L. 106-102): An Overview*, CONG. RESEARCH SERV. (1999), *available at* http://epic.org/privacy/glba/RL30375.pdf (last visited Nov. 10, 2008).

9. *See generally id. See also* Elizabeth F. Brown, *E Pluribus Unum-Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 7 (2005) ("The [Gramm-Leach Bliley Act] repealed portions of the Glass-Steagall Act of 1933, the Bank Holding Company Act of 1956 and other laws in order to permit banks, securities firms, insurance companies, and other entities engaged in the provision of financial services to become affiliated with one another in order to form financial conglomerates. These types of affiliations allow financial services entities to cross sell each other's products and services.") (internal citations omitted); *see also* Isaac Lustgarten, *International Legal Developments in Review 1999: Business Regulation: The Gramm-Leach Bliley Act and International Banking*, 34 INT'L LAW 429 (Part II) (1999).

10. For example, a variable annuity requires a person to make payments until retirement, at which time that person receives a stream of income until his or her death that is based on the investment performance of the payments. It is offered by insurance companies, broker-dealers and banks, and it is classified as a securities product. *See* Nationsbank of North Carolina, N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251 (1995).

11. Unfortunately, the best example of this is that, during the corporate scandals of the early 2000s, it was revealed that many parts of certain financial holding companies collaborated with the scandal-ridden firms. *See generally The Role of Financial Institutions in Enron's Collapse: Hearing Before Permanent Subcomm. On Investigations of the S. Comm. on Gov't Affairs*, 107th Cong., 107-618 (2002) (statement of Robert Roach, Chief Investigator); *In re* Enron Corp., No. 01-16034, (Bankr. S.D.N.Y. 2003) (App. D, Third Interim Report of Neal Batson at 1), *available at* http://www.enron.com/media/3rd_Examiners_Report_AppendixD.pdf (last visited Nov. 11, 2008) ("Citigroup helped Enron implement-and in some cases designed-a number of SPE transactions.").

In the private investment world, private equity has expanded to include venture capital, which specializes in start-up companies,[12] and hedge funds, which make their money from trading strategies.[13] Investment banks have also embraced this private world, offering asset management comparable to the private financial participants (e.g., private equity firms), as well as providing services to them.[14] However, the competition between regulated and unregulated firms is not all in one direction: private firms have become major providers of capital to nonfinancial firms and are now the equivalent of investment and commercial banks.[15] Stock exchanges have also gone international to expand their product offerings, and have themselves become privately owned, for-profit companies.[16] Moreover, they compete with broker-dealers, commercial banks, and private financial firms, which have created their own trading platforms.[17]

On the regulatory front, Gramm-Leach-Bliley reaffirmed the previous framework of functional regulation, which means that regulators maintain jurisdiction over their traditional clientele (e.g., the Securities Exchange Commission (SEC) over broker-dealers and the Office of the Comptroller of the Currency (OCC) over national banks) and the Board of Governors of the Federal Reserve regulates the holding company and provides a safeguard of last resort for the stability of the financial system.[18] However, as will be discussed in more detail below, much financial activity, including

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12. *See generally* NEW FINANCIAL CAPITALISTS, *supra* note 4; *see also* National Venture Capital Assoc., *The Venture Capital Industry: An Overview*, http://www.nvca.org/def.html (last visited Sept. 24, 2008).

13. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-200, HEDGE FUNDS: REGULATORS AND MARKET PARTICIPANTS ARE TAKING STEPS TO STRENGTHEN MARKET DISCIPLINE, BUT CONTINUED ATTENTION IS NEEDED 1 (2008), *available at* http://www.gao.gov/new.items/d08200.pdf (last visited Nov. 10, 2008) [hereinafter GAO HEDGE FUND REPORT] ("[T]he term is commonly used to describe pooled investment vehicles that are privately organized and administered by professional managers and that often engage in active trading of various types of securities and commodity futures and options contracts.").

14. The services fall under the rubric of "prime brokerage," which generally means that a registered broker-dealer offers to a hedge fund transaction services for its trading and secured loans using the securities owned by the fund as collateral. *See generally* Philipp Hildebrand, *Hedge funds and prime broker dealers: steps towards a "best practice proposal"*, 10 FIN. STABILITY REV. 67 (2007), *available at* http://www.banque-france.fr/gb/publications/telechar/rsf/2007/etud2_0407.pdf (last visited Nov. 10, 2008).

15. *See* Andrew Crockett, *The evolution and regulation of hedge funds*, 10 FIN. STABILITY REV. 19, 22 (Apr. 2007), *available at* http://www.banque-france.fr/gb/publications/telechar/rsf/2007/etud2_0407.pdf (last visited Nov. 10, 2008).

16. The best example here is the former New York Stock Exchange, which is now NYSE Euronext, after going private and merging with a major European exchange. *See generally* NYSE.com, About Us, http://www.nyse.com/about/1088808971270.html (last visited Aug. 26, 2008).

17. *See generally* Scott Patterson & Aaron Lucchetti, *Boom in 'Dark Pool' Trading Networks Is Causing Headaches on Wall Street,* WALL ST. J., May 8, 2008, at C1 (describing alternative trading systems).

18. *See generally* 12 U.S.C. § 1844(c)(2), (4) & (5) (2008).

private financial firms, remains outside the direct jurisdiction of any financial regulator.[19]

This essay addresses whether financial regulators have taken the most appropriate regulatory approach towards the diverse and complex private financial activities that occur both inside and outside regulated financial conglomerates. Part II identifies the various kinds of private financial activities and examines the general approach of financial regulation to the unregulated private firms conducting those activities. Part III reviews the migration of those activities into regulated financial firms and the primary strategy of regulators regarding those activities, as well as the similarities between this strategy and the regulators' approach with respect to unregulated firms, particularly in risk management. Next, Part IV addresses questions raised by the current financial crisis about the effectiveness of these similar approaches. Then, Part V discusses major obstacles to improving risk management in private firms and in regulated firms conducting comparable activities, especially the structure of employment and compensation in the securities industry today. In conclusion, Part VI provides several observations about the possibility of reform with respect to private financial activities.

II. THE PRIVATE FINANCIAL WORLD[20]

Private financial institutions are typically organized in a uniform fashion. Financial specialists, often former investment bankers and traders, set up financial advisory firms, which may or may not be registered with the SEC as an investment adviser or broker-dealer.[21] These firms, in turn, organize investment funds to which institutional investors and high-net-worth individuals subscribe.[22] The funds are unregulated because they do not raise money through a public capital-raising[23] and because the funds themselves qualify for one of the exceptions to the Investment Company

19. *See* discussion *infra* Part III.

20. For current purposes, private financial institutions are those institutions involved in private equity and alternative asset management.

21. Under the Investment Advisers Act of 1940, an investment adviser need not register with the SEC if it does not hold itself out to the public as such, nor acts as an adviser to a registered investment company, and if it has fewer than 15 clients in the preceding 12 months. *See* 15 U.S.C. § 80b-3(b)(3) (2008). "Client" refers to a fund established by the adviser, not to the beneficial owners of the fund. A person need not register as a "broker" or "dealer" unless it engages "in the business of effecting transactions in securities for the account of others," (15 U.S.C. § 78c(a)(4)(A) (2008)), or "in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. § 78c(a)(5)(A). A key term in this definition is "business." Since the adviser purchases and sells securities for the client fund, it is not considered to be a broker or dealer.

22. *See* 15 U.S.C. § 80a-3(c)(7).

23. In other words, funds raise money through private placements, which can be exempt from the requirement to register the securities offering with the SEC. *See* 15 U.S.C. § 77d (2008); 17 C.F.R. § 230.506 (2008).

Act of 1940.[24] The funds, in turn, specialize in a particular kind of investment and/or investing strategy depending upon the expertise of the investment manager. In general, private equity funds focus on long-term investments in existing firms that are often taken private to be rehabilitated.[25] In contrast, venture capital funds invest in start-up firms,[26] while hedge funds focus on trading strategies with extensive use of derivatives to hedge risk or to speculate.[27] Thus, depending upon the kind of fund, investors will be more or less restricted in receiving the return on their investment. Many funds also use extensive leverage in their investments in order to boost their returns, as do investors in the funds.[28]

Some private financial firms prefer to remain unregulated and thus elect not to become registered broker-dealers or investment advisers.[29] Apart from abortive efforts to regulate these private financial participants, the approach of U.S. financial regulators to them has been twofold.[30] First, financial regulators indirectly regulate: they gather information about, and exercise some influence over, the activities of private financial firms through their power over regulated firms, such as banks and broker-dealers.[31] These latter, regulated firms provide products and services to the private firms, such as trading services and margin in the case of broker-dealers[32] and loans and investment products, such as participation in

24. Investment companies are exempt from registration if their shares are not offered publicly and if either their shares are not beneficially owned by more than 100 investors, 15 U.S.C. § 80a-3(c)(1), or their purchasers are "qualified" (i.e., individuals owning at least $5 million in investments, or firms owning at least $25 million in investments). 15 U.S.C. § 80a-3(c)(7).

25. *See* Investopedia.com, Private Equity, http://www.investopedia.com/terms/p/privateequity.asp (last visited Nov. 9, 2008).

26. *See* National Venture Capital Association, *supra* note 12.

27. *See* Investopedia.com, Hedge Fund, http://www.investopedia.com/terms/h/hedgefund.asp (last visited Nov. 9, 2008).

28. *See* Thomas Schneeweis, Hossein Kazemi &Vassilis Karavas, *Leverage Impacts on Hedge Fund Risk and Return Performance*, ISENBERG SCH. OF MGMT., U. MASS. at 1 (2004), *available at* http://www.lyracapital.com/documents/Leverage-final.pdf (last visited Nov. 9, 2008). They do this in accordance with a basic principle of financial economics that, if one borrows money at a fixed rate of return in order to invest it, together with one's own money, at a greater rate, the return on the investor's contribution will be greatly magnified. *See also* Investopedia.com, Leverage, http://www.investopedia.com/terms/l/leverage.asp (last visited Nov. 9, 2008).

29. *See* GAO HEDGE FUND REPORT, *supra* note 13, at 12–13 (discussing registration of hedge fund advisers).

30. The most notorious example was the SEC's rule amendment to Rule 203(b)(3)-1, which changed the definition of client for adviser registration purposes from the "fund" to the "beneficial owners" of the fund (i.e., limited partners or members in limited liability companies), except for funds with the lengthy lock-ups typical of private equity or venture capital funds. This rule was struck down as outside the SEC's power by the Court of Appeals for the District of Columbia Circuit. *See* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

31. This is the general practice in sophisticated economies throughout the world with respect to hedge funds. *See generally* Daniele Nouy, *Indirect supervision of hedge funds*, 10 FIN. STABILITY REV. 95 (2007).

32. On this indirect regulation through broker-dealers, see GAO HEDGE FUND REPORT, *supra* note 13, at 19.

syndicated loans and structured vehicles, in the case of commercial banks.[33] The private participants are also counterparties with regulated financial firms in the trading of many, often exotic, financial instruments, particularly complex derivatives, such as credit derivatives.[34] Financial regulators can thus gather information about the activities and risk exposure of private firms and their sponsors from the regulated firms, especially since the risk models and capital positions of the regulated firms have to take account of and reflect their dealings with these firms.[35] Indeed, financial regulators can influence the conduct of the unregulated firms simply by insisting that particular transactions with them occur in a specified way or that the provision of leverage to them be restricted (e.g., by requiring more capital in a regulated firm in order to engage in a particular transaction with a private firm).[36]

Second, financial regulators encourage the alternative asset management industry to adopt "best practices" for its members and thus to regulate itself.[37] For example, the President's Working Group on Financial Markets, which is composed of the main U.S. financial regulators,[38] recently received reports of proposed best practices for hedge funds[39] and for hedge fund investors.[40] Financial regulators are being particularly astute here, for they must know that self-regulation is often a predecessor to official regulation, which occurs after the private parties have created a regulatory model that they cannot enforce among themselves, and when regulators step in and transform the model into a public good.[41] In a related

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33. *Id.* at 24–25.

34. *See id.* (noting that hedge funds account for more than 80% of the credit derivatives market). These would be instruments in which, among other things, an investor essentially purchases protection for the risk of holding debt of a particular company. *See* Investopedia.com, Credit Derivative, http://www.investopedia.com/terms/c/creditderivative.asp (last visited Nov. 9, 2008).

35. *See* Nouy, *supra* note 31. *See also* GAO HEDGE FUND REPORT, *supra* note 13, at 2.

36. *See* Nouy, *supra* note 31. *See also* GAO HEDGE FUND REPORT, *supra* note 13, at 2.

37. *See, e.g.*, REPORT OF THE ASSET MANAGERS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, BEST PRACTICES FOR THE HEDGE FUND INDUSTRY (2008), *available at* http://www.ustreas.gov/press/releases/hp927.htm (last visited Nov. 9, 2008) [hereinafter ASSET MANAGERS' COMMITTEE REPORT].

38. The Group is chaired by the Secretary of the Treasury and includes the Chairs of the Federal Reserve, the SEC, and the Commodity Futures Trading Commission. *See* United States Department of the Treasury, Office of Financial Market Policy, Mission, http://www.treas.gov/offices/domestic-finance/financial-markets/fin-market-policy/ (last visited Nov. 9 2008).

39. These reports were provided by hedge fund managers themselves. *See* ASSET MANAGERS' COMMITTEE REPORT, *supra* note 37.

40. These reports were provided by institutional investors. *See id.*

41. That is, a particular sector of the financial industry initially agrees with financial regulators to adopt best practices under the view that adequate self-regulation may make regulation unnecessary. However, once the best practices become standard, it is in the interest of sector members to have the government enforce them, so that a participant cannot "free ride" on the enhanced reputation of the sector without actually complying with the standards. For efforts in the United Kingdom to promote self-regulation of hedge funds, see HEDGE FUND WORKING GROUP,

vein, financial regulators also encourage participants to develop standards with respect to activities and transactions that unregulated financial firms engage in, often with regulated firms as their counterparties.[42] By doing so, financial regulators avoid devoting scarce resources to gaining expertise in an area in which they have no experience.[43]

Financial regulators are not necessarily focused on preventing the failure of a private financial firm. While financial regulators should be indifferent, they may actually hope that such a failure would lead the remaining private participants to agree to regulation and/or to enter into regulated financial groups, which would lead to a consolidation and maturation of the private financial industry. The real concern for financial regulators, which justifies their monitoring, is that the failure of an unregulated financial firm might adversely affect a regulated financial institution, which could, in turn, lead to a cascade of additional failures of financial institutions, a freezing up of the financial system, and, in the worst scenario, a drastic decrease in overall economic activity.[44] This amplification of financial institution failure is known as systemic risk.[45] Financial regulators faced this kind of situation in 1998 when they had to deal with the failure of the celebrated hedge fund, Long-Term Capital Management, which triggered more regulatory attention to the systemic risks posed by hedge funds.[46]

The failure of a private financial firm, if it is large enough, could also give rise to widespread media and political attention.[47] Increasingly, ordinary individuals are exposed to private financial firms through their investments in pension funds and in other institutional investors, which in turn invest in these private firms' alternative investment vehicles.[48] Indirect financial harm to ordinary individuals from the failure of a private firm

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HEDGE FUND STANDARDS: FINAL REPORT (2008), *available at* http://www.hfsb.org/sites/10109/files/final_report.pdf (last visited Nov. 10, 2008).

42. *See, e.g.*, *id.*

43. For an example of this kind of self-regulation, see Int'l Swaps and Derivatives Ass'n., Inc., http://www.isda.org (last visited Nov. 10, 2008). In particular, this Association adopted guidelines on structured products in response to the recent subprime financial crisis. *See, e.g.*, STRUCTURED PRODUCTS: PRINCIPLES FOR MANAGING THE DISTRIBUTOR-INDIVIDUAL INVESTOR RELATIONSHIP, INT'L SWAPS AND DERIVATIVES ASS'N., INC. (Exposure Draft May 12, 2008), *available at* http://www.sifma.org/private_client/pdf/GlobalRSP-Distributor-PrinciplesMay ExposureDraft.pdf (last visited Nov. 10 2008).

44. Roger Ferguson & David Laster, *Hedge Funds and Systemic Risk*, 10 FIN. STABILITY REV. 45, 50 (2007).

45. *See id.* at 49.

46. *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

47. *See generally* Raghuram G. Rajan, *Financial conditions, alternative asset management and political risks: trying to make sense of our times*, 10 FIN. STABILITY REV. 137, 141–142 (2007).

48. *See* Riva D. Atlas & Mary Willliams Walsh, *Pension Officers Putting Billions Into Hedge Funds*, N.Y. TIMES, Nov. 27, 2005, at A1, *available at* http://www.nytimes.com/2005/11/27/business/yourmoney/27hedge.html (last visited Nov. 9, 2008).

could lead to media demands for regulation and attention from politicians begrudgingly responding to the crisis.[49] If the failure were significant enough, financial regulators would also be blamed for not having been more aggressive in regulating, or advocating the regulation of, the private firms.[50]

The current financial crisis that was sparked by the failure of the subprime mortgage market is a good example of this kind of acute media and political attention on financial regulation.[51] It has brought to the forefront the following valid concerns about an approach that relies on indirect regulation of private financial firms coupled with their self-regulation.[52] First, some regulated firm personnel have strong incentives not to monitor closely private firms. For example, traders within investment banks who are directly involved in the provision of transaction services to private firms are reluctant to limit such business even when required by their firm's risk management. Even investment bank and commercial bank management may resist the limits, for they are competing with other banks for the business of private firms. This problem is exacerbated because the personnel and management of investment and commercial banks may not rationally compare the gains from short-term trading and other gains from ignoring the position limits with the discounted present value of the long-term dangers arising from ignoring these limits. As will be discussed more below, current employment and compensation practices in regulated firms undermine a proper recognition of the discounted long-term dangers.[53] This fact applies to bank executives as well, since in the financial conglomerates that deal with private firms and that are publicly traded firms, executives have the typical enormous compensation contracts that make them impervious to any financial disaster.[54]

Second, the current model of indirect regulation may be extremely difficult to carry out for regulated institutions, which are actually few in number and all critical to the financial system.[55] Obtaining adequate

49. *See e.g.*, Jackie Calmes, *Obama and McCain have different approaches to Wall Street*, INT'L HERALD TRIB., Sept. 16, 2008, *available at* http://www.iht.com/articles/2008/09/16/america/16record.php (last visited Nov. 10 2008) (noting that both Obama and McCain have responded to the recent turmoil in the financial industry with calls for increased regulation).

50. Crockett, *supra* note 15, at 25.

51. *See* discussion *infra* Part IV.

52. On some of the following points, see generally Nouriel Roubini, *Hedge Funds: Do We Need To Regulate Them and How?* (June 2007) (on file with author).

53. *See* discussion *infra* Part V.

54. *See, e.g.*, *Supplemental Information on CEO Pay and the Mortgage Crisis, Memorandum from the Majority Staff, Comm. on Oversight and Government Reform to Members of the Comm. on Oversight and Government Reform*, 110th Cong. (2008) (describing enormous compensation contracts of CEOs (departing) of financial institutions that performed poorly during the mortgage crisis).

55. In the United States, only the financial conglomerates, like Citigroup and JP Morgan, have the capacity to provide services to the private financial institutions. *See* Hildebrand, *supra* note 14, at 72.

information from the private firms with whom they do business is difficult because private firms are in competition with the regulated firms, giving them a competitive incentive not to share all their information, and increasing the likelihood that they will spread their business among different financial firms.[56] For example, a regulated financial institution may find it difficult to get a complete understanding of the amount of leverage in a particular hedge fund, since investors may borrow funds to make an investment in a fund of funds, the fund of funds may use leverage for its investments in the hedge fund, and the fund itself may borrow from numerous financial intermediaries.[57]

The appropriateness of the current approach to private financial firms may come down to the adequacy of the risk management models used by regulated firms in their dealings with unregulated counterparties, as well as of the models used by unregulated firms to manage their own risks. To be adequate in the former case, the model would have to take account of the risk that the investment or commercial bank would not have all the necessary information about its unregulated counterparty (or that the counterparty might act opportunistically in withholding certain of this information), specify how the financial institution responds to this risk (e.g., imposing higher margins, taking bigger "haircuts" on the collateral of the private firm, limiting exposure to the private firm), and rigorously enforce this response among its personnel. The model would have to assume that the unregulated firm's undisclosed direct and indirect leverage could be greater than what is disclosed and then consider the consequences for the regulated firm if a liquidity crisis arose for the private firm and for the market more generally. A private financial firm needs similar models addressing the same risks in the unregulated counterparties that it transacts with. As discussed later in this essay, the question is whether current risk models are up to these tasks and whether they can be adequately applied.[58]

III. PRIVATE FINANCIAL FIRMS WITHIN THE REGULATED WORLD

Private financial firms and their activities have also migrated into regulated financial conglomerates due to Gramm-Leach-Bliley. As discussed above, it officially approved the formation of financial holding companies that engage, or that own companies that are engaged, in all kinds of financial activities.[59] The statutory list it provided of permissible financial activities is broad and covers all functions of a full-service investment bank, including investment advisory services and merchant

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56. *See* Crockett, *supra* note 15, at 26.
57. *See* Roubini, *supra* note 52, at 9.
58. *See* discussion *infra* Part IV.
59. *See* discussion *infra* Part II.

banking.[60] Significantly, the statute also empowered the Federal Reserve and the Treasury Department to add activities to the list and set forth open-ended criteria for them to use, such as changes in the competitive market for financial services, technological developments for delivering financial services, and the ability of the holding companies to compete in the financial services marketplace.[61] Thus, as private financial firms offer new kinds of financial products and services, as well as technological innovations in their delivery, Gramm-Leach-Bliley permits financial holding companies to acquire the private firms or engage themselves in similar activities.

Therefore, a financial conglomerate can create, "in house," the equivalent of a private financial firm or, for the right price, acquire a private firm, such as a private equity firm or a hedge fund adviser. Financial conglomerates have done both to gain market share in these financial activities. To take one notable example, the current CEO of Citigroup, Vikram Pandit, came to Citigroup when it acquired his hedge fund firm.[62] Now, financial conglomerates, through their asset management divisions, offer their own private equity and hedge funds to their wealthy clientele, which are chiefly institutions and high net worth individuals.[63] They often compete with the private financial firms to whom they provide prime brokerage services.[64] The financial conglomerates also engage, for their own account, in proprietary trading and investing, particularly similar to hedge fund activity.[65] Private financial firms have thus been partly "domesticated" by becoming a part of regulated financial conglomerates.

The regulation of private financial activities conducted within financial conglomerates should pose less difficulty for financial regulators, who have collective jurisdiction over the conglomerates.[66] Yet it is important to emphasize the nature of this regulation. Particularly since Gramm-Leach-Bliley, financial regulators focus not so much on whether and how a

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60. *See* 12 U.S.C. § 1843(k)(4) (2008).

61. *See* 12 U.S.C. § 1843(k)(2)–(3).

62. Pandit was a founding member and chairman of Old Lane, L.P., a hedge fund and private equity manager. Before that, he was the President and Chief Operating Officer of Morgan Stanley's investment banking business, which emphasizes the movement of personnel back and forth between regulated and unregulated financial firms. Citigroup.com, Biography of Vikram Pandit, http://www.citi.com/citigroup/profiles/pandit/bio.htm (last visited Aug. 22, 2008).

63. *See generally Goldman LBO Fund to Raise about $20B*, AFX INTERN'L FOCUS, Mar. 27, 2007.

64. *See generally Bank of the Year for M&A: Goldman Sachs*, THE BANKER, Oct. 1, 2001, *available at* http://www.thebanker.com/news/fullstory.php/aid/4325/Bank_of_the_year_for_M_A:_Goldman_Sachs.html (last visited Nov. 10, 2008) ("Many critics believed that Goldman's active private equity investment and management of private equity money for third party investors would generate conflict of interest between the bank and its clients.").

65. *See* Emma Trincal, *Hedge Funds Acquisitions: Good for Returns?*, HEDGEWORLD DAILY NEWS, Feb. 5, 2007, *available at* http://www.hedgeworld.com/preview_news.cgi?section=peop&story=peop2873.html&area=premium&source=wealth_management (subscription required).

66. 12 U.S.C. § 1844 (2008).

financial conglomerate can engage in particular financial activities, but upon the competency of the group's management and adequacy of the group's capital to support them.[67] In other words, the role of financial regulators is no longer primarily to determine the appropriateness of a particular financial activity for a group. There are several reasons for this regulatory position, aside from Gramm-Leach-Bliley. First, financial regulators do not have the resources to regulate substantively and quickly evolving financial activities; they must leave this kind of regulation to the market participants.[68] Second, the position is based upon a particular normative view of the most economical way to regulate financial institutions: if the financial institutions themselves (and the managers of these institutions) have their own money at risk in the activities and not just investors' money, they have self-interested reasons for taking the necessary safeguards with respect to the activities.[69]

Determining adequate capital for financial institutions is no longer just an issue of setting a certain baseline percentage of capital relative to the assets, the traditional leverage ratio in financial institutions.[70] Rather, for some time, determining adequacy of capital has required a "risk-based" approach: capital should be proportional to the risk of the assets themselves, because the riskier the assets, the more capital is required.[71] Moreover, even off-balance sheet activities must be taken into consideration in the capital determination, both for their own inherent risks and the chance that they will move onto the institution's balance sheet.[72] Once an institution's overall risk exposure is calculated, the institution sets aside a statutorily imposed amount of capital for these total "risk-weighted" assets and activities.[73]

As financial assets and activities have become more complex, risk assessment of them and the resulting capital determination have evolved as well. Under the current regulatory scheme for large financial institutions that are engaged in private financial activities, the institutions themselves

67. *See* 12 U.S.C. § 1843(l)(1) (2008).

68. This perspective is apparent in the structure of Gramm-Leach-Bliley. The basic conditions for a firm to become a financial holding company are that its banks are "well capitalized" and "well managed." *See* 12 U.S.C. § 1843(l)(1).

69. *See infra* for more discussion on the normative perspective in finance today.

70. *See, e.g.*, 12 C.F.R. § 3.6(b) (2008) (leverage ratio for national banks); 12 C.F.R. pt. 225, App. D (2008), *available at* http://www.fdic.gov/regulations/laws/rules/6000-2200.html#6000appendixd (last visited Nov. 10, 2008) (leverage ratio for holding companies).

71. *See, e.g.*, 12 C.F.R. § 3.6(a) (2008) (risk-based capital ratio).

72. *See, e.g.*, 12 C.F.R. pt. 225, App. A, Sec. III (2008), *available at* http://www.fdic.gov/regulations/la-ws/rules/6000-1900.html#6000appendixa (last visited Nov. 10, 2008).

73. This is the well-known risk-based capital model promulgated by the Basel Committee on Banking Supervision and adopted by participatory countries. This model is known generally as Basel I. For the Federal Reserve's version, see 12 C.F.R. pt. 225, Apps. A, E & G.

develop the models to assess asset risks, including counterparty risks.[74] In other words, financial regulators increasingly leave it to the institutions themselves to establish the models for determining the risk of assets and thus the necessary amount of capital. Once again, the regulators recognize that they do not have the resources to design risk models for use by the institutions.

Therefore, bringing private financial activities within the sphere of financial regulation does not necessarily mean that there is strong governmental oversight of the activities or that the government establishes standards for them. Certainly, regulators will become more familiar with activities conducted within a regulated institution, or a part thereof, and can insist upon certain practices with respect to them. But, except in a crisis, financial authorities defer to the regulated institutions as to the conduct of the activities and, significantly, to the risk assessment of the activities, and thus to the adequacy of the financial institutions' capital. In a financial crisis, such as the current one, regulators may be more active in discussing these valuation and risk assessment issues in detail, and even requiring that institutions enhance their capital position.[75] However, if an institution's own practices and models are seriously inadequate, it is likely that this will become apparent too late to prevent significant damage to, and even failure of, the regulated firm.[76]

IV. RISK MANAGEMENT AND THE MARKET MODEL

Current circumstances have presented a test for such a regulatory approach that relies greatly on risk management models. The collapse of the credit markets was triggered by losses in asset-backed securities, including those backed by subprime mortgages.[77] During a sustained period of very

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74. This remark greatly simplifies things. Under the revised Basel capital framework, known as Basel II, a financial institution must take account of its credit risk, market risk, and operational risk in determining its appropriate capital. While guidance has been given as to market risk (12 C.F.R. pt. 225, App. E), the Federal Reserve and the other banking regulators have just adopted guidelines as to credit and operational risks. *See* Risk-Based Capital Standards, Advanced Capital Adequacy Framework—Basel II. 72 Fed. Reg. 69,288 (Dec. 7, 2007). All these frameworks rely heavily on an institution's own assessment of its risks.

75. This essay was completed before the financial crisis became acute following the summer. Obviously, in a significant crisis like the present one, regulators will do everything possible to help financial institutions improve their capital position so that they, and our economic system, can survive. *See, e.g.*, *Treasury Announces TARP Capital Purchase Program Description*, U.S. Treasury HP-1207 at 30, (Oct. 14, 2008), *available at* http://www.ustreas.gov/press/releases/hp1207.htm (last visited Nov. 9, 2008).

76. *See infra* Part IV. Clearly, the demise of Bear Stearns was partly due to its own private financial activities (e.g., hedge fund activity).

77. Subprime mortgages were initially and chiefly, but not exclusively, the cause of the collapse. *See generally* Dr. Faten Sabry & Dr. Thomas Schopflocher, *The Subprime Meltdown: A Primer*, Part I of a NERA Insight Series (June 21, 2007), *available at* http://www.nera.com/image/SEC_SubprimeSeries_Part1_June2007_FINAL.pdf. However, economists who compare the current crisis to other post-World War II financial crises believe that it has all the characteristics

low interest rates, credit was extended widely to real estate buyers (even to those with low incomes and little savings) and the debt was packaged and resold as differing kinds of securities to investors looking for higher returns on debt investments.[78] Unfortunately, it was done without a complete appreciation for the risk of nonpayment by the buyers and with a resulting mispricing of the asset-backed securities.[79] The default rates and plummeting real estate values caused a broad reevaluation and repricing of the securities backed by those mortgages.[80] As a result, investors became suspicious that other asset-backed securities were not appropriately priced and the onslaught of selling led to falling prices for those securities.[81] This resulted in a general loss of liquidity for many of these and other financial assets and a freezing-up of the market for issuance of similar securities.[82] For example, the market for existing leveraged-buyout (LBO) securities, which are debt that fund company acquisitions by LBO firms, all but disappeared, and banks, unwilling to make any new LBO loans, attempted to extricate themselves from their prior commitments to fund buyouts.[83] With falling prices in financial assets, financial institutions became concerned about their own weakened capital position and about the solvency of their counterparties.[84] They were reluctant to engage in

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of a serious, but typical, financial crisis: a run-up in asset and equity prices due to capital inflows, slowing economic growth, an increase in public debt, and a large current account deficit. *See* Carmen M. Reinhart & Kenneth S. Rogoff, *Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison* (Nat'l Bureau of Econ. Research, Working Paper No. 13,761, 2008).

78. *See generally* Sabry & Schopflocher, *supra* note 77.

79. Many of the buyers made little or no down payments and were unable to afford the mortgage payments. They depended on the homes increasing in value in order to make the home purchase a worthwhile one. *See generally* JOINT ECON. COMM., THE U.S. HOUSING BUBBLE AND THE GLOBAL FINANCIAL CRISIS: HOUSING AND HOUSING-RELATED FINANCE (2008).

80. In effect, the situation was complicated. There were securities backed by subprime mortgages, often with the structured vehicle that held the mortgages issuing different classes or "tranches" of securities. In addition, there were other vehicles that held these asset-back securities and/or derivatives (e.g., credit default swaps based on these securities) and that issued their own tranches of securities (known as collateralized debt obligations). *See generally* Sabry & Schopflocher, *supra* note 77.

81. *See generally* Richard J. Caballero & Arvind Krishnamurthy, *Musical chairs: a comment on the credit crisis*, 11 FIN. STABILITY REV. 9, 10 (2008).

82. *See generally id.*

83. The most well-known dispute involved the acquisition of Clear Channel by private equity groups Bain Capital and Thomas H. Lee where the banks who had made the commitment to fund the acquisition refused to honor their commitment. *See* Clear Channel Commc'ns, Inc. v. Citigroup Global Mkts, Inc., 541 F. Supp.2d 874 (W.D. Tex. 2008). The dispute was settled, with the banks receiving a more favorable interest rate. *See* Peter Lattman & Sarah McBride, *Clear Channel Suitors, Banks Reach Deal,* WALL ST. J., May 14, 2008, at C3.

84. Problems came to financial institutions because they had to "mark to market" their own securities positions, as well as clients' securities collateral. However, when many kinds of securities, which were traded privately among institutions, essentially stopped trading, it became difficult for the institutions to give an accurate assessment of their own financial position. *See generally* TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, FINAL REPORT OF THE TASK FORCE ON THE SUBPRIME CRISIS 16–19 (2008).

transactions with, and particularly to extend credit to, other firms because they were unsure about the exposure of these firms to the troubled securities.[85] Indeed, these circumstances satisfied many of the conditions for the classic definition of a financial "shock" with systemic consequences, as opposed to a financial disturbance.[86]

Problems from the credit crisis first surfaced in financial conglomerates[87] due to their own involvement in private financial activities, including in-house hedge funds, proprietary investments in asset-backed securities, and closely related special purpose entities organized to invest in assets.[88] As a result, those institutions took enormous write-downs in their positions in asset-backed and other securities and had to raise capital in order to maintain adequate capital ratios and to safeguard their very solvency.[89] Bear Stearns did not survive the crisis on account of its activities and investments in subprime assets and merged with J.P. Morgan, another financial conglomerate.[90]

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85. *See, e.g.*, Deborah Solomon, *U.S. to Buy Stakes in Nation's Largest Banks*, WALL ST. J., Oct. 14, 2008, at A1 (listing the institutions: Goldman Sachs, Morgan Stanley, J.P. Morgan, Bank of America, Merrill Lynch (soon to be acquired by the preceding), Citigroup, Wells Fargo, Bank of New York, State Street, with an estimated investment of a total of $130 billion by the Treasury).

86. A shock, as opposed to a disturbance, would have (i) enhanced credit risk, particularly counterparty credit risk, (ii) loss of market liquidity, (iii) rapid changes and losses of value of financial instruments, particularly complex financial instruments, (iv) doubt about the accuracy of financial models, (v) inability of models to deal with "tail" risks, (vi) problems in settlement, and (vii) illiquidity of many complex instruments. These circumstances all seem present today. However, other "shock" characteristics have not occurred, or not completely occurred: (viii) costs of appropriate risk management, (ix) difficulty of restructuring when creditors cannot be located easily, and (x) questions about the ability of regulators to work together. *See* COUNTERPARTY RISK MGMT. POLICY GROUP, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 7–10 (2005). For a detailed discussion of the crisis and the risks facing the global financial system, see BANK FOR INT'L SETTLEMENTS, 78TH ANNUAL REPORT: 1 APR. 2007–31 MAR. 2008, at 137–49 (2008).

87. These include the former largest, full service investment banks, which were Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley, and financial holding companies. *See* Rachelle Younglai, *SEC Finds Voice with Investment Bank Plan*, BASELINE.COM, July 28, 2008. As is now well known, as a result of the crisis, none of these investment banks any longer exists as they formerly did. Two (Bear Stearns and Merrill) were sold to financial holding companies; one (Lehman) went bankrupt; and two (Goldman and Morgan Stanley) themselves became financial holding companies.

88. *See, e.g.*, Gregory Zuckerman & Jenny Strasburg, *Banks Fumble at Operating Hedge Funds,* WALL ST. J., May 31, 2008, at B1 (describing problems of financial conglomerates' involvement in hedge funds); David Enrich, *Citigroup Hedge-Fund Loss Weighs on Three Banks,* WALL ST. J., May 20, 2008, at C1.

89. *See, e.g.*, David Enrich, et al., *Citigroup, Merrill Seek More Foreign Capital,* WALL ST. J., Jan. 11, 2008, at A1.

90. The Wall Street Journal published an interesting series of articles on Bear Stearns' demise. *See* Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns*, WALL ST. J., May 27, 2008, at A1; Kate Kelly, *Fear, Rumors Touched Off Fatal Run on Bear Stearns*, WALL ST. J., May 28, 2008, at A1; Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Last Days*, WALL ST. J., May 29, 2008, at A1. *See also SEC v. Cioffi: SEC Charges Two Former Bear Stearns Hedge Fund Portfolio Managers with Securities Fraud*, Exchange Act Release No. 20,625 (June

This outcome suggests that, among other things, the risk management models of financial conglomerates did not accurately assess the risks of the securities and suffered from a fundamental failure: underestimation of the risks that an unlikely, but disastrous, event might occur and that a liquidity crisis would be widespread and affect all assets equally.[91] Moreover, the risk models of the financial institutions were not the only faulty ones, for the risk assessment of the securities by the "valuation" professionals, the rating agencies, was similarly flawed.[92] As in the corporate financial scandals that occurred earlier in this century, the rating agencies failed to do their job of properly assessing the risk of securities, although this time it involved evaluating the risks of the subprime asset-backed securities.[93]

So far, it is not entirely clear how the crisis has affected private financial firms. The crisis could be viewed as demonstrating another example of an over-emphasis on financial regulation, since the most publicized adversely affected institutions are regulated financial groups. Yet it is difficult to know exactly the condition of unregulated financial institutions, such as hedge fund advisers and the private equity firms that have not gone public. Nevertheless, private equity firms have clearly experienced problems with some of their funds, and there have been hedge fund failures.[94] A lack of publicity and the structure of private financial firms make it difficult to know exactly what problems they are experiencing, if any. A hedge fund adviser can restrict withdrawals from funds, or, if a fund's investments are particularly troubled, the adviser can

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19, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20625.htm (explaining civil action against managers of Bear Sterns' own hedge funds that collapsed on account of their subprime investments). Again, neither Lehman nor Merrill survived as stand-alone firms. *See* Carrick Mollenkamp, Suzanne Craig, Serena Ng & Aaron Lucchetti, *Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash,* WALL ST. J., Sept. 16, 2008, *available at* http://online.wsj.com/public/article_print/SB122145492097035549.html (last visited Nov. 10, 2008).

91. These are referred to as a "fat tail" problem (i.e., that the risk of unlikely events is greater than it seems) and the co-variance problem (that assets begin to move together in price). *See* Barry Eichengreen, *Ten questions about the subprime crisis*, 11 FIN. STABILITY REV. 19, 21 (2008).

92. *See* STAFF OF THE SEC'S OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (2008) (for the problems in credit agencies with respect to securities backed by subprime loans). The SEC in fact has proposed rule changes as to how credit agencies rate structured products. *See also* Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 73 Fed. Reg. 36,212, 36,235 (June 25, 2008).

93. *See, e.g.*, Peter R. Fisher, *What happened to risk dispersion?*, 11 FIN. STABILITY REV. 29, 35 (2008).

94. *See, e.g.*, Carrick Mollenkamp & Serena Ng, *Hedge Funds Squeezed As Lenders Get Tougher*, WALL ST. J., Mar. 7, 2008, at A1 (describing problems in Carlyle Group fund); Cassell Bryan-Low, Carrick Mollenkamp & Gregory Zuckerman, *Peloton Flew High, Fell Fast*, WALL ST. J., May 12, 2008, at C1 (describing the rapid demise of hedge fund Peloton Partners LLP).

distribute the funds' investments, rather than cash, to the investors.[95] By remaining private, they are somewhat more protected from the kind of market rumors that can lead to a "run on the bank" similar to the case of Bear Stearns and Lehman Brothers.[96] If funds are highly leveraged, as seems to be the case, there should be more fund failures as funds are forced to sell assets to meet margin calls.[97] But this action occurs if a prime broker determines that the fund's collateral is inadequate and if the regulated firm were to do this, it might have to mark down its own positions in similar collateral.[98]

Serious problems may still emerge for private market participants, which will in turn lead to even more difficulties for regulated financial institutions. After all, many private market firms, as well as regulated firms, engaged in risky investment strategies at a time of great liquidity, market stability, and low interest rates, and this disguised the fact that their returns resulted from favorable circumstances, not from their investment acumen.[99] In the parlance of the trade, few of them have outperformed the market by producing "alpha."[100] Although the regulated participants, through their investment in or imitation of private firms, have suffered significant losses, there is no reason to think that private market participants are in a much better position. They all use similar risk models and also rely upon the rating agencies for evaluations of their investments.

We can only hope now that the current circumstances do not end up being a complete financial collapse, as opposed to the serious financial

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95. *See, e.g.*, Susan Pulliam, *Locked In: When Hedge Funds Bar the Door*, WALL ST. J., July 2, 2008, at A1 (describing how hedge funds can put up "gates" to restrict investors' withdrawals from a fund).

96. Landon Thomas, Jr., *JPMorgan and Fed. Move to Bail Out Bear Stearns*, N.Y. TIMES, Mar. 14, 2008, *available at* http://www.nytimes.com/2008/03/14/business/14cnd-bear.html (last visited Sept. 24, 2008).

97. Pulliam, *supra* note 95, at A1; *see also* Mortgage-bond Fund Sells Assets After Margin Calls, USA TODAY, Mar. 7, 2008, *available at* http://www.usatoday.com/money/markets/2008-03-07-carlyle-fund-selloff_N.htm.

98. Moreover, the Federal Reserve's response to the crisis has been to flood the market with liquidity, which helps all financial participants, including hedge funds, remain afloat. *See* ADRIAN BLUNDELL-WIGNALL, ORG. FOR ECON. CO-OPERATION AND DEV., THE SUBPRIME CRISIS: SIZE, DELEVERAGING AND SOME POLICY OPTIONS 19–20 (2008) (discussing, among other things, threats posed by failure of hedge funds to prime broker-dealers and the manner in which the injection of liquidity helps prevents this failure). For an excellent discussion of the Federal Reserve's conventional and unconventional efforts to address the crisis, see generally Stephen G. Cecchetti, *Crisis and Responses: The Federal Reserve and the Financial Crisis of 2007–2008* (Nat'l Bureau of Econ. Research Working Paper No. 14,134, 2008) (noting in particular how the Federal Reserve has increased the kind of collateral (including asset-backed securities) that it will take for its loans and other operations).

99. *See, e.g.*, Rajan, *supra* note 47, at 141–42.

100. In finance, "beta" refers to the market return that is correlated with market risks. An investment manager should not be rewarded for obtaining a beta return, but only for adding to it, which is alpha. *See id.* at 139–41 (speculating on the real reasons for the above average performance of many hedge funds).

shock that we are experiencing. A serious shock leads to an enormous political reaction to finance, as retail investors demand reform of the financial system.[101] Even if the financial system is stabilized,[102] the dominant perspective regarding financial regulation—that there is too much regulation and not enough deference given to market solutions—is likely to ring hollow.[103] The problems with regulated financial conglomerates and private financial firms have less to do with regulatory, as opposed to a market, failure. As explained above, they arise from the failure of risk models that have been developed by market participants, not imposed by regulators. In other words, the current crisis raises questions about the deference to such market participants.

V. THE RISK MANAGEMENT SOLUTION

One pragmatic solution to the problems raised in the current financial crisis is to enhance the risk models and the role of risk management in private financial firms and in regulated firms, with respect to the latter's comparable activities and their dealings with private firms. This response would be similar to the reaction of financial regulators when it was revealed that financial firms had participated in the corporate scandals of Enron, Worldcom and others, either by setting up special purpose entities used by companies to engage in fraud or, without inquiring into their true financial position, by helping the companies raise capital. In those instances, regulators encouraged financial institutions to set up a firm-wide transaction and relationship committee that would evaluate risks, including legal and reputation risks, arising from transactions and relationships with clients, and to improve legal compliance by enhancing the role of a chief compliance officer.[104] On the basis of the new crisis, financial regulators should tell regulated financial firms that they must improve their risk models, institute a firm-wide senior-level risk management committee, and appoint a chief risk management officer or officers, who will have a special role in a firm's risk management.

Indeed, there have been reports that large financial institutions have enhanced their risk management. For example, Citigroup now has multiple risk managers whom the CEO regularly consults.[105] More significantly,

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101. *See id.* at 142.

102. *See* Jia Lynn Yang, *How bad is the mortgage crisis going to get?*, *available at* http://money.cnn.com/2008/03/14/news/economy/krugman_subprime.fortune/ (last visited Sept. 24, 2008).

103. This perspective is already making its way into the financial press. *See also* Jon Hilsenrath, *Markets Police Themselves Poorly, but Regulation Has Its Flaws*, WALL ST. J., July 21, 2008, at A2 (describing increasing disenchantment with market regulation of finance).

104. *See generally* James A. Fanto, *Subtle Hazards Revisited: The Corruption of a Financial Holding Company by a Corporate Client's Inner Circle*, 70 BROOK. L. REV. 7 (2004).

105. *See* David Enrich, *Citigroup Installs New Risk Managers*, WALL ST. J., Feb. 28, 2008, at C3.

financial regulators are pushing for an improvement in risk management in regulated institutions. As a result of the crisis, the Federal Reserve, the SEC, and several major foreign financial regulators conducted a review of risk management practices through the end of 2007 at major international financial institutions under their jurisdiction.[106] The review revealed that, despite past regulatory guidance on this subject, many major financial institutions failed to provide an adequate governance structure for dealing with risk.[107] In particular, the report found that, in the institutions, there was rarely a high-level committee taking a firm-wide perspective on the current risks facing the institution.[108] Without this kind of committee, management of the firms could not see the magnitude of risks, share information about them among its business lines,[109] and take coordinated action to address them.[110] Moreover, the report found that risk models used in firms were often flawed because they were based on inappropriate assumptions (e.g., ratings used for structured finance products were the same as those used for standard corporate securities) and incomplete data (e.g., historical data was only for periods of low volatility), and that stress testing of the models did not anticipate possible scenarios (e.g., co-movement of assets prices at a time of near total loss of liquidity).[111] They also found that risk management at troubled firms was not imaginative and dynamic enough to address fast changing situations, and that it was often pushed into the background and even ridiculed by traders and bankers, who wanted to complete transactions.[112]

Clearly, the same pressure for enhanced risk management is being placed upon the private financial firms. As has already been mentioned, the President's Working Group received two reports on best practices for hedge funds and for investors in these funds.[113] Both of the reports recommended

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106. *See* SENIOR SUPERVISORS GROUP, OBSERVATIONS ON RISK MANAGEMENT PRACTICES DURING THE RECENT MARKET TURBULENCE (Mar. 6, 2008) [hereinafter SENIOR SUPERVISORS GROUP].

107. *See id.*

108. *See id.* at 3, 7–9.

109. For example, brokers in a firm's trading division would neglect to tell investment bankers in corporate finance about the shrinking market for certain kinds of securities. Therefore, the bankers would keep structuring deals to sell the securities, which would mean that the financial institution itself might end up holding a large portion of the securities that it could not sell. This apparently occurred during the subprime crisis because so many financial institutions were left holding large positions in subprime-backed securities.

110. *See* SENIOR SUPERVISORS GROUP, *supra* note 106.

111. *See id.* at 3–5, 14–17.

112. *See also* Randall S. Kroszner, Governor, Bd. of Governors of the Fed. Reserve Sys., The Importance of Fundamentals in Risk Management, Speech at the American Bankers Association Spring Summit Meeting, (Mar. 11, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20080311a.htm; Paul L. Lee, *Risk Management and Corporate Governance: Mind the Gap*, 90 BNA BANK. RE. 878 (May 5, 2008) (discussing history of emphasis upon risk management oversight by bank regulators).

113. *See* ASSET MANAGERS' COMMITTEE REPORT, *supra* note 37.

strengthening risk management with respect to operations of and investments in these funds.[114] The report from hedge fund advisers insisted that an adviser have in place procedures and policies (including having a chief risk officer and other specialized personnel) for accurately measuring the various risks of a fund (liquidity, leverage, market, counterparty credit, and operational) so that it can accurately disclose the fund's risk profile and adequately deal with them.[115] Money managers are urged to improve their risk management with respect to the risks of investing in hedge funds, the evaluation of a hedge fund's own risk management, and understanding of a fund's liquidity, leverage, operations and business risks, and compliance.[116]

Certainly, it is important for both regulated and unregulated financial firms to enhance their risk management. Yet the fundamental problem may not be with the risk models themselves, or the risk managers. Even though financial professionals can make mistakes, use flawed assumptions, or lack the best organizational structure for raising risk concerns, all of which need to be addressed and improved, the real problem may be that there are serious obstacles to installing or following proper risk management in a financial firm.

These obstacles may include the compensation structure, related employment practices, and ultimately the ideology prevalent in financial firms. For its participants, Wall Street has become a place of short-term rewards and compensation for short-term results, such as bonuses based upon fees for completing transactions and for the performance of a trading desk.[117] Private financial firms are no different, although private equity firms may have a longer-term horizon, given how the firms structure their management and performance fees.[118] It is not an exaggeration to say that financial professionals have a basic goal of obtaining as much compensation as possible and then, if necessary, moving on, even if it means switching from firm to firm and from regulated to unregulated firm, and back again. Moreover, financial firms have reinforced this conduct because they use an extreme version of the standard short-term cost/benefit approach in dealing with their employees: "either produce or get out." Even the financial regulators that issued the report on risk management, discussed

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114. *See id.*; *see also* REPORT OF THE INVESTORS' COMMITTEE TO THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, BEST PRACTICES FOR HEDGE FUND INVESTORS (2008), *available at* http://www.ustreas.gov/press/releases/hp927.htm [hereinafter INVESTORS' COMMITTEE REPORT].

115. *See* ASSET MANAGERS' COMMITTEE REPORT, *supra* note 37, at 22–32; INVESTORS' COMMITTEE REPORT, *supra* note 114.

116. *See* ASSET MANAGERS' COMMITTEE REPORT, *supra* note 37, at 22–36.

117. *See* Dennis K. Berman, *Grim Reaper of Jobs Stalks Street*, WALL ST. J., Mar. 11, 2008, at C1 (discussing these practices).

118. Generally, private equity firms will receive their compensation when a particular fund is liquidated after its investments in underlying companies have been sold. Hedge funds receive both fees for assets under management and performance fees. *See* ASSET MANAGERS' COMMITTEE REPORT, *supra* note 37, at 9–10 (on hedge fund fees).

above, observed that the current financial crisis was partly due to the short-term compensation structure common at Wall Street firms and to its resulting focus upon making deals and acquiring market share regardless of the risks involved.[119]

In these circumstances, with these compensation and structural pressures, risk managers have difficulties in finding ways reasonably to decrease risk, even if they use adequate risk models. Risk managers can use their models to emphasize that catastrophic risks are greater than what people believe (the "fat tail" of risk). However, bankers and traders, concerned about their bonuses, and management, concerned about firm profitability and share price, will argue that the model exaggerates the risks and that someone emphasizing the fat tail is being unduly pessimistic at the expense of business.[120] Financial professionals also suffer from the typical human focus upon the present and tendency to use an overly optimistic discount rate when evaluating bad future outcomes.[121]

More importantly, if there is no crisis present or on the horizon, risk managers have little to appeal to when dealing with bankers, traders, and executives in financial firms. They cannot appeal to the long-term stability of the firm because few executives and employees will have a sufficiently long-term horizon and senior executives are also unlikely to worry, given the rich benefits accorded to them. Appealing to the long-term financial stability of the economy and the country will also fail, because it will conflict with the concept of pursuit of *individual* wealth that is thought to insulate individuals from any macroeconomic disaster. In any event, such concerns are too abstract to be taken into consideration in the dominant cost/benefit calculus. Furthermore, there is nothing to ensure that the risk

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119. *See* SENIOR SUPERVISORS GROUP, *supra* note 106, at 7; *see also* Randall S. Kroszner, Improving Risk Management in Light of Recent Market Events, Speech at the Global Association for Risk Management Professionals Annual Risk Convention (Feb. 5, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/kroszner20080225a.htm ("Clearly, it is up to financial institutions themselves—not bank supervisors—to decide how compensation should be structured, but managers and boards of directors should understand the consequences of providing too many short-term and one-sided incentives. They would benefit from thinking about compensation on more of a risk-adjusted basis. Accordingly, I encourage institutions to think about ways to alter existing compensation schemes to include some types of deferred compensation, since the risks of certain investments or trades may not manifest themselves in the near term. Thus, it makes sense to try to match the tenor of compensation with the tenor of the risk profile and thus explicitly to take into account the longer-run performance of the portfolio or division in which the employee operates. This type of compensation arrangement is already in use at many nonfinancial firms."). *See also* FINAL REPORT OF THE INSTITUTE FOR INTERNATIONAL FINANCE COMMITTEE ON MARKET BEST PRACTICES: PRINCIPLES OF CONDUCT AND BEST PRACTICES RECOMMENDATIONS, at 49–51 (July 2008) (concluding that compensation practices in the financial sector were a factor in the financial crisis and that they must change to reflect long-term results, but providing vague guidance on how this would come about).

120. One remembers that, not so long ago during the dot.com bubble, entrepreneurs, investment bankers, and stock analysts asserted that there was a new era of finance without the risks of traditional business cycles.

121. *See, e.g.*, HERSH SHEFRIN, BEHAVIORAL CORPORATE FINANCE 6–7 (2007).

managers will themselves be properly trained and motivated to raise long-term concerns.

The standard compensation response, which would be to link compensation in financial services to long-term performance of transactions and investments by the individual banker or trader,[122] is unlikely to work. It is not clear how deferred compensation would be structured in many situations, such as prime brokerage, and what length of time would qualify as "long term." Moreover, it is doubtful that the compensation of many financial professionals can be tied to the long-term performance of the firm when firms want the flexibility to end employment relationships without paying prohibitively for the privilege. In addition, aligning the interests of agents and the firm does not adequately address the macroeconomic harms from financial activities, such as systemic risk, since they do not likely even figure in the financial firm's calculus in the first place.

Reform that would properly train risk management professionals and allow them to function properly within financial firms would have to be fundamental, altering the way firms conduct business and financial professionals think and conduct themselves, and therefore, it would be a long-term project. A proper discussion of it is beyond the scope of this essay.[123] Suffice it to say, finance professionals are familiar with the standard economic model of the self-interested economic actor, in which individuals are presumed to act on their own behalf in the pursuit of wealth.[124] The model is an overwhelming characteristic of the financial industry because finance professionals shape their views and conduct upon it (and assume that others do the same), and the result is that alternative perspectives are otherwise crowded out.[125] These other perspectives are clearly subordinate even if they would actually help counter the self-interest focus that leads to the kind of destructive consequences that we see now in the subprime mortgage crisis. Naturally, changing the basic ideology of finance professionals will not occur overnight.

VI. CONCLUSION: THE NECESSITY OF ACTIVE REGULATORY OVERSIGHT

In the short term, therefore, it is necessary for both regulated and unregulated private financial firms to enhance their risk management. Due to the shock that these firms have experienced from the current financial crisis, they are already actively engaged in this task, and there will be little

122. *See generally* Michael C. Jensen, *Foundations of Organizational Strategy*, (Harvard Univ. Press 1998) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=244154 (on compensation systems).

123. I have undertaken some analysis of this issue in my essay, James Fanto, *The Continuing Need for Broker-Dealer Professionalism in IPOs*, 2 ENTREPRENEURIAL L.J. 679 (2008).

124. *Id.*

125. *Id.*

objection to a regulatory mandate on this subject. Yet improvements in risk management should not be left to the firms, with financial regulators playing the role of a sideline observer.

This does not mean that regulators need be responsible for designing risk management models, for this has been outside their expertise for some time. However, they can be more insistent that regulated firms establish firm-wide risk management committees and that the committees have real power in the firm, including with respect to any transactions with the private financial firms.[126] After all, the regulators have examination and visitorial powers,[127] which means that they can check on the day-to-day functioning of the committees and the risk management process. Indeed, the largest firms are in constant communication with regulators, and risk management should be an important part of this regular dialogue.

Monitoring the risk management process will be most important when the current crisis ends and optimism returns to the financial markets, for that will be the time when firms are most ready to downplay risks. Moreover, examiners and senior regulators must be more skeptical of the risk models that the institutions use. One need not be an expert on risks to question the assumptions of a risk model and to criticize an institution's overly optimistic view of the risks facing it.

Financial regulators should be up to the task, despite ongoing skepticism about the motivation of personnel, who generally come from the private sector and expect eventually to return to it. As much as financial regulators will be sympathetic to the industry that they regulate, their mission is to be concerned about and to promote the long-term health of the financial industry and thus of the U.S. economy—a focus now absent from financial firms—not the short-term profitability of a particular financial institution. With this mission, which the best financial firms must surely acknowledge, regulators can insist that the firms take into account the risks facing them. In turn, they can insist that firms select appropriate discount rates for the pricing of these risks, as opposed to the unduly optimistic ones that are often used in financial institutions during boom periods. In sum, regulators have to counter the tendency of financial institutions to focus on the short term and try themselves not to be swept up into the enthusiasm over asset pricing bubbles.

The underlying point of this essay's review of risk management, occasioned by an examination of the private financial firms and their relationships with (including absorption by) regulated financial firms, is simple. It is dangerous for financial regulation and thus for the financial sector to be overly confident in the benefits of the market model, of which

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126. As for the regulators' relationship with the latter, this indirect regulation, coupled with the "best practices" approach, remains their only source of influence, in the absence of legislation.

127. 12 U.S.C. § 1844 (2008).

the private financial firm is a paradigm, and to be equally overly dismissive of regulation. If anything, risk management involving private financial firms, whether outside or inside regulated financial firms, has been a case study in this danger, rather than an example of the obvious supremacy of the market model. This review suggests that, for the stability of the financial system, it is time to reestablish the balance between financial markets and regulation on strong enough grounds so that they endure when the good times in finance return.

ARE LEVERAGED BUYOUTS A FORM OF GOVERNANCE ARBITRAGE?

Dale A. Oesterle[*]

I. INTRODUCTION

From the passage of the Sarbanes-Oxley Act of 2002 (SOX) until the recent subprime financial crisis, the nation witnessed a remarkable growth in "going-private" acquisitions.[1] As a percentage of total acquisitions, the purchase of publicly-held companies by privately-held companies jumped approximately twenty points.[2] Scholars, with some notable exceptions,[3] point to the increased compliance costs of SOX as a significant cause of the change.[4]

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1. Christian Leuz, Alexander J. Triantis & Tracy Y. Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* 4 (European Corporate Governance Institute, Finance Working Paper No. 155/2007, 2004), *available at* http://ssrn.com/abstract=592421 (documenting a spike in going private that is largely attributable to the Sarbanes-Oxley Act). Charts, *Leveraged Buyout Market and Going Private*, MERGERS & ACQUISITIONS, Feb. 2008, at 93–95. By 2007, the high point in the growth of going private transactions, LBOs accounted for 30 percent by value of the total value of mergers and acquisitions. In 2001, it was only two percent. The growth from 2002 to 2007 was nothing short of an explosion.

2. COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MARKETS REGULATION (2006) [hereinafter CAPITAL MARKETS REGULATION, INTERIM REPORT].

3. Some believe that an increased availability of low cost credit, facilitating leveraged financing, is the primary cause of the going-private acquisitions. Allison Taylor & Ruth Yang, *Evolution of the Primary and Secondary Leveraged Loan Markets, in* HANDBOOK OF LOAN SYNDICATIONS AND TRADING (Allison Taylor & Alicia Sansone eds., 2007). *See also* William Bratton, *Private Equity's Three Lessons for Agency Theory*, 3 BROOK. J. CORP. FIN. & COM. L. 1 (2008). The cause is overstated. A company must show a profit to leverage successfully and at issue is why private equity buyouts offer the prospect of substantial profits to buyout funds. Adding leverage to existing profit flow does not seem to explain the attraction of going private, given the premiums paid in the acquisitions. Some target companies are, for example, showing no profits. Buyout funds must rationally believe that they can increase profits to justify cashing in on the new leveraged position. The belief that an increase in profits is available is the subject of the speculation on the role of SOX, for example. *See also* Andreas Beroutsos & Conor Kehoe, *A Lesson in Governance from the Private Equity Firms*, FIN. TIMES, Nov. 30, 2006, *available at* http://www.mckinsey.com/aboutus/mckinseynews/equity_firms.asp. (Authors are directors of McKinsey & Company) ("[P]ublic equity markets still face a real challenge from private equity . . . not from . . . its giddy use of financial leverage. Rather the challenge comes from private equity's ability to align owners and managers more effectively.").

4. *E.g.*, William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: the Irony of "Going Private"*, 55 EMORY L. J. 141 (2005); Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going Private Decisions*, 44 J. OF ACC. & ECON. 116 (2007). For an argument that SOX's encouragement of going private acquisitions is a benefit to the public by reducing the public trading of securities by firms that are prone to financial fraud, see Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (Kauffman-RAND Inst. for Entrepreneurship Pub. Policy, Working Paper Series No. WR-300-2-EMKF, 2008), *available at* http://repositories.cdlib.org/berkeley_law_econ/fall2005/12/.

Scholars who believe SOX legislation and rules to be a primary cause of the popularity of going-private acquisitions point primarily to two SOX effects that are significant increases in regulation of publicly-traded companies: (1) increased audit requirements on internal controls, most notably Section 404, and (2) increased exposure of executives to liability from, among other provisions, certification requirements in Section 302 and 906.[5] There is, however, another feature of going-private acquisitions that merits study as a significantly contributing cause: the ability of controlling shareholders to structure the board of directors free of new constraints from SOX and from listing requirements of our national exchanges.[6]

Private buyout groups have used their freedom to construct tailored boards of directors to substantially alter the management structure and style of the public companies they take over.[7] Such changes deviate significantly from the "good corporate governance" rules many favor for publicly-traded companies. Participants in the deals believe the management changes add significant value to the firm by increasing firm returns. In other words, going-private acquisitions could have an element of "governance arbitrage" about them.[8] If correct, that is, if the portfolio companies of private buyout funds are more successfully managed than those same companies when publicly traded, then we should question our traditional norms of "good corporate governance" for publicly traded companies.

This essay discusses the non-scientific evidence of the management changes that follow going-private transactions and encourages empirical scholars to test the hypothesis that going-private transactions enable more efficient and effective board oversight and management.

II. THE TYPICAL GOING-PRIVATE TRANSACTION: LEVERAGED BUYOUTS DEFINED

A going private transaction is defined as one in which a publicly-traded company reorganizes its capital structure to avoid the public reporting requirements of the Securities and Exchange Act of 1934. A publicly-held company must file annual and quarterly public reports under section 13(b) of the 1934 Act.[9] A company is publicly-held if it is listed on a national securities exchange,[10] has registered a public offering,[11] or has more than

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5. *E.g.*, Mary Calelgari & Howard Turetsky, *Selling to Escape Compliance Costs*, MERGERS & ACQUISITIONS, Sept. 1, 2006, at 54.

6. *See* discussion *infra* Part IV.

7. *Id.*

8. The term "governance arbitrage" is used in Beroutsos & Kehoe, *supra* note 3.

9. *See also* Securities and Exchange Act of 1934, § 13a, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a et seq. (2004)) and Securities and Exchange Act of 1934, § 15d, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a et seq. (2004)).

10. Securities and Exchange Act of 1934 § 12(b), 15 U.S.C. § 78l (2004).

11. 17 C.F.R. § 240.12d2-2 (2008).

five hundred shareholders and ten million dollars in assets.[12] A publicly-held company escapes the periodic filing requirements if it reduces the number of its record shareholders of each of its registered securities to less than three hundred and delists all securities from any national exchange.[13] At that point, the company becomes privately-held and has the option of "going dark" (i.e., suspending its public filing of annual and quarterly reports).[14] Most companies choose to stop filing the public reports.[15] A few privately-held companies continue to file public reports because they either owe contractual obligations to debt holders, or think it is prudent to generate a record of reports that eases their return to the public capital markets in the future.[16]

There are several methods of going private. In single-firm reorganizations, a public company executes a reverse stock split, buying back its own stock (often in a self-tender offer), or engages a merger with a subsidiary to reduce the number of shareholders to less than three hundred.[17] In acquisitions by one company of another independent company, a privately-held company purchases a publicly-traded company. The privately-held company is referred to as a "strategic" buyer if it is another operating company (usually in the same industry).[18] More frequently, the privately-held acquiring company is a newly-formed

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12. Securities and Exchange Act of 1934 §12(g)(1)(B), 15 U.S.C. §78l (2004). 17 C.F.R. §240.12g-1 (2008).

13. Paul R. Bessette, Michael J. Biles, Christopher W. Ahart & Helen V. Heard, *Considering Going Dark?*, FIN. EXECUTIVE, Nov. 2006, at 2.

> The first step in going dark is delisting the company's securities from their exchange. This action eliminates the registration requirements of Section 12(b) of the Securities Exchange Act of 1934. Exchange Act Rule 12d2-2(d) permits a company to file an electronic application to withdraw a class of securities from listing on the exchange in accordance with the exchange's rules.

Id. Some authors use a Rule 13e-3 filing to signal a going private transaction. The Rule requires special disclosures in going private transactions. Rule 13e-3 filings only apply, however, to single firm transactions and to two-firm transactions in which a member of the target management team participates in the buyout. *E.g.,* Carney, *supra* note 4. However, hostile buyouts or other buyouts in which the entire management team is excluded from participation in the buyout vehicle at the time of the acquisition are omitted. Buyouts with management participation, also known as management buyouts, create severe conflict of interest problems that have long troubled the courts. *E.g.,* Dale Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207 (1988). Rule 13e-3, requiring among other things, that the issue declare the transaction to be "fair," is the SEC's effort to control the conflict of interest problems.

14. Leuz, Triantis & Wang, *supra* note 1, at 1.

15. *Id.* at 7.

16. Robert P. Bartlett, III, *Going Private But Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going Private Decisions*, 5 (Univ. Ga. Sch. of Law, Research Paper Series, Paper No. 08–003, 2008), *available at* http://ssrn.com/abstract=1088830.

17. Leuz, Triantis & Wang, *supra* note 1, at 4–5.

18. Bartlett, *supra* note 16, at 7.

subsidiary of a "financial" buyer, a pool of money gathered specifically to purchase this and similar companies.[19]

Acquisitions by financial buyers sparked the remarkable increase in going-private acquisitions in the early part of this decade.[20] These buyers are predominately private equity funds, also known as buyout funds.[21] The buyout funds, which are typically structured as limited partnerships or limited liability companies, are run by well-known fund management firms in the form of buyout partnerships or companies.[22] The management firms solicit capital from elite investors to avoid registration or filing requirements under a multitude of potential regulatory provisions.[23] The trade-off for investors is that the buyout fund's investors are locked-in for a period of time. The terms of capital investment in the buyout fund do not grant robust redemption rights that an investor can trigger quickly should she want out of the fund.[24] Once a buyout fund is capitalized, the management firm finds a suitable publicly-traded target company and negotiates an acquisition. The fund creates a shell company as the acquisition vehicle and funds the purchase of the target company's securities with a portion of the buyout fund's cash capital and borrowings from other financial players.[25] The shell company, typically in a two-stage acquisition (cash for control followed by a back-end, cash out merger), acquires a super-majority of the voting shares and thus control of the target company.[26] The shareholders of the target company receive cash and the buyout fund, occasionally with a few other investors who buy a few minority shares, becomes the dominant, residual controlling shareholder.[27] The target company becomes a "portfolio" company of the buyout fund.[28] Once a buyout fund has exhausted its capital by purchasing portfolio

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19. *Id.* at 8.

20. *Id.* at 3.

21. *Id.* at 8.

22. Ludovic Phalippou & Oliver Gottschalg, The Performance of Private Equity Funds 7 (EFA Moscow Meetings, 2005) (unpublished Working Paper, *available at* http://ssrn.com/abstract=473221).

23. The funds raise money in private placements (avoiding the Securities Act of 1933 registration requirements), have less than five hundred investors (avoiding the reporting requirements of the Securities and Exchange Act of 1934), are not mutual funds (are exempt from the Investment Company Act of 1940), never take more than twenty-five percent of their investment capital from regulated pension funds (avoiding regulation by ERISA), and avoid any acts that would get them classified as a broker/dealer, a bank, an underwriter, a market-maker, or a commodity pool. The fund manager is careful to avoid regulation under the Investment Advisors' Act of 1940. *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 275–78 (2007).

24. *See id.* at 280–81.

25. Hence, the leverage in "leveraged buyout." *See* Bartlett, *supra* note 16, at 9.

26. *See* Joshua M. Koenig, *A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505, 520 (2004). This often occurs after a first stage of stock acquisitions.

27. *Id.* at 533.

28. David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 722 (2008).

companies, it is "fully invested" and the buyout fund's management firm renews the cycle by creating new buyout funds for future acquisitions.

A mature buyout fund does not intend to keep portfolio companies long-term.[29] Rather, it seeks to sell all the acquired portfolio companies for a sizable profit and return cash proceeds to the buyout fund's investors within five to seven years.[30] To realize profits, the buyout fund resells the portfolio companies through public offerings or to other private buyers or strategic buyers in negotiated deals.[31] Realizing a profit on resale is much more than mere asset speculation; the buyout company expects to enhance significantly the portfolio company's value by installing new management in the portfolio company so as to correct flaws in the previous management's decisions, strategy and practices. For example, new management may unlock the company's value by "spinning off" or selling assets[32] to make better use of company assets or capital, and streamlining or modernizing operations.

A fund specializing in buyouts is distinguishable from other important types of private-equity funds with similar structures. A fund's type is defined by its choice of investments and holding or exit strategies.[33] Venture capital funds take equity positions in start-up and emerging companies (primarily those developing technology), with a turnaround goal of five to ten years.[34] These funds are usually more patient than buyout funds and only take full management control when the existing management stumbles badly.[35] Hedge funds take highly-leveraged, partial-equity positions to make pure asset speculation plays or to pressure the company to make immediate operational changes.[36] The hedge fund's investment turnaround goals are as short as one day and as long as two

29. Geoffrey Colvin & Ram Charan, *Private Equity, Private Lives*, FORTUNE, Nov. 27, 2006, at 190, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394344/index.htm.

30. Per Stromberg, *The New Demography of Private Equity*, GLOBALIZATION OF ALTERNATIVE INVESTMENTS 3–26 (World Economic Forum, Working Papers Vol. 1, 2008), *available at* http://www.weforum.org/pdf/cgi/pe/Full_Report.pdf (finding almost 60% of private equity fund investments exit more than five years after the initial investment. In addition, the length of time portfolio companies remain under the control of private equity firms has increased in recent years. Less than 6% of buyout transactions end in bankruptcy or financial distress. This translates to a default rate of 1.2% per year, compared to an average default rate of 1.6% for U.S. corporate bond issuers and 4.7% for U.S. junk bond issuers).

31. Gary Barnett, *Collateralized Fund Obligations: An Example of a Securitization of Private Equity Fund Investments (CFO)*, 1653 PLI/CORP 459, 463 (2008).

32. A spinoff grants assets to existing shareholders as an in specie dividend on their stock. Otherwise the management sells the assets to independent parities.

33. Christopher W. Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What is it? Why is it Bad?*, 75 U. CHI. L. REV. 1071 (Summer 2008).

34. Illig, *supra* note 23, at 270–71.

35. *Id.*

36. *E.g.*, Henny Sender, *Hedge Funds Show Resilience in Thorny Times*, FIN. TIMES, Jan. 28, 2008, *available at* http://us.ft.com/ftgateway/superpage.ft?news_id=fto012820081457435278.

years.[37] Hedge funds do not often buy control of a firm and do not hold any single investment for long.[38]

Buyouts of a company are usually met with substantial hostility in the company's locality. When a buyout fund installs new managers and relocates facilities elsewhere, the local citizenry and political leaders are not happy, particularly if the move is overseas.[39] Mike Huckabee, for example, successfully derailed Mitt Romney's campaign for the Republican presidential nomination in 2008 with an oft-repeated line: "I believe most Americans want their next president to remind them of the guy who they work with, not the guy who laid them off."[40] Romney was one of the founders of Bain Capital, a well-known buyout firm.[41]

When managers of the target firm are involved in the buyout, they are charged with disloyalty to local interests and conflicts of interest with the target company's shareholders.[42] If the buyout fund's operating maneuvers fail and a healthy local company ends up in bankruptcy, local citizens are further incensed. Support for a buyout comes only when locals are convinced their local company is failing and a buyout fund could keep it alive, even if the company must be changed to survive. Leveraged buyout popularity rests exclusively with the quietly happy investors of the to-be-purchased target companies, who usually receive a healthy 20 to 40 percent premium price for their shares,[43] and investors in the buyout fund[44] and its management firm[45] that enjoy heady returns from the fund's activities.

III. PRIVATE EQUITY FUND RETURNS

Data on the returns of private equity funds is limited because neither the management firms, nor the funds or the investors in the funds are required

37. *See* SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

38. *Id.*

39. *See, e.g.*, Phil O'Connor, *In Prestige or Jobs, or Both: "We'll be taking a hit"*, ST. LOUIS POST-DISPATCH, Jul. 12, 2008, at A8.

40. Perry Bacon Jr. & Michael D. Shear, *Hopefuls Clash in Debate as 1st Southern Primary Nears*, WASHINGTON POST, Jan. 11, 2008, at A9, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2008/01/10/AR2008011004007_pf.html. Chelsea Clinton, others have noted, took time off from a private equity fund to campaign for her mother.

41. Jenny Strasburg & Peter Lattman, *Credit Crunch Rocks Bain, As Funds Fall Up to 50%*, WALL ST. J., Oct. 3, 2008, at C1.

42. Brody Mullins & Kara Scanell, *Politics and Economics: Buyout Firms Join Lobbying Efforts*, WALL ST. J., Sept. 1, 2006, at A4.

43. United States Government Accountability Office Report to Congressional Requesters, *Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention*, Sept. 2008, GAO-08-885 at 18.

44. Beroutsos & Kehoe, *supra* note 3. The top funds have routinely returned healthy premium over market indexes.

45. Buyout firms take twenty percent of the profits and management fees. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 22 (2008).

to file public reports.[46] Although the funds generate performance reports, the managers of the funds give the reports to investors under strict contractual duties of confidentiality.[47] Investors, such as public university endowments that must publicly report on their investments, are not invited to invest. Moreover, there are no Securities and Exchange Commission rules to standardize the content of the reports.[48] Financial economists studying the industry must instead rely on voluntary reporting in private equity trade publications by management firms.[49] Private equity trade publications providing summaries of the industry data note that many funds do not report voluntarily and admit that the non-reporting firms are the most likely to be the worst performers.[50] The data in the publications may, therefore, contain the effects of an over-reporting of desirable results in the summary.[51] However, there may also be an under-reporting of superior results, if some firms do not want to attract regulatory and political attention to their successes.[52] Moreover, and most importantly, much of the studies are dated and do not address the 2002-2007 period at issue in this essay.

A well-known study on private equity returns, conducted by Steven N. Kaplan and Annette Schoar, analyzed the returns of private equity funds that were fully liquidated between 1980 and 2001.[53] Kaplan and Schoar's surprising conclusion was that those investors would have received better returns by investing in an index fund for the S&P 500.[54] Their results were largely confirmed in a study that updates the data to 2003.[55] Both studies used only liquidated funds to focus on cash payments and, therefore, omit projections of gains in still invested funds that may have been fully invested seven or more years before the end date of the studies, 1994 or 1996 to date. The approach, therefore, largely omits data from funds raised and invested in the 2002 to 2007 boom period.[56] An academic study based solely on the period in issue here, from 2002 to 2007, is not known to this author.

There is no doubt that the current economic credit crisis has adversely affected the private equity industry as well as the financial industry in general. This year's growing financial crisis has dried up sources of capital

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46. Rod Newing, *Private Equity: Coming Out of the Shadows*, FIN. TIMES, Oct. 12, 2007.

47. *Id.* at 7.

48. Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1791 (2005) ("Private equity, as the name suggests, is largely exempt from public disclosure requirements").

49. *Id.*

50. Bratton, *supra* note 3, at 14.

51. Kaplan & Schoar, *supra* note 48, at 1794.

52. Newing, *supra* note 46; *see also* Bob Kennedy, *Weathering a Storm, Beset by Attacks from Washington, Private Equity is on the Defensive*, MERGERS & ACQUISITIONS, Jul. 2007, at 61.

53. Kaplan & Schoar, *supra* note 48, at 1791.

54. *Id.* at 1821.

55. Phalippou & Gottschlag, *supra* note 22.

56. Bartlett, *supra* note 16, at 22; *see also* Bratton, *supra* note 3, at 3.

for buyout fund activities.[57] With the loss of funding, the number of buyouts has declined precipitously.[58] Several buyouts announced in 2007 failed to close in 2008 as financial backers withdrew.[59] Fund investors, often under pressure themselves to marshal cash, have exercised their withdrawal rights.[60] A substantial number of newly-created funds have failed to raise sufficient capital to begin operations.[61] It may take several years for the financing of buyouts to return. However, the slowdown in private equity funding in 2008 does not necessarily mean funds raised after 2002 and before 2008 that are fully-invested, or that funds which have otherwise yet to liquidate, are not doing well. With the S&P 500 down substantially since early 2008,[62] private equity funds may still be out-performing the market.[63]

In any event, the trade publication StateStreet.com has published data on the five year period of interest in this essay that is in sharp disagreement with Kaplan & Schoar's conclusions.[64] The StateStreet.com study is based on reported private equity fund returns from January 1997 to September 2007 and is not limited to liquidated funds. A table of the results is contained below.

Strategy	*Number of Funds*	*Commitments ($B)*	*Long-term IRR%*
Buyout:	619	$ 813	15.70%
Venture Capital:	600	$ 204	12.42%
Other:*	162	$ 136	14.13%
Total:	1,381	$1,153	15.03%
S&P 500 Index:	N/A	N/A	10.51%**

57. Heidi Moore, *Deal Makers: Ripe for layoffs?*, WALL ST. J., Feb. 21, 2008, at B1.

58. *See Top Deals of 2008*, MERGERS & ACQUISITIONS, Feb. 2008.

59. *See* Dana Cimilluca, Cassell Bryan-Low & Jenny Strasburg, *As Deals Crash, Investors Flee Hedge Funds,* WALL ST. J., Mar. 29, 2008, at B1.

60. Peter Lattman and Keenan Skelly, *Calstrs Will Invest Less In Latest Blackstone Fund; Move Hints at Worry Over Private Equity In Public Markets*, WALL ST. J., Sept. 4, 2008, at C3.

61. *See* Andrew Ross Sorkin, *As Hedge Funds Seek Cash, Market Suffers, Report Says*, N.Y. TIMES, Nov. 7, 2008, *available at* http://dealbook.blogs.nytimes.com/2008/11/07/as-hedge-funds-seek-cash-market-suffers-report-says/?scp=1&sq=hedge%20fund%20no%20investing&st=cse.

62. *See* Peter A. McKay, *Dow Loses 45.10 as Comeback Fails to Erase All of Big Loss*, WALL ST. J., Mar. 5, 2008, at C1 (As of March, the Standard and Poor's 500 was down 9.6%).

63. *Cf.* Sender, *supra* note 36. (It was banks that "blew up the world," not hedge funds).

64. *Id.*; State Street Private Equity Index, http://www.statestreet.com/analytics/is_179_private_edge.html (last visited May 20, 2008). (Private Equity Index composition and dollar-weighted internal rate of return, net of management fees and carried interest, measured January 1, 1997 through September 30, 2007. * "Other" includes distressed investment, mezzanine and special situations funds; ** Compound annual growth rate 1957 through Sept. 30, 2007).

From the table, one sees that the private equity funds easily beat the S&P 500 Index over the sample period.

As noted above, some critics will claim that only successful funds are represented in the sample because only successful firms will voluntarily report. The reports are marketing for new fund creation.[65] Support for the StateStreet.com data comes from the tremendous success in capital-raising shown in buyout funds during the same period.[66] Investors in record numbers and in record amounts flocked to the funds. This growth of investment capital was fueled by the funds' high returns.[67] Kaplan and Schoar would suggest that the investors were misled perhaps, but from another perspective, perhaps they were not. Investors with skin in the game (cash at risk) believed that the funds offered above market returns.

Even if the Kaplan and Schoar finding is correct, that buyout funds in general do not provide above-market returns, the data on many funds remains encouraging. First, funds established early in a buyout-friendly economic cycle did very well and funds established late in the cycle did poorly.[68] Therefore, studies on buyout returns must define and take into account these cyclical periods.[69] Second, buyout funds that produced capital gains early in a cycle are the most likely to remain successful throughout the cycle.[70] In other words, the best determinate of a buyout fund's future success appears to be the nature of its past success. For example, top-tier private equity firms like The Blackstone Group, Kohlberg Kravis Roberts & Co., and Bain Capital LLC, showed spectacular returns while second tier firms struggled to match the S&P 500.[71] Investors who poured money into the successful funds were likely attracted by such returns. Selecting successful funds was, to a degree, predictable. Yet oddly enough, Kaplan and Schoar's data, weighted by buyout fund size, did not reflect this finding. Third, Kaplan and Schoar's study does not account for risk.[72] Some studies claim that diversified going private funds show less market volatility than the S&P 500 and therefore, should show smaller returns.[73] Finally, and perhaps most importantly, is that the Kaplan and Schoar data

65. Kaplan & Schoar, *supra* note 48, at 1794.

66. Charts, *supra* note 1.

67. State Street, *supra* note 64.

68. Kaplan & Schoar, *supra* note 48, at 1819.

69. A study could catch the middle of a cycle. This is particularly a problem for going private studies because going private in large numbers is a very recent phenomenon.

70. Phalippou & Gottschlag, *supra* note 22, at 24; Kaplan & Schoar, *supra* note 48, at 1813.

71. *See, e.g.*, Maryland Tax Education Foundation**,** Press Release: *Latest Research Concludes that Private Equity Funds Fail to Deliver Premium Rates*, July 23, 2008, *available at* http://www.marylandtaxeducation.org/privateequityfund.pdf (last visited Nov. 20, 2008).

72. Kaplan & Schoar, *supra* note 48, at 1797.

73. *See* Joost Driessen, Tse-Chun Lin & Ludovic Phalippou, *A New Method to Estimate Risk and Return of Non-Traded Assets From Aggregate Cash Flows: The Case of Private Equity Funds*, (Nat'l Bureau of Econ. Research, Working Paper No. 14144, June 2008), *available at* http://.ssrn.com/abstract=965917.

was based on net returns reported by fund investors, not gross returns to the buyout fund.[74]

The difference between net returns to investors and gross returns to the funds is due substantially to the fees paid to the management firm.[75] Management firms charge a number of fees that are deducted from the gross returns of the buyout fund.[76] These fees are usually two percent of the capital committed to the fund per year, a twenty percent slice of the profits distributed (the "carried interest"),[77] and transaction fees on the purchase and sale of portfolio companies.[78] A management firm that returns eight percent or more to its investors has done very well when the net return of eight or more is translated into gross returns.

The observers claim that such a division of profits, with twenty percent or more going to the management firm that made a very small capital investment, is highly inequitable.[79] They necessarily discount as insignificant that the division creates the incentives for the management firm that generate the higher returns to the investors.[80] Without those incentives, investors may very well receive less robust returns.[81] Nevertheless, the buyout fund's higher returns have, of course, attracted the attention of Congress, which wants to tax these firms at higher rates than they currently pay.[82]

Therefore, Kaplan and Schoar's data, based on net returns, supports a claim that the buyout funds generate substantial gross returns that exceed meaningful relevant market indexes.[83] The StateStreet.com data also supports the claim.[84] Nevertheless, what is not entirely clear is the source of gross returns. The gross returns of private equity funds do not appear to be pure leverage plays. They are also related to the increased performance of portfolio companies under the new management hired by the buyout fund. Data on portfolio companies that are sold back to the public after a period of buyout fund management show gains in both market value and in accounting-based performance figures.[85] Note that the Kaplan and Schoar

74. Kaplan & Schoar, *supra* note 48, at 1791.
75. Fleischer, *supra* note 45, at 8–9.
76. *See id.*
77. This usually occurs after the investors receive an eight percent return and is subject to a clawback if distributions drop. *Id.* at 8, 22.
78. Illig, *supra* note 23, at 287.
79. Fleischer, *supra* note 45, at 5–6.
80. Illig, *supra* note 23, at 283–88.
81. *Id.*
82. *See* Howard E. Abrams, *Taxation of Carried Interest*, 116 TAX NOTES, July 16, 2007, at 183.
83. *See* Shourun Guo, Edith S. Hotchkiss & Weihong Song, *Do Buyouts (Still) Create Value?*, Address to the Swedish Institute for Financial Research Conference on The Economics of the Private Equity Market, (Mar. 21, 2008).
84. State Street, *supra* note 64.
85. *See generally* Bratton, *supra* note 3.

position suggests that performance gains in the portfolio companies are entirely captured by the buyout fund management company and denied to the buyout fund investors. It is hard to believe that buyout fund investors are this gullible. In any event, the gross returns of buyout funds deserve careful attention.

IV. MANAGEMENT CHANGES IN PORTFOLIO COMPANIES

An important characteristic of buyout fund activity is their experimentation with and development of unique management styles.[86] Management restructuring seems to have aided significantly in creating value within newly-acquired portfolio companies.[87] It is this hypothesis that needs further statistical investigation. This essay contains a brief summary of antidotes that should encourage such a study.

The reduction in the number of shareholders in a going private acquisition has inherent structural advantages. The reduction facilitates investor monitoring of target company managers and heightens accountability.[88] The reduction more closely aligns managers' interests with the interests of the shareholder.[89] And the reduction enables buyout funds to implement quickly, and without opposition, optional structural changes that provide substantial managerial advantages.[90] The changes in management strategy include changes in management structure and compensation, changes in financial structure that affect management incentives, and changes in internal control procedures.[91] Each of these strategic changes is considered below.

First, management firms of buyout funds radically alter board structure and management compensation of portfolio companies.[92] The buyout fund managers, for example, reduce the number of inside directors holding management positions in the portfolio company. The fund replaces management directors with directors appointed from within the management firm.[93] The CEO of the newly-private portfolio company is rarely the Chairman of the Board and often not even on the Board of Directors.[94] The CEO often attends board meetings but cannot vote.[95]

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86. Allan Holt, co-head of US Buyout Group, The Carlyle Group, when asked about going private deals, remarked, "[t]he number one reason is the availability of capital. It opens up a universe of possibilities." *See generally* Colvin & Charan, *supra* note 29.

87. Beroutsos & Kehoe, *supra* note 3, at 15; Colvin & Charan, *supra* note 29, at 190; Emily Thornton et al., *Going Private*, BUS. WEEK, Feb. 27, 2006, at 52, *available at* http://www.businessweek.com/magazine/content/06_09/b3973001.htm.

88. Beroutsos & Kehoe, *supra* note 3, at 15.

89. *Id.* at 15.

90. Colvin & Charan, *supra* note 29, at 190.

91. *Id.*

92. Beroutsos & Kehoe, *supra* note 3, at 15.

93. *Id.*

94. *Id.*

95. *Id.*

Buyout management firms also reduce the number of outside directors. The few outside directors that are seated are portfolio industry experts, those affiliated with other portfolio industry participants or industry service companies.[96] The new outside directors are not "independent" as that term is often used in modern corporate governance parlance. This is in conflict with modern "good corporate governance" standards that rely primarily on the placement of outside, independent directors on powerful, independent board sub-committees such as the audit, compensation, and nomination committees.[97]

For compensation, all board members in portfolio companies receive nominal amounts of cash, not options or stock, and they are expected to *purchase* equity positions in the company.[98] Inside directors, members of the buyout fund management group, profit from their position in the buyout fund. Outside directors profit from their positions in related industry positions. Executive pay in cash is heavily indexed to portfolio company-specific performance goals based generally on revenue increases.[99] Compensatory options in portfolio stock take three to five years, or even longer, to vest.[100] Unlike typical executive compensation agreements in public companies, there are few cash bonuses tied only to stock price and no golden parachutes or other change-of-control protections.[101] The board and management have "skin in the game." In comparison to executives in publicly-traded companies, the executives in buyout fund portfolio companies participate more heavily in upside gains and downside losses than do the executives in publicly-traded companies. Managers in publicly-traded companies participate in the upside gains of investors but also do well even if investors do not (they do not participate in the investors downside losses).[102] In publicly-traded companies, the board is compensated handsomely in cash, in options that vest quickly (from six months to three years), in cash and equity bonuses at year-end, and in golden parachute severance payment packages.[103] Executive pay packages in publicly-traded companies are complex and opaque and much less dependent on an evaluation of company performance indexed to an industry standard than are pay packages in portfolio companies.[104]

96. Colvin & Charan, *supra* note 29, at 190.
97. *See generally* Beroutsos & Kehoe, *supra* note 3, at 2.
98. Colvin & Charan, *supra* note 29, at 190.
99. *Id.*
100. *See* Press Release, Boston Consulting Group, What Public Companies Can Learn from Private Equity (June 2006) at 8, *available at* http://www.bcg.com/impact_expertise/publications/files/What_Public_Companies_Can_Learn_from_Private_Equity06.pdf.
101. *Id.*
102. Colvin & Charan, *supra* note 29.
103. *See* Press Release, Boston Consulting Group, *supra* note 100, at 8.
104. *Id.*

Second, buyout funds use more leverage by substantially increasing a portfolio company's debt-to-equity ratio. The funds "make the equity sweat." The increased leverage directly affects portfolio company management incentives. Debt-financing takes advantage of "cheap credit" and has come in for considerable criticism of late as portfolio companies struggle to maintain solvency in 2008's tight credit market. But increased leverage also substantially contributes to the management incentive environment favored by buyout firms. High levels of leverage cause portfolio company management to develop an intense focus on company cash flow, squeezing working capital to maximize cash revenue.[105] Marginal operations are sold quickly and cash expenses are monitored carefully.[106] The use of leverage complements the changes in executive compensation packages for portfolio company executives by increasing the manager's personal stake in the extreme upside gains and in the downside losses.

Third, buyout management firms usually impose a new reporting system on portfolio company accountants and auditors. Most significantly, the outside auditor reports directly to the buyout fund, as well as to the portfolio company. This is an important and underappreciated change in oversight because it eliminates the classic problem of auditor conflicts-of-interest in publicly-traded companies. In publicly-traded companies, auditors are hired by company management to whom they report and on whose practices they report. Auditors, concerned about management satisfaction with their services because management pays them, report for the benefit of investors whose money is entrusted to those managers.[107] The effect of the conflict is that bad information has a tendency to get overlooked or understated in the audit report.[108] In implementing SOX, Congress attempted to remedy the conflict of interest by empowering publicly-traded companies' independent audit committees. The audit committee, under SOX, must consist of independent outside directors that not only hire auditors but that also create and oversee an internal financial

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105. Colvin & Charan, *supra* note 29, at 190.

106. *Id.*

107. Colin Blaydon & Fred Wainwright, *Surprise! Valuation Guidelines Are Being Adopted*, VENTURE CAPITAL J., June 2005, at 58, 59, *available at* http://mba.tuck.dartmouth.edu/pecenter/research/Valuations.pdf (Burgiss Group and J. P. Morgan auditing products used by investors to analyze private equity portfolio holdings. Reports go directly to investors). *See*, *e.g.*, Private Informant, Private Equity Database Reporting and Analytical Services, http://www.burgiss.com/index-23.html (last visited Nov. 11, 2008); *see also*, *e.g.*, Press Release, J.P. Morgan, JPMorgan Private Equity Fund Services Launches DealVault Technology (Apr. 1, 2008), *available at* http://www.jpmorgan.com/cm/ContentServer?c=TS_Content&pagename=jpmorgan%2Fts%2FTS_Content%2FGeneral&cid=1159339629741. Consider the hue and cry if football umpires were paid by football coaches for calls made during the game itself. That is what we do with auditors.

108. CAPITAL MARKETS REGULATION, INTERIM REPORT, *supra* note 2, at 116.

control system.[109] SOX also adds penalties for managers that compromise the integrity of any audit. Under SOX, however, the basic conflict remains: shareholders are passive consumers of audit reports paid for by those who are audited, managers. In portfolio companies, auditors that are hired by and report to the primary investor, the buyout fund, have stronger incentives to serve their client's desire to have a dependable and accurate assessment of portfolio company affairs that includes both the good and the bad. Buyout firms demand accurate, truthful information about their portfolio companies to assess the competency of a company's managers; auditors are compelled to tell even a harsh truth to the client-investors or suffer reputational damage as unreliable auditors.

One of the surprises in the reports of portfolio management practices is that buyout funds usually impose SOX internal control requirements on portfolio companies in both auditing and disclosure systems. The internal control procedures of the publicly-traded companies do not change when the companies are taken private. It is only the auditors' hiring and reporting that changes. It is difficult to determine whether buyout funds opt to use SOX internal controls because they are optimal management devices or because having the systems in place makes the portfolio company easier to resell in a public offering.

V. THE TOTAL EFFECT

By implementing structural changes to management, buyout funds seek to better align the interests of a company's management with its investors.[110] The buyout fund places and compensates executives so that they have a substantive financial interest in the company that mirrors the stake of the fund.[111] And a buyout fund reforms a board of directors that will be more efficient in defining company strategy, and in supporting and monitoring the company's executive officers.[112]

Executives in portfolio companies have remarked on the clarity of their mission and function.[113] For example, Thomas von Krannichfeldt, the CEO of AZ Electronic, once noted that "[t]he focus on cash flow is very intense . . . [m]ost employees who came from Clariant [AZ's previous publicly-traded owner] had never seen that. As a consequence, what they'd done with regard to controlling inventory or working capital wasn't terribly good, and we could improve on that a lot."[114] Public companies often disagree over what to measure, whether it is earnings per share, return on equity,

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109. *Id.* at 115; *see also* 15 U.S.C. § 78j-1(m)(2) (2004).
110. *See* Guo, Hotchkiss & Song, *supra* note 83, at 4.
111. *See* Colvin & Charan, *supra* note 29.
112. *Id.*
113. *Id.*
114. *Id.* at 1.

EBITDA, or return on net assets.[115] In private equity portfolio companies, there is no confusion—cash flow is king.[116] Jon Luther, the CEO of Dunkin Brands, explains: "There's now a very different discipline in how you spend money. If it doesn't grow the business, why would you do it?"[117]

Executives in private equity portfolio companies also have noted that they have more freedom to take risks and make difficult but necessary decisions.[118] According to Donald J. Gogel, the CEO of private equity firm Clayton Dubilier & Rice, Inc., portfolio company executives do not have a gun pointed at their heads all the time.[119] There are no rigid internal hierarchies to prevent decisions and investors appreciate longer time horizons.[120] In publicly-traded companies, executives often feel the need to focus on quarterly results and are more risk averse to longer term gambles.

CEOs of portfolio companies also spend more time on operations and less time talking to shareholders, analysts, and the media. Some estimate that CEOs in publicly-held companies spend only sixty percent of their time on operations and forty percent of their time on public relations.[121] Similarly, boards in publicly-held companies must deal with investor relations, usually through an Investor Relations Subcommittee, and worry about multiple shareholder ballot initiatives. There are no such diversions in a portfolio company.

Finally, portfolio company executives, chosen by management firms, are paid larger cash salaries.[122] As a result, public companies have lost some of their brightest stars to private equity firms.[123] The portfolio company pay packages are not subject to the harsh glare of the financial press and Gretchen Morgenson of the New York Times.[124] For example, VNU, a Dutch global information and media company, paid General Electric's (GE) superstar vice chairman David Calhoun $100 million to become VNU's Chairman of the Executive Board and CEO.[125] GE's Paul

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115. *See* Colvin & Charan, *supra* note 29, at 190. EBITDA refers to Earnings Before Interest, Taxes, Depreciation and Amortization.

116. *Id.*

117. *Id.*

118. Thornton, *supra* at 87, at 4.

119. *Id.* at 2.

120. *Id.*

121. *See, e.g.*, PAUL ARGENTI & JANIS FORMAN, THE POWER OF CORPORATE COMMUNICATION 64 (2002).

122. Sanchirico, *supra* note 33, at 73.

123. *See generally* Joann S. Lublin, *Star Search: Can Public Companies Compete for Talent Against Private-Equity and Venture-Capital Firms? We Talked to Both Sides*, WALL ST. J., Apr. 14, 2008 at R8.

124. Gretchen Morgenson is assistant business and financial editor and a columnist at the New York Times. She has covered numerous topics relating to private equity, finance and Wall Street, including issues surrounding excess of executive compensation. *See* Gretchen Morgenson, http://topics.nytimes.com/top/reference/timestopics/people/m/gretchen_morgenson/index.html (last visited Nov. 11, 2008).

125. Colvin & Charan, *supra* note 29, at 4.

Bossidy also left, and joined Cerberus.[126] Procter & Gamble's CEO, A.G. Lafley, complained in 2006 that he had "lost a half-dozen people" to buyout funds.[127] A well-known executive recruiter during that time noted that "[t]op candidates are no longer waiting around to be recruited to a public company, instead they're jumping to a private-equity firm and watching for the right opportunity to become a CEO. It wasn't like this ten years ago."[128]

The pay package comes with risk, however. A far larger share of executive pay is tied to the performance of the business.[129] Top executives are required to put a substantial amount of their own money into the buyout.[130] The CEO of Dunkin Brands once noted: "I insisted that all officers invest personally. Management has a substantial amount of their personal money in this. It makes a huge difference in the 40 officers of the company when they show up for work . . . . [T]hey have an ownership mentality rather than a corporate mentality."[131]

The day-to-day operation of a portfolio company's board of directors is also very different from the typical board of directors in a publicly-held company. The portfolio company's board is smaller and consists only of representatives of the private equity fund and industry experts whose explicit job is to help management create and execute strategy.[132] Steven Denning, Chairman of the Board of General Atlantic, notes that "[t]he board is far more involved in assisting the company."[133] Jon Luther, the CEO of Dunkin' Brands, praised the board's connections and advice, saying: "Our three partners are able to connect us with people we otherwise couldn't meet. For example, the Carlyle folks introduced us to one of their investors in Taiwan, and we soon had an agreement for 100 Dunkin' Donuts stores there."[134] Pramod Bhasin, the CEO of GenPact, echoed Luther's comments: "Their access to markets, to people, to the right headhunters, the right lawyers—that's a huge help to companies that are newly independent, because without it, we'd have to swim for it ourselves."[135]

In sum, private equity firms have figured out how to attract and keep the world's best managers, focus managers extraordinarily well, provide strong profit-based incentives, free managers from distractions, provide managers with expert outside help they can use, and maximize their productive time and output.

126. *Id.*
127. *Id.*
128. *Id.* (CEO recruiter, Gerard Roche of Heidrick & Struggles).
129. *Id.* at 3.
130. *Id.*
131. Colvin & Charan, *supra* note 29, at 3.
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*

The only structural drawback is, perhaps, a potential conflict of interest inside the private equity firm that could affect portfolio company operations. Although managers of the buyout fund are agents of the fund's investors, the managers of the fund may be tempted to promote their own interests as fund managers over the interests of the fund's investors by raising new funds or keeping redemptions low in existing funds. An example might be the efforts of a buyout fund manager to conceal a portfolio company's troubles so as to keep buyout fund valuations up. This conflict can translate into directors from the managers of the fund to the managers of the portfolio company acting in ways that are not in the best interests of the fund's passive investors. The ability of the fund's passive investors to monitor the fund managers' conduct is the constraint that controls the conflict. Most buyout fund investors have substantial inspection rights written into their equity purchase agreements that enable them to monitor fund managers and fund portfolio companies' performance.[136]

VI. PUBLIC REACTION

The general media reaction to rapid growth of private equity buyouts in the five year period after 2002 has been largely negative. The new wealth of private equity management firms has been questioned, while the media has assumed some form of cheating has occurred.[137] Wealth increases reflected in the buyout funds in this period were often regarded with suspicion and cynicism. A typical example occurred in a cover story in Newsweek in July of 2008, where co-authors Evan Thomas and Daniel Gross called private-equity firms "Masters of the Universe" and "the true aristocrats," noting that "even their secretaries, it seems, have English accents."[138] Attempting to indicate hubris, the authors said, "Private-equity partners are not just in it for the money (though the successful ones make tons of it), but for the power to reshape whole industries."[139] Imagine that! Of course, another word for reshape is "improve."[140]

The media suspicion of private equity firms is possibly due to discomfort over such a naked exhibition of the operation of the shareholder primacy principle. In conflicts among corporate constituencies such as shareholders, managers, creditors, employees, local citizens, or even the environment, American corporate law directs boards of directors to favor

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136. Leuz, Triantis & Wang, *supra* note 1; Charts, *supra* note 1, at 93–95.

137. *See* Kennedy, *supra* note 52, at 61.

138. Evan Thomas & Daniel Gross, *Taxing the Super Rich*, NEWSWEEK, Jan. 10, 2008, http://www.newsweek.com/id/32992?tid=relatedcl. Daniel Gross had spilled a great deal of ink criticizing private equity funds at Newsweek the past two or three years. His articles are a classic populist media attack on the industry. *See, e.g.*, Daniel Gross, *Borrowers are out in the Cold*, NEWSWEEK, Mar. 3, 2008, http://www.newsweek.com/id/114713.

139. Thomas & Gross, *supra* note 138.

140. *Id.*

the interests of the residual claimants of the profit flow, the shareholders, under the shareholder primacy principle. Despite some ambiguity and slippage in case law and state statutes, the shareholder primacy principle, although tattered a bit, still defines the primary duty of corporate managers. In publicly-traded companies, there is more room for the ambiguities and openings to have an effect and for companies to consider interests other than simple profit motives.[141]

In portfolio companies run by private equity firms, there is no ambiguity or slippage in the operation of the shareholder primacy principle—the companies are run solely to make money for the buyout fund, which is the portfolio company's controlling shareholder. It is an illustration of shareholder primacy on a large scale in its purest form acting on companies of intense interest to the public. It is no surprise that the operation of such companies unsettles those who wish for "softening" of the "rough edges" of capitalism.[142] Those "compassionate capitalists"[143] and those who believe in democratic socialism surely are hardwired to despise the operation of buyout funds.[144]

It is important to note that buyout funds and their portfolio companies are not the primary culprits in the current economic downturn. While both are suffering like everyone else, the companies that have failed first with compounding results were publicly-traded financial institutions.

VII. LESSONS FOR PUBLICLY-TRADED COMPANIES

Publicly-held companies cannot mimic the portfolio companies of private equity buyout funds. Regulations prohibit some of the structural changes, and "Best Practice" corporate governance rules pushed by a well-intentioned, concerned lobby may retard others.[145] However, there are lessons from private equity practice that a public company may want to consider using. A publicly-held company could limit inside directors to representatives of large shareholders, although it is unlikely that companies will do so.[146] Managers who run these companies will want to stay on the board. Similarly, it is possible to have auditors hired by and reporting to large investors in publicly-traded companies, but it is unlikely that companies will do so. Nevertheless, it is an intriguing proposal that a publicly-traded company's audit subcommittee ought to be composed entirely of representatives of large shareholders. Such success in private equity practice supports the idea.

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141. State constituency statutes, for example, often only apply to publicly-traded companies.
142. John Vinocur, *France's Tough Guy, Files Down His Rough Edges*, INT'L HERALD TRIB., Jan. 16, 2007 (Sarkozy wants to "make capitalism moral.").
143. *E.g.*, *Face Value: The Compassionate Capitalist*, ECONOMIST, Aug. 4, 2005.
144. *E.g.*, Jane Hardy, *The State of the Union*, 102 INT. SOCIALISM J., Spring 2004.
145. *E.g.*, Corporate Governance, http://www.corpgov.net/ (last visited Oct. 7, 2008).
146. *See* Press Release, Boston Consulting Group, *supra* note 100.

The use of outside directors to assist and advise rather than to oversee is obstructed by regulations and listing rules. At present, we are infatuated with the outside (i.e., non-executive), "independent" director as a monitoring force in publicly-held companies. A publicly-traded company, by law, cannot limit outside directors to "non-independent" industry experts.[147] SOX legislation mandates the audit committee in a publicly-traded company consist entirely of independent directors who do not "accept any consulting, advisory, or other compensatory fee from the [company]" and are not "an affiliated person of the [company] or any subsidiary thereof."[148] An affiliate is a person that controls the company, directly or indirectly and "control" means to possess "the power to direct or cause the direction of management and policies of a [company], whether through the ownership of voting securities, by contract, or otherwise."[149] Aside from the obvious problem with the definition—that all outside directors seem to be affiliates under the "by contract, or otherwise" language—the rule also seems to prohibit executives in companies that provide professional services to the company, such as lawyers, consultants, and accountants, from serving as outside directors.[150]

Similarly, under stock exchange listing requirements, unless a listed company has a fifty percent majority owner, a majority of directors must be "independent" and the board must have entirely independent subcommittees on nominating and corporate governance, compensation, and audit.[151] A director is not "independent" if he has a "material relationship" with the company.[152] A material relationship can "include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships."[153] Notably, the rule's exception for a company with a majority owner recognizes that such a company may benefit from a board structure that replicates that of a portfolio company. In short, it would be very difficult for publicly-traded companies to replicate the practice of private equity portfolio companies of using affiliated industry experts as outside directors.

The two practices of private equity firms that public companies could match more easily, perhaps, are the compensation packages offered to executives and the greater use of leverage in financial structures to raise working capital. Again, neither is likely to be widely incorporated in publicly-traded company practice. Executive compensation practices in

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147. *See* Securities and Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1(m)(2) (2004).

148. Securities and Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1(m)(3)(B) (2004).

149. 17 C.F.R. § 240.12b-2 (2008).

150. Clark Judge, Comment, *Regulation is Blocking Enterprise in Silicon Valley*, FIN. TIMES, Jun. 5, 2007, at 17. (SOX prohibits legendary venture capitalist could not serve on broad of directors of one of this portfolio companies that had gone public).

151. NYSE, Inc., Listed Company Manual § 303A.00 (2003).

152. *Id.* § 303A.02 (2004).

153. *Id*. § 303A.02(a) Commentary (2003).

publicly-held companies suffer from considerable pressure to keep compensation obscure and complex so as to avoid public condemnation. The possibility of increased profit with high levels of debt-financing is not attractive to managers and other employees who have a vested interest in the company's survival. The recent credit crisis may sour our taste for leverage for years to come.

The tension between the governance recommendations for publicly-traded companies and privately-held companies is well illustrated in the dust-up in the United Kingdom between competing "panel-of-expert" professional commissions, so common in the country. Legal professionals in the United Kingdom have long championed the use of industry "good corporate governance" recommendations for its business. In 2003, an industry working group released the Higgs Report on Corporate Governance, which advocated the use of independent outside directors on multiple board subcommittees.[154] The explosion of private equity buyout funds led to the formation of a second commission focusing on good governance rules for private equity practice. In the Walker Report of 2007 on Private Equity, the commission came to the conclusion that the Higgs Report recommendations would not work for private equity firms and recommended, instead, the limited use of "non-independent" outside consultants as board members—in essence applauding current practice.[155] The Walker Report was excoriated by Derek Higgs, the author of the 2003 report,[156] and others who wanted the governance standards for publicly-held companies to be applied to privately-held companies.[157] Walker's response was that "it would be 'dotty' . . . to insist that private equity firms appoint independent directors to the boards of portfolio companies they acquired."[158] In sum, the pressure from the "good governance community" is the reverse of what it perhaps ought to be: asking successfully privately-held companies to adopt the management practices of their less successful publicly-traded brethren.

154. Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors*, Jan. 2003, http://www.berr.gov.uk/files/file23012.pdf. *See also* John Carver, *The Promise of Governance Theory: Beyond Codes and Best Practices*, 15 CORP. GOVERNANCE: AN INT'L REV. 1030, 1037, (2007); Peter Montagnon, *The Governance Challenge for Investors*, 12 CORP. GOVERNANCE: AN INT'L REV., 180, 183, (2004).

155. SIR DAVID WALKER, GUIDELINES FOR DISCLOSURE AND TRANSPARENCY IN PRIVATE EQUITY (2007), http://www.altassets.com/pdfs/wwg_report_final.pdf. *See also* Jeffrey Pellin, *Disclosure and Transparency in Private Equity Consultation*, WALKER WORKING GROUP (2007).

156. Higgs, *supra* note 154.

157. Ruth Sutherland, *Has Sir David Tamed the Tycoons?*, THE OBSERVER, Nov. 25, 2007, *available at* http://www.guardian.co.uk/business/2007/nov/25/privateequity.businessandmedia.

158. Martin Arnold, *Buy-out Industry Urged to Buy into External Directors*, FIN. TIMES, July 18, 2007, at 2.

VIII. CONCLUSION

Since publicly-traded companies are unlikely to be free to match the management advantages of private equity funds over their portfolio companies, "governance arbitrage" may always remain an explanatory incentive for successful going private transactions. Market participants believe the value added by improved governance practices is substantial and are eager to invest their own cash on their assessment if other economic conditions are conducive to an acquisition. Financial economists have yet to assess whether they are correct, however.

THE IMPACT OF "GOING PRIVATE" ON CORPORATE STAKEHOLDERS

Kent Greenfield[*]

As capital markets in the United States increasingly "go private," there are a number of implications of this trend that have yet to be decisively analyzed. It is unclear how the retreat of companies from public capital markets will affect corporate governance, business competitiveness, and public oversight. It is also unclear how the privatization of corporate finance will affect non-shareholder stakeholders of firms, most centrally employees, communities, and the environment.

Some scholars and public policy experts believe that concern for such stakeholders should not hold any relevance in the discussion of corporate law in general, and thus may be presumed to believe the same about a conversation about privatization.[1] In such a view, these concerns lie outside the realm of corporate governance law; they therefore should be of no great moment in the debate over whether public policy should respond to the strong "going private" trend. But for those of us corporate law scholars who assume that corporate governance should be analyzed in part according to its impacts on a broad range of stakeholders, one cannot decide how to respond to privatization without knowing how it affects those stakeholders.[2]

I suggest that, at least at a level of abstraction and as a matter of theory, there is little reason to be particularly skeptical of private companies, as compared to public companies, in their treatment of stakeholder interests. Private companies may be good citizens or bad citizens, good employers or bad employers. But this will be determined by what happens in the

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1. *See, e.g.*, Hansmann, H., Kraakman R.H., *The End of History for Corporate Law*, 89 GEO. L.J. 439, 442 (Jan. 2001) (arguing that the most efficacious legal mechanisms for protecting the interests of non-shareholder constituencies lie outside of corporate law); *see* George W. Dent, *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance* 25 (Case Research Paper Series in Legal Studies, Paper 07-21, 2007) (advocating "shareholder primacy" as the best way to protect non-equity stakeholders and promote social responsibility), *available at* http://ssrn.com/abstract=995186.

2. *See* Silvia Ayuso, Miguel Angel Ariño, Roberto Garcia Castro & Miguel A. Rodriguez, *Maximizing Stakeholders' Interests: An Empirical Analysis of the Approach to Corporate Governance* (IESE Business School Working Paper, Paper No. 670, 2007), *available at* http://ssrn.com/abstract=982325; David K. Millon, *The Ambiguous Significance of Corporate Personhood* (Washington & Lee Public Law and Legal Theory Research Paper Series, Paper No. 01–6, 2001), *available at* http://ssrn.com/abstract=264141; David K. Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000); David K. Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992); Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers,* 69 N.C. L. REV. 1189 (1991); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993).

governance and behaviors of particular companies, not by some theoretical predisposition. This essay is intended to be a brief introduction to several of the factors that weigh into the public/private comparison.

I. TWO CONVENTIONAL WISDOMS

Conventional wisdom regarding the going private phenomenon holds that it creates negative effects for non-shareholder stakeholders. Such a result occurs because the surge in going private transactions is part and parcel of the gladiatorial culture of Wall Street,[3] where financial elites buy and sell entire companies for the gain of a tiny minority.[4] Little concern is paid to anyone or anything other than the financial gain of those elites. Privatization firms buy up companies and take them out of the public markets, allowing them to be shielded from public scrutiny while they disembowel the company of its assets.[5] The surge of privatization is reflective of a money culture that disregards interests of anyone or anything that cannot be translated into financial benefit to the firm. These include environmental conscientiousness,[6] fairness to employees,[7] and democratic norms of accountability.[8]

This conventional wisdom was echoed most recently by Republican presidential candidate Mike Huckabee, who commented on fellow candidate Mitt Romney's experience in private equity, saying, "[I believe] most Americans want their next president to remind them of the guy they work with, not the guy who laid them off."[9] In Europe, too, privatization is often the target of political leaders. Speaking about hedge funds and private equity groups in April 2005, Franz Müntefering, then chairman of the German Social Democratic Party and soon to be German vice-chancellor, contended: "Some financial investors don't waste any thoughts on the people whose jobs they destroy."[10]

But there is a competing conventional wisdom, and it directly conflicts with the first one. This narrative proposes that the only way to protect companies that want to take a long-term view, or that want to take into account interests that do not easily translate to financial income, is to

3. Compare www.wallstreetgladiator.com, which expressly draws on this symbolism.

4. Dale A. Oesterle, *Are Leveraged Buyouts a Form of Governance Arbitrage?*, 3 BROOK. J. CORP. FIN. & COM. L. 53 (2008).

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. Gail Collins, Op-Ed, *The Battle of the Mitts*, N.Y. TIMES, Jan. 12, 2008, *available at* http://www.nytimes.com/2008/01/12/opinion/12collins.html?_r=1&oref=slogin (citing Mike Huckabee's Campaign Ad running in Michigan).

10. Steven J. Davis, et al., *Private Equity and Employment* 43 (World Econ. Forum, Globalization of Alternative Investments, Working Papers Volume I, 2008), *available at* http://www.weforum.org/df/cgi/pe/Full_Report.pdf.

privatize the company and insulate it from the short-term pressures of the capital markets. The following prominent examples illustrate this competing version of conventional wisdom.

In 1985, Levi Strauss & Co. (Levi's) went through a leveraged buyout (LBO), which was one of the largest ever up to that date.[11] The LBO took the company out of the public capital markets and allowed the descendents of Levi Strauss, the Haas family, to regain control.[12] Among the reasons given by the family for the LBO was to enable the company to maintain its culture of community involvement and its commitment to social responsibility.[13] This was more than mere lip service. Soon after the LBO, Levi's announced uncommonly progressive standards for its contractors and refused to do business in China for over five years to protest China's human rights record.[14] The company also divested its pension funds from some companies doing business in South Africa, at a time when apartheid still existed.[15] The LBO occurred because the company believed it had more room to act in a socially responsible way toward its multiple stakeholders if it were controlled by the Haas family, who has a long familial tradition of philanthropy,[16] than by a gross aggregation of public shareholders.

Another paradigmatic example of the social benefits of privatization is that of Malden Mills, a private apparel company in Massachusetts. Malden Mills, the manufacturer of Polertec fabric, suffered a devastating factory fire just before Christmas in 1995.[17] The president and principal owner,

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11. *Buyout Backed at Levi Strauss*, N.Y. TIMES, July 31, 1985, at D11, *available at* http://query.nytimes.com/gst/fullpage.html?res=9A02EFD81338F932A05754C0A963948260.

12. *Id.*

13. *Id. See also* James Sterngold, *Levi Strauss Stock Buyout Would Benefit Small Group*, N.Y. TIMES, Feb. 21, 1996, at D2, *available at* http://query.nytimes.com/gst/fullpage.html?res=9D0DE0D61339F932A15751C0A960958260&sec=&spon= (discussing Levi's "growing reputation for social responsibility").

14. William Beaver, *Levi's is leaving China – Levi Strauss*, BUSINESS HORIZONS, Mar.–Apr. 1995, *available at* http://findarticles.com/p/articles/mi_m1038/is_n2_v38/ai_16793712; *see also* http://www.democracynow.org/1998/6/30/levi_strauss_returns_production_to_china. Even while publicly traded, the company had followed a number of acclaimed social responsibility policies, including an openness toward unionization and plant closing notification policies that were more protective of employees' interests than what the law required. *See* CHARLES DERBER, CORPORATE NATION: HOW CORPORATIONS ARE TAKING OVER OUR LIVES AND WHAT WE CAN DO ABOUT IT, at 188, 284 (1998); *see also Levi Strauss & Co. Global Sourcing and Operating Guidelines*, *reprinted in* KARL SCHOENBERGER, LEVI'S CHILDREN: COMING TO TERMS WITH HUMAN RIGHTS IN THE GLOBAL MARKET PLACE app. A, at 265 (2000). The argument for the LBO was, in part, that these efforts at social responsibility might become increasingly difficult if the company remained a public company and thus perhaps a target of hostile takeover attempts.

15. *Timeline South Africa*, BBC NEWS, Sept. 20, 2008, *available at* http://news.bbc.co.uk/2/hi/africa/country_profiles/1069402.stm.

16. *How Levi's Trashed a Great American Brands*, FORTUNE, Apr. 12, 1999, *available at* http://www.ninamunk.com/documents/HowLevisTrashedaGreatAmericanBrand.htm.

17. Steve Wulf & Tom Witkowski, *The Glow From a Fire*, TIME, Jan. 8, 1996, *available at* http://www.time.com/time/magazine/article/0,9171,983916,00.html.

Aaron Feuerstein, announced after the fire that the company would rebuild the factory (even though its competitors were moving off-shore) and maintain payroll in the meantime.[18] He paid Christmas bonuses even though the factory was in ruins, and was held up as an example of excellent corporate citizenship.[19]

Feuerstein articulated his rationale in stakeholder-centric terms, saying:

> I have a responsibility to the worker, both blue-collar and white-collar. I have an equal responsibility to the community. It would have been unconscionable to put 3,000 people on the streets and deliver a deathblow to the cities of Lawrence and Methuen. Maybe on paper our company is worthless to Wall Street, but I can tell you it's worth more.[20]

Feuerstein became a minor celebrity for a time, sitting next to Hillary Clinton in the Senate gallery during former President Bill Clinton's 1996 State of the Union address.[21]

I have sometimes used Levi's and Malden Mills in my own scholarship and lectures as examples of socially responsible companies.[22] A common challenge to such examples is that such ethical, stakeholder-oriented behavior would be impossible for a public company. The notion implicit in this challenge is that privatization makes social responsibility more, not less, possible.

In fact, both the Levi's and Malden Mills stories come with some limitations and important caveats, if offered as examples of successful corporate social responsibility. Levi's is regarded as a successful business, but it had a very tough decade in the 1990s.[23] Malden Mills has traveled an even tougher road: it went through bankruptcy and has been purchased by another company.[24] Feuerstein is no longer the principal owner or CEO.[25] These companies attempted, with different degrees of success, to take into account the interests of stakeholders in an industry—the apparel business—that is extremely competitive and labor intensive. They may or may not be

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18. *Id.*
19. David Lamb, *Massachusetts Mill Town Gets Angel for Christmas*, L.A. TIMES, Dec. 19, 1995, at A1.
20. BARBARA A. GLANZ, HANDLE WITH CARE: MOTIVATING AND RETAINING EMPLOYEES 251 (2002).
21. JOSEPH WILLIAM SINGER, ENTITLEMENT: THE PARADOXES OF PROPERTY 198 (Yale University, 2000); *see also* Alison Mitchell, *State of the Union: The Overview; Clinton Offers Challenge to Nation, Declaring, 'Era of Big Government is Over'*, N.Y. TIMES, Jan. 24, 1996, at A1, *available at* http://query.nytimes.com/gst/fullpage.html?res=9D05E2DB1F39F937A15752C0A960958260&sec=&spon=&pagewanted=all.
22. KENT GREENFIELD, THE FAILURE OF CORPORATE LAW 90–91 (2006) [hereinafter THE FAILURE OF CORPORATE LAW].
23. *See* Chris Reidy, *In the Marketplace, They are no Longer Such a Great Fit*, THE BOSTON GLOBE, Feb. 23, 1999, at A1; *see also* Greg Johnson, *Blue Period*, L.A. TIMES, Nov. 6, 1997, at D1, *available at* http://articles.latimes.com/1997/nov/06/business/fi-50688.
24. *A Change at Malden Mills*, N.Y. TIMES, Mar. 10, 2003, at C8.
25. *Id.*

the best examples of how companies can successfully take seriously the concerns of stakeholders. But the fact that they tried to do so at all, especially in such a competitive industry, is a testament to the conventional wisdom that such efforts are more likely when companies are private and can insulate themselves in some respects from the vagaries of the capital markets.

Undoubtedly, it is odd to assert two conventional wisdoms about a given subject—especially two that run at cross-purposes. But both of these claims are prominent enough that they deserve to be called such. Also, both conventional wisdoms have some merit, at least at the theoretical level.[26] On the one hand, private companies are often seen as havens for corporate raiders who care little about the experiences of the businesses' non-equity stakeholders, and public markets are seen as a way for the public to have influence on the decision-making of firms. On the other hand, privatization may allow some companies the freedom from market pressures that make it more difficult to take a long-term, stakeholder view. Let us look more carefully at these competing stories about privatization.

II. PUBLIC VERSUS PRIVATE COMPANIES

From the standpoint of non-shareholder stakeholders, there are key differences between public and private companies. It is initially unclear, however, whether there is reason to believe that one form or the other is likely to lead to corporate governance that is more beneficial to all investors in the firm. To find out, it is necessary to consider some major differences: time horizon, disclosure, concentration of equity ownership, and autonomy of management.

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26. I should hasten to add that perhaps the existence of these two conflicting narratives can be best explained by a study of the history of privatization rather than the theory of it. Both the Levi's and the Malden Mills experiences can be explained in major part by a dedication of the Jewish owners to seeing the business as an extension of their own moral obligations. *See* SINGER, *supra* note 21, at 200; SCHOENBERGER, *supra* note 14, at 36. The private nature of both firms gave them the freedom to act with less attention to the short-term concerns of the capital market. But both companies struggled to keep their vision in place in part because of the difficulties posed by other markets, most prominently the product market. The recent going private trend does not in any way seem motivated by social concerns. Private equity firms are not as a rule dominated by families who want to use the companies they purchase to act out moral obligations, but by high net worth investors that see the purchased companies as mechanisms for building wealth, usually in a short time frame. *See, e.g.*, Michael Alles, *Private Equity Funds: Champions of Governance and Disclosure?*, 4 INT'L J. DISCLOSURE & GOVERNANCE, 217, 220 (2007) ("[P]rivate investors in private equity funds care only about making money."), *available at* http://www.palgrave-journals.com/jdg/journal/v4/n4/full/2050068a.html.

A. TIME HORIZON

Private companies are not limited by the short-term vision said to plague public markets.[27] Share turnover in publicly-traded, Fortune 500 companies is very high—over 100% per year—and is even higher for smaller companies.[28] Reporting requirements impose quarter-by-quarter reporting, which requires companies to track the short term and encourages markets to reflect short-term interests.[29] A recent study of chief financial officers revealed that a significant majority of them would voluntarily make decisions costly to the firm in the long-term in order to meet quarterly Wall Street projections.[30] No one advocates for short-term management, but public markets make it more likely to occur.[31]

One example of short-term thinking that hurts employees is the so-called "7 percent rule," which is the Wall Street notion that one way to achieve a short-term bump in stock price—usually the aforementioned 7%—is to announce lay-offs.[32] Economic studies indicate that no such benefit continues over the long term.[33] Nevertheless, the frequency of this short-term bump in stock prices has ensured that the "7% rule" is often a managerial heuristic.[34] So if short-term management hurts stakeholders and long-term management benefits stakeholders, privatization may be a positive trend for stakeholders because it frees managers to manage with a longer time horizon and without the need for immediate accountability in the form of profits.

On the other hand, managers of public companies are not totally driven toward short-term gains. Managers of public companies often have a longer time horizon than shareholders, and the business judgment rule gives those managers sufficient leeway to manage with an eye toward at least the medium term.[35] Privatization, in contrast, is often done in order to perform a quick-flip of the target company, often within a year or two.[36] When management takes such a short time horizon, stakeholders with a long-term horizon (e.g., employees, communities, and those concerned with the environment) tend to lose out.[37] Perhaps the question of whether

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27. Mark Goyder, *Ownership and Sustainability – Are Listed Companies More Responsible*, ETHICAL CORPORATIONS, July 14, 2008, at 46–49.

28. LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 277–78 (2007).

29. Goyder, *supra* note 27, at 46–49.

30. MITCHELL, *supra* note 28, at 277–78.

31. Goyder, *supra* note 27, at 46–49.

32. For a more in-depth description of the 7% rule, see Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL'Y REV. 1, 12–13 (2008).

33. *Id.*

34. *Id.*

35. *Id.* at 13–14.

36. *See* SEIU, BEHIND THE BUYOUTS: INSIDE THE WORLD OF PRIVATE EQUITY 14 (Apr. 2007); *see generally* Oesterle, *supra* note 4 (discussing the short term horizon of PE firms).

37. *See* Oesterle, *supra* note 4.

privatization is a good thing for non-equity stakeholders turns on an empirical judgment on the number of companies taken private only to be flipped. According to the World Economic Forum, while leveraged buyouts using private funds are quicker to flip than those using public funds, only 12% of privately-funded LBOs go public or are re-sold within two years, and less than 3% do so within twelve months.[38] At face value, this data supports the notion that privatization would not have a large impact on the time horizon of management, at least with regard to stakeholders.

When all is said and done, perhaps what can be said is that in private firms, it is more possible for managers to manage for the long term, even if not more likely. To the extent that, in the long term, stakeholder interests and shareholder interests in fact coalesce,[39] private companies may at least have more freedom to bring that coalescence about. Moreover, if stakeholder-oriented firms allocate surplus differently, a longer time horizon *might* matter, because more time often allows reciprocal benefits of stakeholder management to accrue.[40] For example, studies show that when employees believe their employers treat them fairly, employees are more loyal and obey company rules more.[41] This reciprocity is a natural human reaction and does not develop overnight. So, when stakeholder governance creates good feelings on the part of employees and other stakeholders, a longer time horizon would allow the benefits gained from those good feelings to accrue.

This theory must include a handful of caveats. First, to the extent that long-term interests of shareholders and other stakeholders do not necessarily coalesce, the lengthened time horizon will not be a significant benefit to privatization. Second, the long term may be too far away to make such coalescence real. As Keynes would say, in the long term we are all dead.[42] If that is true, then perhaps what really matters is not long-term management, but the current allocation of corporate surplus (i.e., whether private companies will allocate less of the corporate surplus to equity and more to communities and employees). While being a private company might make such an allocation more possible if equity and management want it to occur, there is nothing in the structure of the governance of private companies that makes it occur on its own accord.

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38. *See* Davis, *supra* note 10.

39. *See* Oesterle, *supra* note 4.

40. For a more robust analysis of reciprocal benefits in the workplace and in corporate governance, see THE FAILURE OF CORPORATE LAW, *supra* note 22, at 158–85.

41. For a more in-depth analysis of this effect within companies, see Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS L. REV. 581, 627–40 (2002).

42. JOHN M. KEYNES, A TRACT ON MONETARY REFORM 80 (1923).

B. DISCLOSURE

One of the oft-mentioned distinctions between private and public firms is the fact that private companies can go "dark" and can operate without disclosing certain kinds of information to the public.[43] Information that can be hidden from the public can include specifics of executive compensation, financial structure, and plans for the future.[44] To the extent that stakeholders use the data in their labor negotiations, consumer purchasing habits, or shareholder activism to pressure companies to act differently, the loss of this information to the public is a key difference between public and private firms. One might see the obligation of disclosure as one part of the implicit social contract between business and a democratic society. That is, disclosure might be seen as a part of the set of requirements imposed by the polity on the corporate form in exchange for the power to aggregate wealth.[45] To the extent that private firms are less subject to that democratic check, they may take into account the interests of the polity less often than public firms.

There are several indications that these differences in disclosure do not have much of an impact on stakeholders. First, according to Robert Bartlett, a significant and growing percentage of private companies voluntarily subject themselves to disclosure obligations, including those of Sarbanes-Oxley.[46] Perhaps disclosure is a bonding mechanism for management to reassure investors, and even the public at large.[47] In any event, privatization is increasingly done not to avoid financial disclosure but for other reasons. Something other than disclosure obligations is driving companies to privatize.

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43. For an excellent analysis of the effects of privatization on disclosure, *see* Robert P. Bartlett, III, *Going Private But Staying Public: Reexamining the Effects of Sarbanes-Oxley on Firms' Going Private Transactions*, 76 U. CHI. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088830.

44. *See* Oesterle, *supra* note 4.

45. Andre Kah Hin Khor, *Social Contract Theory, Legitimacy Theory and Corporate Social and Environmental Disclosure Policies: Constructing a Theoretical Framework* (unpublished essay), Nottingham Univ. Bus. Sch. *available at* http://www.ibe.org.uk/runner-up%20essay%20-%20undergrad%20category.pdf.

46. *See* Bartlett, *supra* note 43.

47. Irene Karamanou & George P. Nishiotis, *Disclosure vs. Legal Bonding: Can Increased Disclosure Substitute for Cross-Listing?*, at 4 (Mar. 2007), *available at* http://www.hec.unil.ch/urccf/seminar/IAS%20vs%20CL.pdf (citing research suggesting that bonding benefits are associated with increased disclosure); Richard Lambert, Christian Leuz & Robert E. Verrecchia, *Accounting Information, Disclosure, and the Cost of Capital*, at 16 (Aug. 2006), *available at* http://fic.wharton.upenn.edu/fic/papers/06/0620.pdf ("As more public information is generated, the assessed variance of the firm's cash flows goes down, and the discount of price relative to the expected cash flow declines."); *see generally* David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553, 1554–1583 (2004); Jeffrey Ng, *The Effect of Information Quality on Liquidity Risk*, (July 21, 2008), *available at* http://ssrn.com/abstract=1097382.

The second reason why differences in disclosure may nevertheless be immaterial to stakeholders is that typical financial disclosure provides only limited benefits to non-equity stakeholders. Materiality to shareholders does not equal materiality to employees or other stakeholders, and the disclosure of financial data may reveal little of importance to those interests. For example, financial disclosure may mean little to employees who worry about whether the company is going to relocate their particular factory overseas. The decision may not be material to the typical shareholder, in that it would not have a reasonable likelihood of affecting the shareholder's decision to buy or sell the stock, especially if the company is large and the factory relatively small in comparison to the company's business as a whole. But such a decision would be absolutely crucial to the employees who are employed in the factory. So the requirement that companies disclose material financial information may simply be neither here nor there to most employees.

C. CONCENTRATION OF EQUITY OWNERSHIP

Private companies, by definition, have more concentrated equity ownership.[48] To some degree, this concentration makes companies appear to be more like European companies, which are typically held less widely than U.S. companies.[49] In Europe, blocks of shares are owned by banks or other institutions,[50] and thus their shares are also typically less liquid than those of U.S. public firms. This correlates with a greater concern for non-equity stakeholders, which is much more of a mainstream idea in European managerial circles compared to the United States.[51] This greater concern for stakeholders may spring from a more robust social contract between businesses and the European polity, or it may be derived from a greater identification between the equity holders and the companies, which in turn imposes reputational constraints on the behavior of the company that would not exist if the equity were held in a more diffuse way. Or, it might spring from the fact that the lower liquidity means that the equity holders are more likely to be physically located in or near the facilities of the companies in

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48. *See generally* Oesterle, *supra* note 4 (referring to the requirement that a company that goes private has less than 300 shareholders).

49. *See* THOMAS CLARKE & MARIE DELA RAMA, FUNDAMENTALS OF CORPORATE GOVERNANCE 9 (2008), *available at* http://www.ccg.uts.edu.au/PDF/fundamentals_of_cg.pdf. ("Though there are many widely held companies in Western Europe, an analysis of ownership structure . . . demonstrate[s] that ownership concentration is more extensive.").

50. *See also* Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 604 (2000) (showing tables of ownership concentration across countries).

51. *See* Torsten Sewing, *Governance: Germany - Driving Through Governance Reform*, ETHICAL CORPORATIONS, Dec. 16, 2007, at 47; *see also* John Russell, *Governance: F&C Investments - Governance Worth Investing In*, ETHICAL CORPORATIONS, June 16, 2008 at 41–42; Goyder, *supra* note 27, at 46–49.

question, so that the behavior of the companies in question are more likely to affect the equity holders themselves. Moreover, this concern for employees in particular is woven into the fabric of corporate governance in Europe; the requirement that employees be represented on the company board, known as "co-determination," exists in 18 of the 25 European Union nations.[52]

The comparison between European publicly-traded companies and U.S. privately-held companies may therefore be helpful. Lower liquidity and greater concentration of ownership lead to a greater identification between the holders of equity and the company itself. It also may mean that the holders of the equity are more likely to be physically located near company facilities. To the extent these parallels hold true—and it is an empirical question whether they do—one should not be surprised if it is indeed the case that private firms in the U.S. consider themselves freer than public companies to take into account the interests of stakeholders.

On the other hand, more concentrated equity ownership means that ownership is bound to be more idiosyncratic. With concentrated equity ownership, such ownership can either be socially responsible like Aaron Feuerstein or be his morally bankrupt mirror image. As compared to public market investors, private equity investors are as likely to be more profit-oriented as less profit-oriented.[53] According to Dale Oesterle, private firms bear this out, and are more focused on the returns of equity ownership than are public firms.[54]

There is a different side of the story. Public markets, including capital markets, have all kinds of players in them.[55] Not all players in the capital markets model themselves after gladiators; some shareholders use their equity ownership to advance other purposes and ideals. Shareholders include unions, public employee pension funds, church groups, and law professors. Shareholders can influence the market and can engage in shareholder activism on anything from the use of napalm to force-feeding geese.[56]

Separation of ownership and control may counterbalance the restraints of the public market, however. With public companies, the "separation of

52. REBECCA PAGE, CO-DETERMINATION IN GERMANY – A BEGINNERS' GUIDE 31 (2006).

53. *See* Donald Jay Korn, *Working the Private Equity Circuit*, BLACK ENTERPRISE, Nov. 1, 1998, http://www.allbusiness.com/business-finance/equity-funding-private-equity/707232-1.html. (Generally "private equity investors are extremely profit-oriented, there are exceptions—especially local groups that have alternative goals.").

54. *See* Oesterle, *supra* note 4.

55. *See* CTR. FOR CAPITAL FLOW ANALYSIS, CAPITAL MARKET PLAYERS: INVESTORS, ISSUERS, AND INTERMEDIARIES, *available at* http://www.capital-flow-analysis.com/market-sectors/market-players.html.

56. *See* Lovenheim v. Iroquois Brands, Ltd., 618 F.Supp. 554 (D.D.C. 1985) (shareholder sued company to include shareholder's proposal regarding force-feeding geese for production of foie gras); Med. Comm. for Human Rights v. S.E.C., 404 U.S. 403 (1972) (SEC did not require Dow Chemical to include a shareholder proposal to limit Dow's sales of napalm in proxy statement).

ownership and control" means that equity holders may not identify with, or be identified with, the activities of the companies whose stock they own.[57] There is thus a loss of reputational constraint on the behavior of public firms.[58] It is possible that, with private companies, they will be identified with their dominant equity investors simply by reputation. For example, the fact that the Haas family saw Levi's as *their* company meant that they projected their family values onto the company culture, to the benefit of the company's stakeholders.[59]

One other effect of concentrated equity ownership deserves mention. As equity ownership becomes more concentrated, it is typical for companies to rely on debt rather than equity financing, which leads to a higher debt-to-equity ratio.[60] This higher leverage may have effects on non-shareholder stakeholders. It is a financial truism that leverage leads to greater volatility in return on equity.[61] To the extent that such volatility leads to riskier decisions on the part of management (because equity holders enjoy a disproportionate benefit from risky decisions that pay off, and their downside risk is limited because of limited liability), high leverage will be a negative for those stakeholders that value stability rather than risk.[62] In other words, to the extent private firms are highly leveraged, they will have greater incentives to make riskier decisions with the possibility of high payoffs.[63] This will be especially true if the equity of the specific private company is held in a private equity firm that has a number of such companies in a diversified portfolio, because the risk is hedged.[64] From the standpoint of the private equity firm, the risk of any particular company failing because of its risky decisions is more than made up for by the potential upside to equity in the other companies.[65] From the standpoint of the stakeholders of the individual firms, who are not able to diversify away the downside risk of their company's failure, the riskier decisions brought about by high leverage are a worry.[66]

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57. *See* Beaver, *supra* note 14.
58. *Id.*
59. *Id.*
60. *See* Güner Gürsoy and Kürşat Aydoğan, *Equity Ownership Structure, Risk-Taking and Performance: An Empirical Investigation in Turkish Companies*, Bilkent University, Ankara, Turkey (1998), *available at* http://www.bilkent.edu.tr/~aydogan/OwnershipStructure.pdf.
61. Frederic L. Pryor, ECONOMIC EVOLUTION AND STRUCTURE (1996), at 110, *available at* http://books.google.com/books?id=OPvCsPjeJ68C&pg=PA110&lpg=PA110&dq=leverage+leads+to+greater+volativolatility&source=web&ots=w1AGVKSOX-&sig=JhyuIuqGapr8jI5NYfEYwniT2ZY&hl=en&sa=X&oi=book_result&resnum=6&ct=result.
62. Gürsoy & Aydoğan, *supra* note 60.
63. *Id.*
64. Efficient Markets and the Portfolio Theorem, http://arnoldkling.com/econ/saving/portfol.html (last visisted Nov. 4, 2008).
65. *Id.*
66. For a related point, see generally Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE. W. RES. L. REV. (forthcoming 2008), for a discussion of the divergent interests of non-shareholder stakeholders and shareholders with regards to how leveraged a company should be.

D. AUTONOMY OF MANAGEMENT

If management is more autonomous, it is possible for managers to use their autonomy to allocate more of the corporate surplus to employees and other stakeholders.[67] Discretion can mean that more of the corporate surplus goes to employees and other stakeholders, because managers can use their own sense of fairness and "just dessert" as a guide in allocating the accumulated corporate surplus and can be freed from a strict fiduciary obligation to maximize returns to shareholders.[68] This was the ostensible argument behind the stakeholder statutes adopted during the 1980s: by giving more autonomy to managers, non-equity stakeholders would benefit.[69] Some research bolsters the argument that this effect has been one of the by-products of those stakeholder statutes.[70]

With regard to the public/private company debate, one would assume that management is less autonomous in a public company because the company faces capital market discipline[71] and the managers occasionally face legal discipline if they do not pay close attention to the well-being of shareholders.[72] In private companies, there is less capital market pressure and thus the potential for more managerial autonomy.[73] And assuming the benevolence of private company management, this autonomy will give it

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67. *See* Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991); Frank J. Garcia, Note, *Protecting Nonshareholder Interests in the Market for Corporate Control a Role for State Takeover Statutes*, 23 U. MICH. J.L. REFORM 507 (1990); Alexander C. Gavis, Comment, *A Framework For Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451 (1990).

68. *See generally* McDaniel, *supra* note 67; Garcia, *supra* note 67; Gavis, *supra* note 67. For a detailed description of a behavioral experiment showing how managers unfettered with an obligation to advance solely the interests of shareholders might use such freedom, see Kent Greenfield and Peter C. Kostant, *An Experimental Test of Fairness Under Agency and Profit-Maximization Constraints (With Notes on Implications for Corporate Governance)*, 71 GEO.WASH. L. REV. 983 (2003).

69. *See* McDaniel, *supra* note 67; Garcia, *supra* note 67; Gavis, *supra* note 67.

70. A study conducted by Marianne Bertrand and Sendhil Mullainathan supports this argument. They studied the impact on wages of state anti-takeover legislation, which many states passed during the 1980s. On the basis of their findings, they argue that anti-takeover legislation decreased the threat of takeovers and, thus, expanded managerial discretion. Using firm-level data, Bertrand and Mullainathan found that anti-takeover laws increased non-management wages 1% to 2% or about $500 per year. This study bolsters the proposition that managers, if given more legal discretion to allocate the firm's surplus without fear of legal challenge, would allocate more to labor. Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation* (MIT Dep't of Econ. Working Paper No. 98-19, 1998). *See also* Greenfield and Kostant, *supra* note 68, at 983 n.74.

71. *See* Arnoud W. A. Boot, Radhakrishnan Gopalan & Anjan V. Thakor, *Market Liquidity, Investor Participation and Managerial Autonomy: Why do Firms Go Private?*, 2–3 J. FIN. (forthcoming 2008), *available at* http://www.olin.wustl.edu/firs/pdf/MemberPapers/472/14.pdf.

72. Managers can be held legally responsible for actions that violate their duty of care if shareholders can prove that decisions are not properly informed. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del.,1985); Aronson v. Lewis, 473 A.2d 805, 812 (1984).

73. *See* Boot et al., *supra* note 71.

more flexibility to allocate a greater portion of the corporate surplus to non-equity stakeholders.

But this does not ring true with the current privatization trends. Private equity firms do not appear to follow in the Aaron Feuerstein or Haas family models. As Dale Oesterle has written, private equity firms today are even more oriented toward the prerogatives of equity than are public firms.[74] If this is right, then the autonomy of private-firm management might be used not for the benefit of stakeholders, but for the benefit of the managers themselves and their cohort of equity owners.

Moreover, the notion that managers have more autonomy in private firms may simply be incorrect. Owners of private-company equity may be more involved and engaged in the management of private firms.[75] They may not take too kindly to management allocating corporate wealth they believe is theirs to other stakeholders. Ironically, management of public firms may be better able to use their own moral sensibilities as a guide than the management of private firms. The equity of public companies is typically held by gross aggregations of shareholders, and shareholders have difficulty coordinating their monitoring efforts.[76] Management is therefore insulated from oversight because of agency costs.[77] Concentrated ownership, more of the norm in private companies, makes it easier for shareholders to monitor management and more difficult for management to "go off the reservation" and act in ways that benefit stakeholders at the expense of shareholders.[78]

III. CONCLUSION

Obviously, this discussion is merely a first cut at the various ways in which private companies may be better or worse for stakeholders than public companies. There certainly are other material characteristics of private firms that I have not identified here. But given this first view, it does not appear that privatization is necessarily positive or negative for stakeholders. There may be somewhat more freedom for private firms to operate with a view toward stakeholder interests, but the impact is likely to be marginal. And that freedom could cut the other way, giving private firms the ability to insulate themselves from stakeholder interests and public oversight, making them even more profit-oriented and less concerned about the public interest.

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74. *See* Oesterle, *supra* note 4.

75. *See id.* (discussing how private company management are more accountable to shareholders).

76. Marco Pagano and Ailsa Röell, *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to go Public*, 113 Q. J. OF ECON., 187–225 (1998).

77. *Id.*

78. *Id.*

To protect stakeholders, assistance should come from legal reforms such as adjustments in fiduciary duty requirements and the makeup of corporations' decision-making bodies. These reforms should be applied to both publicly-traded and privately-financed firms. The benefits to stakeholders arising organically from privatization, if they exist at all, are likely to be marginal. If we are convinced that stakeholders deserve some additional protection, then we should look outside of corporate governance or seek to weave a concern for their interests into the very fabric of the firm itself.[79]

79. For a more robust exploration of this possibility, see generally Greenfield, *supra* note 66.

LOOTING: THE PUZZLE OF PRIVATE EQUITY

Daniel J.H. Greenwood[*]

In 2007, The Blackstone Group (Blackstone), a publicly traded private equity firm, paid its Chief Executive Officer (CEO) Steven Schwarzman roughly $350 million in cash compensation. Including the stock he received in connection with Blackstone's public offering, Schwarzman's personal compensation for the year was over $5 billion.[1]

Five billion dollars is a stunningly large sum. For comparison, in 2007–08, the Chicago public school system spent only $4.648 billion to fund 44,417 employees, including 24,664 teachers, to educate 408,601 students in 655 schools.[2] Alternatively, Schwarzman's pay, by itself, could have paid for a Nimitz class aircraft carrier (approximately $4.5 billion),[3] with enough left over to operate Princeton University for six months—all 5,400 employees and 160 buildings necessary to educate 7,085 students, publish 2,000 scholarly works per year, run a 6.5 million volume library and a museum with over 72,000 works of art, and generally operate one of the world's great research universities.[4]

In 2006, four American hedge fund managers—James Simons, Kenneth Griffen, Edward Lampert and George Soros—reportedly received more

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* Professor of Law, Hofstra University Law School. Thanks to Jim Fanto, the Journal editors, and my fellow panelists.

1. George Anders, *For Now at Least, Blackstone's Chiefs Decide Their Own Pay*, WALL ST. J., Mar. 26, 2008, at A2; Joe Bel Bruno, *Blackstone's Schwarzman makes $5.13B*, HUFFINGTON POST, Mar. 12, 2008, *available at* http://www.huffingtonpost.com/2008/03/12/blackstones-schwarzman-m_n_91193.html?referer=sphe-re_related_content&referer=sphere_related_content (last visited Nov. 22, 2008). Blackstone Group L.P., Annual Report (Form 10-K), at 134–36, 145, 147 (Dec. 31, 2007) (describing $729 million award of vested Blackstone Partnership Participation Units; $350 million cash payments to Schwarzman; $4.773 billion grant of unvested Blackstone Participation Units; and purchase of ownership interests from Schwarzman for $684 million). Peter G. Peterson, Blackstone's Chairman of the Board but better known for his long campaign to privatize Social Security, received at least $1.4 billion in vested Participation Units in connection with the transaction, and payment of $1.9 billion for his ownership interest in the predecessor firm. *Id.* at 136, 147. At year end, Schwarzman was beneficial owner of almost 234 million Participation Units, worth $7.24 billion at the initial public offering price, and Peterson owned about 45 million Units, valued at about $1.4 billion. *Id.* at 145. Prior to going public, Blackstone was not required to disclose compensation, so it is not clear over what period Schwarzman and Peterson received the interests that were cashed out in the IPO or what other compensation they received in earlier years.

2. Chicago Public Schools, CPS at a Glance, http://www.cps.k12.il.us/AtAGlance.html (last visited Nov. 22, 2008). Most data from fiscal year 07–08.

3. US Navy, Aircraft Carriers – CV, CVN, http://www.navy.mil/navydata/fact_display.asp?cid=42-00&tid=200&ct=4 (last visited Nov. 22, 2008).

4. Princeton's fiscal 2006 budget was $1 billion. Princeton University, Finances, A Princeton Profile 2007-2008 (2007), http://www.princeton.edu/pr/facts/profile/07/finances/; Princeton University, About Princeton University (2007), http://www.princeton.edu/pr/facts/profile/07/about/; Princeton University, Scholarship and Research, http://www.princeton.edu/pr/facts/profile/07/scholarship/; Princeton University, Princeton Art Museum, Collections, http://artmuseum.princeton.edu/collections/.

than a billion dollars each from their firms.[5] In total, the top twenty-five hedge fund managers together cost $14 billion for the year,[6] two-thirds as much as Wall Street's entire reported profit that year ($20.9 billion).[7]

Is it possible that these men have actually earned the money they have received? Can one person contribute as much as, let alone five times more than, all the employees of Princeton University combined? Simplistic defenses of high executive pay are sometimes based on the claim that standard market models imply that employees must be paid their marginal product—that is, that the wealth these individuals have received must reflect the value they contribute.[8] The opposite is more nearly true. No plausible economic account of the private equity and hedge fund industry would lead us to believe that these money managers are creating new value greater than their executives' pay. In particular, the "agency-cost" problem cannot be solved by adding yet another level of highly paid agents supervising agents, even if they are paid at unprecedentedly high levels. Rather than exemplifying the success of American capitalism, these funds instead epitomize the current crisis.[9] We are suffering from a new culture of private corruption. Our highly paid executives are not making money, but taking money.

The private equity sector is the most extreme manifestation of the new corruption. Corporations exist in a liminal zone created by two radically opposed moral systems: on the one hand, the competitive ethos of market and contract, in which no one is his brother's keeper and only the minimal rules of fair play limit self-interest; and on the other hand, the cooperative, self-abnegating spirit of fiduciary duty, in which the fiduciary must entirely set aside thoughts of self in order to serve a greater cause. Corruption,

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5. Jenny Anderson & Julie Creswell, *Make Less Than $240 Million? You're Off Top Hedge Fund List*, N.Y. TIMES, Apr. 24, 2007, at A1.

6. Even in this elite group, inequality reigns. The highest paid, Simons, took home $1.7 billion, while Soros, a piker by comparison, merely made $950 million. *Id.* The poor relations at the bottom of the top twenty-five received just under $250 million each. *Id.* In the publicly traded sector, top CEO earnings are usually quite a bit lower. According to the AFL-CIO, the average CEO of an S&P 500 company made $14.2 million in 2007, while by Forbes' calculation the highest paid, Larry Ellison of Oracle, made $192 million. *See* AFL-CIO, 2008 Executive Paywatch, http://www.aflcio.org/corporatewatch/paywatch/ (last visited Nov. 22, 2008); *CEO Compensation: #1 Lawrence J. Ellison*, FORBES Apr. 30, 2008. Number 4 on Forbes' list is Countrywide Financial's Angelo R. Mozilo, who was paid $102.84 million in the last year before his company collapsed from a surfeit of mispriced mortgages. *CEO Compensation: #4 Angelo R. Mozilo*, FORBES, Apr. 30, 2008.

7. THE CITY OF NEW YORK EXECUTIVE BUDGET, FISCAL YEAR 2008 (2008) at 6, *available at* http://www.nyc.gov/html/omb/pdf/sum4_07.pdf.

8. In standard models of competitive product markets, at equilibrium price equals marginal cost; by analogy, in competitive labor markets supply should equal demand when employees are paid their marginal product. I know of no evidence that the world actually works this way.

9. "A year ago hedge funds were the omnipotent vanguard of financial capitalism." *The incredible shrinking funds; Hedge funds in trouble*, THE ECONOMIST, Oct 25, 2008.

commonly defined as the use of public office for private purpose, can be understood as a breach of the wall between these two moral systems.

In the last generation, executives have engaged in a sort of moral arbitrage, replacing fiduciary with market norms to justify allocating to themselves an ever-increasing share of the corporate pie. The private equity sector has taken this process to its logical conclusion; it has completely abandoned the notion that corporate office brings with it obligations. Instead, it openly celebrates self-enrichment over institution building or public service. Unfortunately, corruption is just as corrosive in the private sector as in the public sector. Office-holders who seek personal enrichment will nearly always find looting more profitable than construction and betraying co-adventurers more lucrative than genuine commitments.

The essay proceeds as follows. In Part I, I explain the normative duality of the firm and its relationship to classic understandings of corruption. Part II summarizes the rhetorical devices by which corporate executives have arbitraged between the two spheres in order to escape the bonds of professional and fiduciary duties. Part III applies this analysis to the private equity world: by re-characterizing managers as shareholders, private equity can authorize previously unknown levels of looting. Part IV explores the theoretical and practical crises that result. Private equity accentuates the "agency-cost problem" by adding another layer of managers with unprecedentedly high pay and increased discretion. Simultaneously, and more importantly for the economy as a whole, it heightens the paradox of the managerial role in a "shareholder-centered" theory of the firm. Successful corporations require trust: neither employees nor passive investors fully negotiate ex ante contracts. Modern conceptions of the "share-centered" corporation threaten that trust, by encouraging managers to breach implicit commitments to employees whenever expedient to increase shareholder returns. Contractual understandings of managerial roles, in turn, justify managers treating shareholders with equal cynicism. Private equity heightens the stakes. On the one hand, high-powered incentive pay promises executives extreme payoffs from successful exploitation of employees or other contracting parties. On the other hand, the private equity system offers ideological justification for self-interested looting by freeing managers from any residual sense of obligation to the firm itself, its employees or passive investors. Other corporate participants are likely to respond in the only effective way: by mistrust and withdrawal. The overall effect likely will be to reduce American competitiveness and economic growth prospects. In short, on a practical level, the success of private equity threatens market collapse. On a theoretical level, the success of private equity delivers the final blow to whatever is left of the efficient market paradigm.

I. CORRUPTION AND NORMATIVE DUALITY IN THE FIRM

A. CORRUPTION

In the public sphere, we generally understand corruption to mean using public office for personal gain. Public officials, we think, ought to view themselves as public servants, dedicated to working for the public good. Similarly, competition for office between parties or individuals should be based on varying views of the content of that goal or how best to attain it. In corrupt governments, however, officials use the power of their office to enrich themselves, their families, their tribe or political supporters, without regard for their fellow citizens.[10] Worse, once corruption, patronage and cronyism begin to dominate a system, each successive wave of office holders may seek to enrich themselves or their cronies as fast as possible before the inevitable overthrow by a new group, who, more often than not, seem to think that reform means no more than giving a new gang a turn at the trough.[11]

The most craven simply steal national or government property or take bribes, using their office to grab existing wealth rather than creating new projects. Slightly more subtly, others allow their cronies to overcharge the government for services that other firms or governmental agencies could provide more cheaply or competently. Boss Tweed's associate George Washington Plunkitt contended that while this "dishonest graft" is wrong, the Tweed machine limited its own activities to "honest graft:" giving government work only to his supporters who provided just as good service as anyone else.[12] Generally, however, we frown on patronage and

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10. In Weber's terms, corrupt officials act as if they "owned" the position, in the manner of a pre-modern enfeoffed estate. Weber distinguishes between officials who "may assume the character of an 'entrepreneur,' like the *condottiere* or the holder of a farmed-out or purchased office, or like the American boss who considers his costs a capital investment which he brings to fruition through exploitation of his influence" on the one hand, or in contrast, those who "may receive a fixed wage, like a journalist, a party secretary, a modern cabinet minister, or a political official." Modern expert bureaucratic administration, he says, "stands opposed to all these [corrupt or ownership] arrangements. Modern bureaucracy in the interest of integrity has developed a high sense of status honor; without this sense the danger of an awful corruption and a vulgar Philistinism threatens fatally . . . . Without this moral discipline and self-denial, in the highest sense, the whole apparatus would fall to pieces." MAX WEBER, FROM MAX WEBER: ESSAYS IN SOCIOLOGY 86–88, 95 (H.H. Gerth & C. Wright Mills eds. & trans., 1946) [hereinafter FROM MAX WEBER]. *Cf.* MAX WEBER, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION 56–77 (1947) (pilfering resulting from failure to distinguish between public and private); John Waterbury, *Endemic and Planned Corruption in a Monarchial Regime*, 25 WORLD POL, 533–555 (Jul. 1973) (defining corruption).

11. For a recent review of the extensive literature on corruption, see, for example, Jonathan Hopkin, *States, Markets and Corruption: A Review of Some Recent Literature*, 9 REV. INT'L POL. ECON. 574 (2002). For a classic attack on crony capitalism, see Dwight D. Eisenhower, Farewell Address to the Nation (Jan. 17, 1961).

12. KENNETH D. ACKERMAN, BOSS TWEED: THE RISE AND FALL OF THE CORRUPT POL WHO CONCEIVED THE SOUL OF MODERN NEW YORK 2 (2005); WILLIAM L. RIORDAN, PLUNKITT OF

favoritism in the public sector, partly because government ought to work for the good of all, not just "stalwarts," cronies, party loyalists or fellow tribe-members, and partly because, as has been noticed as long ago as Deuteronomy[13] and as recently as the investigators into the K Street Project, Plunkitt's distinction is not maintained in practice.[14]

In the private sphere, corruption raises almost identical problems. When corporate officials or decision makers treat their positions as licenses to seize corporate money, or to manage the firm in order to benefit themselves, cronies or protégés, the entire company, and indeed the entire society suffer.

Successful firms, like successful economies, require that employees and other participants view the firm as a team and identify their own interests with the firm's collective interests.[15] Just as patriots sacrifice for their country, soldiers fight for their platoon, and public servants work for the public, employees work for the firm, sacrificing for the greater good on the assumption that if the firm does well, so will its employees. Working for the whole, employees and other participants need not concern themselves with precise accountings of every contribution and every return on their own investments.[16] Instead, they see its good as their own, much as patriots see working for their country as a privilege rather than a burden. When things are working as they should be, employees see the firm as a common enterprise in which all have invested, rather than a zero-sum game in which

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TAMMANY HALL: A SERIES OF VERY PLAIN TALKS ON VERY PRACTICAL POLITICS 3 (Signet Classics 1995) (1905).

13. *Deuteronomy* 16:19 is one of the earliest discussions of bribery still part of popular culture: "Do not pervert justice; do not favor individuals; and do not take bribes, for bribes blind the eyes of the wise and distort the words of the righteous." *Deuteronomy* 16:19. Talmudic commentators pointed out that since the first clause of the sentence bars perversions of justice, the ban on bribery would be redundant if it only barred officials from accepting payment to change their verdicts in bad faith. Instead, the ban must be meant to bar even accepting a tip from the side that you would have found for anyway. Rava explained that tips and bribes make the official feel connected to the briber and thus makes him partisan. The problem is not merely bad faith, but a good faith failure to see when a friend is doing wrong. *Babylonian Talmud, Tractate Ketubot* 105b. For further discussion, see NEHAMA LEIBOWITZ, STUDIES IN SHEMOT VOL. II 450 (World Zionist Org. 1976).

14. In the public sector, the civil service was meant to limit patronage – Plunkitt's honest graft. In the private sector, however, we maintain the honest graft/dishonest graft distinction. Corporate directors are clearly permitted to engage in the former. *See, e.g.*, Bayer v. Beran, 49 N.Y.S.2d 1, 2 (Sup. Ct. 1944) (upholding contract with wife of President against conflict of interest claim); N.Y. BUS. CORP. L. § 713 (2008) (permitting nepotism and cronyism); 8 DEL. CORP. CODE § 144 (2008).

15. *See* Daniel J.H. Greenwood, *Enronitis*, 2004 COLUM. BUS. L. REV. 773, 811–12 n.78 (2004).

16. Margaret M. Blair & Lynn A. Stout, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002) [hereinafter *Team Production*]; *see* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA, NEW SERIES 386, 390–91 (1937) (contending that firms form to finesse problems with pricing mechanism).

the more the employer gets, the less the employee has.[17] But if firm executives begin to use their positions as vehicles for personal advancement without regard to the common good, team spirit will disappear as surely in the private sector as it will in the public sector. No one likes to be taken advantage of, and nothing makes it as obvious that the team has been suckered as seeing their contributions to the collective enterprise lining private pockets.[18] As ordinary employees learn not to trust their managers, customers learn not to trust producers, and economic actors throughout the economy cease to conceptualize the organizations they deal with as teams and allies, our corporate form of capitalism will be as damaged by the new corporate corruption as the bureaucracies of failed states are by the old culture of baksheesh, bribery and patronage. If every corporate executive is looking out only for himself, then Burke's condemnation of the East India Company—which made many officials rich while destroying a country and losing money itself—and Adam Smith's prediction that the corporate form can never succeed, will ring true.[19]

In the end, private corruption is even more dangerous than public corruption, precisely if not paradoxically because in the private sector the meaning of corruption is not always clear. While governmental officials normally accept that they should be public servants even when they don't act like them, private sector executives have an alternative ideology that can actually turn corruption, cronyism and abuse of office into the highest form of virtue. In the private sector, the self-sacrificing ideals of service must always confront the self-interested norms of free contract in a free market.

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17. *Cf.* DAVID M. GORDON, FAT AND MEAN: THE CORPORATE SQUEEZE OF WORKING AMERICANS AND THE MYTH OF MANAGERIAL "DOWNSIZING" (1996) (describing costs of lack of trust created by corporate "low road").

18. Executive compensation has risen steadily and dramatically over the last three decades, even as median incomes have stagnated. *See, e.g.*, David H. Autor, Lawrence F. Katz & Melissa S. Kearney, *The Polarization of the U.S. Labor Market*, 96 AM. ECON. REV. 189 (2006); Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21(2) OXFORD REV. ECON. POL. 283, 283–303 (2005); Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 49–70 (2003); Steven N. Kaplan & Joshua D. Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* (AFA 2008 New Orleans Meetings Paper, CRSP Working Paper No. 615, 2007), *available at* http://ssrn.com/abstract=931280 (showing that CEO salaries rose dramatically, but along with rather than at the expense of, other top incomes); Thomas Piketty & Emmanuel Saez, *The Evolution of Top Incomes: A Historical and International Perspective*, 96 AM. ECON. REV. 200, 200–206 (2006).

19. *See* Daniel J.H. Greenwood, *Markets & Democracy: The Illegitimacy of Corporate Law*, 74 UMKC L. REV. 41, 46 n.14 (2005) (discussing Burke's criticisms). "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own . . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers." ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 606–07 (Bk V, ch 1, para 107) (Penn State Electronic Classic Series Publication 2005) (1776).

B. NORMATIVE DUALITY IN THE FIRM

Our bureaucratic, corporate version of market capitalism is characterized by a basic normative duality: The contract norms that govern transactions in the market are fundamentally in conflict with the fiduciary and agency norms that apply within the enterprise. The former norms justify self-centered egoism, while the latter demand self-abnegating altruism.

The nomos of the market begins not with cooperators, but with the self-interested, formally-equal strangers of classical contract law and neo-classical competitive markets.[20] If this is not exactly Hobbes' war of all against all, it is at least the disinterested asocial isolation of Rawls' original position.[21] Contract law, unlike agency law, never requires anyone to accept another's direction, to act on behalf of another, or to adopt the other's interest as his own.[22] This normative universe treats contracting parties as if they were equals even when they are not, in the manner of Anatole France's law that in its "majestic equality, forbids the rich as well as the poor to sleep under bridges."[23] Similarly, it rejects agency's common purpose: in the world of contract, no man is his brother's keeper.[24] The image is, instead, Abraham and Lot separating their flocks and each going their own way, amicable separation rather than familial fraternity.[25]

Under market norms, if I realize that a flea market seller is offering an original Rembrandt for the price of a reproduction, I'm perfectly entitled to buy it for the junk price without disabusing the seller of her error. More than that: I should be proud of my coup and others are far more likely to congratulate me for my astute use of my expertise than to condemn me for sharp dealing. Contract norms expect individuals to make as good a deal as

20. *See generally* Robert Cover, *Nomos and Narrative*, 97 HARV. L. REV. 4 (1983); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PENN. L. REV. 1735 (2001). *See also* Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 567 (2001) ("[C]ontract law encourages parties to be self-interested while fiduciary law encourages them to be other-regarding.").

21. THOMAS HOBBES, LEVIATHAN Ch. XIII (Richard Tuck ed., Cambridge Univ. Press 1996) (1651); JOHN RAWLS, A THEORY OF JUSTICE 15–19 (1999).

22. Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 280 (7th Cir. 1992) ("Contract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother's keeper. That philosophy may animate the law of fiduciary obligations but parties to a contract are not each other's fiduciaries.").

23. *See* ANATOLE FRANCE, LE LYS ROUGE [THE RED LILY] Ch. 7 (Modern Library trans., 1917) (1900). *See also* Hamish Stewart, *Where is the Freedom in Freedom of Contract? A Comment on Trebilcock's The Limits of Freedom of Contract*, 33 OSGOODE HALL L.J. 259, 260–61 (1995) ("Freedom of choice [is] presupposed by doctrines of contract law in that those doctrines treat the contracting parties as autonomous agents who are free and equal in the sense that they have an abstract capacity to enter into contracts.") (internal citation omitted).

24. *Genesis* 4:9; *see also Exodus* 22:20–24 (setting out general rule of concern for others).

25. *Genesis* 13:8; *see also Genesis* 31:52 (Jacob and Lavan), *Genesis* 33:15 (Jacob and Esau).

they can for themselves, limited only by the thin requirements of not committing fraud or deliberately and directly physically harming another.[26]

The nomos of agency is entirely different. Instead of "every man for himself and the devil take the hindmost," this is the world of "all for one and one for all;" instead of sibling rivalry, this is the ethos of a parent shepping nachus from the achievements of her child; instead of competition, this is the world of cooperative enterprise.[27] A fiduciary is expected to set aside his or her own interests in order to work to promote the goals and interests of his or her principal, acting as if the principal's goals were the fiduciary's. When the same flea market Rembrandt seller comes to his art appraiser or a money manager, the expert is expected to immediately disclose the knowledge she has; her first responsibility is to protect the seller, even if she could profit more by looking out for herself. If contract and market norms are the rules that govern fair competitions between teams, agency and fiduciary norms are the principles that apply within teams: team players view benefits to their teammates as benefits to the team itself, and accept the good of the team as their own good.

In corporate law, shareholders are clearly within the market nomos. Shareholders, to be sure, have no contract with the corporation. But they are governed by contractual norms in the limited sense that they have no obligation to consider its interests. They are free to act in their own self-interest without regard for the consequences to fellow shareholders, the corporation itself, or other corporate participants. Indeed, shareholders may even use their corporate position to demand that the corporation dissolve itself, sell itself to another firm, fire incumbent managers or commence mass layoffs of less-privileged employees, abandon long standing commitments to products or services, and so on, without even purporting to make a claim that such actions would be in the interests of anyone other than the shareholder itself.[28] Shareholders are nearly always free to profit maximize without regard for others; the limitations, such as insider trading rules, are easily understood within contractual norms.[29]

But more generally, all potential corporate participants are entitled to take a contractual view when they are outside the firm. Thus, for example, employees and employers negotiating terms are normally governed by

26. Daniel Markovits, *Contract and Collaboration*, 113 YALE L. J. 1417, 1449–50 n.66 (2004).

27. ALEXANDER DUMAS, THE THREE MUSKETEERS 91 (Jaques Le Clercq trans., Modern Library ed., Random House, Inc. 1999) (1844).

28. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (illustrating an instance of a shareholder acting against the interests of the firm as a whole).

29. This may not be immediately obvious, since insider trading is defined with reference to fiduciary principles (under current law, insider trading includes only trading done in breach of a duty of confidentiality). Chiarella v. United States, 445 U.S. 222 (1980). The key is that insider trading is understood as a form of fraud – deceit or unfair advantage that is barred even in the self-interested world of contract.

market and contract norms. Each is entitled, and expected, to seek the best deal he, she or it can get, without regard for the consequences to the other. The only reason for an employer to offer more than lowest wage necessary to attract qualified employees is because it is in the employer's own interest to do so—as, for example, when Henry Ford decided to pay more than a market clearing wage in order to reduce absenteeism and turnover and, therefore, keep the assembly line moving more consistently. Conversely, it is not merely acceptable but admirable for an incoming employee to negotiate for the highest possible pay; it is when prospective hires accept less than that that we expect an explanation. Thus, when Disney's board granted its new CEO, Michael Ovitz, an extraordinary contract, providing for "exceedingly lucrative, if not luxurious" payments even if he were terminated, the Delaware court saw a close issue as to whether the board had breached its fiduciary duty, even if it ultimately concluded that it had not.[30] However, it saw no problem with Ovitz having demanded the "extravagant" terms.[31] Indeed, as far as appears from the published opinions, the plaintiffs did not make such a claim. A free actor in a capitalist market is entitled to get the best deal he can.

In sharp contrast, fiduciary norms ordinarily apply within the firm. Once the employee has been hired, he or she enters into a radically different relationship. Instead of the formal equality of contract and market norms, barring dishonesty but otherwise leaving each party free to make the best deal it can for itself in a "very Eden of the innate rights of Man,"[32] the employee is now governed by the asymmetric norms of agency, in which the agent consents to act on behalf of the corporation and subject to its control.

The law views employees, including top managers, as agents—indeed, servants—of the corporation, and therefore fiduciaries for it.[33] Employees are supposed to work for, not against, their employers: like any agent, employees owe their employer duties of care and loyalty. Directors are not agents, of course, but they too are bound by almost identical fiduciary duties requiring them to work for the firm rather than themselves.[34] For directors and agents alike, these duties are fundamentally similar to the norms of the public sector, requiring that corporate actors set aside their own interests and instead act in the interests of the whole.[35]

Fiduciary norms stem from the demands of cooperation in a common enterprise. Fittingly, given the feudal language of agency's "master/servant

30. *See* Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000).
31. *Id.* at 248.
32. KARL MARX, CAPITAL 195–96 (Modern Library ed. 1992) (1887).
33. 3 AM. JUR. 2D *Agency* § 205 (2008).
34. *See, e.g.*, Matthew Bender & Co., DEL. CORP. L. & PRACT. § 15.02 (2007).
35. 18B AM. JUR. 2D *Corporations* § 1460 (2008).

relationship" and the noble ideals of "finest loyalty"[36] and selfless service, the agency nomos is also a hierarchal world of roles and limitations: agents act on behalf of their principals and under their direction, not the other way around.[37] But our modern firms are more Weberian rationalist than medieval: the leaders themselves are also role- and rule-bound, meant to be renouncing "thought of self . . . , however hard the abnegation," in order to promote the common enterprise.[38] In either case, this much is clear: fiduciaries, including both directors and agents, are supposed to set aside their own interests in order to work for the firm, just as public sector employees are meant to work for the good of the country. An officeholder who uses that office for private enrichment is stealing.

Corporations can only exist if they are governed by corporate, not market, norms: to outcompete markets, firms must do something markets cannot. As Coase pointed out long ago, markets will always be cheaper and more effective at being markets than bureaucratic firms.[39] But that means that the line between market norms and agency or fiduciary norms is critical. Agents and fiduciaries are supposed to look out for the firm; contracting parties are free to look out for themselves. When fiduciaries concentrate on taking from instead of increasing the common fund, they are doing something obviously wrong and corrupt. When contracting parties do exactly the same thing, they are likely to be viewed as simply making the market work as it should. Appearances, however, are deceptive. If corporate actors see the firm as a free-for-all, we will all lose.

II. NORMATIVE ARBITRAGE, TOP MANAGERS AND AGENCY-COST ANALYSIS

One of the great stories of the last two decades has been the largely successful attempt of top managers to justify ever increasing pay by moving from agency to contract conceptions of their role. A couple of decades ago, Michael Milken went to jail, technically for relatively minor insider trading, but in popular opinion for taking a salary that was simply unconscionable.[40] Americans have always made folk heroes of owner/entrepreneurs who make huge fortunes; there is nothing odd about an owner taking a quarter of the company's profits (as Milken did) or even more, as Ross Perot, a

36. Meinhard v. Salmon, 249 N.Y. 458 (1928).

37. *See* Aladdin Const. Co., Inc. v. John Hancock Life Ins., 914 So. 2d 169, 175 (Miss. 2005) ("[T]he [essence] of 'agency' is that the agent acts on the principal's behalf and is subject to the principal's control."); RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

38. *Meinhard*, 249 N.Y. at 463–64. *See also* FROM MAX WEBER, *supra* note 10, at 196–245.

39. Coase, *supra* note 16, at 390–91.

40. *See* Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 444 (2005).

contemporary hero, did. But Milken labeled himself an employee rather than an owner. Employees are agents and an agent is supposed to work for his principal. On its face, a $250 million pay package seemed clear evidence that Milken was working first and foremost for himself. Insider trading or not, his very salary appeared fundamentally corrupt. Today, the uproar over Milken's pay package seems faintly quaint.

Milken's successors have reframed CEO pay, emphasizing not the CEO's role as an agent, but the moment before employment begins when the CEO negotiates his contract as a free and equal competitor in a free market. Under contract norms, any prospective contractor is entitled to bargain hard. Under market norms, he should demand his marginal product, like any factor of production, and the company should be willing to pay it.[41] So, if he can persuade the board that his management will make the company a fortune, he is entitled to be paid that fortune.[42]

Private equity firms have taken this normative arbitrage another major step, re-characterizing managers as investors entirely free of any responsibility to the firm. With no normative constraints from agency law or team play, private equity managers are able, in complete good faith and apparently without rousing any significant social disapproval, to appropriate hitherto inconceivably large slices of the corporate pie. The simple change of title from agent to owner justifies, under standard contractual norms, their pushing self-interested profit-maximization to its logical limit.

The surprising result is that increasingly we do not even know corruption when we see it. Market actors, including investors and CEOs negotiating their contracts alike, are *supposed* to look out for themselves. Nothing is wrong with making infinite amounts of money in the market. On the contrary, it is a sign of virtue: under contract norms, high pay presumptively demonstrates an equally valuable contribution. After all, voluntary contracting parties should not give unless they receive in return something they view as at least equivalent. Moreover, in the corporate world specifically, black letter law holds that shareholders of a public company owe it a fiduciary duty only under the most extraordinary circumstances.[43] Private equity firms charge extraordinary fees for, in

41. Standard microeconomic pricing theory contends that at equilibrium each factor of production will be paid its marginal product. *See, e.g.*, PAUL A. SAMUELSON, ECONOMICS 503–09 (11th ed. 1980).

42. This is a standard trope of the business press, which regularly credits CEOs with having produced the entire increase in stock market capitalization for the company during their tenure. *See, e.g.*, Mark Hodak, *CEOs Aren't Overpaid*, FORBES (May 8, 2008), *available at* http://www.forbes.com/entrepreneurs/2008/05/08/ceos-not-overpaid-ent-competition08-cx-mh_0508hodak.html.

43. Haldeman v. Haldeman, 197 S.W. 376 (Ky. 1917); Zetlin v. Hanson Holdings, Inc., 48 N.Y.2d 684 (1979); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). The major exceptions involve controlling shareholders. Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (noting exception when majority shareholder seeks to divert corporate opportunities at expense of minority).

effect, mining companies of every extractable resource. By any normal understanding, this is corruption: our major corporations are among our most important public institutions, and these officeholders are using their offices for nothing more than private enrichment. But by presenting their role as purely private market actors and investors, they evade the normative structures that would condemn their self-interested destruction of critical social institutions.

A. BEGINNINGS: DEPROFESSIONALIZING MANAGERS

The transformative innovations of private equity build upon the history of the past several decades. To understand the power of the new moral arbitrage—private equity's conversion of corruption into perceived virtue—it is helpful to understand the earlier transformations on which it is based. This section, then, offers a highly stylized account of the ideological history of corporate law since the rise of the "nexus of contracts" theory.[44]

Once upon a time, and it was only partially a fictitious time, corporate executives understood that their private sector positions are a public trust.[45] The leaders of America's great businesses were leaders of America; they were responsible for the welfare of thousands of employees and, in a larger sense, for great American institutions. Employment contracts for ordinary people at their firms were, at least ideally, life-time commitments, including retirement and medical plans that in any other advanced economy would have been key aspects of socialist state services.[46] The primary goals of the position were public: economic growth, good jobs for Americans, and creating stable demand for products and stable sources for raw materials to keep the production machine running, the employees working, and the chimneys smoking.[47] In those days, corporate executives were seen as professionals operating companies in the interests of their employees, customers and investors as best they could. Highly-paid as they were, their wages could be understood as payment for professional work performed,

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44. *See* Armen Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

45. *See generally* JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS (1989) (interviewing directors and reporting that most directors believed that their role was to assure that corporations created good jobs and useful products or services).

46. *See generally* JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (1967) [hereinafter THE NEW INDUSTRIAL STATE] (describing managerial-employee coalition); *see also* John Coffee, *Shareholders Versus Managers: Strains in the Corporate Web*, 85 MICH. L. REV. 1, 23–25 (1986) (describing destruction of implicit contracts).

47. The commentators agreed. *See* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1101 n.157 (1996) (citing literature) [hereinafter Greenwood, *Fictional Shareholders*].

not radically different from those earned by well-paid doctors or lawyers, or, for that matter, their own subordinates.[48]

Increasingly, however, top executives are thinking of themselves differently. In the new era, CEOs are learning to view themselves as freelance entrepreneurs rather than professionals—as self-interested maximizers in a fundamentally market or contractual, rather than agency or fiduciary, relationship. The workaday morality of the market invites actors to seize opportunities for personal advancement when they see them. Thus, executives in this role are entitled to make the best deal they can using the tools they have, including both their skills and their position, that is, their professional abilities and their control of the corporation's decision-making apparatus.[49] As maximizers in a fundamentally arms-length contractual relationship with the company, they need to be incentivized to work in the interests of anyone other than themselves alone.

The transition from fiduciary to self-interested maximizer is critical. I do not mean to invoke a mythological golden age. The CEOs of the professional, fiduciary regime were subject to all the manifold failures of markets, regulation, limited rationality, bureaucratic imperatives, cultural limitations and cognitive dissonance.[50] Still, confusing the interests of General Motors with those of the United States, or the personal interests of the CEO with the interests of his subordinates, is different from believing

48. In 1965, average CEO compensation was approximately 24 times that of the average worker. LAWRENCE MISHEL, et al., THE STATE OF WORKING AMERICA 2006/2007 fig. 3Z (2007), *available at* http://www.stateofworkingamerica.org/tabfig/03/SWA06_Fig3Z.jpg. The 2008 ratio for S&P 500 chief executives, calculated by a slightly different method, is 344. Executive Excess 2008, http://www.faireconomy.org/files/executive_excess_2008.pdf. The ratio of the average CEO pay to the minimum wage for a full time worker was 51 in 1965 and had soared to 821 by 2005. Economic Policy Institute, http://www.epi.org/content.cfm/webfeatures_snapshots_20060627. For detailed, long term data on CEO compensation in the 50 largest publicly traded corporations, see Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, 7, 8 and fig. 1 (2008), *available at* http://ssrn.com/abstract=972399 (showing a general decline in the ratio of compensation of top 3 executives to median employees until 1970 and a steady rise thereafter to 110 in 2005. This number is lower than the MISHEL number in part because it includes the top 3 executives in each company, and there is dramatic and increasing inequality within that group. *See id.* at tbl. 3).

49. Courts clearly acknowledge that when a top executive is negotiating his contract, he is entitled to bargain as hard as he would in any market of strangers. *See, e.g.*, *In re* Walt Disney Co. Derivative Litigation, 906 A.2d 27, 47–8 (Del. 2006). In his role as CEO, of course, he is the company's agent with a fiduciary duty to act in its interest and may not, for example, purchase shower curtains or ice sculptures with company money. *See e.g.*, Grace Wong, *Kozlowski gets up to 25 years*, http://money.cnn.com/2005/09/19/news/newsmakers/kozlowski_sentence/ (describing curtain and sculpture scandals). But in a market, as Alchian and Demsetz noted long ago, all contracts may be renegotiated at any time. *See generally* Alchian & Demsetz, *supra* note 44. Kozlowski's error, it seems, was not his greed but his bad timing. Had he demanded elaborate birthday parties for his wife during his contract negotiations, this would have been no more than tax advantaged self-interestedness, just as appropriate, if included in a contract approved by the board, as Ovitz's contractual right to payment of a quarter billion dollars for flubbing his job.

50. *See, e.g.*, DAVID HALBERSTAM, THE BEST AND THE BRIGHTEST (1972) (describing extremely competent people making bad decisions).

that it is more appropriate to ignore those interests altogether. The fiduciary accepts that she must work for the institution, however imperfectly. The self-interested maximizer is simply the private sector version of public corruption: a position-holder using his position for purely personal gain, without even attempting to consider the public or institutional interest.

B. AGENCY CONCEPTIONS

The de-professionalization of top management was accompanied by a cheerleading ideology that advocated "incentivizing" managers by vastly increasing their take from the corporate pie.[51] Intriguingly, this rhetoric had at its core a confusion of the agency and contract normative understandings: it calls itself agency-cost theory, yet its rhetorical power stems from its contention that even major corporations should be understood as having no more public significance than any individually negotiated contract.[52] It thus rejects any notion of service, duty or public interest within the corporation.

On this account, corporations should be seen as entirely private, the consequence of a series of fully-negotiated bilateral contracts of the simplest, most self-interested variety.[53] Virtually the sole concern of corporate law and governance alike should be enforcing those contracts, principally with the goal of reducing "agency cost," understood to mean a sort of breach of contract: the tendency of managers to act on behalf of their own interests instead of the shareholders' when they have implicitly agreed otherwise. The theory triumphantly vanquished any lingering sense of corporations as public enterprises, their managers as public servants, or corporate law as a subject of critical collective interest.[54] Corporations, it

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51. *See* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138 (May-June 1990); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). More recent commentary has been critical, see, for example, William W. Bratton Jr., *Academic Tournament over Executive Compensation*, 93 CAL. L. REV. 1557 (2005) (reviewing LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004)); Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675 (2005).

52. For standard accounts of the nexus of contracts, agency-cost view, *see* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1996); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 313 (1976). The best critical account remains William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1988).

53. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 52.

54. The same nexus metaphor is regularly invoked in support of the (false) claim that the corporate income tax "really" is paid by shareholders: since the corporation does not exist, its nominal obligations must really obligate someone else. This position ignores not only the law – which clearly exempts shareholders from all corporate obligations – but even the logic of the nexus metaphor, which suggests, rather, that market conditions will determine which corporate participants ultimately see their private gains reduced by corporate taxes. Since shareholders are completely fungible providers of a completely fungible commodity, standard pricing theory

contends, are purely private, appropriately dedicated to unlimited profit maximization.

More subtly, and not as widely noticed, the new privatizing ideology of the corporation as a "nexus of contracts" began to erode the very foundations of the shareholder-centered understanding of the corporation. Agency-cost theory paradoxically insists that managers simultaneously be selfish beyond the norms of civilized society—and selfless beyond the demands of the most stringent of religions. On the one hand, the theory invokes contract norms to argue that managers ought to operate the firm as an extreme form of *homo economicus*, pursuing its profit at the expense of all other values and loyalties.[55] Employees should be viewed as mere tools, to be coddled or exploited as the profit interest dictates, but without a trace of loyalty or friendship. National interests and social responsibility should be ignored; as Milton Friedman famously said, the only social responsibility of the firm is private profits.[56] Taxes should be evaded—rather than acknowledging them as the "price we pay for civilization,"[57] managers should view them as a cost to be ruthlessly reduced like any other. In the most extreme formulation, even criminal law should be viewed as nothing but a cost of doing business; if it is cheaper to lobby for an exemption, to evade or even flat out violate it, that is what managers ought to do.[58]

On the other hand, shareholder-centered theories demand that managers, having treated all their co-workers as means to profit rather than ends-in-themselves, must then voluntarily turn those profits over to shareholders. This is not a contractual view at all. Contract law suggests that parties are entitled to the benefits of their bargain and no more.[59] On theoretical grounds, it is hard to see how a bargain such as the one postulated by agency-cost theorists could arise: no one would ever voluntarily agree to give all the benefits of a bargain—the entire surplus to cooperation—to the other party. Indeed, we know from both introspection and repeated experiments with the Ultimatum Game that most people, most of the time, will prefer to do no deal at all than to give all the benefits to one side.[60]

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suggests that they should be paid no more or less than the cost of the commodity they provide and therefore that it is highly unlikely that corporate taxes ultimately rest on them.

55. *See generally* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY (2001) (felicitously referring to corporations as "externalization machines").

56. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 32.

57. Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

58. *See* EASTERBROOK & FISCHEL, *supra* note 52, at 319. To be sure, this position has a distinguished pedigree outside the corporate sphere, dating back at least to Bentham's contention that criminal law is no more than negative reinforcement.

59. Goodstein Const. Corp. v. City of New York, 604 N.E.2d 1356, 1361 (N.Y. 1992).

60. *See, e.g.*, Christine Jolls, *A Behavioral Approach to Law & Economics*, 50 STAN. L. REV. 1471 (1998) (describing Ultimatum game and research, indicating that people reject offers they

Moreover, the real rights of shareholders bear little resemblance to the imaginary contract postulated by agency-cost theorists. If shareholders are viewed as contracting parties, the contract they have "negotiated" is a very strange one: it specifies nothing to which they are entitled, provides for no time at which they are entitled to the fruits of the bargain (if any) and no sanctions if that time, like the Red Queen's jam tea, never arrives.[61] The "contract," in other words, gives shareholders no contractual rights. Shareholders have no right to withdraw their capital from the firm or to be paid for it while it remains there; the decision when or even whether to take such actions rests solely in the corporation's board.[62] As a result, the marginal cost of existing shareholders is zero, and, of course, in competitive markets, contracting parties should never be able to obtain more than the marginal cost of their product. Thus, a consistent contractual analysis should have suggested that, having bargained for no return, shareholders are entitled to none; having given up any right to withhold their services, they should expect no payment for them. The market for shares should fail, as it does in other markets where marginal cost is below average cost.

Contract and market metaphors presented an even more fundamental challenge to shareholder claims, however. Shareholders are perfectly fungible providers of a perfectly fungible commodity: money. In a competitive market, a perfectly fungible commodity should receive no more than its costs—money should receive no more than the risk adjusted time value of money. Thus, even without entering into the details of the legal rights of shareholders, market theories lead ineluctably to the conclusion that shareholders not only have no special rights to economic (disequilibrium) profits, they have the weakest of all possible claims.

In the early years, the contractual implications were easy to miss, because the "market for corporate control" gave shareholders, or more precisely the stock market as a whole, a powerful mechanism for enforcing its will. If the stock market became unhappy with the way in which managers were managing a firm, it would bid the price of its stock down, and the firm would likely become subject to a hostile takeover, in which the company stock would pass into the hands of a single shareholder, which could then force the firm to conform to market demands. Managers seeking

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perceive as unfair even at substantial expense); Joseph Henrich, et al., *Economic Man in Cross-cultural Perspective: Behavioral Experiments in 15 Small-scale Societies* (Santa Fe Inst. Working Paper No. 01-11-063), *available at* http://www.santafe.edu/research/publications/workingpapers/01-11-063.pdf (describing results of Ultimatum and related games in various societies, generally supporting notion that behavior is far more strongly influenced by normative views than by incentives or self-interest).

61. Daniel J.H. Greenwood, *The Dividend Puzzle: Are Shares Entitled to the Residual?*, 32 J. CORP. L. 103, 134 n.98 (2006) [hereinafter Greenwood, *The Dividend Puzzle*]. Much of this section follows the argument in that essay.

62. *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (detailing shareholders' powerlessness).

to avoid hostile takeover had little choice but to preemptively take the actions the market demanded. The market—non-shareholders as much as shareholders—through the power of price and the legal right to take public companies private, had the power to force managers to conform to the theory.

Rhetorically, standard agency-cost analyses often avoided the problem by the *deus ex machina* of endowing shareholders with a claim to ownership or the "residual."[63] If shareholders can be viewed as the rightful owners of the firm, then the unfortunate fact that they have none of the rights ordinarily associated with ownership makes them peculiarly in need of legal protection. Similarly, if they just are entitled to the entire surplus generated by cooperation—if all other corporate participants are entitled to no more than they could get in a competitive market, which would be their marginal productivity in their second best use[64]—then they are in special need of protection, because ordinary contracts will never get them this.

Thus, the rhetoric returned to the world of fiduciary duty. Traditional fiduciary, agency-based norms required firm agents and directors to set aside their own capitalist instincts in order to work as self-sacrificing team players on behalf of the whole. But if the firm is a mere "nexus of contracts" or a moment in the market, then it necessarily is not real enough

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63. As more consistent theorists pointed out, ownership makes little sense in the context of a "nexus of contracts." Alchian & Demsetz, *supra* note 44. Contract theorists, therefore, often speak instead of shareholders having bargained for a right to the "residual," which is sometimes confusingly called "economic ownership." Other authors redescribed shareholders as "residual risk bearers" selling a form of insurance to the other corporate participants. The semantic change is not meaningful. Shareholders of an on-going publicly traded corporation do not control or otherwise "own" a corporation and they have no right to its "residual": the core of the modern business corporation statutes is that the board, not the shareholders, determines the uses to which corporate assets are put. Nor would we expect anything different. First, in no other market do insurers claim a right to demand that the insured operation be run exclusively in the insurer's interest. Second, shareholders do not in fact provide much insurance, at least for ordinary employees. When times get tough, firms seem to cut employment well before they cut dividends: employees, not shareholders, are the residual risk bearers. *See, e.g.*, Eugene F. Fama & Harvey Babiak, *Dividend Policy: An Empirical Analysis*, 63 J. AM. STAT. ASS'N 1132 (1968) (for a similar point of view); John Lintner, *Distributions of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 AM. ECON. REV. 97 (1956) (reporting on extraordinary stability of dividends); Amal Sharma, et al., *Companies Accelerate Layoffs: Job Cuts Spread to Blue Chips as Continuing Unemployment Claims Hit 26-Year High*, WALL ST. J. (Dec. 5, 2008) (reporting that as recession deepens, companies are "eliminating jobs 'as a preventive measure . . . . Companies want to make sure that they can keep their margins.'"). Another variant took the opposite tack, explaining the supposed right of shareholders to have the firm managed in their interest as necessary to counteract their special vulnerability to ex post exploitation. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 304–307 (1985). This is no more satisfactory. Contractually, helplessness rarely leads to power. But in any event, diversified shareholders are less, not more, dependent on the on-going success of the corporation than other less diversified, more firm specific investors, such as most employees. *See, e.g.*, KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 53–59 (2006); Greenwood, *Fictional Shareholders*, *supra* note 47, at 1065–1066, 1093–1097.

64. Coase, *supra* note 16.

to be the object of fiduciary duties. By combining this incorporeal view of corporations with a mystical view of shareholders as "owners," the traditional fiduciary duties owed to the firm could be shifted instead to the shareholders, understood in a fictionalized, role-based sense as a proxy for the stock market. Managers, it could be claimed, have a fiduciary duty to work for shareholders, which trumps their market right to work for themselves.

But this solution is too easy. Contractual conceptions of the firm create a nearly insoluble ideological tension around the role of managers. To the extent that managers see themselves as in a fundamentally contractual, market-based relationship, they will see themselves as rationalist competitors in a capitalist marketplace—*homo economicus*, not fiduciary altruists renouncing thought of self no matter how hard the abnegation. Contract norms suggest that they will, and indeed should, put their own interests front and foremost.[65] In the contractual nomos, the normative demands of professionalism and agency ring hollow indeed. Instead, we should expect managers to serve corporate interests only to the extent that it is in their personal interests to do so.

Moreover, the role of managers in the shareholder-centered contractual firm replicates the ideological tension. Firms succeed when they induce their employees to work on behalf of the corporate team; successful managers learn to create and maintain that team spirit. Simultaneously, however, the shareholder-centered conception of the firm teaches managers that they must always remember that employees are not the team at all. Rather, managers should be prepared to sacrifice employee interests whenever expedient in the cause of shareholder-value maximization: to create the illusion of a common enterprise while treating employees as no more than resources to be exploited. Not only does the contractual ideology teach managers that they ought to be looking out for number one, but their daily experience teaches them that common enterprise is an illusion, alliances are made to be broken, and those who succumb to the enticements of team spirit will quickly be taken as the marks that they are.

Within the contractual conception of the firm, then, shareholders cannot expect that managers will serve them out of a sense of obligation or loyalty. Both ideology and daily experience work against those virtues. Instead, they must rely on contractual carrots and sticks to "incentivize" managers to act in shareholder interests.

Unfortunately for shareholders, the law gives them only one important stick: the right to sell their stock to a single shareholder who will have the right to change the board of directors at will and thus have the real

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65. For an extreme example of using contract theory to justify managerial grabbing, see Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) (contending that managers should be seen as having "negotiated" for the right to insider trade as additional compensation).

ownership rights public shareholders lack.[66] In the early years of the junk bond-financed takeover boom, the stock market used this threat of takeover to induce managers to break their old alliances and, instead, adopt the new norm of "shareholder value maximization."[67] Thus, stock market returns and top executive salaries both went up quite a bit faster than in the prior several decades,[68] while presumptive tenure and related benefits were eliminated for both unionized and middle managerial employees, salaries below the top levels stagnated, unions were defeated, physical production was shifted first to non-union states and then overseas, the ranks of middle level managers were decimated, corporate income tax payments declined steadily from the early 1950s to the early 1980s, and both median income and the minimum wage stagnated even as labor productivity continued to rise.[69]

However, the poison pill and its statutory equivalents ended hostile takeovers and changed the balance of power. Since the early 1990s, the law has been quite clear that shareholders may exercise the stick of takeover only with the consent of the directors, who are usually under both the

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66. Corporations are under the ultimate control of their board of directors. Public shareholders have the legal right to elect the board, but that right is empty in the ordinary course, if only because the incumbent board controls the proxy machinery. When the firm has only a single shareholder, in contrast, the board serves at the pleasure of the shareholder, which may replace its members at any time.

67. On the effects of corporate governance changes on corporate profits, see, for example, Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Make Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121, 132–33 (2001) (reviewing evidence and possible explanations for effects of takeovers, increased leverage and shifting ideologies).

68. Shareholders received an average compounded return of 15.24% per year in the twenty years from 1982-2002, far above historic norms. IBBOTSON ASSOCIATES, STOCKS, BONDS, BILLS, AND INFLATION (SBBI) YEARBOOK 47 (2008). More recent returns have been lower but still dramatic: the twenty years ending in 2007 still managed an 11.81% annualized return during a period when inflation was only 3.04%. *Id.* During the same period, top executive salaries also jumped dramatically. Frydman & Saks, *supra* note 48, at Fig. 1. Stock returns in part come from other investors, so they are best interpreted as a rough indicator that the stock market anticipated increased shareholder claims on the corporate pie.

69. *See generally* Holmstrom & Kaplan, *supra* note 67. On the diminished prospects of middle management and rank and file employees, see, for example, Coffee, *supra* note 46; MISHEL, *supra* note 48. On taxes, see, for example, Joel Friedman, *The Decline of Corporate Income Tax Revenues*, *available at* http://www.cbpp.org/10-16-03tax.htm. On inequality generally, see, for example, MISHEL, *supra* note 48; RICHARD WILKINSON, MIND THE GAP: HIERARCHIES, HEALTH AND HUMAN EVOLUTION (2001) (noting that inequality reduces health); ROBERT H. FRANK, FALLING BEHIND: HOW RISING INEQUALITY HARMS THE MIDDLE CLASS (2007) (exploring implications of Veblenesque argument that relative status, rather than absolute quantities, drives most desire for goods); ROBERT H. FRANK & PHILLIP J. COOK, THE WINNER-TAKE-ALL SOCIETY: HOW MORE AND MORE AMERICANS COMPETE FOR EVER FEWER AND BIGGER PRIZES, ENCOURAGING ECONOMIC WASTE, INCOME INEQUALITY, AND AN IMPOVERISHED CULTURAL LIFE (1995) (noting that increased inequality causes social dysfunction).

influence and control of the very managers it is to be wielded against.[70] With no stick, only carrots remain. A great many carrots followed.

In the contractual metaphor, there is little difference between shareholders offering carrots or managers helping themselves to them. The point is that markets will give the surplus to trade to those who are in the best position to take it. Managers need shareholders, but shareholders need managers more: money is fungible and managers are not. If the rules of the game are contractual, managers are going to win. Predictably, in the decades since the victory of the privatizing ideology, managers have received ever-increasing salaries and increasingly astonishing quantities of shares or options to purchase shares.[71] Meanwhile, dividends—the primary way corporations traditionally passed corporate assets to shareholders—began to decline even as reported profits increased.[72] Observers contended that corporations were merely shifting to economically equivalent share buybacks to allow shareholders to avoid income taxes,[73] but increasingly buybacks merely counteracted the effect of the ever increasing grants of stock to managers.[74]

In short, while corporate profits seem to have continued to grow, less is being paid out to shareholders.[75] Instead, the growing firm pie is going to debt investors (as interest) and top managers,[76] even as less goes to lower ranked employees, consumers and taxes for the collective enterprise.[77] We

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70. *See* Moran v. Household Int'l, 500 A.2d 1346 (Del. 1985) (upholding poison pill); Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) (upholding "just say no" defense).

71. Frydman & Saks, *supra* note 48.

72. *E.g.*, Harry DeAngelo, Linda DeAngelo & Douglas J. Skinner, *Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings*, 72 J. FIN. ECON. 425 (2004); Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3 (2001).

73. *See generally* Merton H. Miller & Franco Modigliani, *Dividend Policy*, 34 J. BUS. 411 (1961) (setting out the basic theory).

74. HOWARD M. SCHILIT, FINANCIAL SHENANIGANS: HOW TO DETECT ACCOUNTING GIMMICKS & FRAUD IN FINANCIAL REPORTS 143 (2d ed. 2002). In connection with the debates over the proper accounting for executive stock option grants, there were reports that various company's stock buybacks did no more than balance out its employee stock grants. *Cf.*, Eugene F. Fama & Kenneth R. French, *Financing Decisions: Who Issues Stock?*, 76 J. FIN. ECON. 549 (2005) (finding that most firms in their sample issue and repurchase equity each year, but on balance are net issuers of equity).

75. I suspect that we will ultimately discover that the reported profits were, in many instances, mere accounting artifacts, but this remains no more than a hunch until after collapse. As one case study, see, for example, NANCY B. RAPOPORT & BALA G. DHARAN, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (2004).

76. *See generally* Greenwood, *The Dividend Puzzle*, *supra* note 61.

77. The fact that profits have increased, if it is not an illusion, means that consumers have not received the full benefits of decreased corporate costs. Pay rates for the vast bulk of Americans have been stagnant for close to three business cycles even as productivity has risen. Corporate taxes as a proportion of GDP have declined steadily over the same period. In short, the benefits of increased corporate productivity have gone to a remarkably thin slice of corporate participants.

are approaching the predictions of competitive pricing theory: shareholders, having no rights to sell, will receive no returns from the firm.

With firms paying out historically low dividends and stock buybacks only counteracting the effects of stock option grants to executives, the dramatic stock market gains of the 1990s did not result from corporate payouts to shareholders. Instead, they must have come from shareholders selling to one another. Perhaps the stock market stagnation of the last decade is a sign that potential equity investors have begun to understand the logic of the contractual equilibrium: Top managers, having overcome all countervailing sources of power in the corporation (with the possible exception of the bondholders), are now in control. All that is left is to legitimate that control by the trappings of formal ownership.

C. PRIVATE EQUITY: FROM AGENT TO "OWNER"

The private equity boom presents an important new step in our march towards a failed corporatism analogous to the failed states of the Third World. Private equity, like the management buyouts from which it descends, offers the chance for managers to escape the constraints of agency entirely. By becoming the shareholders of the firm, managers jump from servant to master, from agent to owner. By taking the firm private, the new manager-shareholders combine ownership with control and, for the first time, are entirely under contractual norms. As shareholder-owners, they are entirely free to use the corporation's resources for their own private purposes, however short-term and however socially counterproductive.[78] Like the kleptocratic dictators who destroyed promising economies around the Second and Third Worlds, they can become extraordinarily rich even as they contribute to the collapse of the world around them. The story of the golden goose misses the tragedy of the contractualized commons: private equity has learned how to get quite fat eating someone else's goose.

Classic agency-cost analysis bemoaned the separation of (stock) ownership and (corporate) control, because shareholders purportedly are more aligned with the interests of the corporation as a whole than managers. The premise seems false: standard portfolio theory teaches institutional investors to focus on the risk-adjusted present value of future cash flows, making time, space, expertise and particular projects entirely fungible and, in any event, mere diversifiable risks. Human beings and human institutions, however, can only exist in particular places at particular times with meaning derived from particular expertise and particular projects; unlike portfolios we are never fully diversified, risk-neutral or time-indifferent. Since the stock market necessarily views the fundamental commitments of real human beings as mere diversifiable risks, its approach

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78. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (illustrating an instance of a shareholder acting against the interests of the firm as a whole).

to decision-making is fundamentally inhuman and highly unlikely to promote those interests real people would consider most important.[79] But private equity has a complete answer to the traditional complaint: it has abolished the separation of ownership and control by making the controlling managers into significant shareholders. Unfortunately, this merely accentuates the real problem. Neither managers nor shareholders are closely aligned with corporate interests. Manager shareholders may well find that the easiest route to private profit is to loot, not build, the firm.

The source of Schwarzman's billions is a novel form of legal arbitrage: a de-professionalization of management. Using the ordinary understandings of the shareholder role as disinterested and free of fiduciary duties, he and his cohorts have entirely freed themselves, and the managers under them, from traditional agency concepts of self-abnegation.[80] As pure market actors, they are now free to appropriate as much of the corporate assets as they can get their hands on, regardless of the effect on the long-term viability of the institutions they strip, or indeed, of our capitalist system itself. And appropriate they have.

III. PRIVATE EQUITY

Private equity firms buy companies, apply a short form-book of mainly financial reorganizations, and sell them a few years later. In the process, they vastly increase the pay of the underlying company's top management and extract extraordinary sums for themselves. Their own investors also expect to earn above market returns, although it is not clear that they actually do.[81]

All this money can only come from one of two places. Either private equity has discovered a hitherto unknown advance in the science of management, or it has found a new twist on the oldest problem of organizations, corruption. The former seems unlikely, if only because private equity generally draws its expertise from finance rather than management; usually the pre-existing managers continue to run the actual operating companies. Absent evidence of the former, we must conclude it is the latter. Private equity funds are primarily devoted to transferring corporate wealth to private pockets. In the economic jargon, they are in the business of extracting rents, transferring wealth from employees, citizens, the government, and future innovation to a handful of highly paid managers. In the grittier language of politics, they are engaged in legalized theft. But the problem is worse than run-of-the-mill political corruption. Political bribe-takers, at least in this country and this century, normally

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79. Greenwood, *Fictional Shareholders*, *supra* note 47, at 1071–72.

80. Meinhard v. Salmon, 249 N.Y. 458 (1928).

81. FED. RESERVE BANK OF SAN FRANCISCO, CTR. FOR THE STUDY OF INNOVATION AND PRODUCTIVITY, THE ECONOMICS OF PRIVATE EQUITY INVESTMENTS: SYMPOSIUM SUMMARY, Feb. 29, 2008, http://www.frbsf.org/publications/economics/letter/2008/el2008-08.pdf.

recognize that what they are doing is wrong. Private equity, in contrast, is engaged in a sort of moral and legal arbitrage.

Even after a generation of erosion, fiduciary and agency norms remain strong enough to pose at least a psychological restraint on managers who seek to take corporate property or operate the firm for themselves. But shareholders—the primary role through which private equity defines itself with respect to the corporation—owe no such fiduciary duties to the corporation; under both law and popular mores, they are ordinarily free to exploit their position in purely self-interested ways. By exiting the legal regime of fiduciary duty, agency and collective responsibility and shifting, instead, to the devil-take-the-hindmost rules of self-interested markets, they transform the moral valence. Corruption, thus, is redefined as normal, even praiseworthy, profit-seeking, shareholder-value maximizing market success.

A. THE LEGAL STRUCTURE OF PRIVATE EQUITY

Private equity firms consist of a small number of managers who, on the one hand, collect funds from purely passive investors, and on the other hand, control the shares of operating companies.[82] They modify the standard publicly traded corporate structure in several distinct ways.

First, private equity adds an extra layer of managers. Public investors now invest in the operating company via two layers of institutions: the private equity firm and its own investors (which, because they must be "qualified" under the federal regulatory regime, normally are institutions, often representing smaller investors).[83] Operating company managers no longer answer to a board of directors elected by public shareholders. Instead, the operating company board is appointed by the private equity firm. Operating company managers answer to private equity fund managers, who make decisions as shareholders of the operating company rather than as its fiduciaries. Usually, operating managers also are granted significant shareholdings in the operating company in their own right, in order to "incentivize" managers to operate the company in the interests of the shareholders (i.e., themselves).

Second, it reclassifies passive equity investors. Outside equity investors in the operating company are replaced by outside equity investors in the private equity firm's investment fund.[84] For equity investors, this means that there is an extra layer of managers between them and the operating company: they are clients of the private equity fund managers who in turn

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82. *See* Steven M. Davidoff, *The Failure of Private Equity*, 81 S. CAL. L. REV. (forthcoming 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1148178.

83. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(7).

84. Usually, the private equity firm is a partnership and its executives are its partners. The outside investors are passive limited partners in an investment fund managed by the private equity fund. In at least one instance, Blackstone, the private equity firm itself is a publicly traded firm, with its managers as significant shareholders.

control the operating company and its managers. Additionally, they lose the right to freely transfer their interests: private equity fund interests are always structured to avoid federal regulation of public offerings and often are not transferable at all. Instead, investors may have the right to demand their investments back at specified dates, often quite infrequent. Finally, investors have significantly weaker voting rights. As fund investors, they may have limited rights to vote to replace the fund's management company, but in practice this will be meaningless, especially given the restrictions on transfer of interests. The operating companies' boards, of course, will be controlled by the private equity fund managers, who vote the operating companies' shares.

Third, usually leverage vastly increases. Typically, the operating company will borrow significant amounts in connection with the buy-out, replacing equity interests with debt interests. Moreover, the private equity funds typically borrow significantly to purchase the remaining stock. Private equity thus operates much like the "pyramid scheme" utility companies of the Roaring Twenties: borrowing at operating and holding company levels to create total levels of debt that, Modigliani and Miller notwithstanding, would be hard to reach with a simpler corporate structure. As discussed below, this increased leverage unquestionably is a major source of private equity profit; it appears that the layering of debt results in firm creditors failing to fully charge for the risk they are assuming.

Fourth, the claim of passive investors on the firm's profits changes. Public shareholders have a rhetorical, but unenforceable claim on the "profits" of the corporation. In the private equity model, the operating company's shares are held by the private equity fund and the operating company's managers. The fund's shares are voted by the private equity firm's managers, who also supervise the operating company's managers. Thus, unlike public shareholders, these new shareholders actually run the company. Accordingly, they have significant power to influence corporate decision-making so as to direct corporate surplus in their direction. The private equity fund's managers, in turn, negotiate a division of the fund's proceeds between themselves and the fund's passive investors. This generally involves giving the managers the right to charge significant fees both to the operating company and to the investment fund (the latter is the famous 2 and 20 industry standard).

Finally, and most importantly from the perspective of perceived duties, the new legal structure changes the fiduciary obligations of managers. In the private equity model, the operating company shares are held by the private equity fund and voted by the private equity firm's own managers. Thus, the primary role of top executives is as shareholder rather than employee. As shareholders, the private equity firms are either arms-length maximizers or even the beneficiaries of fiduciary duties owed to the firm by its various participants. The normative frame encourages private, short-term, personal wealth maximization with no need to take into account the future or interests of the institutions being managed or making investments except as influences on the managers' own wealth.

B. PRIVATE EQUITY'S INCENTIVES

None of these changes have any clear connection to increasing corporate efficiency. They do not, at least in an obvious way, make it more likely that the corporation will be more able to provide useful products or services to the market at competitive prices or to provide good jobs at good wages. They do, however, mean that the top executives, both the old ones from the operating company and the new ones from the private equity firm, have powerful tools and incentives to transfer wealth to themselves.

Most simply, the new executives can just pay themselves large sums—incentive payments, shares and options, fees for services rendered in their private equity roles. But at least in boom times, the bigger bucks come from boosting the firm's perceived profit and rapidly selling it at a value based on the promise of higher returns for the new shareholders.[85] The issue is how managers will respond to these powerful incentives.

Some executives, no doubt, will act as good professionals should, working hard to make the company as successful as possible. But it is hard to believe that this is the expected source of private equity's outsized gains. Good professionals would already be doing this. Private equity firms do not, as a rule, purport to have special lessons to teach managers how to do a good job; their major innovations—higher debt and higher managerial pay—have not been news for at least a generation. Thus, it is hard to see a potential change at the margin here. Instead, the strong incentives are, I believe, structured to induce managers to do something else altogether: to abandon any lingering sense of professionalism and move wholeheartedly into the enterprise of extracting value.

In the short term, a corporation can nearly always increase its apparent profit by squeezing non-shareholder participants harder. On the expense side, it can reduce employee headcount or pay, increase workloads or renege on promised future benefits. There will be costs in employee morale or institutional capacity, but in the short run they are likely to be minimal. Employees do not jump ship easily, and they may be inclined to accept significant worsening of their working conditions before quitting. Similarly, a company can mine its reputation: customer inertia will guarantee that cost-cutting measures, even if they seriously impact quality or performance, will not immediately drive away clients. Indeed, with a little bit of luck, competitors may match: if every airline shifts to cheaper schedules that

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85. Private equity firms commonly agree with their own passive investors that at sale, any investment profits will be divided 20% for its managers and 80% to its equity investors. Operating company executives profit as holders of company stock or stock options.

work only if the weather is perfect, even when customers notice, their anger will be impotent.

More generally, companies can shift expenses forward into future periods, for example by failing to upgrade technology or to invest in research and development. In many industries, there will be opportunities to accept current payments (and profits) in return for contingent future obligations; rather than providing for the future expenses it can simply pray that the future obligations will never come due or, if they do, will do so after current managers are long gone. If employees are willing to work now in return for promised future retirement or medical payments, current profits go up if the future obligations are ignored or funding is fictional. If counterparties to insurance contracts, insurance-like swap agreements, or guarantees of future performance are willing to rely on the company's good name and credit, the current sales can be booked and the future expenses hidden. At the extreme, of course, this is fraud. But there is often a range of actions that are well short of fraud; more aggressive assumptions can rapidly increase current profits at the expense of a higher likelihood of restatements or failure later, just as leaner staffing cuts current expenses while increasing the chance that the company will be unable to meet future challenges. Private equity offers no new version of these games. It does, however, reward managers more highly for playing them. In the short run, these transfers of wealth will always be the easiest way to generate the extraordinary income of the private equity managers.

C. "SOLVING" THE AGENCY-COST PROBLEM

In sum, private equity offers a novel solution to the agency-cost problem. It adds an additional, and unprecedentedly expensive, layer of agents explicitly aimed at extracting the maximum short-term value from the underlying corporation with little regard for even the appearance of long-run proceeds or the interests of other corporate participants. But by characterizing these agents as "owners," they change the frame within which they are ordinarily judged. Stripping the corporation for private gain suddenly appears to be virtuous, not criminal.

The relabeling means, presumably, that our new robber-barons sleep better. They can view themselves as captains of finance rather than captains of piracy.[86] They can claim to be productive entrepreneurs, rather than mere masters of reverse Robin Hood redistribution, taking from the rank and file and middle class employees to give to themselves. And, of course, they can proceed further and faster than would be possible were they subject to moral qualms, but the damage is the same, or rather, worse. Corruption of

86. Moreover, the generally fawning tone of the business press suggests that they have, or had up until the Fall 2008 market break, convinced the press to see them this way as well.

this sort—the abuse of office for private ends—is at least as destructive in the private sector as in the public one.

In the medium run, private equity is likely to reduce investment and real innovation and threatens the American economic growth machine. In particular, as employees and investors begin to realize that the corporate world is being run for the exclusive benefit of a very small elite, they will be less willing to trust in its promises, thus threatening to undermine the very bases of prosperity itself. Our corporate system depends on the extraordinary capacity of corporations to create teams of professionals and workers willing and able to work together to plan and execute complex, long-term investments.[87] Such a system depends fundamentally on trust and teamwork, and on each actor's willingness to contribute to a joint endeavor, confident that he, she or it will share in the joint rewards. When the leaders of the enterprise routinely appropriate unconscionably large shares of its gains, the rank and file will begin to realize they are being scammed.

D. CONSEQUENCES

In the long run, the problem may be even larger. All bureaucracies, whether public or private, governmental or corporate, depend on their employees acting out of a sense of duty and common purpose. No organization can exist if each actor is out for himself alone. Instead, successful organizations need employees who are willing to sacrifice short-term individual interests for the good of the whole. In sports, we call this team spirit; in politics, we refer to it as patriotism or nationalism; in war, it is loyalty. Corporations require managers and workers who are willing and able to act in the interests of the firm. Players in the Ultimatum Game are willing to destroy the game in order to prevent opponents from appropriating unfair shares of the gains to cooperation.[88] If employees begin to feel that they are not getting a fair shake, we should expect that they will respond in kind, and we will all suffer the consequences.[89]

A firm made up only of rational self-interest maximizers would fail for the same reasons that led Adam Smith to conclude that the corporate form would never succeed: each office-holder would be seeking corporate opportunities that he or she could seize privately, selling corporate assets

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87. *See generally* Coase, *supra* note 16; JAMES K. GALBRAITH, THE PREDATOR STATE: HOW CONSERVATIVES ABANDONED THE FREE MARKET AND WHY LIBERALS SHOULD TOO (2008); THE NEW INDUSTRIAL STATE, *supra* note 46; PETER A. HALL & DAVID SOSKICE, EDS. VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (2001); MICHAEL J. PIORE & CHARLES F. SABEL, THE SECOND INDUSTRIAL DIVIDE: POSSIBILITIES FOR PROSPERITY (1984); WILLIAMSON, *supra* note 63.

88. Jolls, *supra* note 60.

89. TOM R. TYLER, WHY PEOPLE OBEY THE LAW (1990); TOM TYLER AND STEVEN L. BLADER, COOPERATION IN GROUPS: PROCEDURAL JUSTICE, SOCIAL IDENTITY, AND BEHAVIORAL ENGAGEMENT (2000) (showing that employees steal more company pens when they feel that managers are paying themselves excessively).

and contracts to the highest bidder or briber, working for the firm only to the extent that it would improve his or her resume (and even then only if the future job prospects outweighed the present theft, diversion or goof-off possibilities). With no sense of personal connection or duty to the firm and only the morality of strangers to restrain office holders, only fear would keep officers working. "In the groves of their academy," said Burke, "at the end of every vista, you see nothing but the gallows."[90]

Burke's complaint was that basing social order on calculated fear makes for an ugly, unpleasant society. After the experiences of the twentieth century, we can definitively add that for all its ugliness, it does not even work. Fear creates resentment and resistance, not legitimacy. Rational self-interest mediated by fear of firing and anticipation of great rewards is the route to Enron or the extraordinary corruption of the late Ottoman Empire or the failures of the Soviet Union and its cronyist successor, not to productive or useful enterprises.

In corporations, the duality of market and fiduciary norms is critical. Corporations can out-compete unorganized markets, despite internalizing costs of information gathering, supervision and planning that could be left to the market, only because, by commanding the loyalty of employees who accept the agency-fiduciary norms, they have an economy of scale.[91] By creating teams with conscious systems for internal decision-making, they are able to work more steadily and more constructively than markets driven by individual interests and herd behavior. However, if corporate participants ignore their fiduciary obligations, the firm will not survive, or at least will not prosper. A corporation composed of individuals who pursue their own interests loses one of its key advantages over a market, even if its employees—now acting as free agents—restrain their actions within the limits of market norms.

Top executives who view themselves as free agents bound only by contract or market norms have a startling ability and incentive to appropriate corporate assets for their personal use. The ability stems from the usual norms of corporate governance and the reality of managerial autonomy. Top corporate managers set the corporation's short and long term goals, the time-frame in which to fulfill them, and the means the corporation will use to reach its ends.[92] Corporate assets, including any economic surplus, belong to the corporation, and top managers normally

90. EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE Ch. V(3)(a) (Thomas H.D. Mahoney ed., Bobbs-Merrill Co. 1955) (1790).

91. Coase, *supra* note 16; ALFRED D. CHANDLER, JR., SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 17 (1990).

92. Paramount Commc'ns, Inc. v. Time, Inc. 571 A.2d 1140, 1154 (Del. 1989).

control the corporation's decision-making.[93] This is perhaps the key source of the success of the corporate form.[94]

But that very managerial discretion also means that managers who view themselves as entitled to direct the corporation in ways that will maximize their own personal interests can simply cause the corporation to pay themselves more. Self-interested executives, whether labeled employees, shareholders or private equity managers, will often find it in their interest to seize a larger share of the corporate pie even if the net result is to make the pie smaller. CEOs generally operate on extremely short-term time frames, since they are, almost by definition, near the end of their careers.[95] Private equity norms, which expect that the company will be sold within a relatively short period, accentuate this short-termism. As any game theoretician knows, in the end game, defection is often the privately maximizing move.

Even if pay becomes so excessive that it damages the corporation by not merely appropriating corporate surplus, but actually interfering with its ability to invest for the future and to retain the loyalty of lower-echelon employees necessary to continued effective production, the damage is likely to be delayed until the executives can avoid responsibility. It takes a while for employees to build up enough resentment to quit or find ways to maximize their personal interests at the expense of the corporation, and it takes longer for customers, suppliers and investors to notice the changes and adjust their own behavior. Inadequate investment is likely to lead to reduced competitiveness in the next product cycle, but the consequences may be well beyond the relevant time frame.

Moreover, even if damage has begun to affect the company, accounting norms are usually flexible enough to allow managers to conceal problems for a few quarters with relatively little trouble.[96] Indeed, even in the absence of serious problems, executives have a strong incentive to borrow from the future in order to improve current appearances: a few artificially good years followed by a bad year to catch up will invariably produce higher bonuses than a run of average performance, even if the CEO is unable to depart before the crash. If the CEO is lucky or smart enough to exit early, even his reputation may be safe. The true genius of Citigroup's Weill or GE's Welch was in knowing when to exit; had Enron's Lay departed after his 1999 pay

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93. 8 DEL. CORP. CODE § 141 (2008).

94. *See generally* CHANDLER, *supra* note 91; *Team Production*, *supra* note 16.

95. James A. Brinkley & James S. Linck, *What Happens to CEOs After They Retire? New Evidence on Career Concerns, Horizon Problems, and CEO Incentives* (Simon Sch. Bus. Working Paper FR 97-10, 1998), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=567164.

96. Ibrahim M. Badawi, *Global Corporate Accounting Frauds and Action for Reforms*, 26(2) REV. OF BUS. 8, 12 (2005).

package of $42 million,[97] he might well have ended his life as a rich hero too.

Nor is legal intervention much of a deterrent. Criminal prosecution is so rare that ordinary folk-statistics would lead many executives to disregard it entirely, as people normally do with highly unlikely catastrophes.[98] CEOs, in any event, are more likely than ordinary citizens to disregard highly unusual prosecutions as reasons to change behavior. First, extreme optimism is normally a prerequisite for success as a business leader and the experience of repeated success is likely to breed a certain degree of hubris. Second, and even more importantly, the custom is for CEOs to surround themselves with subordinates and, since they largely choose their board members, even superiors with similar world-views.[99] Thus, CEOs who view themselves as free agents are likely to be surrounded by others who agree. Any contrary view, which will underpin any potential lawsuit, is likely to simply slip from view. Criminal prosecution and civil suits, accordingly, will seem not merely unlikely but unjust and unjustified as well.

IV. THEORETICAL AND PRACTICAL CRISES

The value of publicly traded stock is almost entirely a function of shareholders' belief that companies will be managed in their interests, at least to some degree. This follows from the most conventional theory of stock valuation: the price of publicly traded stock ought to reflect the market's guess of the present discounted value of future cash flows that will accrue to shareholders (i.e., future dividends and stock buybacks).[100]

Under current law, shareholders have virtually no rights or power to force public companies to turn over any part of the corporate pie to them so long as it remains public.[101] Thus, if they were to conclude that managers no longer feel morally obligated to voluntarily turn over corporate assets to shareholders, rational investors would value shares at little more than takeover value. But the threat of a hostile takeover is a weak reed on which to build value. Current law gives incumbent managers and directors a virtual veto over takeovers, so bidders seeking to complete a takeover must, in the end, win the support of directors.[102] In contrast, unorganized

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97. Answers.com, AnswerNote: Kenneth Lay, http://www.answers.com/topic/kenneth-lay (last visited Oct. 3, 2008).

98. Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095, 1138 (2006).

99. *See generally* HALBERSTAM, *supra* note 50.

100. Franco Modigliani & Gerald A. Pogue, *An Introduction to Risk and Return*, 30 FIN. ANAL. J. 68, 69 (1974).

101. *See supra* text accompanying note 61.

102. Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1715 (1985) ("Whether used as a shield or, to date more rarely, as a sword . . . [poison pills] . . . tend to grant incumbent management something close to a veto power over any possible merger or takeover bid.").

shareholders can be counted on to accept virtually any bid that is higher than projected value under incumbent management. Thus, bidders should quickly realize that the real competition is for the support of managers, not shareholders, and should bid up the value offered the former rather than the latter.

In short, without faith in managerial good faith, investors would quickly withdraw from the public stock market. Much as in nineteenth century America or many other countries today, public stock markets would shrink to an exceptional and ineffective source of corporate finance.[103] As Jensen predicted at the height of the 1980s buyout boom, but for entirely different reasons, the publicly-traded corporation would wither away, replaced by closely held, debt financed firms.[104] Bond markets, banks, or even private equity funds and other institutional investors would be the primary mechanisms for recycling personal savings, domestic and foreign corporate profits and sovereign-held dollar wealth into the corporate sector, making our system much closer to our European rivals.[105]

The private equity funds, by accelerating the de-professionalization of the managerial class and the rape and pillage of our productive corporations, increase the pressure on the public equity system while also seeming to provide a solution to the agency-cost problem. But the solution won't hold: managers trained to steal from the largely defenseless market actors who make up the portfolio company should find no difficulty in applying the same normative principles and methods to defoliate passive investors in their own private equity funds.

In the end, investors in private equity funds are no more powerful and no less fungible than investors in public equity. Since they are investing in the same productive function and with essentially the same rights, private equity passive investors should earn no more than public equity investors, at least if the equity markets are reasonably competitive. So, if the reason public shareholders can expect returns is that some managers and directors

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103. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836–1937 36–41 (1991) (describing building of American railroads using publicly traded debt); MARK ROE, STRONG MANAGERS, WEAK OWNERS 169–86 (1994) (contrasting American system of equity finance to bank-centered systems in other advanced democracies).

104. Michael C. Jensen & Jerold B. Warner, *The Distribution of Power Among Corporate Managers, Shareholders, and Directors*, 20 J. FIN. ECON. 3 (1988).

105. Kent Greenfield, *September 11th and the End of History for Corporate Law*, 76 TUL. L. REV. 1409 (2002) (arguing against conventional wisdom). *But see* Alan Dignam, *Corporate Governance and the Importance of Context*, 28 OXFORD J. LEG. STUD. 201 (2008) (arguing that international financial markets create pressure to converge towards dispersed shareholding); Henry Hansmann and Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001) (arguing that convergence in opposite direction is inevitable); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (arguing that strong shareholder protection is necessary for development of publicly traded corporations with dispersed shareholdings).

of publicly-traded companies still feel constrained by agency norms to give them a gift they have no power to take, passive investors in private equity funds should shudder indeed. Their managers have no such qualms. To be sure, as in every Ponzi scheme, early investors may make money because it is necessary to attract the next set of marks. But soon enough, investors should discover that giving money to purely self-interested wealth maximizers with no enforceable obligation to return it is an unlikely path to riches; at least for the investors.

In sum, four distinctions seem important between the private equity investor and the public equity investor. First, before private equity investors receive a share of the surplus to corporate cooperation, a new layer of heavily compensated executives will take their cut.[106] Second, and even more unfortunately, both the private equity executives and the underlying operational management will, in the private equity arrangement, be able to think of themselves plausibly as owners or free contractors, rather than servants. Third, whereas corporations have no obligation to distribute profits to shareholders at any time, private equity funds usually exist only for a set period, often a decade. At the end of that period, managers will face an actual date of reckoning.[107] This eliminates the Red Queen's game (jam every other day but never jam today), but at the cost of worsening the end-game problem. Instead of an ever receding horizon, investors face imminent defection.

Fourth, as a practical matter, the private equity funds add leverage. The general view is that this is the main source of their success and I have no doubt that this conventional wisdom is largely correct.[108] Private equity firms buy companies; hedge funds buy, sell or short securities and derivatives. However, both use the same technique: small amounts of equity are multiplied by large amounts of borrowing. Imagine that a fund buys a $100 million company with a profit rate of 6% (or a security with an expected return of 6%), paying for it with $95 million in borrowed funds costing 4% in interest and $5 million in funds contributed by its limited partners. If all goes as planned, the company earns $6 million, of which $3.8 million goes to the lenders as interest. The remaining $2.2 million is available for the fund. If the fund management company charges the standard "2 and 20" – i.e., 2% of the funds under management plus 20% of the profits,[109] it takes $540,000, most or all of which will fund its own managers' pay, leaving the fund investors with $1.6 million, a 33% net

106. *See* discussion *infra* Part III.A.

107. Ludovic Phalippou & Maurizio Zollo, *The Performance of Private Equity Funds*, Sept. 2005, at 29, *available at* http://fic.wharton.upenn.edu/fic/papers/05/0542.pdf.

108. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975, 999 (2006).

109. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 20 (2008) ("'[T]wo and twenty' has remained the industry standard.").

return on their $5 million investment. Nothing to sneeze at, and not very difficult, assuming they can find a lender foolish enough to finance the deal. That last point, though, is the issue.

Theoretically, this is a bit of a puzzle: Modigliani and Miller taught us 50 years ago that debt inside the firm is effectively identical to debt outside the firm.[110] Accordingly, assuming that the market desires more leverage, we would expect to see why firms assume debt internally or institutional shareholders assume it at their level. Using a private equity firm to assume additional debt at an intermediate level appears both superfluous and unnecessarily expensive.[111] Moreover, since the debt here assumes essentially all the downside, but little of the upside,[112] it is hard to see why it should be priced at a mere 4%. The junk bond rates of the 1980s would make more sense (but would make the likelihood of 33% returns for the equity rather low).

The simplest explanation appears to be market myopia.[113] For some reason, lenders have trouble assessing the full degree of leverage associated with complex investments—they are more willing to loan at a lower interest rate if some of the loan goes to the operating company, some to the private equity firm and some to the private equity firm's investors, than they would be if the loan was split only two ways.

Modigliani and Miller make clear that this behavior is irrational.[114] But our recent securitization bubble suggests that it is predictable nonetheless. Lenders seem to have consistently treated formal separations as real, treating highly correlated (or, as in this case, functionally inseparable) investments as if they were independent and thus a form of risk-reducing diversification. A bank that can believe that it has reduced its risk by securitizing a loan and then purchasing the securities using its own securities investment vehicle, or by lending a customer money so that the customer (or the customer's customer) can purchase the securities, or by purchasing default insurance from a counterparty that is as exposed to the

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110. *See* Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Investment, and the Theory of Investment*, 48 AM. ECON. REV. 261, 273–74 (1958) [hereinafter *The Cost of Capital*].

111. Legal restrictions, including the margin loan requirements, capitalization requirements for certain investors, and internal policies for others, may make it difficult to increase debt at the investor level. Pension funds, for example, may be barred from borrowing money to purchase securities – but permitted to purchase securities which represent leveraged investments. However, so far as I know there is no legal bar on placing the debt at the operating company level. Indeed, that was one standard form of leveraged buyout not so long ago. The question remains, then, why pay the private equity firm to do expensively what Milken's successors could do for you more cheaply?

112. If the investment fails, bonds will suffer; the more highly leveraged the firm the less downside protection the bonds have. If it does unexpectedly well, however, the bonds simply receive their contractual interest.

113. *See* Liz Rappaport, *Corporate Bonds Slide Along With Stocks – Investor Deleveraging Hits Junk, Higher-Grade Debt; Market Points to Recession*, WALL ST. J., Oct. 11, 2008 at B1.

114. *The Cost of Capital*, *supra* note 110, at 273–74.

risk of default as it itself is, is a bank that is likely to believe that if it lends to only one level of the private equity structure, it can safely ignore the leverage in the other levels.[115]

The short run success of private equity thus seems to rely on two things: first, an optical illusion that allows it to borrow at rates that do not reflect the true risk involved, and second, normative arbitrage that frees managers from any concern with the future welfare of the firm or its other participants. In the medium run, we should expect lenders to correct their interest rates and equity investors to notice that adding another layer of agents, particularly agents who view themselves as entrepreneurs, is not likely to solve the agency-cost problem. The long run effect of the private equity firms should be to hasten a crisis of faith in the public equity markets, leading to investor withdrawal from the equity markets.

Employees, unlike equity investors, have no practical way to withdraw from the corporate sector fully. However, any employee can withdraw in part at any time: any employee can work harder or less hard, choose to act in the interests of the company voluntarily or see those interests as entirely antithetical to his or her own. Successful companies convince employees to see the company as a team and themselves as team members who ought to sacrifice for the good of the whole. If employees conclude that the company treats only top managers as members of the team, while everyone else is a mere tool to be exploited, they are likely to begin to reframe their team understandings. People in general are quite sensitive to, and resentful of, unfair treatment, and few actions are more universally viewed as unfair as betraying the team.

In the longer run, our growing culture of corruption, the de-professionalization of the managerial elite and the collapse of the distinction between the realms of agency and contract are likely to cause regular financial or political crises if not brought under regulatory control first. Unless, of course, the current credit crunch is sufficiently long lasting to eliminate the leverage opportunities that seem to be essential for this particular skim game.

V. CONCLUSION

The success of private equity firms challenges mainstream corporate governance theory: according to standard agency cost analysis, this should not have happened. Agency problems—the shorthand term for the tendency of fiduciaries in a capitalist system to work for themselves as well as, or instead of, their clients—cannot be solved by adding an additional layer of

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115. *See* Lewis Braham, *Credit Default Swaps: Is Your Fund at Risk?*, BUS. WEEK, Mar. 3, 2008, at 74 (discussing the failure of AIG, which gave "insurance" in the form of credit default swaps against bond defaults, without any offsetting hedge. This is not risk reduction but whitewash).

extremely highly paid agents supported by an ideology that justifies the most extreme forms of self-interestedness. Therefore, private equity is unlikely to be an innovative solution to the age-old agency problem.

Instead, it is better understood as a clever bit of legal arbitrage: by reclassifying agents as principals, it allows former fiduciaries to instead view themselves, and be viewed by others, as entitled to look out only for themselves. And look out for themselves they have: the private equity managers have extracted hitherto unseen sums from our corporations, appropriating for the private benefit of a handful of individuals surplus that otherwise might have gone to other corporate participants, including consumers, ordinary employees, taxpayers and investors in the public securities markets, or might have been devoted to increasing productivity or innovation for the benefit of future generations.

Moreover, private equity challenges the remnants of the efficient capital market hypothesis and the security pricing models with which it is associated: in a capital market that worked even moderately like our competitive models, these firms should have quickly been driven out of business. Rational investors should understand that in a competitive capital market, passive investors will be paid only for assuming undiversifiable risk. When private equity funds promise above market returns, therefore, there are only two choices within a competitive model: either they are lying or they are adding risk. Most hedge funds claim not to be adding risk—"hedging" is a method of reducing risk. Investors ought therefore to refuse to invest with them—liars are never good bets. Moreover, to the extent that hedge funds admit that the above market returns they promise will be associated with above market likelihood of extreme losses, most investors ought, again, to reject the offer. In a world that looked like the competitive markets of the efficient capital market hypothesis, these firms wouldn't exist; it follows then that our world differs in some way.

The basic private equity technique, like the basic hedge fund technique, appears to be to borrow money in order to increase potential returns or losses. If the loans were correctly priced, this would not create new value under standard valuation theories, nor would it be a service that could possibly warrant the high fees typically charged in the hedge fund and private equity worlds. The simplest explanation is that either lenders or fund investors are mispricing risk and have done so for several years at a stretch, contrary to the claims of the efficient market theorists.

This explanation suggests, moreover, that private equity is simply the modern equivalent of the pyramid schemes, margin loans and highly leveraged utility holding companies of the 1920s. Like those earlier edifices built on borrowed money, the contemporary schemes are likely to be highly unstable: if the underlying assets decline in value or fail to provide expected income by even small margins, the lenders are likely to take losses out of scale with their potential profits. Once lenders wake up to this possibility—

most likely only after losses have begun—they are likely to cut back lending rapidly, which will, in turn, make the underlying assets both less valuable and less saleable still, thus beginning a new round of lender panic. Any minor downturn, in short, runs the risk of starting a self-reinforcing cycle of credit and business contraction. The rise of private equity in its present form, then, appears to be another step towards the pre-New Deal world of inequality and instability.

Once we have abandoned the simplest economic models, however, other interesting implications abound beyond the well-understood, if recently ignored, problems of pyramiding of debt, ignored risk and irrational pricing. The private equity funds may have found other ways to redistribute our collective wealth into their private pockets as well.

One possibility is that, even after a full generation, it is still possible to deceive employees by the basic gimmick of replacing equity with debt. When a company earns profits, employees often feel entitled to share in it. But if the same company, selling the same product at the same price with the same real cost structure, replaces its equity with debt, it can—simply by renaming the money it pays out to investors "interest" rather than "dividends"—run smaller profits or even losses even as it pays the same or more money out to investors. Without profits or with losses, it should be able to appeal to employee's local patriotism, team spirit, or simple fear of institutional collapse, restructuring or layoffs, to work together to pull the company out of its crisis. To the extent that this works, employees may be willing to work harder for less funds than prior to the recapitalization. The surplus extracted from them can then be transferred to others—in the early leveraged buyouts, to the investors; today, to the private equity fund managers. On this view, one key to the success of private equity is that, like other highly leveraged forms, it allows business managers to extract more work from employees for the same or less pay, without leading to the immediate unrest that more obviously exploitative methods do. In the medium run, however, two questions predominate. First, how long will this deception work? Second, what are the broader social implications of major corporations treating their employees as mere inputs to be exploited to the maximum degree possible, while simultaneously seeking to enlist those same people as team-members willing to sacrifice for the good of the very firm that is treating them as opponents?

The principal story I have concentrated on in this essay, however, focuses on the people at the top. The rise of private equity appears to be driven by a new form of private interestedness best described as corporate corruption. One classic way for governments to fail is for office-holders to view their office as a means for private enrichment rather than public service. As Idi Amin demonstrated most dramatically, but many other dictators and nomenklatura have found, it is almost always possible for a small elite to become extraordinarily rich if they are willing to ruin the vast bulk of the economy in the process. In the political sphere, part of the corruption problem is that once officials begin to see their offices as private enfeoffments entitling them to personal wealth, whether from bribery, skimming, Boss Tweed's "clean" graft and its modern counterpart in the K Street Project (directing government jobs and contracts to friends and supporters), they must fear that others will demand a turn as well. Short terms of office in a corrupt system, however, are even worse than long ones, as each office holder seeks to enrich himself as quickly as possible with no thought for the long term. In the long term, someone else will be in office. Apres moi, le deluge.[116]

116. After me, the flood.

NOTES

ANOTHER SMALL STEP FOR THE SECOND CIRCUIT MIGHT BE A GIANT LEAP FOR SECTION 43(A) OF THE LANHAM ACT

DIRECTV is "one of the country's largest satellite television service providers, with more than 15.6 million customers nationwide."[1] In the fall of 2006, DIRECTV began a "multimedia advertising campaign based on the theme of 'SOURCE MATTERS,'"[2] for its High Definition (HD)[3] technology television, featuring celebrities Jessica Simpson and William Shatner.[4] The ads implied that DIRECTV HD technology was superior to that of "cable."[5]

Time Warner Cable (TWC) is the second largest provider of cable television in the United States,[6] serving over 13.4 million customers nationally.[7] Cable companies, including TWC, are allowed to operate through franchises obtained from local government entities.[8] The only cable available in some markets—including almost all of New York City, is TWC.[9] Therefore, "DIRECTV and other satellite providers pose the greatest threat to its market share."[10] Since DIRECTV broadcasts directly to customers via satellite, the company does not have the same franchise limitations that cable companies have.[11] It is in direct and "extremely fierce" competition with the cable companies.[12] Additionally, "[s]atellite

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1. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 148–149 (2d Cir. 2007); David Pomerantz, *Time Warner Cable Wins Advertising Decision vs. DIRECTV*, THE N.Y. SUN, Aug. 10, 2007, http://www.nysun.com/article/60242.

2. "The concept of the campaign was to educate consumers that to obtain HD-standard picture quality, it is not enough to buy an HD television set; consumers must also receive HD programming from the "source," i.e., the television service provider." *Time Warner Cable*, 497 F.3d at 149.

3. The FCC defines Advanced Television (ATV) to include any system that results in "improved [television] video and audio quality." *Tentative Decision and Further Notice of Inquiry* in MM Docket No. 87-268, 3 F.C.C. Rcd. 6520, 6521 (1988). High definition television (HDTV), a subset of ATV, generally refers to systems that provide quality approaching that of 35 mm film. *Id*. HDTV "has a resolution of approximately twice that of conventional television in both the horizontal (H) and vertical (V) dimensions and a picture aspect ratio (HxV) of 16:9." ATSC Digital Television Standard at 5, *cited in* Federal Communications Commission Advisory Committee on Advanced Television Service Report (Nov. 28, 1995).

4. *Time Warner Cable*, 497 F.3d at 149.

5. *Id.*

6. Time Warner Cable, Inc. v. DIRECTV, Inc., 475 F.Supp.2d 299, 302 (S.D.N.Y. 2007).

7. *See* Pomerantz, *supra* note 1.

8. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 149 (2d Cir. 2007).

9. *Id.*; *see also* Pomerantz, *supra* note 1 ("Time Warner Cable is the cable franchise holder for New York City, making it the only cable provider for most of the city.").

10. *Time Warner Cable.*, 497 F.3d at 149.

11. *Id.*

12. *Id. See also* Pomerantz, *supra* note 1 ("[C]ompetition between the two companies is fierce.").

companies such as DIRECTV . . . do not need to hold a franchise, and can provide service to any household with a dish."[13]

TWC "offers both analog and digital cable television services to its subscribers," while DIRECTV "offers 100% of its programming digitally."[14] In order for customers of either service to receive HD programming, those customers must also acquire HD television equipment. To qualify as HDTV, the screen resolution must be classified as either 720p, 1080i, or 1080p,[15] but it is neither the cable providers nor the digital satellite television providers who set these standards.[16] The non-profit organization Advanced Television Systems Committee (ATSC)[17] "develops voluntary standards for all digital television, including HDTV."[18] Television companies merely provide the requisite bandwidth to allow for the relevant level of resolution to be passed on to customers.[19] DIRECTV's ad campaign took advantage of the difference in services to attack TWC's HD programming quality.

Shortly after DIRECTV mounted its ad campaign, TWC brought suit seeking, among other things, a preliminary injunction enjoining DIRECTV from continuing to display the advertisements both on television and on the internet.[20] The District Court concluded that TWC and DIRECTV both have "the same picture quality when it comes to HD programming," although technically "analog cable service is inferior in certain respects to digital cable service, in part because a digital cable signal is less prone to corruption than an analog cable signal."[21] Subsequently, on February 5, 2007 the United States District Court for the Southern District of New York issued a preliminary order enjoining DIRECTV from disseminating specific television commercials and internet advertising in any market where TWC provides cable service, which violated the Lanham Act on literal falsity grounds.[22] On August 9, 2007 the Second Circuit upheld the District

13. *See* Pomerantz, *supra* note 1.

14. Time Warner Cable, Inc. v. DIRECTV, Inc., 475 F.Supp.2d 299, 302 (S.D.N.Y. 2007).

15. *Id*. As footnoted in the opinion, the "p" and "i" designations stand for "progressive" and "interlaced." "In the progressive format, the full picture updates every sixtieth of a second, while in the interlaced format, half of the picture updates every sixtieth of a second. The higher the 'p' or 'i' number, the greater the resolution and the better the picture will appear to the viewer." *Id.*

16. *Id.*

17. "The Advanced Television Systems Committee, Inc. is an international non-profit organization developing voluntary standards for digital television. The ATSC member organizations represent the broadcast, broadcast equipment, motion picture, consumer electronics, computer, cable, satellite, and semiconductor industries. ATSC creates and fosters implementation of voluntary Standards and Recommended Practices to advance terrestrial digital television broadcasting, and to facilitate interoperability with other media." *See* http://www.atsc.org/aboutatsc.html.

18. *Time Warner Cable*, 475 F.Supp.2d at 302.

19. *Id*.

20. *Id.* at 299.

21. *Id.* at 303.

22. *Id.* at 309.

Court's injunction order as to the television advertisements, but reversed the order as to the internet advertisements, holding that the District Court erred in rejecting DIRECTV's "puffery" defense as to those advertisements.[23]

In light of the past development of the Second Circuit's interpretation of Section 43(a) of the Lanham Act,[24] *Time Warner* is another step in the wrong direction. Prior to this decision, the Second Circuit specifically declined to adopt the doctrine of false by necessary implication.[25] The Second Circuit is stretching the literally false doctrine[26] to include false by necessary implication.[27] Here, once again, the court has expanded actionable claims under section 43(a) of the Lanham Act.[28] The decision in *Time Warner* states that although the ads in question do not unequivocally state that DIRECTV provides better image quality than TWC, the implication that they do so justifies TWC's claims.[29] *Time Warner* stands to be a landmark case in the Second Circuit's Lanham Act interpretation. It is a case in which the plaintiff is benefiting from the Second Circuit's common law interpretation of this act, and how this interpretation has evolved since the Act's inception. The Lanham Act has come full circle and is now in direct opposition to the common law claim of false advertising as established in *American Washboard v. Saginaw Manufacturing Co.* in 1900.[30]

The implications of *Time Warner* for the future of the Lanham Act are many. In reaching this decision, the Second Circuit expanded its already overreaching interpretation of section 43(a) of the Lanham Act. In view of the Second Circuit's pattern of expansion, this decision could have

23. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144 (2d Cir. 2007).

24. *See* discussion *infra* Part IV.

25. *See* Johnson & Johnson Vision Care, Inc. v. Ciba Vision Corp., 348 F.Supp.2d 165, 182 (S.D.N.Y. 2004).

26. *See 'Literally False,' 'Puffery' Clarified in Advertising Dispute Between Cable, Satellite TV Providers*, N.Y.L.J. Vol. 238, Aug. 15, 2001 ("Clarifying the false advertising doctrine, the appellate court held that an advertisement can be 'literally false, even though it does not explicitly mak[e] a false assertion, if the words or images, considered in context, necessarily and unambiguously imply a false message.'").

27. *See Satellite TV Ads on HD Quality of Cable Are False*, NAT'L. L.J. VOL. 29, NO. 51, Aug. 20, 2007 ("The [Second] Circuit affirmed the injunction, modified parts of it for clarity and took the opportunity to clarify its position on claims of false advertising. Adopting the 'false by necessary implication' doctrine, the court concluded that the Simpson and Shatner ads were literally false, even though they do not explicitly make false assertions, because the words or images, considered in context, necessarily and unambiguously implied a false message that it is impossible to get the best picture from cable."); *see also* Pomerantz, *supra* note 1 ("The Court of Appeals for the [Second] Circuit yesterday upheld a lower court's decision in favor of Time Warner Cable and went a step further, saying the current legal standards for false advertising are too vague.").

28. *See* Pomerantz, *supra* note 1 ("A legal dispute between [TWC] and DIRECTV over which company provides clearer high-definition image quality could prompt stricter court regulation on false advertising.").

29. *Id.*

30. American Washboard Co. v. Saginaw Mfg. Co., 103 F. 281 (6th Cir. 1900).

sweeping implications for other courts' interpretation and application of section 43(a). Part I of this note will discuss the commercials at issue in this case. Part II will examine the facts and specific holdings in the Second Circuit *Time Warner* decision, and exactly how it departs from the Second Circuit's prior application of section 43(a). Next, Part III will explore the history of section 43(a) of the Lanham Act and its development through case law. Part IV will explore the Second Circuit's increasingly expansive conclusions about literal falsity. Part V will discuss the implications that this decision has for future litigation under this section, in light of a growing list of problems associated with section 43(a) of the Lanham Act. Finally, Part VI will offer a few solutions.

I. THE COMMERCIALS

A. THE JESSICA SIMPSON COMMERCIALS

The first commercial at issue, the "Original Simpson Commercial," began airing on October 25, 2006.[31] In the commercial, the actress Jessica Simpson wore a costume from her role as Daisy Duke in the movie *The Dukes of Hazzard*,[32] and said:

> Hey, 253 straight days at the gym to get this body and you're not going to watch me on DIRECTV HD? You're just not going to get the best picture out of some fancy big screen TV without DIRECTV. It's broadcast in 1080i. I totally don't know what that means but I want it.[33]

The commercial concluded with a narrator stating that "for picture quality that beats cable, you've got to get DIRECTV."[34] Counsel for TWC contacted DIRECTV about the commercial on November 26, 2006, after it had been airing for just over a month.[35] Two days later, DIRECTV agreed to revise the commercial,[36] and began airing the revised commercial in December.[37] The revised commercial was "identical to the Original Simpson Commercial," except for the closing line by the narrator, which now stated that "for an HD picture that can't be beat, get DIRECTV."[38]

B. THE WILLIAM SHATNER COMMERCIALS

Like the "Original Jessica Simpson Commercial," the "Original William Shatner Commercial" went through revision.[39] Both versions

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31. Time Warner Cable, Inc. v. DIRECTV, Inc., 475 F.Supp.2d 299 (S.D.N.Y. 2007).
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*

featured William Shatner as Captain James T. Kirk from the television series *Star Trek*.[40] The Original William Shatner Commercial aired on October 7, 2006, featuring a conversation which purported to take place aboard the Starship Enterprise:

> Mr. Chekov: Should we raise our shields, Captain?
>
> Captain Kirk: At ease, Mr. Chekov. Again with the shields. I wish he'd just relax and enjoy the amazing picture clarity of the DIRECTV HD we just hooked up. With what Starfleet just ponied up for this big screen TV, settling for cable would be illogical.
>
> Mr. Spock: [Clearing throat.]
>
> Captain Kirk: What, I can't use that line?[41]

Again, a narrator concluded the commercial and stated that "for picture quality that beats cable, you've got to get DIRECTV."[42] As in the revised Simpson commercial, in the revised Shatner commercial, the narrator's closing line was changed to "for an HD picture that can't be beat, get DIRECTV."[43]

C. The Internet Advertisements

DIRECTV "also waged its campaign in cyberspace, placing banner advertisements on various websites to promote the message that when it comes to picture quality, 'source matters.'"[44] The internet advertisements began by "showing an image that is so highly pixelated [sic] that it is impossible to discern what is being depicted," below the slogan "SOURCE MATTERS."[45] The screen then divided into two sides, with one side labeled "DIRECTV," and the other side simply "OTHER TV."[46] The screen on the DIRECTV side was "exceptionally sharp and clear," while the other side was "extremely pixelated [sic] and distorted."[47] Only once the screen split could one discern by looking at the DIRECTV side what the image actually portrayed.[48] On its own website, in addition to the banner advertisements elsewhere on the internet, DIRECTV featured a demonstrative advertisement that followed the split screen format, and used

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40. *Id*.

41. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 150 (2d Cir. 2007); *see also* Time Warner Cable, Inc. v. DIRECTV, Inc., 475 F.Supp.2d 299, 303 (S.D.N.Y. 2007).

42. *Time Warner Cable*, 475 F.Supp.2d at 303.

43. *Id.* at 304.

44. *Time Warner Cable*, 497 F.3d 144 at 150.

45. *Id.* at 151.

46. *Id*.

47. *Id*.

48. *Id.* DIRECTV created two of these banner ads, the first featuring NFL football player Eli Manning and the second featuring women snorkeling underwater. Time Warner Cable, Inc. v. DIRECTV, Inc., 475 F.Supp.2d 299, 304 (S.D.N.Y. 2007).

it to "compare the picture quality of DIRECTV to that of OTHER TV, which the advertisement later identified as representing 'basic cable.'"[49] On the top of the blurry side of the screen the following text appeared:

> If you're hooking up your high-definition TV to basic cable, you're not getting the best picture on every channel. For unparalleled clarity, you need DIRECTV HD. You'll enjoy 100% digital picture and sound on every channel and also get the most sports in HD—including all your favorite football games in high definition with the NFL SUNDAY TICKET.[50]

II. ARGUMENTS PRESENTED AND FINDINGS OF THE SECOND CIRCUIT

A. DIRECTV'S ARGUMENTS

DIRECTV's basic contention was that it provided a higher quality of HDTV programming when considering the entire spectrum of subscribers. DIRECTV claimed that the statement in the Revised Simpson commercial, "that 'you're just not going to get the best picture out of a television without DIRECTV'" was not proven false by TWC,[51] because it "refers to the overall picture quality of DIRECTV on all of its channels since that is the only way to determine whether a consumer is getting the most out of their television."[52] DIRECTV pointed out that digital quality in general is better than analog[53] and that according to TWC, forty-eight percent of TWC's subscribers receive analog programming only, while DIRECTV transmits 100% of its programming digitally to each of its customers.[54] Also, referencing a J.D. Power and Associates' 2006 Residential Cable/Satellite

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49. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 151 (2d Cir. 2007).

50. *Id*. The website currently states the following: "By the end of October, DIRECTV will deliver over 70 HD channels. And by the end of the year, you'll get up to 100 of the channels you really want to see in breathtaking HD. That's more than any other cable or satellite provider. If you want to see what your HDTV can really do, your choice is crystal clear: DIRECTV is the only source for the best HD. Get the most from your HDTV. Only DIRECTV will give you up to 100 of your favorite national channels in HD by year's end. For the best HD, get DIRECTV." *See* http://www.DIRECTV.com/DTVAPP/global/contentPageNR.jsp?assetId=P4360042&CMP=ILC-Q407-Film-100HD.

51. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 4, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.

52. *Id.* at 11.

53. *Id*. This was undisputed in the case and conceded by the Second Circuit: "There is no dispute, at least on the present record, that the HD programming provided by Time Warner Cable and DIRECTV is equivalent in picture quality. In terms of non-HD programming, digital service generally yields better picture quality than analog service, because a digital signal is more resistant to interference." *Time Warner Cable*, 497 F.3d at 149.

54. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 11, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.

Satisfaction Study that found the same,[55] DIRECTV concluded "that DIRECTV provides overall better picture quality is further established by the fact that consumers, television installers, and television manufacturers have all found DIRECTV's picture quality to be better than cable."[56]

DIRECTV likewise argued that the statement "for an HD picture that can't be beat, get DIRECTV," is not only a true statement,[57] but is "textbook puffery."[58] The commercial is true because the interpretation of the commercial is "at odds with the plain language of the statement," which simply states that "no other service offers an HD picture that is superior to DIRECTV HD, not that DIRECTV HD is superior to all other HD."[59] Even if this assertion is a bit questionable because it could be implied that if DIRECTV can't be beat, it is necessarily the best,[60] DIRECTV's puffery defense is persuasive and arguably should have been noted more by the Second Circuit.

B. TWC's Arguments

While conceding that no single statement in either the Revised Jessica Simpson Commercial or the Revised William Shatner Commercial was

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55. The 2007 version of this report states "DIRECTV ranks highest in customer satisfaction in three regions and WOW! ranks highest in one region among cable and satellite providers, according to the J.D. Power and Associates 2007 Residential Cable/Satellite Satisfaction Study released today." For press release, see http://www.jdpower.com/press-releases/pressrelease.aspx?id=2007137, posted Aug. 15, 2007.

56. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 11–12, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.

57. *Id.* at 13.

58. *Id.* Puffery "is an exaggeration or overstatement expressed in broad, vague, and commendatory language, and is distinguishable from misdescriptions or false representations or specific characteristics of a product and, as such, is not actionable." 15 U.S.C.A. § 1125(a) (West 2006).

59. *Id.* at 14.

60. However, counsel for DIRECTV points to a strikingly similar case in which the District Court decided that such a statement is entitled to be interpreted just as DIRECTV claims it should. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 13, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191 (citing Novo Nordisk A/S v. Becton Dickinson & Co., 997 F.Supp. 470, 474 (S.D.N.Y. 1998)). In *Novo Nordisk*, defendant "claimed to offer 'the finest and shortest insulin needle available in the U.S.,'" and although the court found that plaintiff's needles were "equally fine and short," the Court rejected plaintiff's claim "that the statements were literally false, finding they only meant 'no needle on the market is finer or shorter.'" *See id.*, (quoting *Novo Nordisk*, 997 F.Supp. at 474). The Court concluded there that "[w]here, as here, more than one competitor produces the finest and shortest needle available on the market, the proper recourse for [plaintiff] is to compete in the market place with its own advertisements." *Id.* DIRECTV counsel assert that "[t]he same conclusion is compelled here. Because Time Warner Cable . . . cannot prove that its HD picture is superior to the JD picture offered by DIRECTV, Time Warner Cable cannot base its literal falsity allegation on this statement" under Novo. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 13, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.

false,[61] TWC maintained that the Second Circuit should not "engage in *disputatious dissection*," but should view the commercials as an "entire mosaic . . . rather than each tile separately."[62] TWC further argued that the Second Circuit should "look[] to the visual images in a commercial to assess whether it is literally false."[63]

TWC did not argue that any specific statement in either revised commercial was literally false. As TWC noted, DIRECTV "removed the word 'cable' from the tag line of the Revised Jessica Simpson Commercial."[64] Yet, TWC maintained that it was implied that the commercial still referred to cable since "cable remained DIRECTV's primary competitor and the clear focus of the ad."[65] Similarly, the Revised William Shatner Commercial claimed that it would be "illogical for a consumer to 'settle' for cable's HD services."[66] However, this claim made no specific assertions about the picture quality of DIRECTV in relation to that of TWC, rendering TWC's claim that literal falsity was implied improper. Moreover, TWC conceded that "there is no single, discrete statement in the Revised William Shatner Commercial that contain[ed] the superiority claim at issue."[67] Instead, TWC urged the court to find that the ads contained literal falsity since "[t]he words were already there; they were simply in two sentences rather than one."[68] TWC also claimed that this interpretation did not "distort" or "convert" the language in the Revised William Shatner Commercial.[69]

Furthermore, while acknowledging that the District Court sided with TWC "in the absence of survey evidence as to the message consumers underst[ood] from the ads,"[70] TWC argued that it could still prove a likelihood of success on the merits "by showing that the advertising at issue [was] literally false as a factual matter."[71] TWC argued that the Lanham Act "encompasses more than blatant falsehoods,"[72] and that, the advertisements at issue contain "blatant falsehoods," rendering consumer survey evidence

61. Brief of Plaintiff-Appellee at 21, Time Warner Cable, Inc. v. DIRECTV, Inc., No. 07-0468 (2d Cir. Apr. 13, 2007).
62. *Id.* at 22, (quoting S.C. Johnson, Inc. v. Clorox Co., 241 F.3d 232, 238 (2d Cir. 2001)).
63. *Id.*
64. Brief of Plaintiff-Appellee at 27, Time Warner Cable, Inc. v. DIRECTV, Inc., No. 07-0468 (2d Cir. Apr. 13, 2007).
65. *Id.*
66. *Id.* at 28.
67. *Id.*
68. *Id.* at 29.
69. *Id.*
70. Brief of Plaintiff-Appellee at 33, Time Warner Cable, Inc. v. DIRECTV, Inc., No. 07-0468 (2d Cir. Apr. 13, 2007).
71. *Id.*
72. *Id.* at 34.

unnecessary.[73] However, as aforementioned, TWC conceded that no single statement in the commercials was singularly false.[74]

C. FINDINGS OF THE SECOND CIRCUIT

In granting preliminary injunctions against the airing of the television advertisements at issue, the Second Circuit upheld the findings of the District Court. The Second Circuit held that the Revised Jessica Simpson Commercial's assertion that a television viewer cannot get the best picture without DIRECTV would likely be proven false.[75] Additionally, the court held that the fact that the Revised Jessica Simpson Commercial did not mention cable specifically was not dispositive, and that "[t]he presumption [of irreparable injury] is properly limited to circumstances in which . . . the plaintiff is an obvious competitor with respect to the misrepresented product."[76] Accordingly, the court concluded that the commercial "'necessarily diminishe[d]' the value of TWC's product."[77]

As for the Revised William Shatner Commercial, the Second Circuit concluded that, taken as a whole, it "unambiguously made the false claim that cable's HD picture quality is inferior to that of DIRECTV's."[78]

III. A BRIEF HISTORY OF THE LANHAM ACT

As several scholars note, the evolution of section 43(a) the Lanham Act in the sixty years since its enactment has been increasingly expansive.[79] One observer contends that "[w]hen section 43(a) of the Lanham Act was enacted . . . neither Congress nor then-President Truman could have predicted the dramatic effect it later would have on our national commerce."[80] An "entire body of case law" has developed that was virtually "non-existent in the 1940s."[81] In light of all this, a look at the

73. *Id.*
74. *Id.* at 21.
75. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 154 (2d Cir. 2007).
76. *Id.* at 162, (citing Ortho Pharm. Corp. v. Cosprophar, Inc., 32 F.3d 690, 694 (2d Cir. 1994)).
77. *Id.*
78. *Id.* at 158.
79. *See* Bruce P. Keller, *The Lanham Act After Fifty Years; It Keeps Going and Going and Going: The Expansion of False Advertising Litigation Under the Lanham Act*, 59 LAW & CONTEMP. PROBS. 131 (Spring 1996). *See also* Ross D. Petty, *Competitor Suits Against False Advertising: Is Section 43(a) of the Lanham Act a Pro-Consumer Rule or an Anticompetitive Tool?*, 20 U. BALT. L. REV. 381 (Spring 1991); Lee Goldman, *The World's Best Article on Competitor Suits for False Advertising*, 45 FLA. L. REV. 487 (July 1993); David Klein, *The Ever-Expanding Section 43(a): Will the Bubble Burst?*, 2 U. BALT. INTELL. PROP. L.J. 65 (Fall 1993); J. Thomas McCarthy, *The Lanham Act After Fifty Years; Lanham Act Section 43(a): The Sleeping Giant Is Now Wide Awake*, 59 SPG LAW & CONTEMP. PROBS. 45 (Spring 1996).
80. *See* Keller, *supra* note 79.
81. *Id.*

enactment of and subsequent caselaw on section 43(a) of the Lanham Act,[82] most notably in the Second Circuit, is helpful.

A. COMMON LAW "PASSING OFF"

Before the legislature formally took note of and codified the claim of false advertising in section 43(a), "at common law, competitors could only obtain relief on a claim of false advertising if they could allege and prove "passing off,"[83] wherein "the deception induces the public to buy the goods as those of plaintiff."[84] Two landmark cases from the early twentieth century exemplify the principle of "passing off," and are important to understand these early courts' conceptions of the claim of false advertising and their reluctance to expand its application.[85]

The first, decided in the Sixth Circuit in 1900, is *American Washboard v. Saginaw Manufacturing Co.*[86] There, the plaintiff, a manufacturer of aluminum washboards, brought suit against the defendant for manufacturing washboards which it falsely claimed to be aluminum.[87] Even though the defendant did not claim to be selling the aluminum washboards sold and manufactured by the plaintiff, it was American Washboard's contention that it was still "passing off" because the plaintiff enjoyed a monopoly on authentic aluminum washboards.[88] The court's conclusion as to the merits of this monopoly argument was unequivocal:

> We are not referred to any case, nor can we think of any reason why one who has obtained a monopoly in the material of which his goods are made should have any broader rights in protecting his trade-name than another who is engaged in competition in the same line of business . . . . [W]e are of opinion that complainant's bill lacks the essential allegations necessary to make the case entitling it to the relief sought.[89]

As one scholar has noted, *American Washboard* "effectively cut off any expansion of federal unfair competition law in the area of false advertising for almost four decades, until the United States Supreme Court's holding in *Erie R.R. v. Tompkins* wiped the slate clean"[90] by striking down the notion of a "federal general common law."[91]

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82. 15 U.S.C.A. § 1125 (West 2006).
83. Robert S. Saunders, *Replacing Skepticism: An Economic Justification for Competitors' Actions for False Advertising Under Section 43(a) of the Lanham Act*, 77 VA. L. REV. 563, 566 (Apr. 1991). As noted by Saunders, the term "palming off," was accorded the same meaning as "passing off" at the time.
84. American Washboard Co. v. Saginaw Mfg. Co., 103 F. 281, 285 (6th Cir. 1900).
85. *See* Saunders, *supra* note 83, at 566.
86. *American Washboard.*, 103 F. at 281.
87. *Id.* at 283.
88. *Id*.
89. *Id* at 287.
90. *See* Saunders, *supra* note 83, at 566.
91. Erie R.R. v. Tompkins, 304 U.S. 64, 78 (1938).

The second important case in which a competitor plaintiff again sought to expand the claim of false advertising by arguing it should apply where a monopoly existed is *Ely-Norris Safe Co.v. Mosler Safe Co.*, decided in 1925.[92] In that case, as in *American Washboard*, the plaintiff manufacturer alleged that the defendant was "passing off" because he enjoyed a monopoly on the goods at issue.[93] The plaintiff sold and manufactured safes under a patent which were "distinctive because they contained an explosion chamber,"[94] and claimed that defendant "manufactured safes in violation of the patent and duplicitously sold them with the appearance of having an explosion chamber," while telling customers they in fact did have one.[95]

In perhaps the first instance of many in which the Second Circuit has displayed a tendency to expand the claim of false advertising, Judge Learned Hand "endorsed the monopoly analogy to passing off that previously had been rejected by . . . the Sixth Circuit"[96] in *American Washboard*:

> [I]f it be true that the plaintiff has a monopoly of the kind of wares concerned, and if to secure a customer the defendant must represent his own as of that kind, it is a fair inference that the customer wants those and those only. . . . If a tradesman falsely foists on a customer a substitute for what the plaintiff alone can supply, it can scarcely be that the plaintiff is without remedy, if he can show that the customer would certainly have come to him, had the truth been told.[97]

However, the Second Circuit's attempt at expansion of the claim of false advertising was thwarted when the Supreme Court reversed Judge Hand's decision two years later.[98]

The next development in false advertising claims was accomplished through legislation soon after, yet was still very conservative. Under section

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92. Ely-Norris Safe Co. v. Mosler Safe Co., 7 F.2d 603 (2d Cir. 1925).

93. *Id.* at 603.

94. *See* Saunders, *supra* note 83, at 566, (citing *Ely-Norris Safe Co.*, 7 F.2d at 603).

95. *Id*.

96. *See* Saunders, *supra* note 83, at 568. It should be noted that technically the first and most significant expansion of the role of federal courts' application of section 43(a) of the Lanham Act was a decision of the Third Circuit. One scholar dubs L'Aiglon Apparel, Inc. v. Lana Lobell, Inc., 214 F.2d 649 (3d Cir. 1954) the "seminal case in expanding the role of section 43(a)." *See* Jeffrey P. Singdahlsen, *The Risk of Chill: A Cost of the Standards Governing the Regulation of False Advertising Under Section 43(a) of the Lanham Act*, 77 VA. L. REV. 339, 344 (Mar. 1991). Saunders likewise is of the opinion that the "Third Circuit was the first to reject the restrictive interpretation of section 43(a) and to give it the broader application that seems clearly indicated by its language." *See* Saunders, *supra* note 83, at 572. However, as will be shown the Second Circuit arguably took over the job of expanding the reach of section 43(a) and continues to do so, as evidenced in the case that is the subject of this note, Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144 (2d Cir. 2007).

97. *Ely-Norris Safe Co.*, 7 F.2d at 604.

98. Mosler Safe Co. v. Ely-Norris Safe Co., 273 U.S. 132 (1927), *rev'd* 7 F.2d 603 (2d Cir. 1925).

3 of the Trademark Act of March 19, 1920,[99] "the legal standard for unfair competition [was] very exacting, limiting liability to defendants who had willfully and with intent to deceive, affixed, applied, or annexed, or used in connection with any article or articles of merchandise . . . a false designation of origin."[100] Many unfair competition claims were precluded by the language of this statute.[101] Overall, section 3 "had little legal impact."[102]

B. PASSAGE OF THE LANHAM ACT

After *Erie* took false advertising claims out of the federal arena by making them state actions, Congress enacted the Lanham Act in 1946.[103] Section 43(a) of the Lanham Act provides a private right of action for false advertising claims in federal court,[104] replacing what was formerly section 3 of the Trademark Act of March 19, 1920.[105] Section 43(a) provides, in relevant part:

> Any person who, on or in connection with any goods or services . . . uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which— (B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her *or another person's* goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.[106]

As noted by several scholars,[107] "there is virtually no legislative history addressing [the] scope or purpose" of section 43(a) of the Lanham Act when it was passed, since it was considered "a relatively insignificant provision."[108] More importantly, "nothing in the legislative history . . . recognizes that a new and potent weapon against false advertising claims was being created."[109] Also, "unlike section 3 [of the Trade-Mark Act],

99. Trademark Act of 1920, ch. 104, § 3, 41 Stat. 533 (1920).
100. *See* Keller, *supra* note 79.
101. *Id*.
102. *See* Klein, *supra* note 79, at 66.
103. Trademark Act of 1946, ch. 540, §§ 1-50, 60 Stat. 427 (1946).
104. *See* Singdahlsen, *supra* note 96, at 343.
105. *Id*. at 344. *See also* Trademark Act of 1920, ch. 104 § 3, 41 Stat. 533, 534 (1920).
106. 15 U.S.C. § 1125(a)(1) (emphasis added). It should be noted that this statute was revised in 1988 to include the words "or another person's" in section (B).
107. *See, e.g.*, Singdahlsen, *supra* note 96, at 344; Joseph P. Bauer, *A Federal Law of Unfair Competition: What Should Be the Reach of Section 43(a) of the Lanham Act?*, 31 UCLA L. REV. 671, 679 (1984).
108. *Id.*
109. *See* Keller, *supra* note 79. This scholar further notes that, "[t]o the contrary, the focus at the time was that section 43(a) provided an express statutory basis for prohibiting false designations of geographic origin, thus bringing U.S. law into conformity with the provisions of

which required a showing of willfulness and intent to deceive, section 43(a) is a strict liability tort."[110]

C. EARLY DEVELOPMENT OF SECTION 43(A)

In the first several years of the Lanham Act, section 43(a) "generally was construed as a codification of pre-Lanham Act law . . . restricted to actions for 'passing off' or actions which include only such false descriptions or representations as are of substantially the same economic nature as those which involve infringement."[111] The first significant expansion of its application began with the landmark case *L'Aiglon Apparel, Inc. v. Lana Lobell, Inc.*[112] which created a statutory tort of false representation of goods in commerce,[113] allowing for a greater array of actionable claims. However, little further expansion occurred until three decades later. During the 1980s, "the law of false advertising as determined by federal courts' interpretations of section 43(a) of the Lanham Act . . . departed sharply from earlier common law readings,"[114] while at the same time the courts saw "a dramatic increase in the number of actions brought under section 43(a)."[115]

Two cases in the early 1980s marked important expansions in the application of section 43(a). First, in *U-Haul Int'l v. Jartran, Inc.,*[116] the Ninth Circuit upheld an earlier court's award of $40 million in damages, half of which were punitive damages,[117] "based on U-Haul's corrective-

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various international conventions to with the United States was a party." *Id.* at 132. *See also* Klein, *supra* note 79, at 66 ("The enactment of section 43(a) was also motivated by international developments and interests.").

110. *See* Singdahlsen, *supra* note 96, at 344.

111. *See* Ethan Horwitz & Benjamin Levi, *Half a Century of Federal Trademark Protection: The Lanham Act Turns Fifty; Fifty Years of the Lanham Act: A Retrospective of Section 43(a)*, 7 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 59, 64 (Fall 1996).

112. L'Aiglon Apparel, Inc. v. Lana Lobell, Inc., 214 F.2d 649 (3d Cir. 1954).

113. *Id.* at 651 ("We find nothing in the legislative history of the Lanham Act to justify the view that this section is merely declarative of existing law. Indeed, because we find no ambiguity in the relevant language in the statute we would doubt the propriety of resort to legislative history even if that history suggested that Congress intended less than it said. It seems to us that Congress has defined a statutory civil wrong of false representation of goods in commerce and has given a broad class of suitors injured or likely to be injured by such wrong the right to relief in the federal courts. This statutory tort is defined in language which differentiates it in some particulars from similar wrongs which have developed and have become defined in the judge made law of unfair competition.").

114. *See* Saunders, *supra* note 83, at 563. *See also* Lillian R. BeVier, *Symposium on the Law and Economics of Intellectual Property: Competitor Suits for False Advertising Under Section 43(a) of the Lanham Act: A Puzzle in the Law of Deception*, 78 VA. L. REV. 1 (Feb., 1992) ("In the last decade and a half, section 43(a) false advertising litigation has increased steadily.").

115. *See* Singdahlsen, *supra* note 96, at 346.

116. U-Haul Int'l, Inc. v. Jartran, Inc., 793 F.2d 1034 (9th Cir. 1986).

117. The court justified doubling the $20 million award under section 35 of the Lanham Act. *See id.* at 1037.

advertising-expenditures theory."[118] In the Second Circuit case *PPX Enterprises, Inc. v. Audiofidelity Enterprises, Inc.,* the court also awarded damages.[119] The court held that PPX "should not have been required to provide evidence of actual consumer confusion,"[120] and remanded to the District Court for further proceedings on its damages claim.[121] The Second Circuit cited the increasingly expansive application of section 43(a) as influential in its decision[122] and, although it recognized that "courts have traditionally distinguished the standard that must be met to state a claim for injunctive relief from the standard necessary to establish entitlement to damages,"[123] it departed sharply from this tradition:

> [W]e perceive no reason why the same logic should not apply in regard to claims for damages . . . [W]e see no need to require appellant to provide consumer surveys or reaction tests in order to prove entitlement to damages. . . . [T]he distinction drawn between stating a claim for injunctive relief and establishing entitlement to damages has less relevance in the context of [section 43(a)] false advertising: Having established falsity, the plaintiff should be entitled to both injunctive and monetary relief, regardless of the extent of impact on consumer purchasing decisions.[124]

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118. *Id.* at 1041. The corrective-advertising-expenditures theory is a damages theory predicated on the idea that recovery of corrective advertising expenditures incurred by a plaintiff to counteract public confusion from a defendant's wrongful conduct is warranted under section 35 of the Lanham Act. Big O Tire Dealers v. Goodyear Tire & Rubber Co., 561 F.2d 1365, 1374 (10th Cir. 1977).

119. PPX Enter., Inc. v. Autofidelity Enter., Inc., 818 F.2d 266 (2d Cir. 1987).

120. *Id.* at 268.

121. *Id.* at 273.

122. The court presented a lengthy list of expansive decisions that influenced its own here: (*See, e.g.*, Dallas Cowboys Cheerleaders, Inc. v. Pussycat Cinema, Ltd., 604 F.2d 200 (2d Cir. 1979) (misappropriating cheerleader uniform in sexually-explicit film); RJR Foods, Inc. v. White Rock Corp., 603 F.2d 1058 (2d Cir. 1979) (imitating trade dress of established, competitive fruit punch); American Home Prod. Corp. v. Johnson & Johnson, 577 F.2d 160 (2d Cir. 1978) (presenting false and misleading claims in comparative advertising of analgesics); Gilliam v. American Broad. Cos., 538 F.2d 14 (2d Cir. 1976) (presenting garbled version of plaintiffs' comedy program to public); Vuitton Et Fils, S.A. v. Crown Handbags, 492 F.Supp. 1071 (S.D.N.Y. 1979) (distributing imitation Louis Vuitton handbags), *aff'd mem.*, 622 F.2d 577 (2d Cir. 1980); Benson v. Paul Winley Record Sales Corp., 452 F.Supp. 516 (S.D.N.Y. 1978) (deceptive marketing of old records of newly successful recording artist); *see also, e.g.*, Camel Hair & Cashmere Inst. v. Associated Dry Goods Corp., 799 F.2d 6 (1st Cir. 1986) (mislabeling of coats that overstated their cashmere content); Smith v. Montoro, 648 F.2d 602 (9th Cir. 1981) (substituting false name in film credits and advertising); Boston Prof'l Hockey Ass'n v. Dallas Cap & Emblem Mfg., 510 F.2d 1004 (5th Cir. 1975) (unlicensed manufacturing of emblems and insignias of professional hockey teams). *See PPX Enter., Inc*., at 270–271.

123. *See PPX Enter., Inc.*, at 271. Normally, for injunctive relief, "plaintiffs, must demonstrate a likelihood of deception or confusion on the part of the buying public caused by the false description or representation." *Id. See also* Coca-Cola Co. v. Tropicana Prod., Inc., 690 F.2d 312, 316 (2d Cir. 1982). While, to establish "entitlement to damages for violation of section 43(a)" a plaintiff "must establish actual consumer confusion or deception resulting from the violation." *PPX Enter., Inc.*, 818 F.2d at 271.

124. *PPX Enter., Inc.*, 818 F.2d at 272–273.

The import of these two decisions, as many scholars note,[125] and as will be discussed in depth herewith, is that section 43(a) is becoming more and more of a competitor tool and less of a necessary deterrent to false advertising or a means of consumer protection.

The next important evolution of section 43(a) came with the false advertising "prong," which was added to section 43(a) by the Trademark Revision Act of 1988.[126] "Pre-1988 judicial interpretations of section 43(a) . . . limited actionable false statements to claims about one's own goods or services; consequently section 43(a) did not provide a cause of action for false statements or representations about a competitor's goods or services."[127] The major effect of the Trademark Revision Act of 1988 was to expand section 43(a) to "include trade libel and product disparagement."[128] This change, "clearly enlarged the scope of section 43(a)" beyond what it had been prior to the amendment,[129] effectively placing a "congressional stamp of approval . . . [on] the Lanham Act metamorphosis."[130]

"Once interpreted as prohibiting only passing-off, section 43(a) of the Lanham Act has increased in scope to include infringement of common law marks, trade dress infringement, and false advertising—including trade libel and product disparagement."[131] By the 1990s, "virtually all advertising claims made in interstate commerce—whether on product packages, in newspaper and magazine advertisements, in television or radio commercials, or disseminated through . . . the Internet—[fell] within the reach of section 43(a) of the Lanham Act."[132] Section 43(a) is now extremely "broad and far-reaching."[133] Since it is a remedial statute, it "allow[s] the courts to adapt its language to changing commercial circumstances."[134] As will be demonstrated by this note, "[s]ection 43(a) has risen from obscurity as a largely ignored subsection of the Trade Registration Act . . . to today's unrivaled legal instrument to combat unfair competition."[135] As predicted by one scholar[136] and evidenced in the case at

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125. *See, e.g.*, Garrett J. Waltzer, *Monetary Relief for False Advertising Claims Arising Under Section 43(a) of the Lanham Act*, 34 UCLA L. REV. 953 (Feb. 1987); James M. Keating, Jr., *Damages Standards for False Advertising Under the Lanham Act: A New Trend Emerges*, 20 RUTGERS L.J. 125 (Fall 1988); Thomas J. Holdych, *Standards for Establishing Deceptive Conduct Under State Deceptive Trade Practices Statutes That Impose Punitive Remedies*, 73 OR. L. REV. 235 (Spring 1994); Petty, *supra* note 79.

126. *See* Klein, *supra* note 79, at 69.

127. *See* Horwitz & Levi, *supra* note 111, at 71.

128. *Id*. at 72.

129. *See* Klein, *supra* note 79, at 69.

130. *See* McCarthy, *supra* note 79, at 46.

131. *See* Horwitz & Levi, *supra* note 111, at 72.

132. *See* Keller, *supra* note 79, at 131.

133. *See* Klein, *supra* note 79, at 87.

134. *Id.*

135. *See* McCarthy, *supra* note 79, at 46.

136. *See* Klein, *supra* note 79, at 88.

hand, it continues to expand, "and will continue to do so, on a case-by-case basis."[137]

D. CURRENT ELEMENTS OF A SECTION 43(A) CLAIM

Although the elements of a section 43(a) false advertising claim vary somewhat among jurisdictions, it is widely accepted that plaintiffs must establish "five elements: (1) a false statement of fact that has deceived, or has the capacity to deceive, a not insubstantial segment of the target audience, (2) affecting interstate commerce, (3) in connection with commercial advertising and promotion, (4) that is material, and (5) that is likely to cause injury."[138] The false statement of fact element is the central issue in the case at hand.

IV. THE SECOND CIRCUIT COURT'S INCREASINGLY EXPANSIVE CONCLUSIONS ABOUT LITERAL FALSITY CLAIMS

A. PRIOR DECISIONS OF THE SECOND CIRCUIT

Prior to *Time Warner*, the Second Circuit recognized that an advertisement, if literally false, could violate section 43(a) of the Lanham Act and "be enjoined without reference to consumer reaction,"[139] and that falsity "extend[ed] to oral as well as visual claims."[140] Some courts went even further and recognized that, although "not all advertisements challenged under section 43(a) as literally false expressly state the alleged falsehood,"[141] the advertisements could still be "false by necessary implication."[142] However, the Second Circuit had declined to follow the "false by necessary implication doctrine" until its decision in *Time Warner*.[143]

The prior standard in the Second Circuit provided that if an advertisement was not literally false, it would need to "have a tendency to mislead, confuse or deceive" to violate the statute.[144] Whether an advertisement was deceptive or misleading was generally determined not by "its tendency or capacity to deceive . . . but by reference to evidence

137. *Id*. (It should be noted here that Klein also predicted correctly that "section 43(a) is likely to extend so far as to conflict with the underpinnings of patent and copyright laws.").
138. *See* Keller, *supra* note 79, at 140–141.
139. *See* Keller, *supra* note 79, at 141, (citing McNeil-P.C.C., Inc. v. Bristol-Myers Squibb Co., 938 F.2d 1544, 1549 (2d Cir. 1991)).
140. *Id.* at 141 (citing Coca-Cola Co. v. Tropicana Prod., Inc., 690 F.2d 312, 317 (2d Cir. 1982)).
141. *See* Keller, *supra* note 79, at 141.
142. *Id*.
143. *See* Johnson & Johnson Vision Care, Inc. v. Ciba Vision Corp., 348 F.Supp.2d 165, 182 (S.D.N.Y. 2004).
144. *See* American Home Prod. Corp. v. Johnson & Johnson, 577 F.2d 160, 165 (2d Cir. 1978).

indicating that the public [would] be misled."[145] This evidence usually was presented in the form of consumer surveys.[146] In fact, for years, "courts and commentators . . . focused almost exclusively on consumer survey results as the only probative evidence that an implicit claim . . . misled the public."[147] This seems a very practical manner of determining whether such an implied claim of falsity actually deceived consumers.[148] Yet, the District Court for the Southern District of New York formally expanded the scope of what it would examine when faced with such an implicit claim in *McNeilab, Inc. v. American Home Prod. Corp.,*[149] which became the new standard of review for misleading or deceptive, yet true, statements. Although the *McNeilab* court maintained that a plaintiff "must adduce evidence (usually in the form of market research and consumer surveys) showing how the statements are perceived by those who are exposed to them,"[150] the surveys' conclusions are not binding on the court.[151] The court could also consider its own reaction to the statements:

> Though the court's own reaction to advertisements is not determinative, as finder of fact it is obliged to judge for itself whether the evidence of record establishes that others are likely to be misled or confused. In doing so, the court must, of course, rely on its own experience and understanding of human nature in drawing reasonable inferences about the reactions of consumers to the challenged advertising.[152]

The Second Circuit readily adopted this new viewpoint, when in *LeSportsac, Inc. v Kmart Corp.*[153] it took the position that consumer surveys are not required at all to prevail in a section 43(a) action.[154] The Second Circuit later held in *Johnson & Johnson Merck Consumer Pharm. Co. v. Smithkline Beecham Corp.* that the presumption that consumers are being deceived "may be engendered by the expenditure of substantial funds in an effort to deceive consumers and influence their purchasing decisions,"[155] and if this presumption arises, it "relieves a plaintiff of the burden of producing consumer survey evidence that supports a claim."[156]

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145. *See* Keller, *supra* note 79, at 141; *see also American Home Prod.*, 577 F.2d at 165 ("It is . . . well established that the truth or falsity of the advertisement usually should be tested by the reactions of the public.").

146. *See* Keller, *supra* note 79, at 141.

147. *Id*. at 142.

148. *But see id*., in which one scholar notes that "[a]lthough it is clear that consumer survey evidence at times may be the most persuasive evidence of an advertisement's tendency or capacity to deceive, it should not be the exclusive means of assessing implicitly false representations."

149. McNeilab, Inc. v. American Home Prod. Corp., 501 F.Supp. 517 (S.D.N.Y. 1980).

150. *Id.* at 525.

151. *Id.*

152. *Id.*

153. Lesportsac, Inc. v. K Mart Corp., 754 F.2d 71 (2d Cir. 1985).

154. *Id*. at 78.

155. *See* Johnson & Johnson Merck Consumer Pharm. Co. v. Smithkline Beecham Corp., 960 F.2d 294, 298–299 (2d Cir. 1992). This opinion further states that "once a plaintiff establishes

Under the "false by necessary implication doctrine," a district court evaluating whether an advertisement is literally false must analyze the message conveyed in full context, i.e., it must "consider the advertisement in its entirety and not engage in disputatious dissection."[157] In an effort to clarify the false advertising doctrine, the appellate court held that "an advertisement can be 'literally false, even though it does not explicitly mak[e] a false assertion, if the words or images, considered in context, necessarily and unambiguously imply a false message.'"[158]

B. THE DECISION IN TIME WARNER IS A DEPARTURE FROM THE COURT'S PREVIOUS DECISIONS

In a case such as *Time Warner*, the Second Circuit's prior decisions that the court could consider its own perceptions[159] and no longer required consumer surveys[160] are problematic. This is especially so since TWC sought both injunctive relief and an accompanying award for damages here.[161] In such an action, a finding of literal falsity to support injunctive relief is prejudicial when coupled with a damages claim. In most cases, such a finding is likely to force settlement of the damages claim. The import of this result is that defendants are not only deprived of having customers or market researchers weigh in on the deceptive nature of the advertisements, but of the benefit of having a jury decide whether the advertisements are literally false to support a damages claim. The Second Circuit's adoption of the "false by necessary implication" doctrine here goes one step further, mandating a finding of falsity based solely on the court's perception of the advertisement in its context and entirety.[162] And, when dealing, as here, with television advertisements, the court's presumption of deception based on the expenditure of substantial funds[163] is equally problematic, since this will be the case with virtually all television advertisements.

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deceptive intent, the burden shifts to the defendant to demonstrate the absence of consumer confusion." *Id.* at 299.

156. *Id*.

157. Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 157 (2d Cir. 2007). (citations omitted).

158. *See* '*Literally False,' 'Puffery' Clarified in Advertising Dispute Between Cable, Satellite TV Providers*, N.Y.L.J. Vol. 238, Aug. 15, 2001 (quoting in part *Time Warner Cable*, 497 F.3d at 149).

159. *See* Keller, *supra* note 79, at 141 (citing McNeil-P.C.C., Inc. v. Bristol-Myers Squibb Co., 938 F.2d 1544, 1549 (2d Cir. 1991)).

160. *See* Lesportsac, Inc. v. K Mart Corp., 754 F.2d 71 (2d Cir. 1985).

161. *See* Plaintiff's First Amended Complaint, 2007 WL 672192 (S.D.N.Y., Jan. 17, 2007).

162. *See* Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 157 (2d Cir. 2007). (citations omitted).

163. *See* Johnson & Johnson Merck Consumer Pharm. Co. v. Smithkline Beecham Corp., 960 F.2d 294, 298–299 (2d Cir. 1992).

The decision in *Time Warner* also lessened the required showing for irreparable harm here,[164] which goes to the element of causation of injury to the plaintiff. It is well recognized that a plaintiff need not prove the existence of an injury caused by the defendant to prevail in a section 43(a) action.[165] A plaintiff must provide proof of a "reasonable basis for the belief that the plaintiff is likely to be damaged as a result of the false advertising."[166] To do so, a plaintiff must demonstrate that it, and defendant, are "competitors in a relevant market,"[167] and that there is "a logical causal connection between the alleged false advertising and its own sales position."[168] Although in *Time Warner* the court required a showing of "irreparable harm," which would seem to be a higher standard than "likely to be damaged," the court's basis for finding such harm seems even more relaxed than its basis for finding likely harm previously. In *Time Warner,* Judge Chester J. Straub, writing for the panel,[169] said that "[t]he likelihood of irreparable harm may be presumed where the plaintiff demonstrates a likelihood of success in showing that the defendant's comparative advertisement is literally false and that given the nature of the market, it would be obvious to the viewing audience that the advertisement is targeted at the plaintiff, even though the plaintiff is not identified by name."[170] There need not be any showing whatsoever of a causal connection between the alleged false advertising and its own sales position. It seems that, in effect, proof of literal falsity here almost mandates a finding of irreparable harm.

A third holding, though less important to the analysis in this note, is that "[t]he category of non-actionable 'puffery' encompasses visual depictions that, while factually inaccurate, are so grossly exaggerated that no reasonable consumer would rely on them in navigating the marketplace."[171]

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164. *See* Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144 (2d Cir. 2007); *see also* Beth Bar, *2nd Circuit Seeks the Truth in Ad Dispute*, THE LEGAL INTELLIGENCER Vol. 236, No. 30, Aug. 13, 2007.

165. *See* Johnson & Johnson v. Carter-Wallace, Inc., 631 F.2d 186, 190 (2d Cir. 1980).

166. *Id*. The court also distinctly noted that "[i]f such a showing is made the plaintiff will have established a reasonable belief that he is likely to be damaged within the meaning of s[ection] 43(a) and will be entitled to injunctive relief, as distinguished from damages, which would require more proof." *Id*. This is significant since many cases involving claims based on television commercials today, including *Time Warner*, are cases in which both injunctive relief and damages are sought simultaneously. This lesser standard of proof with regard to damages is applied to the injunctive portion of the suit, and the result often forces settlement of the damages portion of the suit, effectuating a *de facto* application of the lesser standard of proof to the damages claims.

167. *Id*.

168. *Id*.

169. *See* Bar, *supra* note 164.

170. *See* Time Warner Cable, Inc. v. DIRECTV, Inc., 497 F.3d 144, 148 (2d Cir. 2007).

171. *Id*. at 148.

V. IMPLICATIONS INVOLVED WITH THE SECOND CIRCUIT'S NEW INTERPRETATION OF SECTION 43(A) OF THE LANHAM ACT

There are several implications involved with the Second Circuit's latest interpretation of section 43(a) of the Lanham Act, to be discussed herein. To begin, the evolution of this Act's interpretation increasingly favors plaintiffs. As such, instead of protecting consumers, the Act has become a tool for competitors. Moreover, the more often suits are filed under the Act, the more costs of advertising are rising, further reducing the benefits of advertising to consumers. Finally, consumers and defendants alike are harmed when plaintiffs are able to prevail on the merits in a preliminary injunction action, forcing settlement without trial on a concomitant damages claim.

A. PLAINTIFFS ARE INCREASINGLY FAVORED IN SECTION 43(A) CLAIMS

As a result of the expanding interpretation of what an actionable claim is under section 43(a), currently several aspects of section 43(a) litigation are preferential to plaintiffs. *Time Warner* is another resounding example of this trend. First, as exemplified by *Time Warner*, plaintiffs no longer must show that the public actually believed the statements in the challenged advertisements.[172] Second, the burden of proof is not actual harm.[173] As a result, a plaintiff is merely required to show that plaintiff and defendant are actually competitors.[174] In such a situation, a defendant can be found liable under section 43(a) for unfair competition without even naming the plaintiff.[175] Third, courts rush straight to judgment for the plaintiff on a lowered standard for injunctive relief, without considering whether there exist differing interpretations when literal falsity applies.[176] In the end, many cases are forced into settlement.[177]

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172. *See Time Warner Cable.*, 497 F.3d at 153. "When an advertisement is shown to be literally or facially false, consumer deception is presumed, and the court may grant relief without reference to the advertisement's actual impact on the buying public." *See also* Coca-Cola Co. v. Tropicana Prod., Inc., 690 F.2d 312, 317 (2d Cir. 1982).

173. *Time Warner Cable*, 497 F.3d at 161. (Internal quotations omitted). "We have resolved that a plaintiff need not point to an actual loss or diversion of sales to satisfy this requirement."

174. *Id.* at 162. "The presumption of irreparable injury is properly limited to circumstances in which injury would indeed likely flow from the defendant's objectionable statements, [for example] . . . [when] the plaintiff is an obvious competitor with respect to the misrepresented product." *See also* Ortho Pharm. Corp. v. Cosprophar, Inc., 32 F.3d 690 (2d Cir. 1994).

175. *Time Warner Cable*, 497 F.3d at 162. "[T]he fact that the commercial does not name plaintiff's product is not necessarily dispositive." *Id.*

176. *See* McCarthy, *supra* note 79, at 74. For further discussion, see *infra* note 214, and accompanying text.

177. *See* Arthur Best, *Monetary Damages for False Advertising*, 49 U. PITT. L. REV. 1 (Fall 1987).

B. Claims of Unfair Competition Will More Often Be Used As A Competitor Tool And Not For Consumer Protection

There is a definite trend in Lanham Act section 43(a) toward its use as a competitive tool, and away from its use for true consumer protection.[178] As attorneys saw section 43(a)'s potential for supporting claims, they "began pushing the courts to apply it to more and different types of false advertising and unregistered trademark infringement. The federal [judiciary] . . . responded enthusiastically."[179] It has become a "much-used and potent statute," for attorneys and competitors alike.[180] "In recent years, there has been a dramatic increase in the number of such suits brought by competitors."[181] On the heels of the 1988 revision, one scholar wondered whether "section 43(a) [would] be used anticompetitively to quash advertising to the detriment of consumers,"[182] since competitors have a "much stronger incentive to sue" than consumers.[183] Yet, it was also noted that, as is relevant here, competitors "presumably have greater expertise than consumers concerning the quality of the goods in question and how consumers are likely to interpret advertising claims. Therefore, they can more readily identify and prove false advertising claims."[184] However, this "competitors as experts" phenomenon in the false advertising arena is a dangerous and slippery slope, as evidenced in *Time Warner*, wherein the interpretation of literal falsity was once again expanded. It has also been argued that "smaller competitors, unable to match the advertising expenditures of larger firms, may find it less expensive to challenge the advertising content of the larger firm in court than to mount a counter-advertising campaign."[185] However, as evidenced here, in the plethora of drug-company actions of late, and in cases such as *U-Haul*,[186] which quashed a small competitor,[187] it is usually the big competitors waging these wars and knocking out other big competitors.

As evidenced by the popularity of claims between drug companies in this arena, it is clear that they incentivize competitor suits. One scholar notes that "[e]stablished companies, particularly those selling parity products, often find it beneficial to stretch the truth. For example, some commentators have estimated that every 1% increase in market share created by advertising for over-the-counter drug companies increases sales

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178. *See* McCarthy, *supra* note 79, at 52.
179. *Id.*
180. *Id.*
181. *See* Goldman, *supra* note 79, at 488.
182. *See* Petty, *supra* note 79, at 381–382.
183. *Id.* at 382.
184. *Id.*
185. *Id.* at 383.
186. U-Haul Int'l, Inc. v. Jartran, Inc., 793 F.2d 1034 (9th Cir. 1986).
187. *Id*.

by $15 million."[188] He further notes, "[i]t is inevitable that some consumers will be misled by commercial advertising. Given the time and space limitations of the various media outlets, advertising copy is necessarily incomplete."[189]

"As competitors continue to expand the limits of section 43(a) by using the statute to monitor how rivals market their products through advertising, increasingly interesting legal issues will arise . . . One thing is clear: The expansion of false advertising law will keep going, and going, and going . . . ."[190] Today, "the proper use and scope of section 43(a) has become an important issue in the traditional battle between the competing policies of fair competition and free competition. Before passage of the Lanham Act, such issues were largely played out in the context of state common law. [Now], the battleground is section 43(a)."[191]

In addition, seeking injunctive relief is relatively quick and cheap for plaintiffs, whereas in many cases it is extremely disruptive to the defendant.[192] Therefore, a competitor can succeed in enjoining an adversary's advertising "within months or even weeks of filing suit,"[193] which is obviously extremely costly to television advertisers, and another competitive incentive to file such suits.

Time Warner is a prime example of using section 43(a) of the Lanham Act as a competitor tool. DIRECTV counsel argued quite persuasively that "the motivation behind [TWC's] Motion for Preliminary Injunction is not to enjoin false and misleading advertising, as it contends."[194] "Rather, [TWC] seeks to impermissibly prevent DIRECTV from engaging in truthful, accurate commercial speech regarding the nature of its products and services so that [it] can obtain a competitive advantage in the marketplace."[195] DIRECTV further contended that TWC "cannot point to a single statement . . . that is literally false,"[196] nor has TWC shown "evidence of actual consumer confusion" to prove that the advertisements are "likely to mislead."[197] Furthermore, as noted by DIRECTV, the Second Circuit had not adopted the "doctrine of falsity by necessary

188. *See* Petty, *supra* note 79, at 388.
189. *See* Goldman, *supra* note 79, at 488 n.2.
190. *See* Keller, *supra* note 79, at 157.
191. *See* McCarthy, *supra* note 79, at 74.
192. *See* Petty, *supra* note 79, at 392.
193. *Id.*
194. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 4, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.
195. *Id.*
196. *Id.*
197. *Id.*

implication,"[198] so TWC's attempt to argue that the "overall message of the advertisements is literally false"[199] was misplaced.[200]

Counsel for DIRECTV argued in its Second Circuit briefing that TWC "concedes, as it must, that none of the advertisements makes any actual comparison between DIRECTV's HD programming and that of cable."[201] This makes it impossible for the literally false argument to hold. Therefore, the Second Circuit needed to expand its interpretation of section 43(a) to include and adopt the doctrine of false by necessary implication.

DIRECTV alleged that TWC's true motivations for seeking preliminary injunctions in the case were to "attempt to exercise editorial control over all of DIRECTV's advertisements."[202] This motivation is exemplified by the fact that TWC "agreed not to sue DIRECTV over the Jessica Simpson commercial if DIRECTV changed the tagline to remove reference to cable . . . . Yet . . . after DIRECTV made the only change requested by TWC, it ask[ed] th[e] Court to enjoin the revised commercial."[203] DIRECTV counsel argued that the "scope of the requested injunction [was] hopelessly overbroad, vague and unconstitutional," since it sought not only "to enjoin the advertisements at issue," but asked the Court "to issue a blanket injunction preventing DIRECTV from engaging in any future advertising that may criticize Time Warner Cable's or cable's picture or audio quality in any form, even concededly inferior analog, regardless of the truthful nature of such advertisements."[204] Further, "the First Amendment prohibits Time Warner Cable from silencing its competitors from truthfully informing the public of the deficiencies in its products and services."[205] Also, counsel pointed out that TWC was at the time engaging in the very same activity it sought to enjoin by "running its own advertisements falsely stating that DIRECTV is obsolete and prone to excessive outages."[206]

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198. *Id*. *See also* Johnson & Johnson Vision Care Inc. v. Ciba Vision Corp., 348 F.Supp.2d 165, 182 (S.D.N.Y. 2004).

199. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 4, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.

200. Counsel for DIRECTV referred to another District Court decision to make the assertion that "[s]hould the Court even consider the doctrine of necessary implication, Time Warner Cable must show that the Revised Simpson Commercial is 'susceptible to *no more than one* interpretation' and that this interpretation is false." (emphasis added) *See id*. at 14, (quoting Johnson & Johnson-Merck Consumer Pharm. Co. v. Procter & Gamble Co., 285 F.Supp.2d 389, 391 (S.D.N.Y. 2003)). *See also Ciba Vision*, 348 F.Supp.2d at 182–184.

201. *See* DIRECTV, Inc.'s Opposition to Plaintiff's Motion for a Preliminary Injunction at 4, Time Warner Cable, Inc. v. DIRECTV, Inc., (S.D.N.Y. Jan. 17, 2007) (No. 06 Civ.14245), 2007 WL 672191.

202. *Id*. at 5.

203. *Id.*

204. *Id*.

205. *Id*.

206. *Id*.

Overall, it is clear that TWC's motivation in filing this suit was not to protect consumers, but to injure its competitor DIRECTV. TWC took advantage of the Second Circuit's liberal interpretation of section 43(a) of the Lanham Act, and was even successful in expanding that interpretation.

C. COSTS OF ADVERTISING WILL RISE, REDUCING THE BENEFITS OF ADVERTISING TO CONSUMERS

Expansion of the enforcement of section 43(a) is not "cost-free": it "may chill useful, informative advertising; often involving significant litigation costs; and may produce anticompetitive results."[207] It is well recognized that "[i]nformational advertising increases buyer knowledge about the price, quality and benefits of various products, thus reducing consumers' search costs and the total costs to consumers of transacting business."[208] And, advertising "induces sellers to improve the quality of their goods."[209] "Advertising may also reduce barriers to entry [into the market] and improve product offerings by allowing the new entrant to quickly gain market awareness and acceptance."[210]

Despite one scholar's conclusion that "although the variety of alternative enforcement mechanisms reduce[s] the need for competitor actions, competitor actions provide benefits that no other policing tool provides,"[211] he also notes that alternative enforcement mechanisms are many: Consumers, the Federal Trade Commission, State Attorneys General, the National Advertising Review Board, and the television networks are all alternative enforcement mechanisms.[212] Accordingly, "[i]t is important to create critical breathing space for legitimate comment and criticism about products and services. On the other hand, there is a need for a meaningful state or federal remedy against intentional falsification of facts about a product that demonstrably causes a loss of sales."[213] In the case at hand, there was no evidence presented to suggest that there was intentional falsification of facts or that there would be any loss of sales, since none was required.

207. *See* Goldman, *supra* note 79, at 490.
208. *Id.* at 491.
209. *Id.* at 492.
210. *Id.*
211. *Id.* at 491.
212. *Id.* at 504.
213. *See* McCarthy, *supra* note 79, at 74.

D. NO ACTUAL HARM NEED BE SHOWN FOR A PLAINTIFF TO BE AWARDED DAMAGES, WHILE THE THREAT OF A LARGE DAMAGE AWARD WILL FORCE SETTLEMENT

Even though a plaintiff must show "actual consumer confusion or deception"[214] to get money damages, judges may award double or treble damages without the plaintiff having to demonstrate any intent to defraud or malicious interference with business practices.[215] "While the usual remedy obtained is an injunction, occasionally large damage awards have been recovered," including huge punitive damage awards.[216] Until *U-Haul,* "most plaintiffs who allege[d] false advertising violations under the Lanham Act [were] only able to enjoin defendants from falsely advertising."[217] The allowance of damages has created a "tremendous incentive for firms to aggressively litigate Section 43(a) false advertising claims."[218] This also arguably forces settlement, which is not necessarily good or fair to the defendant. In fact, a settlement, the terms of which are undisclosed,[219] did result in this case, separate and apart from the equitable portion of the suit,[220] and a spokesperson for TWC confirmed in press reports that it "came several weeks before" the Second Circuit upheld the District Court judge's preliminary order "that DIRECTV stop airing televised ads featuring Jessica Simpson and William Shatner, because they seemed misleading."[221] Further, as noted by DIRECTV and TWC officials, "their settlement made the ruling moot."[222] However, "the written decision

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214. Normally, for injunctive relief, "plaintiffs must demonstrate a likelihood of deception or confusion on the part of the buying public caused by the false description or representation." PPX Enter., Inc. v. Autofidelity Enter., Inc., 818 F.2d at 271. *See also* Coca-Cola Co. v. Tropicana Prod., Inc., 690 F.2d 312, 316 (2d Cir. 1982). While, to establish "entitlement to damages for violation of section 43(a)" a plaintiff "must establish actual consumer confusion or deception resulting from the violation." *PPX Enter., Inc.*, 818 F.2d at 271. However, as noted herein, this standard was relaxed in the Second Circuit in *PPX Enter*. *See id.* at 272.

215. *See* U-Haul Int'l, Inc. v. Jartran, Inc., 793 F.2d 1034 (9th Cir. 1986).

216. *See* McCarthy, *supra* note 79, at 57 ("One of the largest awards in any false advertising case was the $40 million award in the 1986 U-Haul case in the Ninth Circuit. Finding the defendant a commercial privateer engaged in predatory false comparative advertising, the court awarded $20 million in damages and another $20 million in increased and punitive damages, plus attorney fees.").

217. *See* Waltzer, *supra* note 125, at 979.

218. *Id*.

219. *See* Bar, *supra* note 164 ("Jade L. Ekstedt, DIRECTV's public relations manager, and Alexander Dudley, senior director for corporate communications at Time Warner Cable, confirmed that the parties have reached a settlement. Both, however, declined to elaborate on its terms."); "Time Warner Cable Settled a lawsuit against DIRECTV alleging . . . ," CONSUMER ELECTRONICS DAILY, Aug. 10, 2007 ("DIRECTV and Time Warner Cable officials . . . wouldn't disclose the terms [of their settlement].").

220. *See* Bar, *supra* note 164.

221. *See* "Time Warner Cable Settled a lawsuit against DIRECTV alleging . . . ," CONSUMER ELECTRONICS DAILY, Aug. 10, 2007.

222. *Id*.

may have wider implications for other companies deciding how to portray competitors in their advertising."[223]

VI. PROPOSED SOLUTIONS AND CONCLUSION

The decision in *Time Warner* will only serve to incentivize competitors and encourage not only more lawsuits, but more competitive commercials. Although competitive advertisement has several advantages for consumers, those advantages come not from competitors pointing fingers at each other, but from providing information to the public about products and services that they offer, whether new to the market or old. The Second Circuit's approach in *Time Warner* "likely will result in decreased information to the consuming public about alternative brands and new products, which rely heavily on advertising to create a market share."[224] Courts should be conscious of the new competitive tools that they give with each new expansion of section 43(a) of the Lanham Act and realize that litigation in this arena has really come full circle. After seeing big business march in time and again and quash new entries into the market, courts, and especially the Second Circuit, should tighten their interpretation of section 43(a) and consider the import their decisions will have on the marketplace and individual consumers. Section 43(a) should strive to protect consumers—not big businesses like TWC.

Cynda E. D'Hondt[*]

223. *See* Larry Neumeister, *Appeals Court Upholds Ad 'Puffery' Warner Had Sued DIRECTV For Distorting Its Service*, SAN JOSE MERCURY NEWS, Aug. 10, 2007.

224. *See* Waltzer, *supra* note 125, at 973.

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DUELING OVER DUAL-USE GOODS: THE U.S. DEPARTMENT OF COMMERCE'S MISGUIDED ATTEMPT TO PROMOTE U.S. SECURITY AND TRADE WITH CHINA THROUGH RESTRICTIVE EXPORT CONTROLS

On July 6, 2006, the U.S. Department of Commerce's Bureau of Industry and Security (BIS) published in the *Federal Register* a proposed version of what has come to be known as the "China Military Catch All Rule."[1] The rule proposed not only to tighten U.S. export licensing policy for certain goods destined for China but also to create a program for trusted Chinese end-users to facilitate trade.[2] The published notice requested public comment on the proposed rule "in order to obtain the benefit of a variety of viewpoints before publishing any final rule."[3]

And comment the public did. During the ensuing months, in which BIS extended the comment period an additional month,[4] over fifty individual comments were submitted, totaling nearly 1,000 pages.[5] For just under twelve months, this public and often contentious debate unfolded over what final form, if any, the rule should take.[6] Generally, the debate pitted American businesses and exporters—proponents of liberalized trade controls on China—against the United States government and, more specifically, the Commerce Department, which view such trade controls as effective tools of foreign policy and national security.[7] Ultimately, the United States government and the Commerce Department prevailed and heavy restrictions were placed on trade.

The publication of the final version of the China Military Catch All Rule[8] on June 19, 2007 has been hailed by the government as embodying "one of the most important changes to export control policy in many

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1. Revisions and Clarifications of Export and Reexport Controls for the People's Republic of China (PRC); New Authorization Validated End-User, 71 FED. REG. 38313 (July 6, 2006) [hereinafter Proposed Rule].

2. *Id.* at 38313–14.

3. *Id.* at 38316.

4. R.G. Edmonson, *Comment period on dual-use export rules extended*, JOURNAL OF COM., Oct. 19, 2006.

5. Assistant Secretary of Commerce for Export Administration Christopher A. Padilla, *The Future of U.S. Export Controls on Trade with China*, STATES NEWS SERVICE, Jan. 29, 2007, *available at* http://www.bis.doc.gov/news/2007/padilla02012007.htm [hereinafter Padilla 1/29/07].

6. *See, e.g.*, *Exporters Urge BIS to Reconsider China 'Catch-All' Rule*, MANAGING IMPORTS AND EXPORTS, April 2007, *available at* LEXIS (describing the publishing of the proposed rule as "kicking up a veritable storm among U.S. exporters").

7. Padilla 1/29/07, *supra* note 5.

8. Revisions and Clarifications of Export and Reexport Controls for the People's Republic of China (PRC); New Authorization Validated End-User; Revision of Import Certificate and PRC End-User Statement Requirements, 72 FED. REG. Vol. 33646 (June 19, 2007) [hereinafter Final Rule].

years."[9] In an op-ed in the *San Jose Mercury News*, Under Secretary of Commerce for Industry and Security Mario Mancuso argued that the new rule "strike[s] the right balance in our complex relationship with China" by "support[ing] U.S. companies in competing successfully in China while restricting the export of technologies that would contribute to China's military modernization."[10]

In reality, the new rule will most likely do quite the opposite. The China Military Catch All Rule will not only negatively impact American business interests in China, but will also do little to slow China's military modernization and may even undermine U.S. national security. Part I of this note provides a brief overview of U.S. dual-use[11] export controls and then specifically addresses those with direct application to China in order to place the new regulations in the proper context. Part II examines the final incarnation of the China Military Catch All Rule in detail, highlighting both the changes between the proposed and final versions and the major changes to current U.S. dual-use export control policy.

Part III provides an evaluation of the immediate and long-term consequences of the rule's implementation, both in the United States and in China, and addresses three specific implications. This note will first argue that the rule unnecessarily expands liability for U.S. exporters, as well as for entities throughout the supply chain. The specter of harsh penalties requires greater due diligence efforts to ensure that these newly controlled items do not end up bolstering China's military. These developments make the costs (administrative or otherwise) of doing business for U.S. exporters in China greater,[12] while making their foreign counterparts more attractive to Chinese buyers,[13] thereby further fueling the political time bomb that is America's ballooning trade deficit with China.[14] Second, the rule will undermine U.S. business competitiveness in China and in other markets. The final rule is strictly unilateral in nature as the United States has been unable to convince a single ally to adopt similar restrictions.[15] With many

9. Padilla 1/29/07, *supra* note 5.

10. Mario Mancuso, *Securing our Exports to China: New Rules Can Limit Military's Access to High Technology*, SAN JOSE MERCURY NEWS, June 18, 2007, *available at* http://www.bis.doc.gov/news/2007/oped06_18_07.htm.

11. The term "dual-use" is defined as "[i]tems that have both commercial and military or proliferation applications." *See* 15 C.F.R. § 772.1 (2007).

12. Letter from 23 Organizations to Stephen Hadley, (Sept. 21, 2005), *available at* http://www.usaengage.org/storage/usaengage/Publications/2005_09_nftc_catchall.pdf.

13. William Reinsch, "Future of Export Controls," Remarks to the Practicing Law Institute (Dec. 11, 2006), *available at* http://www.nftc.org/newsflash/newsflash.asp?Mode=View&articleid=1843&Category=All.

14. Li Ruogu, *Real Issues in China-US Trade Imbalance*, CHINA DAILY, May 9, 2008.

15. Memorandum from Paul Freedenberg, Ass'n for Mfg. Tech., on Overview of the China Military Catch-All Regulation to the Interested Parties (June 19, 2007), *available at* http://www.amtonline.org/document_display.cfm/document_id/55349/section_id/103/overviewofthechinamilitarycatch-allregulation.

of these items available elsewhere, Chinese firms are likely to turn to foreign competitors for their products.[16] Likewise, due to the rule's extraterritorial application through its reexport provisions,[17] foreign companies will increasingly "design out" U.S. components in their products, damaging U.S. economic interests in other markets as well.[18] Third, this new economic reality will mean that U.S. businesses are competitively disadvantaged in their dealings in the hyper-competitive Chinese market. This will reduce the profits they have to re-invest in cutting edge research and development (R&D). Because the Pentagon now relies primarily on commercial technology to equip America's military,[19] a reduction in private sector R&D for high-technology will only serve to jeopardize U.S. military superiority,[20] a result fundamentally contrary to the stated goal of the rule itself.[21]

I. U.S. DUAL-USE EXPORT CONTROLS

A. A BRIEF HISTORY OF U.S. DUAL-USE EXPORT CONTROLS[22]

The United States emerged from the wreckage of World War II as the undisputed leading economic power in the world, even though, paradoxically, international trade was an insignificant component of America's economic prowess.[23] Despite playing the preeminent role in international trade and global financial markets, the domestic market was the United States' primary concern after the war.[24] Faced with the onset of the Cold War and the division of nations into ideological blocs,[25] the key objective at the core of U.S. export controls—and those of its allies[26]—was

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16. *Id.*

17. Reexport is "an actual shipment or transmission of items subject to the [Export Administration Regulations] from one foreign country to another foreign country." 15 C.F.R. § 772.1 (2007).

18. THE COALITION FOR SECURITY AND COMPETITIVENESS, RECOMMENDATIONS FOR MODERNIZING EXPORT CONTROLS ON DUAL-USE ITEMS 7 (Mar. 6, 2007), *available at* http://www.securityandcompetitiveness.org/files/dual-use_recommendations.pdf.

19. Michael Hirsh, *The Great Technology Giveaway?; Trading with Potential Foes*, FOREIGN AFFAIRS 2 (1998).

20. Robert L. Paarlberg, *Knowledge as Power: Science, Military Dominance, and U.S. Security*, INTERNATIONAL SECURITY 122, 129–30 (Summer 2004).

21. "In general, however, this rule proposes certain revisions and clarifications to licensing requirements and policies with regard to the PRC and more precisely reflect U.S. foreign policy and national security interests." Final Rule, *supra* note 8, at 33646.

22. For a much more expansive and detailed look at the history of U.S. export controls, see WILLIAM J. LONG, U.S. EXPORT CONTROL POLICY 13-68 (1989); *Dual-Use Export Controls in Historical Perspective*, *in* RICHARD T. CUPITT, RELUCTANT CHAMPIONS: U.S. PRESIDENTIAL POLICY AND STRATEGIC EXPORT CONTROLS 31–50 (2000).

23. U.S. EXPORT CONTROL POLICY, *supra* note 22, at 14.

24. *Id.*

25. *E.g.*, the North Atlantic Treaty Organization (NATO) and the Warsaw Pact.

26. At this time, America's allies were in the process of rebuilding after the war and "were little concerned about export policy." However, the United States was able to secure "allied

to restrict the ability of the Soviet Union and its satellites to acquire key items that would aid their military development,[27] as well as to "inflict [upon them] the greatest economic injury" possible.[28] The establishment of the Coordinating Committee for the Control of Multinational Trade (CoCom)[29] in 1949 embodied this strategy,[30] seeking to prevent the West from fulfilling Lenin's prediction that "the capitalists will sell [the communists] the rope with which we will hang them."[31]

CoCom, an informal agreement among like-minded states,[32] sought to control three categories of goods: conventional arms, nuclear-related items, and dual-use items.[33] Of the three, the dual-use restrictions were the most controversial as they inevitably restricted normal commerce, limiting the trade of goods and technologies that had both civilian and military applications.[34] This impact primarily fell on U.S. exporters for a number of reasons.[35] First, even though all CoCom members pledged to restrict controlled dual-use technology, "the United States was the most zealous export controls enforcer."[36] Second, U.S. businesses had a virtual monopoly in dual-use technologies for much of the Cold War.[37] Thus, due to CoCom restrictions, large and potentially lucrative markets overseas were simply

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cooperation through the enormous economic leverage the U.S. trade and aid policies exerted in the years immediately following the Second World War . . . ." LONG, *supra* note 22, at 17–18.

27. Christopher F. Corr, *The Wall Still Stands: Complying with Export Controls on Technology Transfers in the Post-Cold War, Post-9/11 Era*, 25 HOUS. J. INT'L L. 441, 450 (2003); DOUGLAS E. MCDANIEL, UNITED STATES TECHNOLOGY EXPORT CONTROL 97 (1993).

28. LONG, *supra* note 22, at 15.

29. For an in-depth study of CoCom, see MICHAEL MASTANDUNO, ECONOMIC CONTAINMENT: COCOM AND THE POLITICS OF EAST-WEST TRADE (Cornell Univ. Press 1992) (noting that "export control policies and their coordination in CoCom have been an integral part of the postwar international system [and that] to understand them is to understand more fully the dynamics of that system.").

30. LONG, *supra* note 22, at 17.

31. Corr, *supra* note 27, at 449–50.

32. THE HENRY L. STIMSON CENTER, STUDY GROUP ON ENHANCING MULTILATERAL EXPORT CONTROLS FOR US NATIONAL SECURITY, FINAL REPORT 16 (Apr. 2001).

33. Corr, *supra* note 27, at 451.

34. *Id*. at 451–52.

35. One expert has characterized export controls as a structural cost "paid primarily by the United States to maintain a liberal international economic order during a time of severe U.S.-Soviet rivalry." *See* LONG, *supra* note 22, at 14. *See also*, MASTANDUNO, *supra* note 29, at 28 (noting that "the history of U.S. export control policy has been one of subordination of business interests to the pursuit of national security and foreign policy goals by the state. American firms have been consistently frustrated by the Byzantine nature of the U.S. control system, their variable access to it, and their inability to influence decisively the substance of policy.").

36. Corr, *supra* note 27, at 452; William J. Long, *Global Security, Democratization, and Economic Development after the Cold War: New Goals for U.S. Export Control Policies*, *in* GARY BERTSCH, ET AL., INTERNATIONAL COOPERATION ON NONPROLIFERATION EXPORT CONTROLS 67–68 (1994) [hereinafter Long, *Global Security*]. *See also* MASTANDUNO, *supra* note 29, at 13, 18 (arguing that during 1949–58 and 1980–84, the United States, through the use of CoCom controls, sought to engage in "economic warfare" against the communist bloc).

37. Corr, *supra* note 27, at 452.

off-limits to U.S. exporters.[38] This de facto monopoly on dual-use technologies actually had the somewhat surprising effect of ameliorating potential American business displeasure at these broad controls, as "it was quite unlikely that another country, particularly a non-CoCom country, was in a position to supply the technology" to these closed markets.[39] This potential discontent was further placated by the seemingly endless Pentagon budget, which showered U.S. companies with lucrative contracts for the domestic military market.[40] Additionally, in line with widespread public anti-communism, many business groups actively voiced their opposition to trade liberalization with the Soviet Union and its satellites.[41]

This honeymoon was not to last, however, as by the mid- to late-1970s foreign companies had begun to close the technological gap, prompting U.S. companies to face greater competition.[42] As business leaders and the export community pushed for liberalized export controls, especially in light of uneven enforcement among CoCom members,[43] the U.S. government took the opposite approach and pressured CoCom to become even more restrictive, so that by the end of the 1980s, "the United States presided over an increasingly restive CoCom alliance."[44]

With the end of the Cold War and the dissolution of the Soviet Union, the rationale underlying CoCom was no more and CoCom was disbanded in 1994.[45] It was replaced in 1996 with the establishment of the Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies (Wassenaar Arrangement),[46] a voluntary, loose association of thirty-three like-minded countries.[47] The Wassenaar

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38. *Id*.

39. Corr, *supra* note 27, at 452.

40. Jeff Gerth & Eric Schmitt, *The Technology Trade: A Special Report; Chinese Said to Reap Gains In U.S. Export Policy Shift*, N.Y. TIMES, Oct. 19, 1998, at A1.

41. LONG, *supra* note 22, at 13–24; CUPITT, *supra* note 22, at 82; MASTANDUNO, *supra* note 29, at 28.

42. Corr, *supra* note 27, at 452; MCDANIEL, *supra* note 27, at 97; Long, *Global Security*, *supra* note 36, at 65.

43. U.S. allies in CoCom long favored more narrowly tailored strategic control on East-West trade, given their "relatively greater economic interest in East-West trade and their preference for a less confrontational political relationship with the Soviets." MASTANDUNO, *supra* note 29, at 13.

44. Corr, *supra* note 27, at 452–4 (highlighting the key role played by the "Toshiba-Kongsberg incident," where two Japanese and Norwegian companies transferred advanced milling machines and related technology to the Soviet Union in violation of CoCom).

45. *Id*. at 455; *see also* Michael Lipson, *The Reincarnation of COCOM: Explaining Post-Cold War Export Controls*, THE NONPROLIFERATION REVIEW 34 (Winter 1999) (arguing that the decision to disband CoCom "was driven by increased sensitivity to national economic competitiveness in a globalizing economy, concerns that controls were inhibiting market reforms in former communist states, and a sense that CoCom was overly dominated by the United States.").

46. For a detailed history on the transition between CoCom and the Wassenaar Arrangement, see Lipson, *supra* note 45, at 33.

47. Corr, *supra* note 27, at 455 n.35.

Arrangement's primary goal is to "promot[e] transparency and greater responsibility in transfers of conventional arms and dual-use goods and technologies."[48] The Wassenaar Arrangement essentially requires members to notify each other of transfers of listed exports after the transfer has taken place and when licenses for similar transfers are denied.[49] Under the Wassenaar Arrangement, unlike with CoCom, members no longer have veto power over another member's exports, there is no requirement for pre-shipment notification of exports and members are left to implement the Wassenaar controls solely at their own discretion.[50] This has prompted one security specialist to describe the Wassenaar Arrangement as a "'chat society' with no teeth,"[51] while others have noted that it "is proving to be mostly a paper tiger."[52] Indeed, one former U.S. defense official has said that the United States destroyed CoCom "in a reckless way, before there was a replacement regime" and that the Wassenaar Arrangement "doesn't control anything" and is "basically a reporting society."[53] These lax requirements apparently have done little to boost compliance, as a 2002 U.S. government study found that many members were delinquent in their reporting requirements.[54]

The dissolution of CoCom and its replacement with a weaker regime reflected the policies of the Clinton administration and many of its key officials, most notably William Perry, a Silicon Valley executive who was tabbed to be the deputy defense secretary.[55] At his 1993 Senate confirmation hearing, Perry stated that controlling dual-use exports was a "hopeless task."[56] He further stated that dual-use controls "only interfere[] with our companies' ability to succeed internationally."[57] Perry concluded that efforts to control dual-use technologies in the post-Cold War era would be futile, and that export promotion was the way to bolster America's industries in the increasingly globalized economy.[58]

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48. *See* The Wassenaar Arrangement, *Guidelines and Procedures, Including the Initial Elements*, July 2004, *available at* http://www.wassenaar.org/2003Plenary/initial_elements 2003.htm.

49. Corr, *supra* note 27, at 455.

50. *Id*.

51. Richard Read, *U.S. Trade, Security Interests Clash Over Tech Exports to China*, THE OREGONIAN, Feb. 3, 2003, at A07 (quoting James Mulvenon).

52. Hirsh, *supra* note 19, at 2.

53. Peter H. Stone, *High-Tech's High Anxiety*, NATIONAL JOURNAL, Vol. 30, No. 50, Dec. 12, 1998, at 2926 (quoting Peter Leitner).

54. U.S. GENERAL ACCOUNTING OFFICE, NONPROLIFERATION: STRATEGY NEEDED TO STRENGTHEN MULTILATERAL EXPORT CONTROL REGIMES, GAO-03-43, 10, 13–4 (2002).

55. Stone, *supra* note 53.

56. *Id*.

57. Gerth & Schmitt, *supra* note 40.

58. Hirsh, *supra* note 19.

With some exceptions, the Clinton years were generally marked by the systematic easing of dual-use export controls.[59] However, the terrorist attacks of September 11, 2001 "changed the focus of the Bush Administration and Congress from liberalization and streamlining to tightening controls and increasing scrutiny of export transactions and technology transfer."[60] This shift can be seen most superficially in the name change of the Commerce Department bureau in charge of dual-use export controls from the Bureau of Export Administration to the Bureau of Industry and Security.[61] It can be seen more substantively from the recent comments of Bush administration officials that economic policies and national security policy are becoming "increasingly intertwined"[62] and that "[e]xport controls do not exist in a policy vacuum, isolated from broader issues of national or international concern [but] . . . are guided by and reflect larger U.S. foreign policy and national security imperatives."[63]

B. U.S. DUAL-USE EXPORT CONTROLS ON CHINA

In line with this shift in focus, it is now "a clear and unwavering principle" that U.S. export controls must be subservient to broader U.S. strategic aims, "reflect[ing] and support[ing] America's larger foreign policy toward China."[64] That such a security-dominant mantra was advanced by the assistant secretary of Commerce for export administration—ostensibly a position concerned with the promotion of expanded trade—aptly demonstrates how the agency primarily responsible for U.S. export control administration views its primary purpose with regard to China.[65] However, there must be a balance between security and trade, especially with regard to China and its much-ballyhooed market of

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59. Gerth & Schmitt, *supra* note 40; Stone, *supra* note 53; Thomas Friedman, *U.S. Ending Curbs on High-Tech Gear to Cold War Foes*, N.Y. TIMES, Mar. 31, 1994, at A1.

60. Corr, *supra* note 27, at 459.

61. *Id*.

62. Assistant Secretary of Commerce for Export Administration Christopher A. Padilla, *The Future of Export Controls*, STATES NEWS SERVICE, May 15, 2007, *available at* http://www.bis.doc.gov/news/2007/padilla05152007.htm [hereinafter Padilla 5/15/07].

63. Padilla 1/29/07, *supra* note 5.

64. *Id.*; *see also* Mario Mancuso, Technology Leadership, Economic Power, and U.S. National Security: U.S. Dual-Use Trade with China, Keynote Address to the Heritage Foundation, Feb. 20, 2008, *available at* http://www.bis.doc.gov/news/2008/mancusoheritage02202008.htm (stating that U.S. "export controls do not, in a strict sense, 'balance' trade and security . . . . As a national security bureau within an economic agency, our most solemn obligation is to protect the security of the nation. And there is nothing of comparable (or near comparable) worth against which we 'trade-off' U.S. security.").

65. It could very well be argued that this security-dominated view is not confined only to China. *See* Corr, *supra* note 27, at 461 (noting that after September 11, 2001, "BIS shifted its posture somewhat, emphasizing security and tougher export controls. It has been more reluctant to promote the interests of U.S. exporters when faced with opposition from the traditionally tougher agencies such as the Defense and State Departments.").

1.3 billion people.[66] Consequently, "export controls must also take into account our complex relationships with emerging powers and economies. Nowhere is this more evident than in the case of China."[67]

On the one hand, Bush administration officials talk of promoting "China's peaceful economic development"[68] and encouraging Beijing's role as a "responsible stakeholder"[69] in the international system. Export controls, they argue, support this policy by "facilitat[ing] hundreds of millions of dollars of civilian high-technology trade annually,"[70] thus expanding trade and increasing economic interdependence between China, the United States and the global marketplace.[71]

On the other hand, China's continued military modernization, characterized by its rising military budget, is making Washington nervous.[72] The Department of Defense estimates that China's military spending has increased by double-digit percentages each of the past fifteen years, with China's officially announced 2008 military budget rising to approximately $58.8 billion.[73] However, both the U.S. government[74] and non-government

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66. The notion of a single market of 1.3 billion people is actually rather illusory. The reality of China's domestic market is that no such unity exists so as to tie together the divergent tastes, needs and proclivities of China's population. Often, markets exist solely within cities or certain economic zones. *See* Getting Past the Hype of China's 1.3 Billion Customers, China Law Blog, Aug. 15, 2007, *available at* http://www.chinalawblog.com/2007/08/chinas_13_billion_customers_an.html.

67. Padilla 5/15/07, *supra* note 62.

68. Padilla 1/29/07, *supra* note 5; China itself used to refer to its own "peaceful rise" but the implications contained therein made many of its neighbors nervous. It has since begun referring to its "peaceful development." *See* Evan S. Medeiros, *China Debates its 'Peaceful Rise' Strategy*, YALEGLOBAL ONLINE, June 22, 2004, *available at* http://yaleglobal.yale.edu/display.article?id=4118; *China Committed to Peaceful Development*, CHINA DAILY, Apr. 30, 2006, *available at* http://www.chinadaily.com.cn/china/2006-04/30/content_581391.htm.

69. Robert B. Zoellick, Whither China: From Membership to Responsibility? Remarks to the National Committee on United States-China Relations, Sept. 21, 2005, *available at* http://www.ncuscr.org/files/2005Gala_RobertZoellick_Whither_China1.pdf ("[I]t is time to take our policy beyond opening doors to China's membership into the international system: We need to urge China to become a responsible stakeholder in that system.").

70. Padilla 1/29/07, *supra* note 5.

71. Under Secretary of Commerce for Industry and Security Mario Mancuso, *Enhancing Secure Trade with China*, Remarks to the U.S.-China Business Council, June 18, 2007, *available at* http://www.bis.doc.gov/news/2007/mancuso06182007.htm.

72. David Lague, *China Plans Steep Increase in Military Spending*, N.Y. TIMES, Mar. 5, 2008, *available at* http://www.nytimes.com/2008/03/05/world/asia/05china.html?n=Top/News/World/Countries%20and%20Territories/China.

73. Assistant Secretary of Defense for International Security Affairs Peter W. Rodman, *The Military Power of the People's Republic of China*, Testimony before the House Armed Services Committee, June 22, 2006, *available at* http://www.globalsecurity.org/military//library/congress/2006_hr/060622-rodman.pdf; Lague, *supra* note 72 (reporting that China's 2008 military budget is to increase by 17.6 percent to approximately $58.8 billion).

74. *See, e.g.*, OFFICE OF THE SECRETARY OF DEFENSE, ANNUAL REPORT TO CONGRESS ON THE MILITARY POWER OF THE PEOPLE'S REPUBLIC OF CHINA 25 (2007), *available at* http://www.defenselink.mil/pubs/pdfs/070523-China-Military-Power-final.pdf (noting that China's official budget leaves out many large expenditures, and therefore China's total military

experts[75] estimate actual military expenditures to be two to three times the official Chinese government budget.[76] Still, even using the high-end of these credible estimates, the Chinese defense budget pales in comparison to what the Pentagon spends annually.[77] Additionally, while China has certainly become more transparent regarding its military buildup,[78] much uncertainty remains.[79] Indeed, even if the United States or the international community knew more about China's command and control structure, its nuclear posture or its submarine capabilities, such knowledge would provide no insight into Chinese motivations or intentions. The fundamental question is not whether China is going to become a world power, but what will China do once it has that power.[80]

In response to this and other uncertainties, the Bush administration's foreign policy towards China has been to "prudently hedge against . . . [China's] rapid military buildup."[81] The term "hedging" in this context is manifested by "pursuing policies that, on one hand, stress engagement and integration mechanisms and, on the other, emphasize realist-style balancing in the form of external security cooperation with Asian states and national military modernization programs."[82] This "delicate balancing act" allows one state "to maintain its extensive and mutually beneficial economic ties

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budget for 2007 is between $85 billion and $125 billion, 1.9 and 2.8 times, respectively, the officially announced figure of $45 billion) [hereinafter CHINA MILITARY POWER REPORT].

75. *See*, *e.g.*, Keith Crane, et al., MODERNIZING CHINA'S MILITARY: OPPORTUNITIES AND CONSTRAINTS 243 (2005), *available at* http://www.rand.org/pubs/monographs/2005/RAND_MG260-1.pdf (estimating that China's military expenditures for 2003 should be 1.4 to 1.7 times the officially announced number).

76. Lague, *supra* note 72.

77. The Pentagon's budget for Fiscal Year 2007 was $439.3 billion. *See* Office of Management and Budget, Department of Defense, *available at* http://www.whitehouse.gov/omb/budget/fy2007/defense.html. The Pentagon's budget for Fiscal Year 2009 is $515.4 billion, a 7.5% increase over the previous year's budget. U.S. Department of Defense, *News Release: Fiscal 2009 Department of Defense Budget Released*, Feb. 4, 2008, *available at* http://www.defenselink.mil/comptroller/defbudget/fy2009/2009_Budget_Rollout_Release.pdf.

78. China recently committed to provide previously undisclosed military figures to the United Nations in an effort to assuage international concerns regarding the transparency of its military modernization effort. *See China promises more military transparency*, SPACE WAR, Sept. 2, 2007, *available at* http://www.spacewar.com/reports/China_promises_more_military_transparency_999.html.

79. Padilla 1/29/07, *supra* note 5.

80. Variations of this question are posed in Evan S. Medeiros, *Strategic Hedging and the Future of Asia-Pacific Stability*, 29 WASHINGTON QUARTERLY 145, 147 (Winter 2005–06) (raising the following questions: "even if China is currently a rising power with limited aims, will it evolve into a revolutionary power with revisionist goals that challenges the regional or even the global order? Will China's diplomatic and military propensities change over time as it accumulates material power and status?").

81. Padilla 5/15/07, *supra* note 62. The term "hedging" vis-à-vis China is also used in other official U.S. government publications. For example, see OFFICE OF THE SECRETARY OF DEFENSE, QUADRENNIAL DEFENSE REVIEW REPORT 30–31 (2006), *available at* http://www.defenselink.mil/qdr/report/Report20060203.pdf.

82. Medeiros, *supra* note 80, at 146.

with" the other state and its neighbors "while addressing uncertainty and growing security concerns about the other."[83]

As a key component of this strategy, it is stated U.S. policy to use export controls to deny the export, reexport or transfer of any items "that would make a direct and significant contribution to China's military."[84] Keeping in mind the potential economic cost, Assistant Secretary of Commerce Padilla has noted that U.S. "export controls must reflect the duality inherent in this policy and must distinguish between different kinds of customers within a large and diverse economy."[85] Indeed, China, like almost any other trading partner, "contain[s] an assorted and varying mix of attractive trade opportunities and security risks."[86]

Being able to differentiate between legitimate civilian end-users and those posing as fronts for the military has become an increasingly important task for Washington, given that no other country in the world makes "more organized efforts to obtain and illegally export controlled U.S. technology" than China.[87] Such efforts are highlighted by a number of export control cases brought in the United States in recent years for attempts to export controlled technology to China.[88] These cases underpin the rationale behind

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83. *Id*. at 146.

84. Padilla 1/29/07, *supra* note 5.

85. Padilla 5/15/07, *supra* note 62.

86. Mancuso, *supra* note 71. Indeed, one commentator has called China the "poster child for the double-edged nature of the globalization of technology." Adam Segal, *New China worries*, INTERNATIONAL ECONOMY, Sept. 22, 2007.

87. Padilla 1/29/07, *supra* note 5.

88. For example, seven people were arrested in New Jersey in July 2004 for the illegal export of components for electronic warfare systems, smart weapons, radar systems, and communication equipment to China in violation of the federal *Arms Export Control Act*. Noting that past shipments were believed to have ended up with the Chinese military or institutions affiliated with the military, authorities said that the arrests were the latest in a crackdown on what they believed to be "a covert network in the United States that purchases sensitive weapons technology." *Seven Arrested for Illegal Transfers of Weapons to China*, ASIAN EXPORT CONTROL OBSERVER 7, Aug./Sept. 2004, *available at* http://cns.miis.edu/pubs/observer/asian/pdfs/aeco_0408.pdf; *see also Four New Jersey Residents Sentenced for Illegal Exports to China*, INTERNATIONAL EXPORT CONTROL OBSERVER 9, May 2006, *available at* http://cns.miis.edu/pubs/observer/pdfs/ieco_0605e.pdf. Four months later, the California-based Interaero Inc. was fined $500,000 and placed on five-year probation for illegally exporting six shipments of missile and jet fighter equipment worth $40,000 to a Chinese entity. *See U.S. and German Companies Accused of Illegally Exporting Military Parts to China*, ASIAN EXPORT CONTROL OBSERVER 16, Dec. 2004/Jan. 2005, *available at* http://cns.miis.edu/pubs/observer/asian/pdfs/aeco_0412.pdf. In February 2005, BIS placed a Temporary Denial Order on the Wisconsin-based Wen Enterprises, its president Ning Wen, and his wife Hailin Lin for "conspiring to sell electronic components controlled under U.S. Export Administration Regulations (EAR) to [a Chinese entity] without the proper licenses over thirty times from June 2002 through September 2004." *Temporary Denial Order Issued for Unauthorized Transfers of Electronic Components*, ASIAN EXPORT CONTROL OBSERVER 9–10, Feb./Mar. 2005, *available at* http://cns.miis.edu/pubs/observer/asian/pdfs/aeco_0502.pdf. Ning Wen was found guilty by a jury and sentenced to 5 years in jail. His conviction was upheld by the U.S. Court of Appeals for the Seventh Circuit. *U.S. v. Ning Wen*, 477 F.3d 896 (7th Cir. 2006). In February 2006, Ko-Suen Moo, a Tawainese national, was charged in U.S. federal court with being a Chinese covert agent and attempting to acquire and

U.S. Immigration and Customs Enforcement[89] deeming "China's aggressive and wide-ranging espionage as the leading threat to U.S. technology."[90] It would appear, however, that the effort to acquire sensitive dual-use items is not confined to the United States.[91]

These attempts to procure U.S. high-technology dual-use items come as little surprise given that China's continued military modernization is increasingly reliant on commercial technologies.[92] This reality might be more directly related to cost-efficiency rationales than weaknesses in China's military industries, though that remains an unsettled point.[93] The Department of Defense's annual report on China's military power states

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export military components and weapons to China. *Taiwan National Charged with Plotting Illegal Export of Engines, Missiles to China*, INTERNATIONAL EXPORT CONTROL OBSERVER 10–11, Mar. 2006, *available at* http://cns.miis.edu/pubs/observer/pdfs/ieco_0603e.pdf. On May 17, 2006, Moo pled guilty in the Southern District of Florida to export violations, as well as bribery and conspiracy violations and acting as an agent of a foreign government. *See* U.S. Immigration and Customs Enforcement Factsheet, *Select Arms & Strategic Technology Investigations (ASTI)*, Nov. 2006, *available at* http://www.fas.org/asmp/iceasti.htm [hereinafter ICE Factsheet].

89. A Department of Defense report states that since 2000, U.S. Immigration and Customs Enforcement officials have "initiated more than 400 investigations involving the illicit export of U.S. arms and technologies." *See* CHINA MILITARY POWER REPORT, *supra* note 74, at 29. For a partial list of recent ICE investigations relating to arms and strategic technology investigations, see ICE Factsheet, *supra* note 88.

90. CHINA MILITARY POWER REPORT, *supra* note 74, at 29.

91. *E.g.*, *Head of Russian Space Company Arrested for Allegedly Transferring Dual-Use Technologies to Chinese Entity*, INTERNATIONAL EXPORT CONTROL OBSERVER 22–24, Dec. 2005/Jan. 2006, *available at* http://cns.miis.edu/pubs/observer/pdfs/ieco_0512e.pdf; *Illegal Export of Unmanned Helicopters to China Reveals Gaps in Export Control Awareness in Japan*, INTERNATIONAL EXPORT CONTROL OBSERVER 4–5, Feb. 2006, http://cns.miis.edu/pubs/observer/pdfs/ieco_0602e.pdf; *Sensitive Machine Tool Exports from Taiwan to China*, INTERNATIONAL EXPORT CONTROL OBSERVER 6–7, May 2006, *available at* http://cns.miis.edu/pubs/observer/pdfs/ieco_0605e.pdf; *Yamaha Motor Receives Fine for Attempted Unlicensed UAV Transfer to China*, INTERNATIONAL EXPORT CONTROL OBSERVER 7–8, Mar./Apr. 2007, *available at* http://cns.miis.edu/pubs/observer/pdfs/ieco_10e.pdf.

92. Padilla 1/29/07, *supra* note 5; *see also* Adam Segal, *The Civilian High-Technology Economy: Where is it heading?* Testimony before the U.S.-China Economic and Security Review Commission, Mar. 16, 2006, *available at* http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_03_16_17wrts/06_03_16_17_segal_greenberg.php; Deputy Under Secretary of Defense for Technology Security Policy and National Disclosure Policy Beth M. McCormick, Testimony before the U.S.-China Economic and Security Review Commission, Mar. 17, 2006, p. 2, *available at* http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_03_16_17wrts/06_03_16_17_mccormick.php.

93. Roger Cliff, Testimony before the U.S.-China Economic and Security Review Commission, Mar. 16, 2006, p. 5, *available at* http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_03_16_17wrts/06_03_16_17_cliff.php (noting that to the extent that certain designs and technologies are available from foreign sources, "it probably has not made sense for China to attempt to develop completely new types of weapons" due to cost-efficiency). However, Richard Bitzinger has argued that from this same trend, "one may infer that the Chinese military remains dissatisfied with the quality and capabilities of weapon systems coming out of domestic arms factories" or that these factories cannot produce the requested weapons in sufficient amounts. *See* Richard A. Bitzinger, *Modernizing China's Defense Industries: How Effective Have Been Recent Reforms?* Testimony before the U.S.-China Economic and Security Review Commission, Mar. 16, 2006, *available at* http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_03_16_17wrts/06_03_16_17_bitzinger.php.

that "[m]any dual-use technologies, such as software, integrated circuits, computers, electronics, semiconductors, telecommunications, and information security systems, are vital for the [Chinese People's Liberation Army's] transformation into an information-based, network-centric force."[94] Given that China lacks the capability to indigenously produce many of these and other key dual-use technologies, Beijing has had "to obtain from abroad through legal and illegal commercial transactions"[95] items for use in such high-value systems as submarines,[96] missiles,[97] and, potentially, an aircraft carrier.[98] U.S. officials expect these efforts to continue.[99]

II. THE CHINA MILITARY CATCH ALL RULE

It is in this context that BIS announced the final China Military Catch All Rule on June 19, 2007.[100] This rule amended the Export Administration Regulations (EAR),[101] the export control provisions of which "are intended to serve the national security, foreign policy, nonproliferation, and short supply interests of the United States . . . [by] restrict[ing] access to dual use items by countries or persons that might apply such items to uses inimical to U.S. interests."[102] The EAR is the implementation mechanism of the Export Administration Act of 1979,[103] under which Congress granted the

94. CHINA MILITARY POWER REPORT, *supra* note 74, at 29.

95. *Id*.

96. QUADRENNIAL DEFENSE REVIEW REPORT, *supra* note 81, at 29–30; CHINA MILITARY POWER REPORT, *supra* note 74, at 29; Bitzinger, *supra* note 93 (noting that China's dependence on foreign technology is "especially acute" concerning jet engines, marine diesel engines, avionics, and submarines); Bernard D. Cole, Testimony before the U.S.-China Economic and Security Review Commission, Mar. 16, 2006, *available at* http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_03_16_17wrts/06_03_16_17_cole.php (stating that the "most effective military capabilities being acquired by China . . . is its already capable and growing submarine force").

97. QUADRENNIAL DEFENSE REVIEW REPORT, *supra* note 81, at 29–30; CHINA MILITARY POWER REPORT, *supra* note 74, at 29.

98. *See* Andrew F. Diamond, *Dying with Eyes Open or Closed: The Debate over a Chinese Aircraft Carrier*, KOREAN JOURNAL OF DEFENSE ANALYSIS, Vol. XVIII, No. 1, Spring 2006, *available at* http://cns.miis.edu/other/diamond060426.pdf.

99. McCormick, *supra* note 92, at 1–2 (noting that the United States "expect[s] China to continue making a concerted effort to acquire asymmetric and 'leap ahead' technologies from the U.S. through legal and illegal means.").

100. Final Rule, *supra* note 8, at 33646.

101. 15 C.F.R. § 730-774 (2007).

102. 15 C.F.R. § 730.6.

103. The Export Administration Act of 1979 actually expired in 1989. Since then, due to an inability to forge consensus on a new version of the Act, the president has been forced to issue a series of executive orders under the International Emergency Economic Powers Act (IEEPA) to maintain the U.S. export control system. See, Ian F. Ferguson, et al., *Export Administration Act of 1979 Reauthorization*, CRS REPORT FOR CONGRESS 3–4 (Mar. 11, 2002); *Bush Extends Emergency Export Control Act*, ASIAN EXPORT CONTROL OBSERVER 19, Oct./Nov. 2004, available at http://cns.miis.edu/pubs/observer/asian/pdfs/aeco_0410.pdf.

executive branch the authority to regulate foreign commerce.[104] Section 5 of the Act maintains the executive's authority to develop lists of controlled items for export and proscribed countries.[105] The President's designee—the Commerce Department—has the responsibility of composing the dual-use control list, known as the Commerce Control List (CCL), as well as identifying those proscribed countries.[106] Items included on the CCL, which itself is within the EAR, are "subject to the export licensing authority of BIS."[107]

In amending the EAR, the final China Military Catch All Rule does four things. First, it places new restrictions on the export, reexport, or transfer[108] of approximately twenty products and associated technologies[109] that have both civilian and military applications when the exporter has "knowledge" or "is informed" that the items are destined for "military end-use" in China.[110] Second, the final rule establishes a presumption of denial for export license applications that would make "a direct and significant contribution" to China's military capabilities,[111] or for items going to China that are controlled for reasons of chemical and biological weapons proliferation,[112] nuclear nonproliferation,[113] and missile technology.[114] Third, the final rule creates a "Validated End-User" program, which allows specified items to be exported without a license to certain pre-approved Chinese entities.[115] Finally, the rule raises the total dollar threshold to $50,000 or greater for transactions requiring an End-User Statement as issued by China's Ministry of Commerce.[116] To properly understand what obligations the final China Military Catch All Rule places upon U.S. exporters, it is first necessary to examine these provisions in closer detail.

A. NEW LICENSING REQUIREMENTS

The China Military Catch All Rule amended section 744.21 of the EAR to state that an exporter may not export, reexport, or transfer any of the approximately twenty specified products or associated technologies without a license if, at the time of the transaction, the exporter either has

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104. Ferguson et al., *supra* note 103, at 2.
105. Long, *Global Security*, *supra* note 36, at 59.
106. *Id*.
107. 15 C.F.R. § 738.1(a) (2007).
108. Transfer is "[a] transfer to any person of items subject to the EAR either within the United States or outside of the United States with the knowledge or intent that the items will be shipped, transferred, or transmitted to an unauthorized recipient." 15 C.F.R. § 772.1 (2007).
109. Supplement No. 2 to § 744 (2007).
110. 15 C.F.R. § 744.21; Final Rule, *supra* note 8, at 33647.
111. 15 C.F.R. § 742.4(b)(7) (2007).
112. 15 C.F.R. § 742.2(b)(4).
113. 15 C.F.R. § 742.2(b)(4).
114. 15 C.F.R. § 742.2(b)(4).
115. 15 C.F.R. § 748.15 (2007).
116. 15 C.F.R. § 748.10.

"knowledge" or has "been informed" by BIS that the item is intended for a "military end-use" in China.[117] "Knowledge" is defined by the EAR as including:

> not only positive knowledge that the circumstance exists or is substantially certain to occur, but also an awareness of a high probability of its existence or future occurrence. Such awareness is inferred from evidence of the conscious disregard of facts known to a person and is also inferred from a person's willful avoidance of facts.[118]

An exporter may also posses knowledge if it has "been informed" "either individually by specific notice" or through the publishing of an amendment or a separate notice in the *Federal Register* that informs the exporter "that a license is required for specific exports, reexports, or transfers of any item because there is an unacceptable risk of use in or diversion to 'military end-use' activities in the PRC."[119] Such specific notice is to be given at the direction of the Deputy Assistant Secretary for Export Administration.[120]

Supplement 2 to section 744, entitled "Restrictions on Certain Military End-Uses in the People's Republic of China (PRC)," contains the list of items that are subject to the military end-use license requirement as defined in section 744.21.[121] The list controls items in nine of the ten categories contained in the CCL. No items on the list fall into "Category 0 - Nuclear Materials, Facilities and Equipment and Miscellaneous," the lone unaffected category.[122] Included in the list of items subject to the final rule are: depleted uranium,[123] certain oscilloscopes,[124] high performance computers,[125] telecommunications equipment operating outside normal

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117. 15 C.F.R. § 744.21(a) (2007).
118. 15 C.F.R. § 772.1 (2007).
119. 15 C.F.R. § 744.21(b).
120. 15 C.F.R. § 744.21(b).
121. Supplement No. 2 to 15 C.F.R. § 744 (2007).
122. The other nine CCL categories are: 1-Materials, Chemicals, Microorganisms, and Toxins; 2-Materials Processing; 3-Electronics; 4-Computers; 5-Telecommunications and Information Security; 6-Lasers and Sensors; 7-Navigation and Avionics; 8-Marine; and 9-Propulsion Systems, Space Vehicles and Related Equipment. 15 C.F.R. § 738.2(a) (2007).
123. Defined as any uranium containing less than 0.711% of the isotope U-235. *See* Supplement No. 2 to 15 C.F.R. § 744.
124. "Limited to digital oscilloscopes and transient recorders, using analog-to-digital conversion techniques, capable of storing transients by sequentially sampling single-shot inputs at great than 2.5 giga-samples per second," and related technology. *See* Supplement No. 2 to 15 C.F.R. § 744.
125. "Limited to computers . . . with an Adjusted Peak Performance ('APP') exceeding 0.5 TeraFLOPS (WT)," and software "specially designed or modified for the 'development', 'production', or 'use' of equipment controlled by 4A101." *See* Supplement No. 2 to 15 C.F.R. § 744.

temperatures,[126] phased array antennae,[127] certain airborne communications and inertial navigation systems,[128] and aero gas turbine engines.[129]

Initially, in the proposed rule published in July 2006, forty-seven items were to be subject to the military end-use control.[130] However, responding to concerns raised in public comments, BIS "conducted a structured military and economic impact review" which used three criteria, "no one of which being solely determinative," to determine which items were to remain on the list: "(1) the military applicability of each item; (2) the relative foreign availability of each item; and (3) the level of U.S. commercial exports of each item" to China.[131] Of the three, BIS accorded military applicability the greatest weight, while indigenous Chinese production of an item was given greater weight than "evidence of foreign availability from countries that cooperate with the United States in multilateral export control regimes."[132] In conducting this review, "[w]hen BIS found limited evidence of foreign availability and significant military applicability, the item remained on the list, even if it was a major commercial export."[133]

Between the proposed rule and its ultimate form, items affecting sixteen Export Control Classification Numbers (ECCNs) were removed from the list, including items containing low-level encryption.[134] The export, reexport and transfer to China of the remaining twenty items and related technologies is now subject to this new licensing requirement if the exporter knows or is informed that the item is intended for a "military end-use" in China.[135] Section 744.21(f) defines "military end-use" as meaning:

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126. "Limited to telecommunications equipment designed to operate outside the temperature range from 219K (-54 ˚C) to 397K (124 ˚C)" and related software and technology. *See* Supplement No. 2 to 15 C.F.R. § 744 (2007).

127. Specific to phased array antennae "operating above 10.5 Ghz . . ." and related software and technology. *See* Supplement No. 2 to 15 C.F.R. § 744.

128. "Other navigation direction finding equipment, airborne communication equipment, all aircraft inertial navigation systems no controlled under 7A003 or 7A103, and other avionic equipment, including parts and components, n.e.s.," and related software and technology. *See* Supplement No. 2 to 15 C.F.R. § 744.

129. "Limited to 'aircraft', n.e.s., and gas turbine engines not controlled by 9A001 or 9A101," and related software and technology. *See* Supplement No. 2 to 15 C.F.R. § 744.

130. Proposed Rule, *supra* note 1, at 383138.

131. "Q&As on the Bureau of Industry and Security's China Policy Rule," 2007, *available at* http://www.arentfox.com/publications/pdfs/export/QAs_bis_finalrule.pdf; *see also* Final Rule, *supra* note 8, at 33647–8.

132. "Q&As on the Bureau of Industry and Security's China Policy Rule," *supra* note 131; *see also* Final Rule, *supra* note 8, at 33647–8.

133. "Q&As on the Bureau of Industry and Security's China Policy Rule," *supra* note 131, at 4–5; Final Rule, *supra* note 8, at 33647.

134. Petra A. Vorwig, *New Export Control Rule for Exports to China Released by Commerce Department*, Steptoe & Johnson, LLP Publications, June 22, 2007, *available at* http://www.steptoe.com/publications-4590.html.

135. 15 C.F.R. § 744.21(e)(1) (2007).

> incorporation into a military item described on the U.S. Munitions List . . . [or] the Wassenaar Arrangement Munitions List . . . ; incorporation into items listed under ECCNs ending in 'A018' on the CCL in Supplement No. 1 to part 774 of the EAR; or for the 'use', 'development', or 'production' of military items described on the USML or the IML, or items listed under ECCNs ending in 'A018' on the CCL. 'Military end-use' also means 'deployment' of items classified under ECCN 9A991 as set forth in Supplement No. 2 to Part 744.[136]

If an item proposed for export is found to meet this definition of "military end-use," the export license applications "will be reviewed on a case-by-case basis to determine whether the export, reexport, or transfer would make a *material contribution* to China's military capabilities and would result in advancing the country's military activities contrary to the national security interests of the United States."[137] This "material contribution" standard is more rigorous than the "direct and significant contribution" standard employed in section 742.4(b)(7), which is addressed in Part II.B herein.[138] However, for now, it is important to note that BIS determined that "items subject to the 'military end-use' control were . . . more sensitive when destined for a 'military end-use' than when they are simply controlled for national security reasons" as in section 742.4.[139] Therefore, BIS determined these items should be "subject to a different licensing review standard, consistent with U.S. foreign and related export control policies for the PRC."[140]

B. PRESUMPTION OF DENIAL

The second major change to the EAR ushered in by the final China Military Catch All Rule is to make it U.S. policy to deny exports of CCL items that are controlled for national security reasons if their export would make a "direct and significant contribution" to China's military capabilities.[141] These national security licensing requirements are based on the goal of restricting the export, reexport or transfer of items "that would make a significant contribution to the military potential of any other country or combination of countries that would prove detrimental to the national security of the United States."[142] These targeted countries include, among others, Azerbaijan, Belarus, China, Iraq, Libya, North Korea, Russia,

136. 15 C.F.R. § 744.21(f) (2007). A new note to paragraph (f) also defines the terms "use," "development," "production," "operation," "maintenance," and "deployment."
137. 15 C.F.R. § 744.21(e)(1) (2007) (emphasis added).
138. Section 742.4(b)(7) reads, in pertinent part: "There is a presumption of denial for license applications to export, reexport, or transfer items that would make a direct and significant contribution to the PRC's military capabilities. . . ." 15 C.F.R. § 742.4(b)(7).
139. Final Rule, *supra* note 8, at 33648–49.
140. *Id.* at 33649.
141. 15 C.F.R. § 742.4(b)(7); Final Rule, *supra* note 8, at 33646–47.
142. 15 C.F.R. § 742.4(a) (2007).

Uzbekistan, and Vietnam.[143] Section 742.4(b)(5) notes that Kazakhstan, Mongolia, and Russia should be "accorded enhanced favorable consideration licensing treatment" in recognition of their efforts to establish export and reexport safeguard measures.[144]

China, however, receives no such consideration. It is true section 742.4(b)(7) states that there is a presumption to approve license applications to export, reexport or transfer items to China for bona fide civil end-uses.[145] However, the final rule also established a "presumption of denial" for items that would make a "direct and significant contribution" to China's military capabilities.[146] To illustrate what might be considered to constitute China's military capabilities, the final rule included as a supplement to section 742 a "Description of Major Weapons Systems"[147] whose advancement "would prove detrimental to the national security of the United States."[148] The list is not exhaustive, but it includes such items as: battle tanks; armored combat vehicles; large-caliber artillery systems; combat aircraft; attack helicopters; warships, missiles and missile launchers, including Man-Portable Air-Defense Systems and Unmanned Aerial Vehicles; offensive space weapons; command, control, communications, computer, intelligence, surveillance, and reconnaissance; precision guided munitions including "smart bombs;" and night vision equipment.[149]

In the proposed version of the rule, BIS sought to deny items controlled for national security reasons that would have made a "material contribution" to China's military capabilities, the same standard that is used for "military end-use" control described above in Part II.A.[150] Such a change in the review standard would have drastically changed U.S. policy in place since 1983, which states that BIS must either conduct "an extended review" or deny applications for the export or reexport of items that would make a "direct and significant contribution" to "a series of listed PRC military activities."[151] In the final rule, BIS decided to maintain the "direct and significant" standard, as it judged the "material contribution" standard "too broad" to be used to review national security-controlled items.[152] However, in a slightly smaller policy shift, for the final rule, BIS decided "to apply it to PRC military capabilities as a whole, rather than a limited list of military activities."[153]

143. *See* "Country Group D:1," Supplement No. 1 to 15 C.F.R. § 740 (2007).
144. 15 C.F.R. § 742.4(b)(5).
145. 15 C.F.R. § 742.4(b)(7); Final Rule, *supra* note 8, at 33646.
146. 15 C.F.R. § 742.4(b)(7).
147. "Description of Major Weapons Systems," Supplement No. 7 to 15 C.F.R. § 742 (2007).
148. 15 C.F.R. § 742.4(a) (2007).
149. "Description of Major Weapons Systems," Supplement No. 7 to 15 C.F.R. § 742.
150. Proposed Rule, *supra* note 1, at 38313; Final Rule, *supra* note 8, at 33647.
151. Final Rule, *supra* note 8, at 33647.
152. *Id.*
153. *Id.*

Finally, for the export and reexport of items to China that are controlled for reasons of chemical and biological proliferation,[154] nuclear nonproliferation,[155] and missile technology,[156] the final rule imposes the same "presumption of denial" that is employed for license applications for export of national security-controlled items.[157] This is done by stating that license applications covered by a particular section (i.e., "missile technology") "when destined to the People's Republic of China, will be reviewed in accordance with the licensing policies in both paragraph (b) of [that particular] section and §742.4(b)(7)."[158]

C. VALIDATED END-USER PROGRAM

The first two elements of the China Military Catch All Rule as described above involve tightening U.S. export licensing policy for specific items that would be exported, reexported, or transferred to China. The third and fourth elements of the final rule are more liberalizing in nature, as they comprise the "carrots" to go along with the aforementioned "sticks."

The third change brought about by the final rule is the creation of the Validated End-User (VEU), a new program that "permits the export, reexport, and transfer to validated end-users of any eligible items[159] that will be used in a specific eligible destination."[160] A validated end-user is an end-user[161] that has been approved by the End-User Review Committee pursuant to the requirements laid out in section 748.15 of the EAR.[162] The End-User Review Committee is made up of representatives of the Departments of Commerce (which also chairs the Committee), Defense, Energy, and State, as well as other appropriate agencies.[163] The Committee's unanimous vote is necessary to authorize VEU status for a potential candidate or to include additional eligible items in the pre-existing authorization.[164] However, a majority vote will suffice to remove VEU authorization from an end-user or to remove a previously eligible item from a pre-existing authorization.[165] The End-User Review Committee has thirty

154. 15 C.F.R. § 742.2 (2007).
155. 15 C.F.R. § 742.3.
156. 15 C.F.R. § 742.5.
157. 15 C.F.R. § 742.2(a)(f); Final Rule, *supra* note 8, at 33646.
158. 15 C.F.R. § 742.3(b)(4). *See also* 15 C.F.R. § 742.2(b)(4); 15 C.F.R. § 742.5(b)(4).
159. It should be noted that "[i]tems controlled under the EAR for missile technology (MT) and crime control (CC) reasons may not be exported or reexported under [VEU] authorization." 15 C.F.R. § 748.15(c) (2007).
160. 15 C.F.R. § 748.15.
161. An "end-user" is defined in the EAR as "[t]he person abroad that receives and ultimately uses the exported or reexported items. The end-user is not a forwarding agent or intermediary, but may be the purchaser or ultimate consignee." 15 C.F.R. § 772.1 (2007).
162. 15 C.F.R. § 748.15.
163. "End-User Review Committee Procedures," Supplement No. 9 to 15 C.F.R. § 748.
164. Supplement No. 9 to 15 C.F.R. § 748.
165. Supplement No. 9 to 15 C.F.R. § 748.

days to complete its review and make determinations whether to grant VEU authorization to the candidate once the candidate's complete application in the form of an advisory opinion request[166] has been "circulated to all [End-User Review Committee] agencies."[167]

This request for VEU authorization, in order to be approved by the End-User Review Committee, must contain certain information about the prospective validated end-user.[168] This information must include, among other details, the name of the proposed VEU candidate and its contact information, "an overview of the structure, ownership and business of the prospective validated end-user," a "list of the items proposed for VEU authorization approval and their intended end-uses," "the physical address(es) of the location(s) where the item(s) will be used," any plans for the reexport or transfer of the item, and a description of the record keeping system that is in place and how it will ensure compliance with VEU requirements.[169] Finally, the request must include, on the original letterhead of the prospective VEU, "an original statement . . . signed and dated by a person who has authority to legally bind the prospective [VEU]" certifying that the prospective VEU will comply with all VEU requirements, "including the requirement that items received under authorization VEU will only be used for civil end-uses," and that the candidate "agrees to allow on-site reviews by U.S. Government officials to verify the end-user's compliance with the conditions of the VEU authorization."[170]

Once the End-User Review Committee receives all necessary materials, it will then consider the prospective VEU's application, taking into account a number of factors. These factors include: the candidate's past compliance with U.S. export controls, its record of "exclusive engagement in civil end-use activities," its capability to comply with VEU requirements, the necessity of "on-site review prior to approval" and its agreement to further on-site reviews to ensure compliance, and the candidate's "relationship with U.S. and foreign companies."[171] Additionally, the Committee will consider the "status of export controls"[172] and "the support and adherence to multilateral export control regimes[173] of the government of the eligible

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166. Supplement No. 9 to 15 C.F.R. § 748 (2007).

167. Supplement No. 9 to 15 C.F.R. § 748.

168. 15 C.F.R. § 748.15(a)(1) (2007). *See also "*End-User Review Committee Procedures," Supplement No. 9 to 15 C.F.R. § 748.

169. "Information Required in Requests for Validated End-User (VEU) Authorization," Supplement No. 8 to 15 C.F.R. § 748.

170. Supplement No. 8 to 15 C.F.R. § 748.

171. 15 C.F.R. § 748.15(a)(2).

172. For information on the status of China's export controls, see EVAN S. MEDEIROS, CHASING THE DRAGON (2005) *available at* http://www.rand.org/pubs/monographs/2005/RAND_MG353.sum.pdf; JONATHAN DAVIS, EXPORT CONTROLS IN THE PEOPLE'S REPUBLIC OF CHINA, (2005) *available at* http://www.uga.edu/cits/documents/pdf/CITS%20China%20Final.pdf.

173. Of the four multilateral export control regimes, China is a member of the Nuclear Suppliers Group. *See* http://www.nsg-online.org/member.htm. It is not a member of the

destination."[174] Currently, the only two eligible destinations are China and, most recently, India.[175] Supplement 7 to section 748 provides a list of "validated end-users, respective eligible items and eligible destinations."[176] As of October 3, 2008, the list contained only five validated Chinese end-users.[177]

If approved for VEU status, an eligible end-user may only use the items obtained under VEU for civil end-uses.[178] Additionally, the validated end-user may only use the item "at the end-user's own facility located in an eligible destination or at a facility located in an eligible destination over which the end-user demonstrates effective control."[179] Finally, exporters and reexporters who utilized VEU are required to submit annual reports to BIS detailing the name and address of each validated end-user that received items, the quantity and value of such items, and the ECCNs of these items.[180]

D. END-USER STATEMENTS[181]

The fourth and final change implemented by the final China Military Catch All Rule is to revise the situations in which a PRC End-User Statement must be obtained. Previously, pursuant to the end-use visit understanding of April 2004 between China's Vice Minister of Commerce and the U.S. Under Secretary of Commerce for Industry and Security, exporters were required to obtain PRC End-User Statements from China's Ministry of Commerce "for all exports [to China] of items on the CCL requiring a license" valued at over $5,000.[182] The final rule raises the dollar threshold triggering the requirement of obtaining a PRC End-User Statement when "the total value of [the] transaction exceeds $50,000."[183]

Wassenaar Arrangement. *See* http://www.wassenaar.org/participants/index.html. It is not a member of the Missile Technology Control Regime. *See* http://www.mtcr.info/english/index.html. It is not a member of the Australia Group. *See* http://www.australiagroup.net/en/participants.html.

174. 15 C.F.R. § 748.15(a)(2) (2007).

175. 15 C.F.R. § 748.15(b).

176. "Authorization Validated End-User (VEU): List of Validated End-Users, Respective Eligible Items and Eligible Destinations," Supplement No. 7 to 15 C.F.R. § 748.

177. Supplement No. 7 to 15 C.F.R. § 748; George Leopold, *Four chip industry players in China 'validated' as U.S. export users*, ELECTRONIC ENGINEERING TIMES, Oct. 29, 2007, at 16. A report from the Wisconsin Project on Nuclear Arms Control called into question the vetting process for these Chinese VEUs, stating that some of them had close ties with the Chinese military. *See* WISCONSIN PROJECT ON NUCLEAR ARMS CONTROL, IN CHINA WE TRUST? Jan. 2008, *available at* http://www.wisconsinproject.org/pubs/reports/2007/inchinawetrust.pdf.

178. 15 C.F.R. § 748.15(d) (2007).

179. 15 C.F.R. § 748.15(d)(1).

180. 15 C.F.R. § 748.15(f)(1)(i).

181. Prior to the publication of the final rule, the EAR used the term "PRC End-User Certificates." However, "to conform with nomenclature that is recognized by [China's Ministry of Commerce]," the final rule amended the EAR to now refer to these documents as "PRC End-User Statements." *See* Final Rule, *supra* note 8, at 33650.

182. Final Rule, *supra* note 8, at 33650.

183. 15 C.F.R. § 748.10(b)(3) (2007).

This does not apply to the export of any computer to China that requires a license[184] or items classified under ECCN 6A003 (cameras),[185] as these items, regardless of dollar value, require a PRC End-User Statement due to U.S. national security concerns.[186]

If the export of an item necessitates that a PRC End-User Statement be obtained from China's Ministry of Commerce, it is incumbent upon the importer in China to obtain the PRC End-User Statement[187] signed by an official in the Department of Mechanic, Electronic and High Technology Industries, Export Control Division I of China's Ministry of Commerce with the Ministry's seal affixed to the Statement.[188] Additionally, the PRC End-User Statement must include the title of contract, the names of the exporter and importer, the end-user and end-use, and a description of the item, dollar value and quantity, along with the importer's signature.[189]

III. IMPACT OF THE CHINA MILITARY CATCH ALL RULE

The aforementioned changes to U.S. export control policy vis-à-vis China will have widespread implications for U.S. exporters, U.S. competitiveness abroad, and U.S. national security. The final rule unnecessarily undermines U.S. economic interests abroad by expanding the potential liability for U.S. exporters and increasing their administrative burdens, disproportionately affecting small and medium business.[190] This expanded liability is not limited just to exporters, as businesses throughout the supply chain will now be subject to nebulous provisions and stiff penalties.[191] Additionally, the extra-territorial impact of the rule by including "reexports" within its scope further expands the potential liability to foreign suppliers, creating an incentive for them to "design-out" U.S. products so as to escape this liability trap.[192] The ultimate effect of these realities will be to place further requirements on already burdened American businesses[193] to the detriment of U.S. competitiveness in the

184. 15 C.F.R. § 748.10(b)(3).
185. 15 C.F.R. § 748.10(b)(3).
186. Final Rule, *supra* note 8, at 33650.
187. 15 C.F.R. § 748.10(c)(1).
188. 15 C.F.R. § 748.10(c)(3).
189. 15 C.F.R. § 748.10(c)(3) (2007).
190. Letter from 23 Organizations to Stephen Hadley, *supra* note 12.
191. Donald A. Weadon, Jr., & Carol A. Kalinoski, *US blunders on with China military-export rule*, ASIA TIMES ONLINE, Sept. 22, 2006, *available at* http://www.atimes.com/atimes/China_Business/HI22Cb01.html; Letter from 24 Organizations to Sheila Quarterman, Nov. 30, 2006, *available at* http://www.aeanet.org/GovernmentAffairs/gakm_ExportCoalitionChinaRegCommentLetter.asp; Donald A. Weadon, Jr., & Carol A. Kalinoski, *New US export controls threaten China trade*, ASIA TIMES ONLINE, Jan. 11, 2006, *available at* http://www.atimes.com/atimes/China_Business/HA11Cb01.html.
192. THE COALITION FOR SECURITY AND COMPETITIVENESS, *supra* note 18, at 7; Freedenberg, *supra* note 15.
193. Mark Foulon & Christopher A. Padilla, *In Pursuit of Security and Prosperity: Technology Controls for a New Era*, WASHINGTON QUARTERLY, Vol. 30, Spring 2007, at 83, *available at*

hyper-competitive Chinese market, as other foreign suppliers are not so burdened.[194]

The unilateral nature of the rule further undermines its potential efficacy, as no U.S. allies or major trading partners are willing to undertake similar restrictions on their trade with China.[195] This will further compound the damage to U.S. business competitiveness in the Chinese marketplace, the access to which is increasingly vital to American businesses.[196] These losses will result in reduced profits for many cutting edge commercial enterprises in the United States, which will ultimately mean lower levels of investment in vital R&D.[197] Such reductions in private R&D will only serve to undermine U.S. national security, as the Pentagon and America's military superiority is increasingly reliant on private sector R&D.[198] Thus, the final China Military Catch All Rule may very well exacerbate the very problems it was designed to solve.

A. INCREASED LIABILITY

In the 1990s, the Clinton administration began to shift the burden for policing export control compliance from the government to the private sector.[199] Industry became more responsible for ensuring compliance with applicable export rules and regulations.[200] From a practical standpoint, such a shift makes sense. Intuitively, exporters tend to have much more technical understanding of their own items intended for export than the government.[201] Additionally, as the government tends to be predominantly focused on national security concerns, an increased governmental role might lead to overly conservative reviewing policies, especially with respect to high-technology items, potentially prompting delays and rising denial rates.[202]

However, this burden-shifting also means that companies are required to determine when end-users in China are likely to use dual-use items for a military end-use.[203] Under the final rule, U.S. exporters are required to obtain a license when they have "knowledge" that their item for export is destined for a "military end-use" in China. Under the EAR, "knowledge is

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http://www.twq.com/07spring/docs/07spring_foulon-padilla.pdf (noting that "U.S. firms face an ever-growing challenge to operate profitably in a hypercompetitive global marketplace").

194. *See* discussion *infra* Part III.B.
195. Freedenberg, *supra* note 15.
196. THE COALITION FOR SECURITY AND COMPETITIVENESS, *supra* note 18, at 5.
197. *See* Paarlberg, *supra* note 20, at 129–30.
198. *See* discussion *infra* Part III.C.
199. Gerth & Schmitt, *supra* note 40.
200. Corr, *supra* note 27, at 491–92.
201. Gregory W. Bowman, *E-mails, Servers, and Software: U.S. Export Controls for the Modern Era*, 35 GEO. J. INT'L L. 319, 365–66 (Winter 2004).
202. *Id.*
203. Gerth & Schmitt, *supra* note 40.

broader than actual knowledge, and would include constructive knowledge where the exporter had reason to know or believe, based on the circumstances, that there was a military end-use, or intentionally blinded itself to the facts."[204] Thus, for BIS to establish a violation of export regulations, "it is sufficient for BIS to show that the exporter should have been aware that the transaction would be a violation of the EAR without hard evidence of actual knowledge."[205] While it is true that BIS used the previously existing definition of "knowledge" in the EAR and thus did not modify the definition with respect to the final rule,[206] it is the subject (Chinese end-users) about which exporters must have knowledge that creates the potential for drastically expanded liability.[207]

Private sector officials have been complaining to the government for the last decade that they are not in a position to make informed determinations on Chinese end-users.[208] This is because the Chinese military is a notoriously nebulous entity and "has long played a role in commercial ventures" and it is often "difficult to distinguish between military officers' personal and professional dealings."[209] Despite the rapid growth of privately-owned businesses in China, state-owned enterprises are still a key element in the Chinese economy.[210] Some of these state-owned enterprises are owned or controlled by the Chinese military.[211] Furthermore, there are a number of universities and supposedly private enterprises that have direct or indirect ties to the Chinese military.[212] This has prompted one export control specialist to state that "[e]xporters should rightly fear a high risk of liability under such a broad definition of knowledge since it is frequently difficult for exporters to determine the ultimate use of products shipped to China."[213] Indeed, Under Secretary Mancuso has stated that it is

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204. Jonathan M. Epstein, *U.S. Department of Commerce Poised to Impose New Restrictions On Exports to China*, THE METROPOLITAN CORPORATE COUNSEL, Dec. 2006, Vol. 14, at 64, *available at* http://www.metrocorpcounsel.com/current.php?artType=view&artMonth=November&artYear=2008&EntryNo=5984.

205. Corr, *supra* note 27, at 513.

206. For a brief explanation of the evolution of the knowledge standard used in the final rule, see *China Export Control Reg to be Clarified in BIS Web Posting*, INSIDE US-CHINA TRADE, Vol. 6, No. 36, Sept. 13, 2006, *available at* LEXIS.

207. Paul Luther & Matt West, *Export of Dual-Use Items to China Addressed by The Department of Commerce*, BAKER BOTTS INTERNATIONAL TRADE UPDATE, June 27, 2007, *available at* http://www.bakerbotts.com/file_upload/templates/docamendsexportadministrationregulationsonexportofdual-useitemstochina.htm.

208. Gerth & Schmitt, *supra* note 40.

209. *Id.*

210. William Armbruster, *Export Controls: Bush administration proposals would tighten restrictions on China trade*, SHIPPING DIGEST, Oct. 2, 2006.

211. *Id.*

212. *Id.*

213. Cliff Burns, *The Chinese 'Catch-All' Saga Continues*, MONDAQ BUSINESS BRIEFING, Sept. 1, 2006, *available at* LEXIS.

"impossible" to trade with Chinese entities without dealing with the government to some extent, due to China's economic structure.[214]

Thus, in order to avoid liability, exporters must engage in much greater due diligence to ensure, to the best of their ability, that their items for export are not destined for a military end-use in China.[215] Currently, exporters are required not only to review various U.S. government lists such as the Denial List and the Entity List,[216] but they will have to conduct increased customer screening of, and investigation into, Chinese end-users who are not on such lists.[217] Furthermore, it is quite possible that the "presumption of denial" of certain licenses ushered in by the final China Military Catch All Rule will, "as a matter of practice, 'bleed over' to applications for commercial uses in China, requiring exporters to go to great lengths to demonstrate the bona fide commercial use of its Chinese customers."[218] These increased due diligence measures will especially burden small- and medium-sized firms, as they will have to divert limited resources to meet these rising administrative costs.[219] The ironic twist is that, by shifting the compliance burden on to private companies, the government has freed up resources to bolster its enforcement activities.[220]

However, the chain of liability does not end with the exporter. The final rule explicitly applies to reexports as well, resulting in the extra-territorial extension of liability to firms outside the United States who reexport U.S.-origin items.[221] Such extraterritorial controls can complicate transactions, serving as a disincentive for foreign buyers to choose U.S. exporters.[222]

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214. *Mancuso Rejects Criticism of VEU Export Control Program*, INSIDE U.S.-CHINA TRADE, Vol. 8, Feb. 22, 2008, *available at* LEXIS.

215. Vorwig, *supra* note 134; *Industry Will Push OMB to Re-Examine China Export Control Rule*, INSIDE US-CHINA TRADE, Vol. 6, Dec. 6, 2006, *available at* LEXIS; Jonathan M. Epstein & Antonia I. Tzinova, *Exporting Commercial Goods and Technology to China Under the New Military End-Use Restrictions*, THE METROPOLITAN CORPORATE COUNSEL, Vol. 15, Dec. 2007, at 69, a*vailable at* LEXIS (stating that "[t]he hardest part of compliance will be assessing what steps need to be taken to be reasonably assured the item is not going to a military end-use").

216. As of October 3, 2008, twenty-two Chinese entities were on the Entity List, which identifies certain foreign entities that are subject to license requirements for specific items. *See* Supplement No. 4 to Part 744, 15 C.F.R. § 744 (2007).

217. Corr, *supra* note 27, at 517–18; Epstein, *supra* note 204 (noting that "the new rule will create additional compliance costs and uncertainty for U.S. exporters, and may have a chilling effect well beyond its stated scope").

218. Epstein & Tzinova, *supra* note 215.

219. Letter from 23 Organizations to Stephen Hadley, *supra* note 12.

220. Corr, *supra* note 27, at 491–2; *see also* Donald Weadon, Jr. & Carol A. Kalinoski, *BIS Stumbles with 'China Rule'*, JOURNAL OF COM., Jan. 24, 2008, *available at* LEXIS (noting that President Bush recently "signed into law a significant enhancement of penalties for infringement or violation of current U.S. export laws, making infractions of this new and untested export [VEU] authorization problematic").

221. *See*, *e.g.*, 15 C.F.R. § 742.4(b)(7) (2007) (stating that "[t]here is a presumption of denial for license applications to export, reexport, or transfer items that would make a direct and significant contribution to the PRC's military capabilities").

222. Corr, *supra* note 27, at 473.

This is especially true when the controls—as here—are unilateral in nature and when the items in question are available from vendors in other countries.[223] The liability for U.S. exporters is daunting in such transactions as "the overseas re-exporter typically lacks information as to whether the U.S. technology, product, or component is subject to re-export licensing requirements, and the U.S. exporter often does not provide sufficient information."[224]

Noting that the United States is one of only a few countries that impose reexport controls, the Coalition for Security and Competitiveness has highlighted the significant compliance burden reexport controls impose on both U.S. companies and their foreign trading partners.[225] Foreign companies are often discouraged by the complexity of these reexport controls from procuring U.S.-origin products, resulting in these same foreign companies "designing out" U.S. components "in favor of components from countries without stringent re-export controls."[226] Japanese companies in particular are known to be especially careful not to violate U.S. export control regulations, prompting them to redesign their products to eliminate U.S. components.[227] Reexporters in other countries are likely to view the extraterritorial effect of the China Military Catch All Rule as confirmation that American firms are unreliable suppliers.[228] Allied nations are likely to further respond by using their blocking statutes[229] to limit the extraterritorial impact of this rule on their domestic businesses.[230] With respect to Chinese companies, they already view the United States to

223. *Id.*; *see also* Segal, *supra* note 86.

224. Corr, *supra* note 27, at 473.

225. THE COALITION FOR SECURITY AND COMPETITIVENESS, *supra* note 18, at 7; R.G. Edmonson, *U.S. issues new rule for dual-use China exports*, JOURNAL OF COM., June 20, 2007, *available at* https://www.joc.com/articles/Printable.asp?sid=42376 (quoting William Reinsch, president of the National Foreign Trade Council, arguing that the Final Rule would render U.S. companies liable for sanctions if their dual-use items were reexported to China).

226. THE COALITION FOR SECURITY AND COMPETITIVENESS, *supra* note 18, at 7.

227. R.G. Edmonson, *Duel over dual-use goods; Industry opposes proposed rules for exports that could benefit Chinese military*, JOURNAL OF COM., Aug. 21, 2006, at 36, *available at* LEXIS.

228. Reinsch, *supra* note 13.

229. "Blocking statutes" preclude or limit the ability of U.S. litigants to obtain information, witnesses, or documents located in countries with such statutes. *See*, *e.g.*, the United Kingdom's Protection of Trading Interests Act, 1980, ch. 11 (Eng.), amended by Civil Jurisdiction and Judgments Act, 1982, ch. 27, and Statute Law (Repeals) Act, 1993, ch. 50, Sch. 1, pt. XIV; Canada's Foreign Extraterritorial Measures Act, R.S.C., ch. F-29, § 3 (1984) (Can.), as amended by Department of External Affairs Act, 1995, ch. 5, 1994-1995 S.C.; France's Law concerning the Communication of Economic, Commercial, Industrial, Financial or Technical Documents or Information Law No. 80-538, 1980 J.O. 1799 (July 16, 1980); Australia's Foreign Proceedings (Excess of Jurisdiction) Act, No. 3 (1984) (Austl.), as amended by Foreign Judgments Act, No. 112 (1991); and South Africa's Protection of Business Act, No. 99, § 1 (1978) (S. Afr.), as amended by Protection of Business Act Amendment, No. 114 (1979), and Protection of Business Act Amendment, No. 71 (1984), and Protection of Business Act Amendment, No. 87 (1987).

230. *BIS Stumbles with 'China Rule,' supra* note 220.

be the least reliable and most restrictive of their major trading partners.[231] The final rule "can only serve to reinforce in the Chinese that negative perception."[232]

This "remarkable liability chain" extends even further. The final rule also applies to the "transfer"[233] of controlled items, which implicates entities throughout the supply chain.[234] These entities include shippers, freight forwarders, banks, accountants and consultants.[235] Additionally, "when viewed through the lens of the corporate-knowledge doctrine, the opportunities for serious liability exposure abound for service providers as well."[236] The language of section 744.6 of the EAR ensures their liability, by stating that:

> No U.S. person shall, without a license from BIS, knowingly support an export, reexport, or transfer that does not have a license as required by this section. Support means any action, including financing, transportation, and freight forwarding, by which a person facilitates an export, reexport, or transfer without being the actual exporter or reexporter.[237]

It is this language that prompted one export control specialist to state that "with higher penalties under the Patriot Act, fines for even minor infractions skyrocket, creating an exposure umbrella resembling a mushroom cloud."[238]

B. REDUCED U.S. COMPETITIVENESS

Statistics clearly demonstrate the reasons why U.S. companies are so enamored with the Chinese market. In 2006, the United States exported $17.7 billion worth of high-tech goods to China, an increase of forty-four percent and more than the total value of U.S. exports to India, Russia and Thailand combined.[239] Since 2000, U.S. exports to China have risen 240 percent, more than to any other market.[240] Applied Materials, a leading Silicon Valley semiconductor company, predicted in 2002 that over the next ten years, approximately twenty percent of its revenues could come from

231. Freedenberg, *supra* note 15.
232. *Id*.
233. A "transfer" is "[a] transfer to any person of items subject to the EAR either within the United States or outside of the United States with the knowledge or intent that the items will be shipped, transferred, or transmitted to an unauthorized recipient." 15 C.F.R. § 772.1 (2007).
234. *US blunders on with China military-export rule*, *supra* note 191.
235. *Id.*; Letter from 24 Organizations to Sheila Quarterman, *supra* note 191.
236. *US blunders on with China military-export rule*, *supra* note 191.
237. 15 C.F.R. § 744.6(a)(1)(ii) (2007).
238. Donald A. Weadon, Jr., *America must relax weapons controls*, THE FINANCIAL TIMES LIMITED, Aug. 1, 2006, at 11, *available at* LEXIS.
239. Mancuso, *supra* note 71.
240. *BIS Finalizes 9 Key Provisions of New China Export Rule*, MANAGING IMPORTS AND EXPORTS, Vol. 2007, No. 9, Sept. 2007, *available at* LEXIS.

trade with China.[241] Additionally, China is on track to overtake Japan as the third-largest destination for U.S. exports sometime in the immediate future.[242] Statistics such as those make it easy to see why James Sasser, U.S. Ambassador to China during the Clinton administration, once remarked that "[t]he Chinese really don't do any lobbying. The heavy lifting is done by the American business community."[243]

For the American business community, the Final China Military Catch All Rule could prove to be the perfect storm, combining with a number of external factors to undermine U.S competitiveness. First, the rule and its restrictions are unilateral in nature.[244] Not one U.S. Wassenaar Arrangement ally has agreed to enact similar provisions.[245] Up until the 1980s, unilateral U.S. export controls were still somewhat effective, as most other nations in the world could not compete technologically with the United States.[246] However, globalization has leveled the technological playing field to the point that such unilateral controls are doomed to failure.[247] Technologically advanced countries like Taiwan, South Korea, Japan, and Malaysia are more than capable of supplying dual-use technology to China.[248] Second, European companies are also more than willing to trade with China, a fact that stems from a very different view of Beijing's ascendancy.[249] The U.S. view is best encapsulated by a 2006 Pentagon report on China which stated that "China has the greatest potential to compete militarily with the United States and to field disruptive military technologies that could over time offset traditional U.S. military advantages absent U.S. counter strategies."[250] Europe tends not to view China as an emerging threat and regards engagement, as opposed to containment, as the proper way to "minimize any risks associated with Beijing's emergence as a global player."[251] In the export control context, most Wassenaar Arrangement

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241. Craig S. Smith, *China Finds Way to Beat Chip Limits*, N.Y. TIMES, May 6, 2002, at C4.

242. *BIS Finalizes 9 Key Provisions of New China Export Rule*, *supra* note 240.

243. William R. Hawkins, Testimony before the U.S.-China Economic and Security Review Commission, Mar. 17, 2006, *available at* http://www.uscc.gov/hearings/2006hearings/written_testimonies/06_03_16_17wrts/06_03_16_17_hawkins.pdf (quoting James Sasser).

244. Freedenberg, *supra* note 15; Segal, *supra* note 86.

245. *Id*.

246. Corr, *supra* note 27, at 508.

247. Stone, *supra* note 53, at 9.

248. R. Aylan Broadbent, *U.S. Export Controls on Dual-Use Goods and Technologies: Is the High Tech Industry Suffering?* 8 CURRENTS INT'L TRADE L.J. 49, 53 (Summer 1999).

249. Corr, *supra* note 27, at 456.

250. QUADRENNIAL DEFENSE REVIEW REPORT, *supra* note 81, at 29–30. However, "[q]uestioning inflated Pentagon claims of Chinese strength and resisting the trend toward a harsher anti-Chinese military stance are essential, therefore, if we want to avert a costly and dangerous cold war in Asia." Michael T. Klare, *Revving Up the China Threat*, THE NATION, Oct. 24, 2005, *available at* http://www.thenation.com/doc/20051024/klare.

251. STUDY GROUP ON ENHANCING MULTILATERAL EXPORT CONTROLS FOR US NATIONAL SECURITY, *supra* note 32, at 13.

members, including much of Europe, "simply do not share the U.S. view of China as a restricted destination."[252]

These divergent viewpoints toward China further undermine the efficacy of U.S. export controls and American business competitiveness, because U.S. policy implicitly assumes cooperation from Wassenaar Arrangement members.[253] In determining whether a certain product is available outside the United States (i.e. "foreign availability"), the Coalition for Security and Competitiveness states that the Commerce Department assumes countries that participate in the same multilateral export control regimes as the United States have adopted the same dual-use controls as the United States.[254] The Commerce Department's process for determining "foreign availability" ignores the differences in these countries' export controls, which is even more important in the context of the Wassenaar Arrangement where members are not obligated to harmonize their control lists.[255] Thus, "many items restricted by the United States are available in Wassenaar member countries because of differences, for example, in licensing administration, compliance and enforcement procedures, technical interpretation of the lists and application of re-export rules."[256] One of the most fundamental differences between the now defunct CoCom and the Wassenaar Arrangement is the absence of authority for a state to veto an export by a fellow member, thus preventing the sale altogether.[257] Thus, "items subject to U.S. controls are now more readily available in other countries, including members of international regimes."[258]

Craig Barrett, the CEO of Intel, equated these unilateral U.S. export controls on goods going to China to "fighting with one hand tied behind my back."[259] Barrett's comment underscores the fundamental importance of multilateral approaches to export controls if they are to be effective.[260] However, the final China Military Catch All Rule is not only unilateral in nature; it seeks to control goods that are widely available from foreign companies.[261] Thus, delays in the export licensing process can be deadly. It

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252. Corr, *supra* note 27, at 456.

253. THE COALITION FOR SECURITY AND COMPETITIVENESS, *supra* note 18, at 6.

254. *Id*.

255. *Id*.

256. *Id.*

257. *Id*.

258. *Id*.

259. Mark LaPedus, *Intel's Barrett cries foul over export controls in China*, EE TIMES, Nov. 2004, *available at* http://www.eetimes.com/showArticle.jhtml?articleID=51202676.

260. Vago Muradian, *Better Export Controls Needed to Check Dual-Use Technologies*, DEFENSE DAILY, January 22, 1998, Vol. 198, No. 14, *available at* Lexis; Stone, *supra* note 53 (quoting Ashton B. Carton, former Clinton administration Assistant Defense Secretary and now Harvard professor, as saying "[t]here's no point in [the United States] controlling things if our partners don't. For dual-use exports, it's crucial to have international consensus.").

261. *Exporters Urge BIS to Reconsider China 'Catch-All' Rule*, *supra* note 6; Letter from 24 Organizations to Sheila Quarterman, *supra* note 191, at 2; Jim Puzzanghera, *Controls tightened on*

can take more than six months for U.S. companies to secure an export license for goods going to China.[262] James Jochum, the Commerce Department's Assistant Secretary for Import Administration, has said that the U.S. government "take[s] a longer time reviewing licenses to China than to any other destination."[263] In 2003, an export application for China took, on average, seventy-two days, longer than for any other country.[264] Such delays inevitably force the foreign buyer to look elsewhere.[265] For example, in 2002, Semiconductor Manufacturing International Corporation (SMIC), one of China's largest semiconductor producers, planned to purchase high-tech items from Silicon Valley-based Applied Materials, but after waiting months for license approval, SMIC instead placed its order with a Swedish company, costing Applied Materials a multi-million dollar deal.[266] As Joseph Xie of SMIC said, "We love to do business with the U.S., but we can't wait forever. Europe and Japan are getting the business."[267]

C. Reduced U.S. National Security

As U.S. exporters go, so goes American military superiority.[268] This is due to a fundamental shift in the way the Pentagon constitutes U.S. military hegemony. During the Cold War, the U.S. defense industry spent billions of dollars specially designing complex, top-secret weapons systems for the Pentagon.[269] That is no longer the case, as "a revolution has turned the U.S. defense industry upside down."[270] Nowadays, it is the private sector that increasingly supplies the Pentagon, as very little is custom-made for the military anymore.[271] Thus, the products from the private sector are "increasingly used to supply off-the-shelf technology for military applications, as government entities find that higher quality and lower prices are available on the open market."[272]

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exports to China, L.A. TIMES, June 16, 2007, at C1, *available at* http://articles.latimes.com/2007/jun/16/business/fi-china16.

262. Smith, *supra* note 241.

263. Read, *supra* note 51.

264. *Id*.

265. Smith, *supra* note 241.

266. *Id.*

267. *Id*.

268. Segal, *supra* note 86 (noting the following "paradoxical outcome for the Pentagon: U.S. national security is tied to the same global process of innovation through global competition and integration that indirectly contributes to the improvement of Chinese military capabilities").

269. Hirsh, *supra* note 19, at 2.

270. *Id*.

271. *Id*.; Stone, *supra* note 53.

272. Michael Beck, et al., STRENGTHENING MULTILATERAL EXPORT CONTROLS 11 (Sept. 2002); *see also* Segal, *supra* note 86 (quoting the U.S. Defense Science board as stating that the Pentagon "relies 'increasingly on the U.S. Commercial advanced technology sector to push the technological envelope and enable the Department to "run faster" than its competitors'").

However, these private sector companies increasingly rely on exports to generate a profit, with no bigger market than China.[273] The profits are then reinvested in R&D to generate the next generation of cutting edge goods.[274] The private sector shares of total R&D in the United States have increased from fifty percent in the mid-1980s to more than sixty-six percent of total R&D in 2003.[275] Overall, total U.S. R&D is greater than $250 billion annually, and while vital in promoting U.S. economic growth and international competitiveness, "[it is] also at the foundation of U.S. military superiority."[276] Private R&D also has the added advantage of being "unhampered by bureaucratic and security restrictions," making it "more flexible, more innovative, and better organized."[277] By reinvesting their profits, which are substantially derived from exports, U.S. private sector companies can further solidify America's technological superiority.[278] Maintaining this technological superiority, given the Pentagon's increasing reliance on the commercial sector, is the foundation of American military hegemony.[279]

There is potentially an additional adverse impact on U.S. national security that must be noted. It is clear that China will continue to seek high-tech dual-use items despite the unilateral U.S. controls contained in the China Military Catch All Rule.[280] To secure its access to these increasingly vital items, China, with its surging foreign currency reserves, "will either partner with, or purchase outright, capable non-U.S. suppliers."[281] This will provide China at some point thereafter with the capability to domestically produce these goods, and once its own domestic demand is met, global prices can be expected to drop.[282] These Chinese producers will then turn their sights to exporting to the U.S. market, causing prices to drop further, and potentially driving out of business many of the U.S. suppliers for these dual-use goods, "essentially gutting the U.S. defense industrial base."[283]

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273. Stone, *supra* note 53.
274. Padilla 5/15/07, *supra* note 62.
275. Paarlberg, *supra* note 20, at 130.
276. *Id.* at 129–30.
277. Rod Smith & Bernard Udis, *New Challenges to Arms Export Control: Whither Wassenaar?* NONPROLIFERATION REVIEW 81, 87 (Summer 2001).
278. Padilla 5/15/07, *supra* note 62.
279. Susan Mora & Jennifer Cummings, *NFTC President Bill Reinsch Says Tightened Export Controls Endanger U.S. Competitiveness and Add Little to National Security Efforts*, December 11, 2006, *available at* http://www.nftc.org/newsflash/newsflash.asp?Mode=View&articleid=1840&Category=All; Laura D'Andrea Tyson, *Washington Can't Keep High Tech to Itself, so Why Try?* BUSINESS WEEK 18 (July 6, 1998).
280. *BIS Stumbles with 'China Rule'*, *supra* note 220.
281. *Id.*
282. *Id.*
283. *Id.*; *see also* Alan M. Field, *Bush administration seeks to reform export controls*, SHIPPING DIGEST, Feb. 11, 2008, *available at* LEXIS (noting that, for example, strict unilateral U.S. export controls "had crippled U.S. exports of night-vision devices," as Chinese competitors had taken

IV. CONCLUSION

The focus of U.S. export policy should be to maintain American dominance in high-technology goods. This is the best path to protecting U.S. national security and American business interests, both at home and abroad. Instead, the final China Military Catch All Rule attempts to shift the focus to the potential for China's military to rival that of the United States. It seeks to do this by placing unilateral restrictions on dual-use goods that China can easily purchase from our foreign competitors. By denying China access to our dual-use technology, the United States is sending Beijing a clear message that Washington views China much more as a strategic competitor than a strategic partner. Such messages only serve to undermine efforts to bring China more into the international system as a "responsible stakeholder." However, by treating China as a strategic adversary, this current U.S. policy will unfortunately only make conflict between the United States and China more likely. Absent real multilateral efforts on the part of the United States, in such a conflict, China will most certainly have access to these dual-use items through our allies, a tragic twist of fate indeed.

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advantage of the opening created by these controls and eliminated the previous U.S. monopoly on such items).

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CORPORATE FREE MARKET RESPONSIBILITY: ADDRESSING RIGHTS VIOLATIONS WITH A FIDUCIARY DUTY APPROACH TO NATURAL RESOURCE EXTRACTIONS IN WEAK GOVERNANCE ZONES

The deep irony is that it is the unfettered rise of corporate power that presents the biggest threat to free markets, and to the ability of free markets to promote individual freedom, equality before the law and equitable prosperity.[1]

I. INTRODUCTION

While the free market has been characterized by some as a conduit for individual freedom,[2] absent institutional prerequisites such as property protections and voluntary contracting, it risks transforming into just the opposite.[3] Nowhere is this dysfunctional transformation more apparent, yet largely unaccounted for, than in the context of corporate natural resource extractions in weak governance zones,[4] where many of these institutional prerequisites are lacking. In pursuing shareholder profit maximization, corporate conduct is premised on the same free market principles, the absence of which can impede the legitimacy of its contracts.[5] From Colombia to Burma, corporate contracts that are voluntary with respect to the contracting government are made at the expense of local communities whose property interests are either undermined or never accounted for. Often, for example, property is physically confiscated, communities are displaced without compensation, environmental effects of new industry create new hazards for local communities, project revenues are

1. Stephanie Blankenburg & Dan Plesch, *Corporate Rights and Responsibilities: Restoring Legal Accountability* (2007), *available at* http://www.opendemocracy.net/globalization-institutions_government/corporate_responsibilities_4605.jsp.

2. *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 8 (1962).

3. Report of the Special Representative of the Secretary-General on the issue of human rights and transitional corporations and other business enterprises, *Business and Human Rights: Mapping International Standards of Responsibility and Accountability for Corporate Acts*, 3, A/HRC/4/035 (9 Feb. 2007) [hereinafter SRSG Report] ("Markets function efficiently and sustainably only when certain institutional parameters are in place. The preconditions for success generally are assumed to include the protection of property rights, the enforceability of contracts, competition, and the smooth flow of information.").

4. Weak governance zones can be "defined as those states, as well as regions or sub-regions within states, in which governments cannot or will not assume their roles in protecting rights—including human rights—providing basic public services and ensuring that public sector management is efficient and effective." INTERNATIONAL ORGANIZATION OF EMPLOYERS, BUSINESS AND HUMAN RIGHTS: THE ROLE OF BUSINESS IN WEAK GOVERNANCE ZONES 3 (2006).

5. *See* discussion *infra* Part IV.

misappropriated, or local stakeholders are excluded from local development.[6] The end result is often local protest followed by state repression accompanied by human rights abuses.[7]

Legal remedies such as the Alien Tort Claims Act[8] (ATCA) have generally been applied to address human rights abuses under an emerging doctrine of corporate social responsibility.[9] The validity of contracts from the perspective of the corporation's free market responsibilities, however, has frequently escaped scrutiny. This oversight results from a failure to account for the first half of a dual-tier pattern of abuses.[10] Extractive operations initially result in first-tier property violations, which entail displacement of local populations, interference with their use of property,[11]

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6. Tarek F. Maassarani, Margo Tatgenhorst Drakos & Joanna Pajkowska, *Extracting Corporate Responsibility: Towards a Human Rights Impact Assessment*, 40 CORNELL INT'L L. J. 135, 138–40 (2007).

7. For example, see Andrew Bosson, *Forced Migration/Internal Displacement in Burma* 53 (May 2007), *available at* http://www.internal-displacement.org/8025708F004CE90B/(httpDocuments)/D057F0FCA432F4B5C12572D7002B147B/$file/Burma_report_mai07.pdf (noting that the energy sector, which is the largest recipient of foreign direct investment in Burma, is associated with forced labor, forced relocations, and widespread land confiscations); HUMAN RIGHTS WATCH, THE PRICE OF OIL: CORPORATE RESPONSIBILITY AND HUMAN RIGHTS VIOLATIONS IN NIGERIA'S OIL PRODUCING COMMUNITIES (1999) [hereinafter HRW NIGERIA REPORT], *available at* http://www.hrw.org/reports/1999/nigeria/Nigew991-01.htm#P190_8265; AMNESTY INTERNATIONAL, COLOMBIA – A LABORATORY OF WAR: REPRESSION AND VIOLENCE IN ARAUCA (2004) [hereinafter AI COLOMBIA REPORT], *available at* http://www.amnesty.org/en/report/info/AMR23/004/2004; AMNESTY INTERNATIONAL, NIGERIA TEN YEARS ON: INJUSTICE AND VIOLENCE HAUNT THE OIL DELTA (2006) [hereinafter AI NIGERIA REPORT], *available at* http://www.amnesty.org/en/report/info/AFR44/022/2005; Robert Dufresne, *The Opacity of Oil: Oil Corporations, Internal Violence, and International Law*, 36 N.Y.U. J. INT'L L. & POL. 331, 336 (2004).

8. Alien Tort Claims Act, 28 U.S.C. § 1350 (2006).

9. While a strict definition of corporate social responsibility is elusive, Thomas McInerny characterizes it as:

> an umbrella term that refers to a variety of initiatives ranging from voluntary codes of conduct to programs whereby companies can undergo external audits to verify the adequacy of their practices in a variety of areas of social concern. Although generally lacking formal state power of sanction, these efforts look to international law for their normative authority, intending to apply sometimes-latent international legal prescriptions directly to corporations.

Thomas McInerny, *Putting Regulation Before Responsibility: Towards Binding Norms of Corporate Social Responsibility*, 40 CORNELL INT'L L.J. 171, 172 (2007). John Ruggie notes that:

> corporate responsibility is being shaped through the interplay of two developments: one is the expansion and refinement of individual responsibility by the international ad hoc criminal tribunals and the ICC Statute; the other is the extension of responsibility for international crimes to corporations under domestic law. The complex interaction between the two is creating an expanding web of potential corporate liability for international crimes—imposed through national courts.

SRSG Report, *supra* note 3, at 8.

10. *See* discussion *infra* Part II.

11. *Id*.

or exclusion from profits earned from their displacement.[12] Corporate recruitment of abusive state forces to protect their operations from resulting unrest consequently generates second-tier human rights violations of protesting communities, including widespread detentions, extrajudicial killings, and forced disappearances.[13]

In highlighting free market questions implicated by first-tier property violations, it is argued here that in order to preserve the legitimacy of a corporate contract for natural resource extractions, a corporation must adapt its fiduciary duty to address, rather than exploit, distortions created by the accountability gaps present in weak governance zones. Two such distortions are (1) the politicization of corporate activity and (2) the creation of a new breed of investor: affected landowners as involuntary investors.[14] In this context, it is not enough that directors be given greater discretion to exercise business judgment[15] in accounting for broader stakeholder interests.[16] An expanded fiduciary duty should encompass a broader duty of due diligence to local communities. The fact that property interests of local community members are frequently invested in the corporate endeavor against their will is more, not less, reason to ensure that their interests are accounted for by a governance structure that prioritizes voluntary contracting.[17] In furtherance of this duty, corporations should be required to put in place a preventative compliance system, which includes impact assessments, community consultations, and reporting requirements.[18] Absent representative local governance in countries where the extractions are taking place, each of these measures serves to address the accountability gap, ensure property protections, and preserve corporate free market legitimacy.

Much of the existing scholarship proposes similar compliance schemes, but looks at corporate accountability from the perspective of its consistency with human rights principles.[19] This note aims to highlight ways in which

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12. *Id.*
13. *Id.*
14. *See* discussion *infra* Part IV.
15. The "business judgment rule" is a presumption that the directors are acting in the corporation's best interest. Gimbel v. Signal Companies, Inc., 316 A.2d 599, 609 (Del. Ch. 1974). This results in "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." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).
16. *See* discussion *infra* Part V.
17. *Id.*
18. *Id.*
19. *See* ANITA RAMASASTRY & ROBERT C. THOMPSON, COMMERCE, CRIME AND CONFLICT: LEGAL REMEDIES FOR PRIVATE SECTOR LIABILITY FOR GRAVE BREACHES OF INTERNATIONAL LAW 5 (2006); John Gerard Ruggie, *Business and Human Rights: The Evolving International Agenda*, 101 AM. J. INT'L L. 819 (2007); Cynthia A. Williams & John M. Conley, *Is There an Emerging Fiduciary Duty to Consider Human Rights?*, 74 U. CINN. L. REV. 75 (2005).

contemporary corporate governance in the United States has failed to appropriately account for its role in weak governance zones in a manner consistent with its own free market principles. In examining local responses to natural resource extraction in countries such as Colombia, Burma, and Nigeria, Part II of this note identifies the dual-tier rights violations that occur when corporate contracts with unrepresentative governments displace local communities and subject protesting populations to abuse. Part III highlights the limitations of existing legal remedies, which have been tailored to address second-tier human rights violations with little opportunity for addressing the root causes of these violations. Part IV explores the free market underpinnings of the shareholder primacy model and its role in generating distortions in weak governance zones. Recognizing these distortions, Part V argues for an expanded conception of corporate fiduciary duties to address first-tier violations. Finally, Part VI concludes the note by briefly evaluating the challenges and prospects for such an approach.

II. UNACCOUNTABLE EXTRACTIONS AND THE DUAL-TIER STRUCTURE OF PRIVATE AND PUBLIC RIGHTS VIOLATIONS

Corporate contracts for natural resource extractions in weak governance zones, which will be referred to here as unaccountable extractions,[20] frequently result in a hierarchy of abuses. An unaccountable extraction that results in dual-tier public and private rights violations generally is embodied by three elements: (1) an agreement between a corporation and an unrepresentative regime[21] that (2) licenses the corporation to extract natural resources[22] (3) either from property on which local communities live[23] or in a way that substantially affects the surrounding population's use of the land.[24] Such extractions typically result in second-tier human rights violations,[25] which commonly occur when state military forces are recruited to protect oil operations or installations in response to local protest.[26] Recent attention to human rights violations, although long-awaited, has in some ways served to overshadow corporate involvement in first-tier property rights violations, which occur when local property interests are negatively affected in the course of the extraction.[27] Oil operations initiated

20. The term "unaccountable extractions" refers to extractions carried out pursuant to an agreement with a corporation and a governing regime in a weak governance zone that generally does not take into account local interests and needs in decision-making.

21. *See* discussion *infra* Part II.A.

22. *Id*.

23. *See* discussion *infra* Part II.B.

24. *Id*.

25. *See* discussion *infra* Part II.A.

26. *Id*.

27. *See* discussion *infra* Part II.B.

by Occidental Petroleum in Colombia, Unocal in Burma, and Shell in Nigeria serve as three illustrations of this inverse dynamic, in which the international community, strapped for adequate market remedies, has been forced to target the result rather than the cause. Working backwards from second-tier violations, which have been the focus of recent scrutiny,[28] helps reveal the severe effects and importance of accounting for first-tier property rights violations.

A. SECOND-TIER HUMAN RIGHTS VIOLATIONS

The dynamics of second-tier human rights violations are exemplified by corporate involvement in the oil-rich north-eastern region of Arauca in Colombia.[29] The region has experienced protracted instability, militarization, and abuse of civilian populations, due in part to competing oil interests between government forces, paramilitary auxiliaries, and guerilla insurgents.[30] The U.S. company Occidental Petroleum (Occidental) intervened in this complex set of relationships in affiliation with the Colombian government. Occidental began pumping oil in Colombia in 1985 based on an "association contract" with Ecopetrol, a state oil company that owned fifty percent of the pipeline.[31] After more than 900 attacks on

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28. In *Doe v. Unocal Corp.*, for example, a district court examined allegations of murder, assault, rape, torture, forced labor, and destruction of homes and property brought by local farmers who challenged Unocal's extractive operations in the Burma. Doe v. Unocal Corp., 963 F. Supp. 880, 883 (C.D. Cal. 1997).

29. Colombia constitutes a weak governance zone by virtue of its ongoing internal conflict. As Amnesty International noted in 2004, "Colombia has spent most of the last 50 years under various states of emergency through which constitutional guarantees have been side-stepped, governments have ruled by executive decree, and the military have been granted broad powers to deal with public order issues. This has led to widespread, flagrant human rights violations." AI COLOMBIA REPORT, *supra* note 7, at 3.

30. The emergence of guerilla groups during La Violencia in the 1950's resulted in the consolidation of the Fuerzas Armadas Revolucionares de Colombia (FARC) in 1966, which is now the largest guerilla group in Colombia established to protect the pro-liberal sectors within the country. AI COLOMBIA REPORT, *supra* note 7, at 4–5. The second largest guerilla group is the Ejército de Liberación Nacional. *Id.* These groups have secured control over various local governments, establishing strongholds, extorting rural estates, and launching increasing attacks on civilian populations. *Id.* During its counter-insurgency operations, the Colombian army has depended on private armed paramilitary groups, which have been implicated in the majority of civilian killings and disappearances. *Id.* To circumvent liability, the armed forces have used these paramilitary auxiliaries to outsource the pursuit of their aims through illegal conduct. *Id.* As a result all three groups—the guerillas, the government armed forces, and the paramilitary groups—have abused civilians, often in pursuit of profits linked to the oil-rich north-eastern department of Arauca. *Id.* Because of its strategic importance, Arauca has become a highly militarized zone. *Id.* The government has experimented with various security policies in the region, paramilitaries have likewise clamped down to secure domestic and international interests in conjunction with government armed forces, and FARC has responded by heightening intimidation of the civilian population.

31. Occidental owns the second half along with Repson-YPF, a Spanish company. *Id*. at 6–7.

the pipeline following its drilling operations,[32] Occidental began funding the Eighteenth Brigade, the local army unit, providing helicopters, fuel, uniforms, vehicles, and approximately $750,000 a year for "logistical support."[33] The Eighteenth Brigade has since been accused of various abuses including cooperation with paramilitary groups in the abduction and killing of alleged guerilla supporters.[34]

The oil-rich Niger Delta region of southern Nigeria has similarly been plagued by escalating conflict surrounding oil production.[35] In the 1990's, the Movement for the Survival of the Ogoni People (MOSOP) mobilized the Ogonis to challenge federal distribution of oil revenues and the activities of Shell in the region. Following protests at its facilities, Shell closed production.[36] Members of the Ogoni tribe were detained, beaten, and summarily executed by the Rivers State Internal Security Task Force, which, like the Eighteenth Brigade, was created to suppress protests.[37]

In Burma,[38] Unocal Corporation entered into an agreement with the government to initiate the Yadana gas pipeline project, which was worth an estimated $1.2 billion.[39] Unocal and one of its subsidiaries are believed to have hired the State Law and Restoration Council (SLORC)[40] to help build its offshore drilling stations for the purpose of extracting natural gas from the Andaman Sea to transport gas from Burma to Thailand.[41] Affected farmers in the Tenasserim region of Burma subsequently brought suit

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32. T. Christian Miller, *A Colombian Village Caught in a Cross-Fire*, L.A. TIMES, Mar. 17, 2002, at A-1, *available at* http://www.commondreams.org/headlines02/0317-01.htm.

33. *Id*. U.S. funds have gone towards the creation of the Fifth Mobile Brigade, which was created specifically to protect the pipeline. AI COLOMBIA REPORT, *supra* note 7, at 7.

34. While Occidental denied paying for arms, it is unclear how the corporation controlled or channeled the use of its funds by the Eighteenth Brigade. Miller, *supra* note 32. British Petroleum similarly contracted with the Colombian army for a three-year period, paying a sum of $60 million. Dufresne, *supra* note 7, at 344–45. In 1998, a U.S.-funded Colombian air force helicopter bombed the village of Santo Domingo, killing seventeen civilians with U.S. munitions. AI COLOMBIA REPORT, *supra* note 7, at 5–6.

35. AI NIGERIA REPORT, *supra* note 7, at 2.

36. HRW NIGERIA REPORT, supra note 7, at 9.

37. Ken Saro-Wiwa, the leader of the MOSOP, and eight additional Ogonis were arrested for murder of tribal leaders and executed following a military trial. *Id*.

38. Following a military coup in 1962, Burma remained under military rule characterized by widespread political oppression and economic mismanagement, with Burma's key industries controlled by military-run enterprises. BBC News Country Profile: Burma, http://news.bbc.co.uk/2/hi/asia-pacific/country_profiles/1300003.stm.

39. *Unocal Pays Out on Burma Abuses*, BBC NEWS, Mar. 22, 2005, http://news.bbc.co.uk/2/hi/asia-pacific/4371995.stm (last visited Mar. 10, 2008).

40. In 1990, following multi-party elections, the military junta, the State Law and Order Restoration Council (SLORC) refused to recognize the National League for Democracy's electoral victory, preventing the party from taking political office. BBC News Country Profile: Burma, http://news.bbc.co.uk/2/hi/asia-pacific/country_profiles/1300003.stm; SLORC Coup in Burma, GlobalSecurity.org, http://www.globalsecurity.org/military/world/war/slorc.htm.

41. Doe v. Unocal Corp., 963 F. Supp. 880, 883 (C.D. Cal. 1997).

alleging murder, assault, rape, torture, forced labor, and destruction of homes and property.[42]

In each of these cases, the focus on corporate complicity in second-tier human rights violations[43] has often overshadowed the root causes of such violations and corporate involvement in creating the environment for such abuses by initiating first-tier property rights violations.

B. FIRST-TIER PROPERTY RIGHTS VIOLATIONS

In Colombia, Nigeria, and Burma, second-tier human rights violations such as detentions, killings, beatings, and summary executions have often been a product of first-tier property violations. Local property rights are adversely affected by unaccountable extractions in several ways. Violations include interference with ancestral land,[44] taking of property without compensation,[45] lack of adequate profit-sharing,[46] failure to follow through in development agreements,[47] and failure to account evenly for competing tribal property interests during the negotiation process.[48]

The use of ancestral lands for natural resource explorations has posed particular problems for indigenous groups.[49] As the Inter-American Commission on Human Rights has noted: "[T]he problems encountered by an Indian population as a result of relocation can affect that population seriously, considering the special ties they have with their original lands. In the Indian's complex scheme of values, what gives meaning to life is its intrinsic connection with their land . . . ."[50]

For indigenous groups, communal land rights are frequently crucial to cultural preservation.[51] Thus, self-determination struggles have been perceived as encompassing "the principle of permanent sovereignty over natural resources."[52] The principle serves as a means for newly independent

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42. *Id.* at 883.

43. *See* discussion *infra* Part III.

44. *See* Lillian Aponte Miranda, *The Hybrid State-Corporate Enterprise and Violations of Indigenous Land Rights: Theorizing Corporate Responsibility and Accountability Under International Law*, 11 LEWIS & CLARK L. REV. 135, 136 (2007) (highlighting indigenous rights to ancestral lands).

45. *See Unocal Corp.*, 963 F. Supp. at 885.

46. *See* AI NIGERIA REPORT, *supra* note 7, at 2.

47. *Id*. at 3.

48. *Id.* at 4; *see also* Maassarani, *supra* note 6, at 138–40.

49. Miranda, *supra* note 44, at 136.

50. Inter-American Commission on Human Rights, *Report on the Situation of Human Rights of a Segment of the Nicaraguan Population of Miskito Origin*, 27 (Nov. 29, 1983).

51. *Id*.

52. This principle is characterized as follows: "Peoples and nations must have the authority to manage and control their natural resources and in doing so to enjoy the benefits of their development and conservation." U.N. Econ. & Soc. Council [ECOSOC], Sub-Commission on the Promotion & Protection of Human Rights, Final Report of the Special Rapporteur, Erica Irene A. Daes, Indigenous Peoples' Permanent Sovereignty Over Natural Resources 5, U.N. Doc. E/CN.4/Sub.2/2004/30 (July 13, 2004) [hereinafter ECOSOC Report on Indigenous Peoples].

states to preserve economic sovereignty against inequitable contracts between external states and companies.[53] For example, in 1995, Colombia granted an oil exploration license to Occidental of Colombia, a subsidiary of Occidental.[54] The government's license authorized Occidental to drill on the ancestral lands of the indigenous U'wa people.[55] While the exploration proved futile, the license disregarded the specialized rights of the U'wa people to their ancestral lands and exposed them to future susceptibility to similar explorations.[56]

Even where ancestral land rights are not at issue, corporations such as Unocal are frequently accused of failing to compensate communities for land taken.[57] As a result of the agreement between Unocal and the SLORC, individuals in the Tenasserim region were either forced to relocate from their place of residence, forced to contribute labor and property, or subjected to various forms of violence.[58] Local populations, such as the Tenasserim farmers, often lose twofold: first, when their property is taken by foreign industries, and second, when profits earned from the extractive operations are not reinvested in the affected community.[59] In Nigeria, for example, while ninety-eight percent of the country's foreign exchange earnings are derived from oil revenues, constituting nearly eighty percent of the country's budget, the people of the Niger Delta see little of this revenue.[60] Despite high profit earnings, local communities often continue to live at the poverty level without adequate infrastructure: electricity supplies are erratic, water quality is poor, and the ongoing burning of gas continues to contaminate the local environment.[61]

Corporations that do agree to provide some form of compensation often refuse to follow through on development agreements,[62] or fail to take into

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53. *Id*. This right is derived from common article 1 of the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights: "All peoples may, for their own ends, freely dispose of their natural wealth and resources. . . . In no case may a people be deprived of its own means of subsistence." *Id*; *see also* International Covenant on Civil and Political Rights art. 1(2), Dec. 16, 1966, S. Exec. Doc. E, 95–2 (1978), 999 U.N.T.S. 171.

54. Miranda, *supra* note 44, at 136.

55. *Id*.

56. *Id*. at 137.

57. *See* Doe v. Unocal Corp., 963 F. Supp. 880, 883 (C.D. Cal. 1997).

58. It was believed that joint venturists, "through the SLORC military, intelligence and/or police forces, have used and continue to use violence and intimidation to relocate whole villages, enslave farmers living in the area of the proposed pipeline, and steal farmers' property for the benefit of the pipeline." *Id*. In *Doe v. Unocal Corp.*, plaintiffs challenged the corporation's contract with the SLORC, arguing that, as a function of this contract, "SLORC soldiers forced farmers to relocate their villages, confiscated property and forced inhabitants to clear forest, level the pipeline route, build headquarters for pipeline employees, prepare military outposts and carry supplies and equipment." *Id*. at 885.

59. *See* AI NIGERIA REPORT, *supra* note 7, at 2.

60. *Id*.

61. *Id*. at 2–3.

62. *Id*.

account the complex tribal distribution of property interests and consequently exclude interested communities from negotiations for oil exploration.[63] Protesters in the Niger Delta, for example, have challenged Chevron Nigeria's failure to provide jobs and development projects in exchange for a "non-disruptive operating environment" agreed to under a Memorandum of Understanding between the protestors and the company.[64] Communities that protest or obstruct oil production have been targeted by security forces, which have razed communities and killed civilians.[65] In the village of Odioma in Nigeria, seventeen individuals were reportedly killed by government forces in retaliation for the killing of local councilors.[66] Eighty percent of homes were subsequently razed.[67] The violence can be linked to a dispute between neighboring communities over control of land sought for oil exploration.[68] Shell Nigeria's compensation of one constituency at the expense of others exacerbated local tensions.[69]

Looking at the various ways in which unaccountable extractions adversely affect local property interests, it is clear that a key underlying element of the ensuing human rights violations is the initial first-tier property violations.[70] Corporations that have used shareholder assets to initiate such extractions implicate not only the ownership rights of the shareholders but also the ownership rights of the local communities.[71] An emerging contemporary corporate social responsibility regime is now encouraging accountability in these various contexts.[72] Because the discourse has focused on second-tier human rights violations, it has been framed largely as an issue of corporate *social* responsibility, focusing on human rights principles. As a result, emerging legal remedies have provided little opportunity to address first-tier property violations, the root cause of the problem.

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63. *Id.* at 4–5

64. *Id*. at 4.

65. AI NIGERIA REPORT, *supra* note 7, at 19.

66. *Id*. at 4.

67. *Id*.

68. *Id*. Violence erupted in the village of Odioma in Nigeria when a Joint Task Force raided the community in search of a vigilante group suspected of killing local counselors. Amnesty International noted that the violence was a result of conflict between communities within the same ethnic group over control of the land designated for oil exploration. After identifying two specific communities as the landowners, Shell Nigeria had to withdraw from the area when it learned that ownership of the land was in dispute. *Id*. at 4–5.

69. *Id*.

70. In 2005, the Joint Task Force, which was also a government security force created to protect major oil installations, fired on protesters at an oil terminal operated by Chevron Nigeria. *Id*. at 3. As Robert Dufresne explains, "In response to the expression of despair and social outrage, and to the voicing of socio-political claims, military or police interventions are undertaken to defend the disturbed concessions and to uphold concretely the conditions for the exercise of exploitation of prerogatives." Dufresne, *supra* note 7, at 336.

71. Miranda, *supra* note 44, at 136.

72. *See* SRSG Report, *supra* note 3, at 7–8.

III. PROTECTION GAPS IN THE EMERGING ACCOUNTABILITY REGIME: THE LIMITED JURISDICTIONAL GRANT OF THE ALIEN TORT CLAIMS ACT

The emerging legal architecture that is being erected under the umbrella of a corporate social responsibility regime represents a crucial step forward in addressing the egregious violations that have occurred at the hands of extractive industries.[73] In the United States, the ATCA provides a civil human rights remedy, giving federal courts original jurisdiction over civil actions brought by aliens for torts that qualify as a violation of the law of nations.[74] Similarly, the Torture Victim Protection Act of 1991 (TVPA) establishes civil liability, irrespective of citizenship, for any individual who, under the authority of a foreign nation, subjects another to torture or extrajudicial killings.[75] While statutory instruments such as the ATCA and the TVPA have provided innovative legal remedies to address human rights violations in federal courts,[76] courts have narrowly construed their jurisdiction to extend to a limited set of abuses.[77] The end result is that courts can address a limited set of second-tier human rights abuses and are circumscribed, if not explicitly prohibited, from reaching first-tier property rights violations within this statutory framework.

While the ATCA opened the door for federal courts to adjudicate certain violations recognized under international law,[78] it remained unclear which acts constituted violations of the law of nations. Subsequent case law has played a central role in clarifying the breadth of applicable violations. In *Filártiga v. Peña-Irala*,[79] a physician in Paraguay brought suit under the ATCA against the former Inspector General of Police in Paraguay for torturing his son in retaliation for his political opposition to the government of President Alfredo Stroessner.[80] The Second Circuit found perpetration of torture in an official capacity sufficient to grant federal jurisdiction.[81] In granting jurisdiction, the court in *Filártiga* nonetheless read the ATCA as providing narrow jurisdiction to adjudicate only a margin of acceptable claims involving "well-established, universally recognized norms of international law."[82]

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73. *See* Terry Collingsworth, *The Key Human Rights Challenge: Developing Enforcement Mechanisms*, 15 HARV. HUM. RTS. J. 183, 188 (2002).
74. Alien Tort Claims Act, 28 U.S.C. § 1350 (2006).
75. Torture Victim Protection Act of 1991, 28 U.S.C. § 1350 (2006).
76. *See* Collingsworth, *supra* note 73, at 188.
77. *See* Beth Stephens, *Corporate Liability: Enforcing Human Rights Through Domestic Litigation*, 24 HASTINGS INT'L & COMP. L. REV. 401 405–06 (2001).
78. *See* Filártiga v. Peña-Irala, 630 F. 2d 876, 887 (2d Cir. 1980).
79. *See generally id.*
80. *Id.*
81. *Id.* at 888.
82. *Id.*

In *Doe v. Unocal Corp.*,[83] where Burmese farmers in the Tenasserim region brought suit against Unocal challenging the Yadana gas pipeline project, the district court reiterated adherence to the high threshold set by the Second Circuit in *Filártiga*.[84] As discussed, farmers alleged that the conduct of Unocal and its local subsidiary had resulted in forced displacement, confiscation of property, forced labor and torture.[85] Rejecting the expropriation claims, the court found that claims of torture and forced labor constituted violations of the laws of nations, triggering federal jurisdiction under the ATCA.[86] Building upon the Second Circuit's important precedent, the court found that even absent state conduct, private enterprise could be held liable because the allegation of forced labor fell within the set of crimes "for which the law of nations attributes individual responsibility."[87] While the court's interpretation of the law of nations extended the ATCA's applicability to private enterprises, it stopped short of extending such applicability to private rights.[88]

This distinction between private and public rights was previously emphasized by the Second Circuit in *Dreyfus v. von Finck*.[89] In *Dreyfus*, the court dismissed a complaint brought by a Swiss citizen seeking recovery against citizens of West Germany on claims of "wrongful confiscation of property in Nazi Germany in 1938."[90] The court found that "[d]efendants' conduct, tortious though it may have been, was not a violation of the law of nations, which governs civilized states in their dealings with each other."[91] Here, the court suggested that violations of the law of nations did not encompass violations of private rights. Similarly, in *Bigio v. Coca-Cola*, the Second Circuit found that Canadian citizens had not established subject matter jurisdiction under the ATCA in alleging that a Delaware corporation had purchased or leased property knowing that it had been unlawfully seized by the Egyptian government based on religious discrimination.[92] The court found that a corporation could not be held responsible for a state's

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83. Doe v. Unocal Corp., 963 F. Supp. 880 (C.D. Cal. 1997).

84. *Id*. at 883, 891–92.

85. *Id*. at 883.

86. *Id*. at 884.

87. *Id.* at 891–92. The Second Circuit had previously held that "the ATCA reaches the conduct of private parties provided that their conduct is undertaken under the color of state authority or violates a norm of international law that is recognized as extending to the conduct of private parties." Wiwa v. Royal Dutch Petroleum Co., 226 F.3d 88, 104 (2d Cir. 2000) (citing Kadic v. Karadzic, 70 F.3d 232, 239–40, 245 (2d Cir. 1995)).

88. *Unocal Corp.*, 963 F. Supp. at 884 (C.D. Cal. 1997).

89. Dreyfus v. von Finck, 534 F.2d 24 (2d Cir. 1976) (Plaintiff was forced to leave Germany and sold his interest in Dreyfus. He alleged that the transaction took place under duress with the price substantially lower than the actual value of the stock.).

90. *Id*.

91. *Id*. at 31.

92. Bigio v. Coca-Cola Co., 239 F.3d 440, 444, 447 (2d Cir. 2000).

"discriminatory expropriation of property," and that such conduct did not amount to an act "of universal concern."[93]

In *Sosa v. Alvarez-Machain*,[94] the Supreme Court confirmed this closed-door approach,[95] cautioning against "adapting the law of nations to private rights" in the absence of congressional action.[96] Because courts retain only a narrow margin of discretion in interpreting violations of international law, they often have limited or no jurisdiction over these initial first-tier violations.[97] As Beth Stephens notes, "human rights and humanitarian law violations such as genocide, summary execution, war crimes and crimes against humanity, disappearance, slavery and forced labor trigger jurisdiction under the ATCA," whereas other claims, such as those "based on expropriation of property," fall outside this jurisdiction.[98] Because this statutory scheme extends only to a small margin of violations that have achieved the level of international consensus, it falls short of addressing the wide range of property violations that often set the stage for second-tier human rights violations worthy of jurisdiction under the ATCA.

In addition to their narrow interpretation of acts constituting violations of the law of nations, courts have also inferred particular bars to adjudicating the validity of foreign conduct. The act of state doctrine, which suggests that "the acts of foreign sovereigns taken within their own jurisdiction . . . be deemed valid," is one basis on which to argue against judicial interference with respect to foreign conduct.[99] Although the scope of this doctrine remains unclear, some have found that judicial interference is valid up until the point where "adjudication of the matter will bring the nation into hostile confrontation with the foreign state."[100] In *Unocal*, the court did not find that this line had been crossed with regards to allegations of torture and forced labor because the U.S. government had already criticized Burma for its human rights abuses and it was therefore "hard to imagine how judicial consideration of the matter [would] so substantially exacerbate relations as to cause 'hostile confrontation.'"[101] Because

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93. *Id*. at 448.

94. Sosa v. Alvarez-Machain, 542 U.S. 692, 713 (2004) (Humberto Alvarez-Machain, who was indicted for the torture and murder of a Drug Enforcement Administration (DEA) official and later acquitted, challenged his abduction in Mexico under a plan authorized by the DEA using Mexican nationals to seize him and bring him to the United States).

95. *Id*. at 725. The court found that that prohibitions against arbitrary arrest also fell short of the ATCA's requirements.

96. *Id*.

97. *See* Khulumani v. Barclay Nat'l Bank Ltd., 509 F.3d 148, (2d Cir. 2007).

98. Stephens, *supra* note 77, at 405–06.

99. Doe v. Unocal Corp., 963 F. Supp. 880, 893 (C.D. Cal. 1997).

100. *Id*.

101. *Id*. The court additionally reasoned that:

> [B]ecause nations do not, and cannot under international law, claim a right to torture or enslave their own citizens, a finding that a nation has committed such acts, particularly where, as here, that finding comports with the prior conclusions of the coordinate

consideration of whether a state is acting in the public interest factors into this doctrine, considerably more deference is afforded to states expropriating land as opposed to committing torture.[102] It has been argued, for example, that "'instructing a foreign sovereign to alter its chosen means of allocating and profiting from its own valuable natural resources' would affront the sovereignty of a state."[103] Because state land expropriations can be justified, often pretextually, on public interest grounds in a way that torture cannot, such expropriations fall more easily within the deferential act of state doctrine,[104] further limiting judicial determinations of first-tier violations.

While the ATCA provides an important opportunity to hold corporations liable for violations of international law, its narrow jurisdictional grant coupled with limiting principles such as the act of state doctrine leaves substantial gaps, if not barriers, in terms of preventative remedies. In the case of Burma, property claims were expressly preempted and the local community had to rely on traditional human rights claims to assert their rights. Similarly in Nigeria, petitioners in *Wiwa v. Royal Dutch Petroleum Co*. alleged first-tier violations, claiming that Shell Nigeria "coercively appropriated land for oil development without adequate compensation, and caused substantial pollution of the air and water in the homeland of the Ogoni people."[105] Their claim, however, also hinged primarily on allegations that Shell Nigeria orchestrated attacks involving torture and extrajudicial killings to suppress local opposition to drilling in the region.[106] The Second Circuit's focus on petitioners' claims of torture and extrajudicial killings in rejecting the corporations' forum non conveniens claims[107] further suggests that under the ATCA, first tier property rights will only be addressed indirectly insofar as they result in second-tier human rights claims.

Given the private nature of property rights in the United States and the deference afforded to states in land appropriations, it seems improbable that courts will be able to address land expropriations under this framework, absent torture or extrajudicial killings. Despite the groundbreaking achievements of recent litigation under the ATCA, the statute's limitations in the context of underlying property violations suggest that while it has become a necessary remedy, it remains an insufficient one. The increasing

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> branches of government, should have no detrimental effect on the polices underlying the act of the state doctrine.

Id. at 884.

102. *Id*.

103. *Id*. (quoting Lui v. Republic of China, 892 F.2d 1419, 1432 (9th Cir. 1989)).

104. *Unocal Corp*, 963 F. Supp. at 893.

105. Wiwa v. Royal Dutch Petroleum Co., 226 F.3d 88, 92 (2d Cir. 2000)

106. *Id*.

107. *Id*.

promotion of a social and economic rights approach will serve as one way of further incorporating property principles within the realm of public protections. However, the lack of substantial consensus in this area suggests that, in the short-run, the responsibility for protecting private rights may rest more appropriately in the private sphere.

IV. CONTEMPORARY CORPORATE GOVERNANCE AND SHAREHOLDER PRIMACY'S DIVORCE FROM TRADITIONAL FREE MARKET PRINCIPLES

In identifying private remedies for private rights violations, the key starting point is to determine whether corporations carry out their extractive operations in developing countries in a manner consistent with their key governance principles. In prioritizing principles of voluntary ownership and contracting, U.S. corporations adhere generally to a shareholder primacy model, under which the corporation serves primarily to maximize the shareholder's profits.[108] In assessing the use of this model in the context of natural resource extractions in weak governance zones, it becomes immediately evident that corporations have, to some extent, abandoned precisely the principles governing ownership and contracting that justified a shareholder primacy approach in the first place.

Corporate contracts with unrepresentative regimes violate three free market principles underlying shareholder primacy: (1) informed and voluntary contracting; (2) the separation of economic power and political authority; and (3) the centrality of private property protections.[109] This free market contradiction creates problematic distortions in the corporation's role, often turning the corporation into a political actor and the local community into an involuntary investor. Where such distortions emerge, corporations can no longer rely on shareholder primacy to justify their conduct until such conduct is reconciled with the free market principles that justified shareholder primacy to begin with.

A. THE SHAREHOLDER PRIMACY MODEL

Under the prevailing shareholder primacy model of corporate governance, shareholders are collectively perceived, by virtue of their

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108. Under a shareholder primacy model of corporate governance, the corporate entity serves first and foremost to promote the interests of shareholders. *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277–78 (1998); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189–90 (2002).

109. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1990, *available at* http://select.nytimes.com/gst/abstract.html?res=F10F11FB3E5810718EDDAA0994D1405B808BF1D3&scp=1&sq=the%20social%20responsibility%20of%20business%20is%20to%20increase%20its%20profits&st=cse (subscription required) [hereinafter *The Social Responsibility of Business*].

investments, as the owners of the corporation,[110] while the corporation is often perceived as "a nexus of contracts" between managers, shareholders and other constituents.[111] Property protection and voluntary contracting are thus two central principles underlying corporate governance.[112] Because shareholders are the owners, the corporation must be "primarily run for [their] pecuniary benefit,"[113] serving to protect their investments and maximize shareholder wealth.[114] Under this scheme, managers are frequently prevented or discouraged from acting in the interest of non-shareholder constituencies unless doing so would be in the best interests of the shareholders themselves.[115]

Because equity owners give decision-making authority to corporate agents, their expectation of profit maximization is protected by a system of fiduciary duty. In what Antoine Rebérioux refers to as a "philosophy of dispossession," shareholders, who must vest control in corporate

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110. Antoine Rebérioux, *Shareholder Primacy and Managerial Accountability, Comparative Research in Law and Political Economy*, CLPE Research Paper 1/2007 Vol. 03, No. 01, 1 (2007), *available at* http://ssrn.com/abstract=961290. The dynamics of the shareholder primacy model are described by Milton Friedman as follows:

> In a free-enterprise, private property system, a corporate executive is an employee of the owners of the business. He has a direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in the law and those embodied in ethical custom.

The Social Responsibility of Business, *supra* note 109.

111. Wai Shun Wilson Leung, *The Inadequacy of Shareholder Primacy: a Proposed Corporate Regime that Recognizes Non-Shareholder Interests*, 30 COLUM. J.L. & SOC. PROBS. 587, 592 (1997).

112. *Id*. at 590–94.

113. Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1278–83 (1991).

114. Rebérioux, *supra* note 110, at 2; *see* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, http://papers.ssrn.com/abstract=94043 (for an analysis of the benefits of a shareholder profit maximization approach).

115. The extent of the doctrine's protections of shareholder interest at the cost of managerial discretion was illustrated in the Michigan Supreme Court's ruling in *Dodge v. Ford Motor Company.* Where shareholders sought to compel seventy-five percent of the company's cash surplus against the director's decision to reinvest profits into the company, the court found that refusal to pay special dividends did not fall within a director's discretion and thus constituted an arbitrary refusal. *See* Dodge v. Ford Motor Co., 204 Mich. 459, 510 (1919). The court reasoned that:

> [a] business corporation is organized and carried on primarily for the profit of 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. . .it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others . . . .

Id. at 507.

executives, counter their dispossession by retaining some influence over managers' decision-making.[116] Managers are held to a "triad of primary fiduciary duties:"[117] duties of due care, loyalty, and good faith.[118] This triad essentially requires directors to act in the best interest of the corporation, refrain from self-dealing, and remain honest.[119] Where there is a conflict of interest with other constituencies of the corporation, shareholder interests generally prevail.[120]

As discussed, the shareholder primacy model is premised on the importance of protecting ownership rights of investors based on a matrix of contractual relationships.[121] Milton Friedman has identified the key set of free market principles underlying the corporate form as follows:

> In an ideal free market resting on private property, no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate. There are no values, no "social" responsibilities in any sense other than the shared values and responsibilities of individuals.[122]

Irrespective of broader social responsibilities, the principles underlying corporate governance implicate a political or legal regime, or what will be referred to here as corporate free market responsibility. As explained by Friedman, this regime provides a series of interconnected underlying assumptions and individual protections: (1) informed and voluntary contracting and on some voluntary exit;[123] (2) the separation of economic power and political authority, which if consolidated adds a coercive element that can delegitimize the voluntary nature of a transaction;[124] and (3) private property protections, which rest definition of property rights.[125] While the shareholder primacy model is premised on these three free market principles, the legitimacy of the model is called into question when corporations engage in unaccountable extractions that stray from these

116. Rebérioux, *supra* note 110, at 5.

117. Williams, *supra* note 19, at 88 (citing Malone v. Brincat, 772 A.2d 5, 12–13 (Del. 1998)).

118. A general duty of disclosure is encompassed in the triad requiring directors to "provide the stockholders with accurate and complete information material to a transaction or other corporate event that is being presented to them for action." Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998). *See generally* Lawrence A. Hamermesh, *Calling Off the Lynch Mob: A Corporate Director's Fiduciary Disclosure Duty*, 49 VAN. L. REV. 1087, 1100 (1996).

119. MODEL BUS. CORP. ACT ANN. § 8.30(a) (2002).

120. Smith, *supra* note 108, at 282 (citing David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, Progressive Corporate Law 35, 1 (Lawrence E. Mitchell ed., 1995)). In the context of corporate takeovers, states have adopted nonshareholder constituencies statutes that allow managers to take into account the interests of customers, suppliers and employees in determining the interest of the corporation. *Id.* at 289.

121. Leung, *supra* note 111, at 590–94.

122. *The Social Responsibility of Business*, *supra* note 109.

123. *Id.*

124. CAPITALISM AND FREEDOM, *supra* note 2, at 115–16.

125. *Id.* at 27.

underpinnings. In such a context, these principles, while maintained with regard to shareholders, do not extend to local communities, whose interests often go unprotected by both the government and the corporation. As a result, contracts between a corporation and a foreign government deny local landowners of their property absent voluntary contracting and under substantial coercion. This gap in protection calls into question the legitimacy of a contract that uses coercive means in the name of the free market. In order to better address this gap, it is necessary to explore each of these free market principles and the ways in which corporations have diverged from them by engaging in unaccountable extractions.

1. Not-So-Voluntary Contracting

Generally, transaction costs will be too high for a corporation to contract with individual communities,[126] so instead the corporation contracts with the government, which retains sovereignty over the country's natural resources.[127] Because government officials contract on behalf of their country's citizens, the voluntary nature of that contract does not depend solely on whether the officials entered into the contract voluntarily, but on whether they did so as a matter of public welfare as opposed to personal gain.[128] Certain public harms that result from government contracts may be justified as products of a representative political process that is meant to facilitate fair distribution of public costs and benefits.[129] In the case of unrepresentative regimes, however, a bilateral arrangement between a corporation and the government that is voluntary and informed

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126. *See* Richard A. Posner, ECONOMIC ANALYSIS OF LAW 54–56 (6th ed. 2002).

127. ECOSOC Report on Indigenous Peoples, *supra* note 52, at 5.

128. The Securities and Exchange Commission (SEC) has increasingly held corporations accountable for bribing state officials under the Foreign Corrupt Practices Act. In 2006, the SEC entered final judgment against corporate employees operating in Nigeria for paying approximately one million dollars in bribes to Nigerian government officials in pursuit of a contract for an oil drilling project. Margaret Ayres, John Davis, Nicole Healy & Alexandria Wrage, *Developments in U.S. and International Efforts to Prevent Corruption*, 41 INT'L LAW 597, 600–01 (Summer 2007). The parties were charged civil monetary penalties. *Id*. Additionally, the SEC also brought a civil action against a former employee of Willbros, a public oilfield services company, for bribery schemes in Nigeria and Ecuador. *Id*. at 602.

129. As Bruce Ackerman notes, "welfare gains can rarely be purchased without social cost—though many may gain, some will lose as a result of the new governmental initiative." BRUCE A. ACKERMAN, PRIVATE PROPERTY AND THE CONSTITUTION 1 (1977). In the United States, the Constitution's Takings Clause has been designed particularly to address problems of equitable distribution and potential misuse of eminent domain, requiring that property be taken only for public use and with just compensation. While the legal interpretations of these two requirements are complex, their mere existence, indicates that the government does not retain complete discretion when it takes property. U.S. CONST. amend. V ("nor shall private property be taken for public use, without just compensation"). As Abraham Bell and Gideon Parchomovsky note: "Assuming that democratic mechanisms make public officials accountable for budget management, compensation is important to create a budgetary effect that forces governments to internalize the costs that their decisions impose on private resource holders." Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547, 580 (2001).

with respect to the government is generally not voluntary and informed with respect to the people living on the land or in the surrounding area, as illustrated in both Colombia and Burma.[130] In each of these cases, the contract was made by the corporation in pursuit of investor interests, whereas the local populations, whose land was a crucial investment in the venture, had no opportunity for voluntary choice.[131] They were not contracted with directly, they were not represented or compensated by the contracting government, and their property interests were not accounted for by the corporation itself.[132]

Under contract law, "[f]reedom of will is essential to the validity of an agreement."[133] A contract will be invalidated in cases of duress or undue influence, where such free will is compromised.[134] The circumstances of unaccountable extractions are analogous given that the absence of free will is actually more exaggerated: certain groups are not only intimidated but completely excluded from the process.[135] A corporation should therefore seriously reconsider the legitimacy of its contracts with an unrepresentative regime when it has reasonable grounds to believe that state contractors were not acting within the best interests of affected communities.[136] Neglect of accountability gaps has led to costly malfunctions such as violent protests and repressive state activity, often in the form of human rights abuses, including torture, forced disappearances, arbitrary arrests, and extrajudicial killings.[137] These forms of state abuse are further exacerbated where corporate influence dictates further consolidation and concentration of political and economic power.

2. The Corporation as a Political Entity

The corporation's pursuit of shareholder interests becomes further divorced from free market principles where corporate activity is politicized,

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130. *See* discussion *supra* Part II.
131. *Id*.
132. *Id*.
133. 17A AM. JUR. 2D CONTRACTS § 218 (2008).
134. *Id*.
135. *See* discussion *supra* Part II on the exclusion of interested parties in Odioma, Nigeria.
136. In analyzing odious debt, for example, Thomas Palley has argued that:

> [an] important measure for guarding against looting via financial markets is the legal doctrine of odious debt. The core idea is that where: (1) loans are made to illegitimate regimes, such as those that come to power undemocratically; (2) loans are not secured for the benefit of the people; and (3) lenders could reasonably have known about [such] conditions . . . then such loans can be deemed illegitimate and unenforceable.

Thomas I. Palley, *Lifting the Natural Resource Curse*, FOREIGN SERVICE JOURNAL (Dec. 2003), *available at* http://www.globalpolicy.org/security/natres/generaldebate/2003/12curse.htm.

137. HRW NIGERIA REPORT, *supra* note 7, at 14, 164.

threatening a coercive consolidation of political and economic power.[138] As Friedman explains:

> [By] removing the organization of economic activity from the control of political authority, the market eliminates this source of coercive power. It enables economic strength to be a check to political power rather than a reinforcement * * * if economic power is kept in separate hands from political power, it can serve as a check and a counter to political power.[139]

This approach, while minimizing government involvement, is not meant to eliminate it.[140] Instead, it designates the government as an essential "umpire to interpret and enforce the rules decided on" and to accordingly "minimize the extent to which government need participate directly in the game."[141] In the United States, government protections come in various forms, from state and federal regulations to protections of private property under the Fifth Amendment of the United States Constitution.[142]

The separation of economic and political authority, crucial to Friedman's competitive capitalist regime, breaks down when corporations contract with non-representative governments to serve a security function. Both corporations and local governments have incentives to preempt the development of legal infrastructure that may inhibit the scope of their operations.[143] Government leaders, who are not required to distribute revenues, stand to gain substantial profits irrespective of whether the local communities sustain substantial losses.[144] Therefore, corporations frequently have incentives to bribe state actors in pursuit of their goals.[145] Corporations cease being purely economic entities where their profits depend, in part, on being able to operate in economies uninhibited by the rule of law and where they use their economic power to preempt the state from evolving into Friedman's regulating "umpire."[146]

Corporations further blur the line by interfering in local conflict dynamics when they recruit government security forces, which may already be in conflict with other local factions.[147] As financial contributors, they

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138. 1000 corporations produce eighty percent of the world industrial output. Blankenburg, *supra* note 1. According to the United Nations Educational, Scientific and Cultural Organization, fifty-one of the world's largest economies are no longer states but corporations. SARAH ANDERSON & JOHN CAVANAGH, TOP 200: THE RISE OF GLOBAL CORPORATE POWER (2000), *available at* http://s3.amazonaws.com/corpwatch.org/downloads/top200.pdf.

139. CAPITALISM AND FREEDOM, *supra* note 2, at 27.

140. *Id*. at 115.

141. *Id*.

142. JAMES W. ELY, JR., THE GUARDIAN OF EVERY OTHER RIGHT: A CONSTITUTIONAL HISTORY OF PROPERTY RIGHTS 54–56 (1998).

143. *See generally* Paul Collier & Anke Hoeffler, *Greed and Grievance in Civil War*, OXFORD ECONOMIC PAPERS 56 (2004).

144. *See supra* note 70 and accompanying text.

145. *See supra* note 128 and accompanying text.

146. *See generally* Collier & Hoeffler, *supra* note 143.

147. *See* discussion *supra* Part II.

may empower one side of a domestic conflict in pursuit of shareholder profits.[148] The corporation's purely commercial role is undermined when it contracts with one side of a party to an internal conflict for the protection of a pipeline in a way that alters the conflict dynamics. As Robert Dufresne notes:

> The involvement of oil companies in internal violence reaches a more significant level when rebels, in order to counter the empowerment of governments that have contracted with oil corporations, directly attack oil concessions or pipelines. Then, rather than being simply part of the working conditions of a larger system that—to a certain and not insignificant degree—oil companies can claim not to control, their activities become directly involved in the dynamics of internal violence. In a sense, the defense of pipelines and of oil concessions is the material threshold that defeats the oil companies' argument that they are uninvolved in conflicts and merely carrying out commercial interaction.[149]

In Sudan, for example, revenues earned by the government in Khartoum through contracts with companies such as Chevron contributed to the government's weapons stockpile.[150] As "participants in the web of local interactions," corporations become "a means for the pursuit of local political objectives."[151] Taking a place within the military web politicizes corporate activity.

In failing to take into account the social realities of extracting resources from countries with unrepresentative and unaccountable political infrastructure, corporate governance structures facilitate exactly the type of consolidation of political and economic power that the free market system seeks to avoid. The absence of voluntary contracting, coupled with the coercive nature of corporate conduct, severely undermines the legitimacy of the corporation's interference with local property interests.

3. Private Property Protections and Dispossession of the Involuntary Investor

By sidestepping local property interests in pursuit of profit maximization, the shareholder primacy model of corporate governance prioritizes the protection of property interests linked to formal investments (shareholder interests) while blindly discounting the property interests linked to other corporate assets (local community interests). Shareholders may argue that where local property protections are lacking, it is the responsibility of the state and not the corporation to account for them. In this case, however, it is the corporation and not the foreign regime that

148. Dufresne, *supra* note 7, at 344.
149. *Id.*
150. *Id.* at 341.
151. *Id.* at 346.

bases the legitimacy of its conduct on respect for ownership and voluntary contracting. Placing the burden on the state ultimately reduces free market principles to a principle of double standards.[152]

The shareholder primacy model, in placing a premium on investor interests, incorrectly presumes that the unaccountable state is a valid transactional partner and that the absence of formal property rights extinguishes the need to recognize such rights. However, property ownership, which is a basic foundation of the shareholder primacy model, has historically been "viewed as establishing the economic basis for freedom from governmental coercion and the enjoyment of liberty."[153] For example, in the United States, constitutional checks on self-interested governmental takings have been put in place under the Takings Clause of the Fifth Amendment, which requires that property be taken only for a public use and in exchange for just compensation.[154] The Fifth Amendment's Due Process clause places an additional check, which, as interpreted by the Supreme Court, prohibits arbitrary and unreasonable deprivations of property.[155] These protections of private property do not exist in a vacuum, but rather are grounded in a representative system of government.[156]

In the case of unaccountable extractions, such checks are lacking. The contract is frequently motivated by self-interest, excludes the interests of the local communities, and is particularly coercive in nature.[157] Government officials, acting on their own behalf, often pocket the profits from the contract.[158] The corporation's use of that property in these cases is no different than a coercive taking or an arbitrary deprivation of property on behalf of the corporation and the government. Thus, while the Second Circuit in *Bigio* may not have found that a U.S. corporation utilizing

152. Mark Gibney and R. David Emerick, *The Extraterritorial Application of United States Law and the Protection of Human Rights: Hold Multinational Corporations to Domestic and International Standards*, 10 TEMP. INT'L COMP. L.J. 123, 145 (1996) ("There is one set of standards—legal and moral—in domestic operations; but a completely different and much lower set of standards when these same entities are operating abroad, particularly in much poorer countries. This dichotomy is wrong, and the governments in the industrialized world have the means of preventing it; by applying extraterritorially many of the domestic and international standards that are adopted and enforced at home.").

153. Ely, *supra* note 142, at 3.

154. *See supra* note 129 and accompanying text.

155. U.S. CONST. amend. V; Village of Euclid, Ohio v. Amber Realty Co., 272 U.S. 365, 395 (1926) ("it must be said before the ordinance can be declared unconstitutional, that such provisions are clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare").

156. U.S. CONST. art. I, § 2 (setting forth election standards and process for the House of Representatives, who are to be chosen "by the People of the several States"); U.S. CONST. amend. XVII (setting forth election standards and process for the Senate).

157. HRW NIGERIA REPORT, *supra* note 7, at 6, 8–9.

158. *See* Douglas Anele, *Nigeria: On Obasanjo and His Critics*, VANGUARD, Mar. 20, 2008, http://www.allafrica.com/stories/200803240161.html.

unlawfully expropriated land had violated the law of nations, the corporation had nonetheless violated its own free market principles.

Additionally, the shareholder primacy model fails to reconcile the role of involuntary investors. In the context of unaccountable extractions, the local community takes on the anomalous role of an involuntary investor. Antoine Rebérioux's "philosophy of dispossession," as applied to the shareholder, can be applied in an exaggerated form to the local community, which is dispossessed of its property without initial approval and without retaining control.[159] Ironically, the corporation accounts for this dispossession with regard to shareholders by prioritizing shareholder interests[160] in a way that simultaneously facilitates a corresponding and somewhat perverse form of dispossession of local communities. To reconcile this paradox, fiduciary duty must be reconceptualized to eliminate the anomaly of the involuntary investor and ensure free market responsibility. While this reconciliation is important on a conceptual level, it also serves to address the monetary, reputational, and legitimacy costs that tend to result when property violations lead to destabilizing and violent unrest.[161] Free market fairness principles are not simply a social construct or moral imperative but rather a practical recognition that unfairness often sparks violence, and violence can be costly.[162]

V. CORPORATE FREE MARKET RESPONSIBILITY: RECONCILING CORPORATE FIDUCIARY DUTIES TO ACCOUNT FOR THE INVOLUNTARY INVESTOR

A corporation's failure to take into account the costs and risks of doing business with unaccountable regimes can result in unaccounted and substantial costs to involuntary investors in the form of security costs, lower growth prospects, and changes to planned investments.[163] Recognition of this reality requires reconsideration of corporate fiduciary duty as applied in the context of unaccountable extractions. As John Ruggie has warned, "[h]istory demonstrates that without adequate institutional underpinnings markets will fail to deliver their full benefits and may even become socially unsustainable."[164] Corporations acting in weak governance zones must

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159. *See* discussion *supra* Part II.

160. *See* discussion *supra* Part IV.A.

161. Deborah Rhode, *Profits and Professionalism*, 33 FORDHAM URB. L.J. 49, 54–55 (2005).

162. In the Warri region, oil companies originally reached an agreement with the Itsekiri leader, ignoring ownership claims of the Ijaw and Urhobo. AI NIGERIA REPORT, *supra* note 7, at 9. Based on the ensuing violence surrounding the oil installations, Chevron has sustained substantial financial losses estimated at up to $500 million. *Id.* at 14.

163. *Id.*

164. SRSG Report, *supra* note 3, at 3 (citing John McMillan, REINVENTING THE BAZAAR: A NATURAL HISTORY OF MARKETS (2002)). John Ruggie is currently the U.N. Special Representative of the Secretary-General on the issue of human rights and transitional corporations and other business enterprises. *Id.* at 1.

account for the absence of the requisite free market institutional parameters, both for the purposes of securing the value of their investments, but also to secure the validity of the free market approach on which their conduct is premised. Where corporations choose to engage in natural resource extractions, they must balance against the risk of contracting with unaccountable regimes by broadening directors' fiduciary duties. Such a balancing must encompass a duty of due diligence with regard to the rights and interests of otherwise unrepresented local communities so as to eliminate the problematic phenomena of involuntary investments.[165]

It is worth noting that the complexity of local property interests may indeed be insurmountable and the suggested approach is not considered a catch-all solution. Under the current framework, however, problems ensue not simply due to the complexity of local interests, but rather from recklessness on behalf of corporations, which fail to perform due diligence to better understand the environment in which they are working. Classic mistakes include the failure to take into account communal conflict over landownership and to compensate the full range of property owners who have interests at stake.[166]

A. CURRENT APPROACHES AND THEIR SHORTCOMINGS

Courts have recognized the need for corporations to adapt to account for their changing role within society and various models have been proposed for considering broader corporate stakeholders.[167] Some courts have chosen to interpret managerial discretion as encompassing greater flexibility to incorporate the interests of other stakeholders.[168] Similarly, the "mediating hierarchy model" suggests that granting directors broader discretion to favor other constituencies actually benefits shareholders' long-term interests.[169] However, the interests served are still limited to "members

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165. While the primary duty may rest with the state, this burden shifts in part to the corporation where its actions help preempt the emergence of states capable of upholding this duty.

166. Violence in Odioma, for example, can be linked to a dispute between neighboring communities over control of land sought for oil exploration. Shell Nigeria's identification of only one constituency at the cost of others exacerbated local tensions. AI NIGERIA REPORT, *supra* note 7, at 4.

167. In *A.P. Smith Mfg. Co. v. Barlow*, the Supreme Court of New Jersey validated a corporation's power to make contributions to academic institutions, recognizing the changing corporate role:

> When the wealth of the nation was primarily in the hands of individuals they discharged their responsibilities as citizens . . . with the transfer of wealth to corporate hands and the imposition of heavy burdens of individual taxation, they have been unable to keep pace with increased philanthropic needs. They have therefore, with justification, turned to corporations to assume the modern obligations of good citizenship.

A.P. Smith Mfg. Co. v. Barlow, 13 N. J. 145, 153 (1953).

168. *See* Shlensky v. Wrigley, 95 Ill. App. 2d 173 (1968).

169. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 297 (1999).

of the corporate coalition" such as shareholders, employees, and creditors.[170]

Other constituency statutes authorize directors to exercise similar discretion. The Pennsylvania statute defining fiduciary duty, for example, allows directors "in considering the best interests of the corporation" to "consider the effects of any action . . . upon communities in which offices or other establishments of the corporation are located."[171] This has allowed certain states to account for interests of broader constituencies. These approaches, however, do not require corporations to take such interests into account, imposing no duties and no liability.[172]

A more compelling and relevant example is the extension of fiduciary duties to controlling shareholders. Analogizing their influence to the control exercised by directors, courts have extended fiduciary duties to controlling shareholders.[173] If we similarly analogize the involuntary investments of local communities to the voluntary investments of shareholders, it is unclear why a parallel extension of rights should not apply to involuntary investors.

Important steps have already been taken towards this end in reconceptualizing not only corporate stakeholders but also the extent of directors' fiduciary duties. Cynthia Williams and John Conley, for example, argue that "directors' fiduciary duties now include a duty to be aware of human rights risks and potential violations within a company's global operations, and to develop policies and management procedures to reduce the risks of such violations."[174] This expanded notion of fiduciary duty, however, remains a duty to traditional shareholders and a duty geared more strongly towards second-tier human rights violations instead of first-tier property rights violations. Friedman himself has emphasized that corporations that invest in communities in which they are working or improving local government in order to "lessen losses from pilferage and sabotage" are not acting under a social responsibility, but rather upholding community interests when they serve the best interests of the corporations.[175] Here, it is not argued that an expanded fiduciary duty is owed to shareholders, but that a parallel fiduciary duty is owed to local communities who, in the context of unaccountable extractions, retain a status analogous to shareholders.[176]

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170. *Id*. at 305.
171. 15 PA. CONS. STAT. ANN. § 1716 (2006).
172. 15 PA. CONS. STAT. ANN. § 1717 (2006).
173. *See* Kahn v. Lynch Communications Systems, Inc., 638 A.2d 1110, 1113 (Del. 1994) (The court has held that "a shareholder owes a fiduciary duty . . . if it owns a majority interest in or *exercises control* over the business affairs of the corporation.").
174. Williams, *supra* note 19, at 87.
175. *The Social Responsibility of Business*, *supra* note 109.
176. *See supra* Part IV.

B. A FIDUCIARY DUTY OF DUE DILIGENCE

The extension of a fiduciary duty of care stems from reasoning underlying the fiduciary duty of loyalty. Fiduciary principles of loyalty apply: "[W]here a person who is empowered to manage the property of others for their benefit uses such property for personal benefit. In modern corporation law, such self-dealing behavior, while not flatly forbidden, is subject to the most searching degree of judicial scrutiny."[177]

A corporation engaged in natural resource extractions frequently uses the property of local communities for the benefit of shareholders without paying adequate or any compensation.[178] In such cases, the interests of formal shareholders may conflict with those of the involuntary investors and the transaction should be subject to rigid scrutiny. The transaction, held to an entire fairness standard, should ensure fair dealing and a fair price for all investors.[179] A corporation that initiates a Memoranda of Understanding (MOU)[180] that promises local development to a local community should be bound by that contract based on a principled free market duty to act in good faith.

The remedy may be equally assessed within the framework of the duty of care. In *Francis v. United Jersey Bank*, the Supreme Court of New Jersey defined a director's duty of care as encompassing an obligation to maintain a rudimentary understanding of the business of the corporation, keep informed of corporate activities, and monitor corporate affairs and policies.[181] It reasoned that "[t]he sentinel asleep at his post contributes nothing to the enterprise he is charged to protect."[182] Accordingly, "[s]hareholders have the right to expect that directors will exercise reasonable supervision and control over the policies and practices of the corporation."[183] For example, directors are required to make reasonable attempts to prevent misappropriation of corporate funds.[184] Extending the scope of this duty to require corporations to obtain greater understanding of the community contexts and communal property interests in the areas in which they operate serves both corporate interests and local community interests. Corporations that seek oil exploration contracts and take into account competing tribal claims to land may circumvent some of the conflict that will later threaten the stability of their operations.

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177. Hamermesh, *supra* note 118, at 1100.
178. *See supra* Part II.
179. *See generally* Hamermesh, *supra* note 118.
180. AI NIGERIA REPORT, *supra* note 7, at 4.
181. Francis v. United Jersey Bank, 87 N.J. 15, 31–32 (1981).
182. *Id.*
183. *Id.* at 32.
184. *Id.*

While corporations often agree to adhere to voluntary principles that require them to take into account local conditions,[185] they nevertheless continue to fail to report human rights violations, scrutinize aggressive actions on behalf of security forces, and ensure adequate training of security forces.[186] Therefore, the parameters of corporate conduct in weak governance zones should be more strongly circumscribed within the framework of corporate fiduciary duty, drawing from existing approaches to fiduciary duty as well as existing soft law mechanisms.[187] In a recent article, Cynthia Williams and John Conley point to the Delaware Chancery Court's decision in *In re Caremark Derivative Litigation*, noting that courts have put "systems in place" to guard against certain risks.[188] Accordingly, corporations could require systematic use of certain processes. The MOU is an important starting point so long as corporations are held to a good faith standard.

Additionally, the performance standards established by the International Finance Corporation (IFC), which are required of corporations seeking IFC investment funds, provide a useful framework for such a concrete system.[189] These standards include impact assessments with human rights elements and community consultation with compliance subject to review by an ombudsman who may hear complaints from those adversely affected.[190] Using the IFC standards as a structure, corporations operating in weak governance zones should be required to put in place a system that applies impact assessments and community consultations. The purpose of such a system is to gauge the impact of their operations on local communities and to account for their needs so as to address first-tier property violations and circumvent second-tier rights violations and their associated costs. Finally, corporations should be held to certain monitoring requirements assessing the ongoing rights implications of their operations and reporting on any violations of such rights. The purpose of such reports would not simply be to highlight human rights abuses, but to indicate to what extent the corporation is accounting for local interests and maintaining its free market responsibilities.

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185. Corporations like Chevron Nigeria are often signatories of the Voluntary Principles for Security and Human Rights, which provide human rights guideposts for companies in their operations. AI NIGERIA REPORT, *supra* note 7, at 4.

186. *Id*. at 8.

187. Soft law mechanisms refer to normative guidelines for operational standard setting and accountability procedures—"global administrative rulemaking." SRSG Report, *supra* note 3, at 16.

188. Williams, *supra* note 19, at 88.

189. SRSG Report, *supra* note 3, at 15.

190. *Id*.

VI. CONCLUSION

Irrespective of broader social responsibilities, the principles underlying corporate governance implicate a certain type of political or legal regime with at least minimal regulatory protections of individual freedom. The absence of these underlying elements in unaccountable extractions calls into question the legitimacy of corporate contracts in these regions. While recent litigation under the ATCA is providing important opportunities for legal redress in response to the most egregious human rights violations, existing mechanisms fall short of reaching first-tier property violations. Thus, a corresponding solution is necessary to address these violations and reconcile shareholder primacy with free market principles. A cynical response to such an approach may be that seeking a greater degree of accountability in the contracting process would be prohibitively expensive and is outside the role of the corporation.[191] However, by avoiding responsibilities to local communities, corporations create additional settlement costs, reputational costs, and risks in terms of the security and stability of corporations' natural resource operations.[192]

Slowly, corporations are being forced to face their free market responsibilities. In 2002, a group of female protestors demanding employment opportunities and investment in local communities occupied an oil terminal owned by Chevron Nigeria.[193] The occupation halted production of an estimated 500,000 barrels of oil per day.[194] Exchanging such costs with a broadly conceptualized fiduciary duty may serve as a more legitimate alternative, which, far from invoking a new paradigm of social responsibility, simply reinstates traditional free market principles. While the practicalities of this approach are more complex than what has been laid out here, particularly given the need for country-specific approaches, the principle of consistency in adherence to free market norms is a critical starting point.

Seher Khawaja[*]

191. DAVID HENDERSON, MISGUIDED VIRTUE: FALSE NOTIONS OF CORPORATE SOCIAL RESPONSIBILITY 29 (New Zealand Business Roundtable, 2001), *available at* http://www.nzbr.org.nz/documents/publications/publications-2001/misguided_virtue.pdf.

192. Rhode, *supra* note 161, at 54–55.

193. '*Deal Reached' in Nigeria Oil Protest*, BBC NEWS, July 16, 2002, http://news.bbc.co.uk/2/hi/africa/2129281.stm.

194. *Id.*

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WHERE DO WE GO FROM HERE? THE BATTLE AGAINST PREDATORY SUBPRIME LENDING

When Margaret Newton, a 76 year old stroke victim with difficulty speaking, seeing, and concentrating, was approached by a local contractor, she was persuaded to purchase siding for $9,990.[1] The purchase agreement arranged financing for Ms. Newton with United Companies Financial Corp., a company that securitized its loans, pooled them and sold them on Wall Street.[2] When the financing closed, Ms. Newton owed not $9,990 but $15,500, which included $3,050 in points and fees, plus settlement charges.[3] Her monthly payment was over $240.[4] Moreover, the siding was not properly installed on her house.[5] Ms. Newton's total monthly income was only $898, and unsurprisingly, she fell behind on her loan payments, at which point United Companies attempted to foreclose.[6] She was not alone in being targeted for a high priced loan.[7] Since the collapse of the housing market however,[8] "active trading in most mortgage-backed securities and other structured credit products has virtually come to a halt."[9] In conjunction with the housing collapse and current financial crisis, one professor has even argued for an outright ban on subprime loans.[10]

In the 1990s, "subprime lending was handled mainly by finance companies that did not fund their high-risk mortgages with federally

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1. *See generally* the findings of fact in Newton v. United Cos. Fin. Corp., 24 F. Supp. 2d 444 (1998); This case was brought to my attention by Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder In Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 506 (2002).

2. *See generally* the findings of fact in *Newton*, 24 F. Supp. 2d 444.

3. *Id.* at 447.

4. *Id.*

5. It had been constructed without installation, and had to be stripped off and re-installed with it to be effective. *See id.*

6. Fortunately for Ms. Newton, she found legal help, sued United Companies, and in November 1998, the court rescinded her loan and awarded her $2,000, finding that she had not received the proper loan disclosures. *Id.*; *cf.* Mox v. Jordan, 463 N.W. 2d 114 (Mich. App. 1990) (family that fell victim to the holder in due course doctrine were forced to pay back a $31,000 loan they never received). This case was brought to my attention by Eggert, *supra* note 1.

7. While in the mid 1990s "fewer than five percent of mortgage loan originations were subprime, by 2005 the figure had jumped to approximately twenty percent." Testimony of Sandra F. Braunstein, Dir., Div. of Consumer and Cmty. Affairs—Fed. Reserve Bd., *Subprime Mortgages*, before the Subcomm. on Fin. Inst. and Consumer Credit, Comm. on Fin. Serv., U.S. House of Representatives, (Mar. 27, 2007).

8. *See* Standard & Poors (S&P), *National Trend of Home Price Declines Continued through the First Half of 2008 According to the S&P/Case-Shiller Home Price Indices*, tbl. 1 (Aug. 26, 2008).

9. Sam Ali, *The Odd Mandate that Ate Wall St. SEC urged to abolish mark-to-market rules*, THE STAR-LEDGER, Oct. 5, 2008, at 1.

10. Alan M. White, *The Case for Banning Subprime Mortgages*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133609#.

insured bank deposits."[11] By 2002, this market expanded, "with big banks [or hedge funds] now controlling 'five of the nation's top ten subprime [lenders],' and several other prominent national banks investing in the subprime market either by extending lines of credit to subprime lenders, or by purchasing subprime loans."[12] Regulatory changes such as the deregulation of the banking industry, the desire for increased profits, "the absence of mainstream lenders in low-income neighborhoods, tax breaks for interest on second mortgages, and 'appreciating real estate values' [all] made conditions ripe for many subprime lenders to engage in predatory practices."[13] Currently, however, "[s]everal structural and economic factors have recently slowed subprime growth and increased delinquencies and foreclosures."[14] The rise in short term interest rates, along with the decrease in the rate of home price appreciation, are just two factors contributing to the rise in delinquencies and foreclosures.[15] "As a result of mounting defaults and delinquencies, one of the largest subprime lenders, New Century Financial Corporation, filed for bankruptcy on April 2, 2007," and the collapse of this industry has led many other lenders to file for bankruptcy, while others have "simply exited the subprime market altogether."[16]

Most of all, predatory subprime lenders have entered this market because of significant monetary incentives.[17] "The borrowers in this [predatory] market are people who, because of historical credit rationing, discrimination, and other social and economic forces, are disconnected from the credit market."[18] Brokers and originators continue to exploit borrowers' disconnection to the credit market and make loans with predatory terms. High-pressure tactics such as door-to-door solicitation and repeated phone calls in order to intimidate homeowners into acquiring high-cost loans are

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11. Anne-Marie Motto, *Skirting the Law: How Predatory Mortgage Lenders Are Destroying the American Dream*, 18 GA. ST. U. L. REV. 859 (2002).

12. *Id.* at 859.

13. *Id.* at 859–60.

14. Dr. Faten Sabry & Dr. Thomas Schopflocher, *The Subprime Meltdown: A Primer*, Part I of a NERA Insight Series (June 21, 2007) at 2, http://www.nera.com/image/SEC_SubprimeSeries_Part1_ June2007_FINAL.pdf.

15. *Id.*

16. *Id.*

17. It has been estimated that subprime loan originations increased from $35 billion in 1994 to $160 billion in 1999, which has been attributed to refinancings and profitable spreads. *See* DEP'T OF HOUS. & URBAN DEV. & DEP'T OF THE TREASURY TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY HOME MORTGAGE LENDING 30, 45 (June 2000) [hereinafter HUD-TREASURY REPORT], *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf.

18. "They have a range of credit ratings and some actually would qualify for prime loans . . . while others cannot afford any credit regardless of the terms." Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1279 (2002) [hereinafter *A Tale of Three Markets*].

just some of the predatory practices they use.[19] Additionally, even if borrowers read the loan documents carefully, these documents are "usually complex enough to make an attorney's eyes cross, leaving little hope that a[n] [average] consumer can wade through the legal double talk."[20]

This exploitation has led to wide-ranging harms to borrowers, who have little legal recourse against lenders and brokers.[21] First, lenders and brokers shift their litigation risk to the secondary market via securitization of these loans.[22] Securitization protects the lenders and brokers from litigation risk because of the protections afforded by the holder in due course rule and weaknesses in the current rules and regulation.[23] Second, "[s]ecuritization drives up the price of subprime loans because investors demand a lemons premium for investing in subprime mortgage-backed securities."[24] As a result, the costs to borrowers are substantial, and "one study estimated that lengthy prepayment penalties in securitized subprime loans boosted borrowers' risk of foreclosure by sixteen to twenty percent."[25] Third, these foreclosures harm the cities where these borrowers default on their loans, as "declining property values resulting from predatory lending mean reduced tax revenues just as abandoned buildings lead to increased demand for fire and police protection."[26] Therefore, changes must be made to this industry

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19. Others include, subprime lenders urging borrowers to "sign loan documents without reading them or with key terms left blank," and selling borrowers unnecessary insurance or other products along with the loan. *See* Motto, *supra* note 11, at 860; *see also* Nat'l Assn of Consumer Advoc., Predatory Lending Practices, http://www.naca.net/predatory-lending-practices (last visited Oct. 25, 2008).

20. *See* Motto, *supra* note 11, at 860.

21. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007) [hereinafter, *Turning a Blind Eye*].

22. *Id.*

23. *Id.*; *see also infra* Part IV and Part V.

24. *Turning a Blind Eye*, *supra* note 21, at 2041. The "lemons premium" exists as a result of the high default risk of borrowers in the subprime lending market, and is the high price on the interest payments that borrowers pay in their loan payments to subprime lenders. This premium makes these securitized loans attractive investments.

25. *Id.* Balloon clauses in those loans raised borrowers' risk of foreclosure by an additional fifty percent. *See generally* Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, Ctr. for Community Capitalism, Kenan Institute for Private Enters. U.N.C., (Jan. 25, 2005).

26. Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355 (2006); *see also, e.g.*, ACORN FAIR HOUS., PREDATORY LENDING IN SOUTH CENTRAL PENNSYLVANIA: A REVIEW OF RISING FORECLOSURE FILINGS AND THE RELATIONSHIP TO PREDATORY LENDING 4 (Dec. 3, 2003), *available at* http://www.acorn.org/fileadmin/Predatory_Lending/FINAL_REPORT.pdf (documenting a 186% increase in foreclosure filings in south central Pennsylvania between 1997 and 2002); STEVEN C. BOURASSA, URBAN STUDIES INST., PREDATORY LENDING IN JEFFERSON COUNTY: A REPORT TO THE LOUISVILLE URBAN LEAGUE 3 (Dec. 2003), *available at* http://www.lul.org/Predatory%20Lending%20Report.pdf (citing a 288% increase in foreclosures in Kentucky between 1995 and 2002); ZACH SCHILLER ET AL., POLICY MATTERS OHIO, HOME INSECURITY 2004: FORECLOSURE GROWTH IN OHIO 3 (Aug. 2004), *available at*

to prevent these predatory lenders and special purpose vehicles (SPVs) that securitize these loans from continuing to profit at the expense of borrowers, cities and investors.

Part I of this note provides a brief overview of the subprime lending problem, a definition of predatory lending and an explanation of the typical practices that it entails. Part II describes the emergence, growth and risks of securitization of subprime home mortgage loans. It further explains why predatory lending persists despite the substantial risk inherent in management techniques employed by securitization.[27] Part III identifies and discusses remedies available to victims of predatory subprime lending and the inadequacies of the remedies in protecting consumers and preventing further predatory lending. Then, Part IV argues that assignee liability on securitized trusts, put forth in a March 2007 article by Kathleen C. Engel and Patricia A. McCoy (Engel and McCoy), is currently too radical a change to the secondary market.[28] Finally, Part V argues that borrowers and investors should have recourse against SPVs, as they are in a position to identify the quality and suitability of the securitized loans for investors, and further discusses potential remedies[29] and ways to improve extant remedies to combat predatory subprime lending.

I. PREDATORY LENDING DEFINED

"One of the key financial developments of the 1990s was the emergence and rapid growth of subprime mortgage lending."[30] Access to credit through the subprime lending market is necessary and appropriate for those who cannot obtain credit through a prime loan but are still capable of making their mortgage payments in a timely manner.[31] "Borrowers who present elevated risk levels can look to the subprime market for credit . . . and take advantage of" lenders looking to provide higher interest loans which can supply "mortgage capital and flexible, subprime loan products."[32] "However, these high-risk borrowers are charged interest and fees by subprime lenders that exceed the rate that traditional prime

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http://www.policymattersohio.org/pdf/Home_Insecurity_2004.pdf (noting a doubling of foreclosure rates in Ohio between 1998 and 2003).

27. For more information, see generally *Turning a Blind Eye*, *supra* note 21.

28. *Id.* at 2042.

29. *A Tale of Three Markets*, *supra* note 18, at 1255. The authors argued for a Self Regulatory Organization (SRO), overseen by the federal government, to regulate the lending industry and securitization of loans as a way to deal with the predatory lending problem. This is one such remedy that may effectively combat this problem. *See id.* at 1259.

30. Edward M. Gramlich, Governor, Remarks at the Fin. Serv. Roundtable Annual Hous. Policy Meeting, 1 (May 21, 2004) (transcript *available at* http://www.federalreserve.gov/boarddocs/speeches/2004/20040521/default.htm).

31. Kevin M. Cuff, Op-Ed., *Subprime Lending Misconceptions*, THE BOSTON GLOBE, July 22, 2007, *available at* http://www.boston.com/news/globe/editorial_opinion/oped/articles/2007/07/22/subprime_lending_misconceptions/.

32. *A Tale of Three Markets*, *supra* note 18, at 1279.

borrowers pay."[33] Subprime lenders provide an important service, but they are not all reputable and some can be destructive.

Predatory lenders are defined by their methods of lending and their target borrowers. "Predatory lenders rely on misrepresentation, threats, unfair pressure and borrower ignorance to engage in their deceptive lending practices."[34] As one court[35] notes, predatory lending is a "mismatch between the needs and capacity of the borrower . . . . In essence, the loan does not fit the borrower, either because the borrower's underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood the borrower has the capability to repay the loan."[36] Predatory lenders often target vulnerable populations, resulting in devastating personal loss, including bankruptcy, poverty and foreclosure.[37] Subprime lenders who do not engage in predatory practices can be referred to as "legitimate subprime lenders."[38] By contrast, "[p]redatory lenders penetrate communities and, like polluters, leave distressed properties and desperate people in their wake."[39] As a result, there is growing concern that "it may not be in the best interest of borrowers or the neighborhoods in which they reside for such loans to be extended in the first place."[40]

Predatory lending is comprised of various abusive practices. These practices result in serious disproportionate net harm to borrowers. One example is "asset-based lending,[41] which entails making loans to borrowers

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33. *Id.*

34. Eggert, *supra* note 1, at 507.

35. *See generally* Assocs. Home Equity Servs. v. Troup, 778 A.2d 529 (N.J. Super.2001) (allowing borrowers' discrimination and unconscionability claims and defenses to proceed in a foreclosure action under the Consumer Fraud Act, the New Jersey Law Against Discrimination, the Fair Housing Act, and the Civil Rights Act).

36. *Id.* This case was brought to my attention by Daniel S. Ehrenberg, *If the Loan Don't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUS. & CMTY. DEV. L. 117, 119–20 (2001) (pointing out predatory lending is easier to discuss than it is to define).

37. *See* Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1304 (Summer, 2006) (describing Associates First Capital's notorious predatory lending practices in 2000, including "high interest rates, upfront fees, balloon payments, and prepayment penalties, [as well as] aggressively selling single-premium credit insurance and 'flipping' or refinancing loans to generate additional fees without benefit to the borrower"). *See also* Nat'l Assn of Consumer Advoc., *supra* note 19.

38. *A Tale of Three Markets*, *supra* note 18, at 1279.

39. Engel, *supra* note 26, at 355.

40. Paul S. Calem et al., *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, 15 HOUS. POL'Y DEBATE 603, 604 (2004).

41. This has been defined as the "pattern or practice" of making high-cost mortgages to consumers based on the consumer's collateral without regard to the borrower's ability to repay (based upon the consumer's current and expected income, current obligations and employment status). *See* HUD-TREASURY REPORT, *supra* note 17, at 78.

whom the lender knows cannot afford the monthly payments."[42] Another practice is harmful "rent-seeking,"[43] where the subprime lenders charge fees and interest rates that are exorbitant[44] compared to the risk that the borrowers present.[45] Many predatory loans may also involve illegal fraud or deception by brokers or lenders.[46] For example, brokers or lenders may procure inflated appraisals or make false promises to refinance loans down the road on better terms.[47] Other forms of non-transparency are harmful but do not amount to fraud, such as when lenders or brokers prevent borrowers from comparison shopping by withholding rate sheets.[48] A disproportionate number of lenders also engage in lending discrimination, by imposing more onerous terms on members of protected groups, resulting in further injustice.[49] Perhaps the most oppressive practice in the subprime lending market is requiring borrowers to waive meaningful legal redress in loan documents.[50] For example, subprime loans often contain mandatory arbitration clauses that require borrowers to take disputes to arbitration and

42. Freddie Mac, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families*, ch. 5 & nn.5–6 (1996), *available at* http://www.freddiemac.com/corporate/reports/moseley/chap5.htm.

43. Cisco Systems defines "rent-seeking" as "[w]hen a company, organization, or individual uses their resources to obtain economic gain from others without reciprocating any benefits back to society through wealth creation. *See* Cisco Systems Glossary, *available at* http://investor.cisco.com/glossary.cfm?FirstLetter=r. *See also* Paul M. Johnson, A Glossary of Political Economy Terms, http://www.auburn.edu/~johnspm/gloss/rent-seeking_behavior (last visited Oct. 27, 2008).

44. These fees are not directly reflected in interest rates, and because they can be financed, are easy to disguise or downplay by lenders. Moreover, while on competitive loans, fees below 1% of the loan amount are typical, predatory loans commonly have fees totaling more than 5% of the loan amount. *See* Nat'l Assn of Consumer Advoc., *supra* note 19.

45. This practice encompasses steering borrowers towards less favorable terms and charging prepayment penalties and points without a corresponding cut in the interest rate as is customary in the prime market. Howard Lax et. al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUS. POL'Y DEBATE 533, 535 (2004); Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUS. POL'Y DEBATE 503, 504 (2004). As noted above, the high interest rates and loan charge fees, and commensurate high returns are what make the securitized subprime loans attractive investments. Thus there is incentive for the parties involved in securitization to allow such an abusive practice to continue.

46. *See generally* Debra Pogrund Stark, *Unmasking the Predatory Loan in Sheep's Clothing: A Legislative Proposal*, 21 HARV. BLACKLETTER J. 129 (2005).

47. HUD-TREASURY REPORT, *supra* note 17, at 79–80.

48. Neither the Truth in Lending Act nor the Real Estate Settlement Procedures Act requires disclosure of rate sheets to borrowers. *See A Tale of Three Markets*, *supra* note 18, at 1255.

49. *See, e.g.*, Debbie Gruenstein Bocian, Keith S. Ernst & Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* at 4 (2006), *available at* http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf (documenting numerous disparities, including that African-American borrowers with prepayment penalties on their subprime home loans were six to thirty-four percent more likely to receive a higher-rate loan than if they had been white borrowers with similar qualifications. Results varied depending on the type of interest rate (i.e., fixed or adjustable) and the purpose (refinance or purchase) of the loan).

50. *See* A. Brooke Overby, *Mortgage Foreclosure in Post-Katrina New Orleans*, 48 B.C. L. REV. 851, 872 (2007). *See generally* Patricia McCoy, *Elder Law; A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725 (2005).

preclude them from joining class actions, thus denying borrowers access to the courts.[51]

Unlike predatory loans, legitimate subprime loans do not display *any* of the markers of abuse listed above.[52] Nevertheless, although "predatory loans are not necessarily subprime," they are most prevalent in the subprime market.[53] Once these loans are securitized and sold in secondary financial markets, the dangers of predatory lending are magnified.[54]

II. SECURITIZATION OF SUBPRIME HOME MORTGAGE LOANS

Securitization "is the process of converting packages of home loans into securities that are backed by collateral in the form of [those] loans."[55] The two-tiered structure of securitization protects investors by preventing creditors of lenders from reaching the assets backing the securities if the lender went bankrupt.[56] This remoteness from bankruptcy in turn "boosts ratings of securitized offerings, [as] rating agencies evaluate and rate securitized loan pools."[57] "SPVs protect investors from the risk of the lender's bankruptcy, [and] often [make it] possible for [a] loan [pool] to earn a higher rating than the lender itself would receive" if rated on an individual basis. "In this way, 'non-investment grade and unrated originators (the majority of the market) [are able to] create investment-grade transactions.'"[58]

In a securitization, once the original lender has made loans to borrowers, "investment banks take pools of home loans, carve up the cash flows from those receivables, and convert the cash flows into bonds that are secured by the mortgages; the bonds are variously known as residential mortgage-backed securities (RMBS) or asset-backed securities (ABS)."[59] Securitizers structure the transaction to isolate the loan pool from the

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51. *See Democratic Candidates on Mortgage Reform*, 27-1 AM. BANKR. INST. J. 10, 56 (Feb. 2008).

52. *A Tale of Three Markets*, *supra* note 18, at 1261.

53. *Id.*

54. *See generally* Arthur E. Wilmarth, Jr., *Point – Counterpoint: Federal Preemption: The OCC's Preemption Rules Exxceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 312–13 (2004) (stating that as of 2004, "the four most costly bank failures since 1997—resulting in total losses to the [Federal Deposit Insurance Corporation] (the 'FDIC') of $ 1.7 billion involved institutions heavily engaged in subprime lending and securitization.").

55. *A Tale of Three Markets*, *supra* note 18, at 1274.

56. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994).

57. *Turning a Blind Eye*, *supra* note 21, at 2046.

58. *Id.* (quoting Henry C. McCall III & Len Blum, *Evolution of the B&C Home-Equity Loan Securities Market, in* ASSET-BACKED SECURITIES 237 (Anand K. Bhattacharyi & Frank J. Fabozzi Eds., 1996)).

59. *Id.* at 2045.

original lender by selling the loan pool to a SPV[60] that passively holds the loans, and is owned by, but legally distinct from, the lender.[61] "The SPV then resells the loan pool to a second SPV [typically in the form of a trust], which is also [legally] independent of the lender and takes title to the bundle."[62] Next, by adding credit enhancements to the loan pool, the SPV reduces the risks associated with loan payment defaults by borrowers.[63] "Internal" credit enhancements include recourse arrangements and senior-subordinated structures, and "external" credit enhancements include irrevocable letters of credit, or financial guaranty insurance from third parties with triple-A credit ratings.[64] "The SPV then creates and issues the mortgage-backed securities and sells the securities to investors."[65] While in some cases, the seller of the loans retains the servicing rights (i.e., collects the loan payments) and distributes the proceeds to investors, in other cases, the SPV services the loans.[66]

The 1980s saw an increase in both the variety of lenders and available capital.[67] Subprime securitization, first pioneered in the 1970s, allowed lenders to make more loans in low- and moderate-income (LMI) neighborhoods.[68] In the 1970s, Freddie Mac spearheaded the securitization of mortgages in an effort to increase the amount of available mortgage

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60. These are "also referred to as a 'bankruptcy-remote entity' whose operations are limited to the acquisition and financing of specific assets." They "serve as a counterparty for swaps and other credit sensitive derivative instruments." *See* Investopedia, SPV, http://www.investopedia.com/terms/s/spv.asp.

61. *See Turning a Blind Eye*, *supra* note 21, at 2045; *see also* Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1552–53 (2004) (focusing on the "nonconforming" or "private label" market).

62. *Turning a Blind Eye*, *supra* note 21, at 2045.

63. *A Tale of Three Markets*, *supra* note 18, at 1274.

64. The SPV will typically raise the credit rating of the securities relative to the lender's own rating, or relative to what would be assigned to the underlying collateral. The amount of credit enhancements required depends on several factors, including "rating agencies' views of the historical performance of the assets, the degree of diversification across obligors, industries, etc. and the structure of the transaction." *See* Stephen A. Lumpkin, *Fundamentals of Asset-Backed Securities Markets*, Second International Roundtable on Securities Markets in China, OECD Shanghai at 14–16 (June 6–7, 2002), *available at* http://www.oecd.org/dataoecd/22/45/2756089.pdf.

65. *A Tale of Three Markets*, *supra* note 18, at 1274.

66. *Id.* at 1288 (Some investors "are requiring that lenders retain the loan-servicing rights, in which case the lenders would have some interest in creditworthiness because servicing costs rise with the risk of default"); *cf.* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUS. POL'Y DEBATE 603, 753–54 (discussing servicing abuses, and explaining that once loans are securitized, a servicer typically becomes responsible for collecting the loan payments and distributing the proceeds, and as a result, some servicers have employed abusive and illegal servicing practices, including charging unjustified fees, actively pushing borrowers into default, and employing exploitative collection methods).

67. *A Tale of Three Markets*, *supra* note 18, at 1273.

68. *See id.*; *see also* Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1267–71 (1991).

capital.[69] Widespread securitization of mortgages began in the 1980s,[70] and "by 1993, sixty percent of home-mortgage loans were securitized."[71] Through technological advances in the early 1990s, it became possible to estimate and price the risk of subprime home loan pools, paving the way for subprime securitizations.[72] Prior to the subprime crisis, most subprime loans were securitized,[73] which led "to claims that securitization facilitates predatory lending"[74] and that the entities involved should actively police lenders.[75] Although securitization continues,[76] currently, there are two proposed accounting rule changes by the Financial Accounting Standards Board[77] (FASB) which some believe may wipe out the market for asset-backed securitization.[78] The first rule change, to Financial Accounting Standard 140 (FAS 140), proposes "elimination of qualified special-purpose entities, which provide a way for banks to keep securitized assets off their balance sheets."[79] According to a TowerGroup report, forcing securitized assets onto the balance sheet could erode banks' annual net earnings by more than $60 billion and require billions of dollars in additional loan reserves and recapitalization.[80] Changes to FASB Interpretation No. 46 (FIN 46(R)), "would provide new, more stringent criteria for when banks are allowed to transfer ownership of securitized assets and liabilities."[81] Despite fears of a possible halt in securitization, others argue the proposed

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69. *A Tale of Three Markets*, *supra* note 18, at 1273.

70. *Id.*

71. *Id.* at 1273 (quoting Leon T. Kendall); *see also* Leon T. Kendall, *Securitization: A New Era in American Finance*, *in* 172 A PRIMER ON SECURITIZATION 2, 2–3 (Leon T. Kendall & Michael J. Fishman eds., 1996).

72. *Turning a Blind Eye*, *supra* note 21, at 2045.

73. In 2005, total securitizations of subprime and home equity loans ballooned to an estimated $525.7 billion. As of 2006, and prior to the credit crisis lenders securitized almost eighty percent of subprime mortgages. *See* Standard & Poor's (S&P), *Rating Transitions 2005: U.S. RMBS Volume and Rating Activity Continue to Set Records*, tbl. 1 (Jan. 24, 2006).

74. *Turning a Blind Eye*, *supra* note 21, at 2040. These claims are correct as will be explained later in this note. *See infra* Parts IV and V.

75. *Id.*

76. According to a survey by Asset Backed Alert, as of October 23, 2008, the year to date volume of asset-backed securities issued totaled $696.4 billion versus $917.2 billion in 2007. *See* Asset Backed Alert, Banker's Glossary, http://www.abalert.com/Public/MarketPlace/MarketStatistics/index.cfm.

77. "Officially recognized as authoritative by the Securities and Exchange Commission," the FASB services "the investing public through transparent information resulting from high-quality financial reporting standards." "Since 1973, the FASB has been the designated organization in the private sector for establishing standards of financial accounting and reporting." Financial Accounting Standards Board, Facts about FASB, http://www.fasb.org/facts/index.shtml#mission.

78. *See* Alan Rappeport, *Securitization's Last Throes?*, CFO.com, (Oct. 24, 2008) *available at* http://www.cfo.com/article.cfm/12494397?f=most_read.

79. *Id.*

80. *See* Joseph Rosta, *Proposals Take Aim at Securitization*, U.S. Banker, (Oct. 2008) (quoting research director for bankcards at TowerGroup Dennis Moroney), *available at* http://www.americanbanker.com/usb_article.html?id=20081028105Q771O.

81. Rappeport, *supra* note 78. For a more detailed discussion, see Rosta, *supra* note 80.

rule change would have "little impact"[82] or will not take effect until "after the financial sector is well on the mend."[83] Nonetheless, entities involved in securitization profit from these practices, so they continue to resist addressing these problems and serve as major conduits for predatory loans.[84] As an excerpt from the now embattled[85] Merrill Lynch & Co. prospectus in 2004 illustrates, the entities involved in securitization rarely investigate the process of underwriting subprime loans before the crisis:

> With the exception of approximately 20.82% of the mortgage loans in the statistical mortgage pool that were underwritten in accordance with the underwriting criteria of The Winter Group, underwriting criteria are generally not available with respect to the mortgage loans. In many instances the mortgage loans in the statistical mortgage pool were acquired by Terwin Advisors LLC from sources, including mortgage brokers and other non-originators that could not provide detailed information regarding the underwriting guidelines of the originators.[86]

Merrill Lynch's admission exemplifies how Wall Street firms have been securitizing subprime home loans without determining if loan pools contain predatory loans. In the worst situations, secondary market actors have actively facilitated abusive lending.[87] In fact, as of 2002, Kathleen Engel and Patricia McCoy said "it is now routine for lenders to originate loans, and sell them to secondary-market institutions, which provide a steady stream of capital to lend."[88] As a result, subprime securitization helped perpetuate the predatory lending cycle.

The process of spreading risk through "tranches" has further hidden the inherent risk in predatory lending. Once loans are transferred to the second

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82. *Id.* (quoting former FASB member Ed Trott). James Mountain, a partner at Deloitte & Touche agreed. *See id.*

83. Rosta, *supra* note 80.

84. Predatory lending lawsuits continue to arise over these practices. *See, e.g.,* Stuckey v. Provident Bank, 912 So. 2d 859 (Miss. 2005); Bankers Trust Co. v. West, No. 20984, 2002 WL 31114844 (Ohio Ct. App. Sept. 25, 2002).

85. The troubled Merrill Lynch & Co. was bought by Bank of America in a $50 billion all stock transaction. *See Bank of America Buys Merrill Lynch Creating Unique Financial Services Firm*, (Sept. 15, 2008), http://newsroom.bankofamerica.com/index.php?s=press_releases&item=8255; *see also* Ellen Messmer, *Lehman failure, Bank of America/Merrill Lynch buyout shake Wall Street again*, NETWORK WORLD, (Sept. 15, 2008), http://www.networkworld.com/news/2008/091508-wall-street-shakeup.html?fsrc=netflash-rss.

86. Merrill Lynch & Co., Prospectus to Prospectus dated June 18, 2004 (Form 424B5), at S-16 (June 24, 2004), *available at* http://www.sec.gov/Archives/edgar/data/809940/000095013604002052/0000950136-04-002052.txt.

87. *See* Austin v. Chisick, (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 659–65 (Bankr. C.D. Cal. 2003) (findings of fact). After allegedly learning of FAMCO's fraud during due diligence, Lehman Brothers nevertheless gave "substantial assistance" through securitization to help finance FAMCO's operations. This case was brought to my attention by Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2061 n.107 (2007).

88. *A Tale of Three Markets*, *supra* note 18, at 1274.

SPV, tranches of bonds are created by the investment bank for the issuer.[89] Rating agencies then measure the credit risk of each tranche by comparing historical data with the loan pools and forecasting the tranche's performance.[90] Sequential tranches are one way in which securitization protects investors (assignees) from credit risk, as investors benefit from conservative risk assessments by rating agencies[91] and can avoid risk through investing in the more highly-rated tranches.[92] However, if the suitability of these loans to the borrowers was taken into account, tranches would logically receive lower ratings when comprised of unsuitable loans to subprime borrowers.[93] The less suitable the loans, the less likely the borrowers are able to pay off the loans and thus, the more unlikely it is that investors in these bonds will get paid back.[94]

By making possible a constant flow of money to the home mortgage market, securitization dramatically altered the once highly regulated business of mortgage lending. Prior to the current credit crisis, banks and other lenders no longer suffered from liquidity restraints and more funds became available to lend.[95] At the height of the subprime bubble, lenders no longer needed "to be large financial institutions with significant deposits and capitalization, and instead sparsely capitalized mortgage bankers and finance companies originated loans for sale on the secondary market."[96] As a result, the illegitimate subprime lenders successfully took advantage of borrowers through predatory lending. In addition, predatory lenders continue to avoid liability, and are not forced to obey proper lending practices because of continued failure of risk management in this industry.

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89. *Turning a Blind Eye*, *supra* note 21, at 2046. The "issuer" is the SPV that issues securities.

90. However, rating agencies do not assess the suitability of the underlying loans for individual borrowers in calculating the credit risk. *See id.*

91. This is because the rating agencies work for the lenders, and are thereby incentivized to provide them with conservative risk assessments. *See* Ethan Penner, *Can the Financial Markets Make a Comeback?*, WALL ST. J., Aug. 27, 2007, at A11; *see also infra* Part VI.

92. Although not the focus of this comment, in their Fordham Law Review Article, Kathleen C. Engel & Patricia A. McCoy provide a clear, detailed explanation of how, through conservative risk assessments by rating agencies, senior tranches have had numerous upgrades in their ratings, yet only one downgrade between 2003 and 2005, despite rising subprime loan default rates. *See Turning a Blind Eye*, *supra* note 21, at 2055–56.

93. *Id.* at 2046–47.

94. Investor's likelihood of repayment is a major aspect of bond ratings. The "tranche system," the predominant structure of choice in subprime RMBS, is termed a "senior subordinate structure" and tranches are arrayed from the most senior (AAA tranche) to the most junior (BBB, BB, B and unrated tranche classes). A rating of BBB-/Baa3 or above is deemed investment-grade, a title that serves to calm investors' concerns about the credit quality of the mortgages backing the securities that they are investing in. The tranche system is paid off in a "waterfall" system, and the senior tranche is paid off before any other. Consequently, the junior tranche is the first to absorb any losses, making it appear doubtful the senior tranche will absorb credit losses. *See id.* at 2046–47.

95. Moreover, non-bank lenders have entered the home-mortgage market through the opportunities created by securitization. *A Tale of Three Markets*, *supra* note 18, at 1274.

96. *Id.*

III. WHY PREDATORY LENDING PERSISTS DESPITE RISK MANAGEMENT

In a 2007 article, Engel and McCoy identify numerous problems with attempts in risk management to protect investors from risk and curb continued predatory lending practices.[97] They examine how, despite attempts at creating lending-market discipline by the secondary market, predatory lending has persisted through diversification, the tranche system, lax disclosure and the excess demand for securitization.[98] The article discusses the need to exert discipline on subprime lenders and proposes forcing them to retain some of the risk associated with loan pools.[99] It focuses on how, although risk management measures are designed to incentivize lenders to make proper loans and cut default risk, none of these measures, singly or together, have curbed abusive lending.[100]

A. THE EVIL ALLIANCE

The first problem identified by Engel and McCoy is the conflict of interest created when lenders work for the SPVs, or, as they call it, the "unholy alliance of marginal lenders and loan aggregators."[101] It has increasingly become the practice for subprime lenders to sell whole loans to outside loan aggregators, generally affiliates or subsidiaries wholly- owned by Wall Street investment banks,[102] who bundle and securitize them. Because subprime aggregation offered advantages to both the investment banks and lenders, it increasingly became popular, "accounting for 42% of the subprime securitizations in 2002."[103] It furthered investment banks' underwriting business and helped them assemble diversified loan pools.[104] The advantage of a diversified loan pool is that the bad loans with low ratings are aggregated with the better higher rated loans, and thus the overall pool receives a high enough rating to be securitized and sold to investors.[105] The advantage of aggregation is particularly strong for small or poorly capitalized lenders, as aggregation permits them to sell loan pools for securitization "that would otherwise be too small to provide

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97. *Turning a Blind Eye*, *supra* note 21, at 2063.
98. *Id.* at 2064–65.
99. *Id.* at 2064.
100. *See id.*; *see also* Quercia, *supra* note 25, at 4–5.
101. *Turning a Blind Eye*, *supra* note 21, at 2065. "Loan aggregators" refers to SPVs who securitize the loans and sell them to investors on the secondary market.
102. At the height of the securitization market, major players included Credit Suisse First Boston, Morgan Stanley, Lehman Brothers, Bear, Stearns & Co., Merrill Lynch, Greenwich Capital, UBS, Bank of America, and Deutsche Bank Securities. *See* Bill Shepherd, *Perils and Phantasm: The Mortgage Securitization Boom is Threatened by Recession, Legislation and Rate Change*, Investment Dealers Dig., Feb. 3, 2003 *available at* http://www.ad-co.com/announcements/IDD.pdf; *see also Turning a Blind Eye*, *supra* note 21, at 2065.
103. *See Turning a Blind Eye*, *supra* note 21, at 2065 n.122.
104. *Id.* at 2065.
105. *See generally id.*

diversification."[106] Thus, aggregation allows investment banks to enjoy subprime profits with reduced legal risk through diversification. Consequently, "Wall Street prizes aggregation" and "[b]ecause they have minimal exposure to suits, aggregators have reduced incentives to guard against abusive practices" by lenders.[107]

B. THROWING OUT THE TRASH

The second issue the article discusses is that lenders do not always retain an interest in the subordinated tranches that they have helped create, so they are disinterested in the quality of the loans in those tranches.[108] Through an affiliate, lenders often buy securities in the lowest-rated tranches, and in conjunction provide those tranches with credit enhancements.[109] Although it appears that the lender retains the riskiest securities, this is not necessarily the case because lenders typically sell to outside investors (principally real estate investment trusts, hedge funds and overseas investors) who want to buy many of these so-called "residuals,"[110] either at the time of offering, or through later secondary market resales.[111] Moreover, lenders can sell their subprime residuals to outside investors "through bonds known as Collateralized Debt Obligations (CDOs)," which essentially securitize residuals from RMBS and other assets.[112] Because

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106. More importantly, "aggregation enables marginal lenders to obtain financing despite obscure or questionable reputations by 'renting' the aggregator's reputation for quality securities." *See id.*

107. *Id.*

108. *Id.*

109. *Id.* These credit enhancements are "usually in the form of an insurance policy or a letter of credit from a financial institution that backs some or all of the securities issued in the transaction (e.g., total value of the asset pool or securities issue, or possibly a governmental guarantee on mortgage loans)." *See* Angela Petrucci, Note, *Accounting for Asset Securitization in a Full Disclosure World*, 30 J. LEGIS. 327, 331 (2004).

110. The residuals are the lowest rated tranches that "receive the excess cash flow that remains after all of the payments due to the holders of other tranches and all of the administrative expenses have been met," and are the BB- and B- subprime tranches. *See* American Banker, Banker's Glossary, *available at* http://www.americanbanker.com/glossary.html?alpha=R (last visited Oct. 30, 2008). These are attractive investments for those who have a greater appetite for risk, because the potential payoff far exceeds those of the senior, more highly rated tranches.

111. *See Turning a Blind Eye*, *supra* note 21, at 2065; *see also* Ruth Simon et al., *Housing-Bubble Talk Doesn't Scare Off Foreigners*, WALL ST. J., Aug. 24, 2005, at A1.

112. "Significantly, U.S. subprime RMBS have comprised the single 'largest collateral asset class in [CDOs] since the inception of the product in 1999.'" Although the central purpose of residuals is to force lenders to retain the bulk of the credit risk they create, when lenders with subprime residuals are permitted to transfer them off their books through CDOs, "they are able to escape the market discipline that residuals were meant to exert." *See Turning a Blind Eye*, *supra* note 21, at 2066.

For example, if a bank issuing mortgage backed securities had $1 billion in mortgages, and they created a CDO for the $1 billion with $300 million for the residual tranche, $300 million for the junior tranche and $400 million for the senior tranche it would be cut up as follows: the bank would sell 400,000 shares at $1,000 per share and 6% interest to the senior tranche, which would amount to a $24 million per year interest payment for the senior tranche. If to the junior tranche predatory lenders can dispose of these residuals (the riskiest tranche classes), the incentive for these lenders to avoid making predatory loans is removed.[113] "As one CDO manager put it, CDOs create 'an awful lot of moral hazard in the [subprime RMBS] sector.'"[114] Thus, this attempt at risk management in lending is subverted as predatory lenders are able to sell the residuals and their accompanying risk on the secondary market.

C. THE NOT SO DILIGENT

Engel and McCoy next address how the due diligence required by current state and federal law is often cursory and is consequently ineffective.[115] Because of inherent conflicts of interest, the best practices adopted by Fannie Mae and Freddie Mac have not been adopted in the subprime secondary market voluntarily, and will not screen out predatory loans from loan pools unless compelled by changes in regulation.[116] Despite recent court reactions such as *In Re First Alliance Mortgage Co.*,[117] and state assignee liability laws, "industry and government observers agree that subprime due diligence is uneven and in need of improvement."[118] This is true for both public offerings of subprime RMBS (where institutional investors often have a real chance to insist on meaningful due diligence in advance), and even more so for Rule 144A private placements.[119] In fact, the high demand for Rule 144A offerings has forced institutional investors to make snap judgments whether to invest, without time for any substantive due diligence.[120] Most simply rely on the efforts of lenders, underwriters, and rating agencies, "even though none of these entities has the same level

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they sold 300,000 shares at $1,000 per share and 7% interest which would amount to a $21 million per year interest payment. Everything else would go to the residual, which here would be 300,000 shares at $1000 and 18.3% interest which equates to a $55 million per year interest payment. Thus, although the residual has the potential to be paid the most per year, they have to wait to be paid until all the more senior tranches have been paid first, which if there are significant defaults. This hypothetical was addressed by Professor Minor Myers, B.A., J.D., of Brooklyn Law School.

113. *Turning a Blind Eye*, *supra* note 21, at 2066.

114. Allison Pyburn, *CDO Investors Debate Morality of Spread Environment*, Asset Securitization Rep., May 9, 2005, http://www.asreport.com (on file with author).

115. *See generally Turning a Blind Eye*, *supra* note 21.

116. *Id.*

117. Austin v. Chisick, (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 659–65 (Bankr. C.D. Cal. 2003).

118. *See Turning a Blind Eye*, *supra* note 21, at 2068.

119. "Rule 144A provides an exemption and permits the public resale of restricted or control securities if a number of conditions are met, including how long the securities are held, the way in which they are sold, and the amount that can be sold at any one time. But even if you've met the conditions of the rule, you can't sell your restricted securities to the public until you've gotten a transfer agent to remove the legend." Securities Act Rule 144, U.S. Securities and Exchange Commission Homepage, http://www.sec.gov/asnwers/rule144.htm (Oct. 6, 2003). Rule 144A private placements, thus allow predatory subprime loans to get past SEC regulation, if they qualify for the exemption, which can easily be accomplished by the sophisticated parties involved in these transactions. *See Turning a Blind Eye*, *supra* note 21, at 2068.

120. *Turning a Blind Eye*, *supra* note 21, at 2068.

of interest in avoiding credit losses as the investors themselves."[121] As a result of this reliance, due diligence in the private-label subprime market often sets a very low bar and rarely succeeds in screening out predatory loan terms or practices.

As of 2007, underwriters, rating agencies, and lenders conducted most subprime due diligence, *not* investors, and typically, due diligence was limited to determining "lender compliance with state and federal consumer protections laws."[122] "For example, automated compliance systems tailor their screening tools to the legal requirements of each jurisdiction."[123] Only screening for legal compliance has been required for rating agencies, and they have not been required to follow the industry's "best practices."[124] For example, the principal federal anti-predatory lending law, the Home Ownership and Equity Protection Act (HOEPA),[125] has strong proscriptions against predatory lending, but at best covers the costliest five percent of subprime home loans.[126] Many states are in need of resilient anti-predatory lending laws, and as legal protections against abusive subprime loans are also weak at the federal level, this lack of meaningful due diligence allows securitized loan pools to include predatory loans without meaningful consequences.[127]

Even where due diligence is required, it is not uncommon for some lenders to say they performed loan-level review when they did not.[128] In the

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121. Only those that are "observationally illegal," are attempted to be screened out. *Id.*

122. *Id.*

123. *See Turning a Blind Eye*, *supra* note 21, at 2068; *see also* ComplianceEase, ComplianceAnalyzer, http://www.Complianceease.com.

124. This is problematic, as there are large existing gaps in governing law, and therefore numerous lending abuses remain legal under state and federal law. Although not the focus of this comment, legislators continue to debate the proper path to take in order to close the gaps that exist in current state and federal laws. *See Turning a Blind Eye*, *supra* note 21, at 2068–69.

125. 15 U.S.C. §§ 1601-1667 (2000). This act amended the Truth in Lending Act (TILA) and established requirements for certain loans with high rates and/or high fees, setting out disclosure requirements, prohibited features, and actions that one may take against a lender who is violating the law. *See* Federal Trade Commission Homepage, *Facts for Consumers: High-Rate, High-Fee Loans (HOEPA/Section 32 Mortgages)*, (Jan. 2007), http://www.ftc.gov/bcp/edu/pubs/consumer/homes/rea19.shtm.

126. *See, e.g.*, Truth in Lending, 66 Fed. Reg. 65604, 65608 (Dec. 20, 2001) (to be codified at 12 C.F.R. pt. 226); *but see* Lisa Keyfetz, *The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Mortgage Market Participants*, 18 LOY. CONSUMER L. REV. 151, 152 (arguing that, although it has limits, HOEPA can be a "powerful vehicle for regulating the home equity lending market and for challenging abusive lending practices through the courts.").

127. *See Turning a Blind Eye*, *supra* note 21, at 2069.

128. "In 2004, the General Accounting Office (now the Government Accountability Office or GAO) looked at this issue and concluded that 'some companies may be more willing than others to purchase loans that are considered questionable in terms of legal compliance, creditworthiness, or other factors." Moreover, as one subprime lender explained to the press, "[w]e're not structured to do 100 percent due diligence [on certain subprime pools], even though Wall Street investment banks might want that." *See id.*

conforming market,[129] both government-sponsored-entities (GSEs) (i.e. Fannie Mae and Freddie Mac) require substantive screening of subprime loans.[130] They "have best practices standards for residential mortgages to borrowers with blemished credit that are stricter in some respects than the laws in many jurisdictions."[131] Yet, as of September 7, 2008, "the government seized Fannie and Freddie which together own or guarantee half the nation's mortgages, after months of uncertainty about their future."[132] Federal Housing Finance Agency (FHFA) Director James B. Lockhart explained "after exhaustive review [of Fannie and Freddie] I have determined that the companies cannot continue to operate safely and soundly and fulfill their critical public mission, without significant action to address our concerns" and placed the GSEs in a conservatorship.[133] While their fate remains undetermined, Federal Reserve Chairman Ben Bernanke recently suggested "[h]aving Fannie and Freddie compete as private firms—perhaps after breaking them into smaller units" as a way to "eliminate the conflict between private shareholders and public policy, diminish risks to the overall economy and financial system and allow them to be more innovative by operating with less political interference."[134]

Until the recent financial crisis, outside of the conforming market, "lenders, issuers, and/or major investors [were] free to adopt internal

129. The conforming market refers to "[a] mortgage that is equal to or less than the dollar amount established by the conforming loan limit set by Fannie Mae and Freddie Mac's Federal regulator, the Office of Federal Housing Enterprise Oversight ("OFHEO") and meets the funding criteria of Freddie Mac and Fannie Mae." *See* Investopedia, Conforming Loan, http://www.investopedia.com/terms/c/conformingloan.asp.

130. *See* Benjamin J. Keys, et al., *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans*, 1, 4 World Bank, (April 2008) (discussing the fact that the underwriting guidelines established by Fannie Mae and Freddie Mac cautioned against lending to borrowers with FICO scores below 620 because such a score is a "strong indication that the borrower's credit is not acceptable."), *available at* http://siteresources.worldbank.org/INTFR/Resources/VigSecuritize0808.pdf.

131. *See, e.g.*, Fannie Mae, Eligibility of Mortgages to Borrowers with Blemished Credit Records, Lender Letter No. 03-00 (Apr. 11, 2000), *available at* http://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2000/lendltrs2000.pdf; Press Release, Freddie Mac, Freddie Mac Promotes Consumer Choice with New Subprime Mortgage Arbitration Policy (Dec. 4, 2003), *available at* http://www.freddiemac.com/news/archives/afford_housing/2003/consumer_120403.html; Press Release, Freddie Mac, Freddie Mac's stance against predatory lending practices (Dec. 28, 2000), *available at* http://www.freddiemac.com/sell/guide/bulletins/pdf/1228indltr.pdf.

132. Sudeep Reddy, *Bernanke Says the U.S. Needs to Maintain a Role in Mortgage Securities*, WALL ST. J. Nov. 1, 2008, at A2, *available at* http://online.wsj.com/article/SB122547596549288517.html?mod=googlenews_wsj.

133. James B. Lockhart, FHFA Director, Statement of FHFA Director James B. Lockhart, 1, 5 (Sept. 7, 2008) (transcript *available at* http://www.ustreas.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf).

134. *See* Reddy, *supra* note 132. Bernanke further stated that "whether the GSE model is viable without at least implicit government support is an open question." *See id.* For a more detailed discussion of Bernanke's blueprint for handling the mortgage-securitization crisis, see *id.*

standards of their own."[135] Nevertheless, in general, "only market actors with high reputational risk, such as bank holding companies contemplating mergers or lenders previously sanctioned for abusive lending, go to such lengths" to attain proper standards.[136] For the majority of market participants, industry self-policing is virtually nonexistent, and as a result, in the nonconforming market for subprime RMBS, lenders and underwriters "rarely screen out loans that are not [expressly] prohibited by law, *even if those loans violate industry standards or inflict significant harm on borrowers*."[137] Moreover, underwriters are "under constant pressure to relax their due diligence, for fear that lenders will move their underwriting business to other underwriting firms," with more lax standards of due diligence.[138] In sum, because of these inherent conflicts of interest, the best practices have not been voluntarily adopted in the subprime secondary market and will not screen out predatory loans from loan pools unless compelled by changes in regulation.

Investors, looking to screen out predatory loans, tend to rely on due diligence by rating agencies, underwriters and lenders.[139] While institutional investors will generally review the disclosures, ratings, structure, and credit enhancements if presented with advance opportunity, if they are not, institutional investors tend to be passive, especially regarding predatory lending concerns.[140] The futility of such reliance is shown by at least one study examining securitized subprime mortgage loan contracts, which suggests that "securitization adversely affects the screening incentives of lenders."[141]

D. THE DANGERS OF DEMAND

Lastly, Engel and McCoy identify excess demand for subprime securitizations as the final reason why investors do not screen subprime RMBS for predatory practices.[142] "In 2004, for instance, Standard & Poor's

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135. *Turning a Blind Eye*, *supra* note 21, at 2070; *see generally Securitization Post-Enron*, *supra* note 61, for a discussion of the differences between the conforming and nonconforming markets.

136. *See Turning a Blind Eye*, *supra* note 21, at 2070.

137. *Id.* (emphasis added).

138. *Id.*; *see also* Penner, *supra* note 91, at A11.

139. *Turning a Blind Eye*, *supra* note 21, at 2070.

140. Moreover, "investors rarely reserve the right post-closing to be notified of predatory lending complaints, to conduct random spot checks, or to perform special audits of lenders when warning signs of predatory lending crop up." However, it is this after-the-fact monitoring that may be the only way to detect certain types of loan fraud and predatory servicing. Further, numerous subprime securitizations are floated on a to-be-announced (TBA) basis, and investors cannot exercise due diligence even when they want to. This is because in TBA offerings loans have not yet been pooled, and although investors can reserve the right to review the eventual loan pool chosen by the lender post-closing, this is risky because the investor has lost leverage once they have parted with their funds. *See id.* at 2071.

141. *See* Keys, et al., *supra* note 130, at 2.

142. *Turning a Blind Eye*, *supra* note 21, at 2075.

(S&P)[143] observed that 'the market for subprime mortgage securities [experienced] significantly more demand than availability for many issuances.'"[144] The liquidity of Rule 144A private placements makes them in short supply.[145] As a result of the demand for bonds in subprime securitization exceeding the supply, "investors are willing to purchase bonds without engaging in thorough due diligence."[146]

Consequently, the risk management techniques used by loan securitizers do not trickle down to deter lending abuses. Until the recent financial crisis, it was believed investors were protected so well by structured finance that S&P routinely assured investors that subprime RMBS "[would] continue to perform in accordance with expectations, given the advances in loan level modeling, structural safeguards, and improvement in loss mitigation techniques."[147] It is clear now that such assurances were unwarranted, as "the world's two largest bond-analysis providers," S&P and Moody's Corp,[148] were engaging in a "race to the bottom," and "repeatedly eased their standards as they pursued profits from structured investment pools sold by their clients, according to company documents, e-mails and interviews with more than 50 Wall Street professionals."[149]

These lending abuses have led to significant harms. When lenders make loans that borrowers cannot afford to repay, borrowers must either reduce spending on necessities such as health insurance, medical bills, day care and critical home repairs, or lose their homes to foreclosure. "When predatory lending results in vacant homes and neighborhood decline, cities lose tax revenues and must pay for added police protection and other city services."[150] The total cost to homeowners and cities is in the billions of

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143. Standard and Poor's is "the world's foremost provider of independent credit ratings, indices, risk evaluation, investment research and data." Standard & Poor's, http://www.standardandpoors.com (last visited Nov. 1, 2008).

144. *Turning a Blind Eye*, *supra* note 21, at 2075 (quoting S&P, Trends in U.S. Residential Mortgage Products: Subprime Sector, Fourth-Quarter 2004, at 3 (Apr. 12, 2005)).

145. Additionally, there is demand for subprime RMBS of all types, driven by portfolio regulation of institutional investors such as banks and insurance companies, and many institutional investors have legal limits on the types of investments they can buy for their own account. Because of these limits, high yields make subprime RMBS attractive, particularly "when other legal investments are in the doldrums." *Turning a Blind Eye*, *supra* note 21, at 2075.

146. *Id.*

147. *Id.* at 2076 (quoting S&P, Trends in U.S. Residential Mortgage Products: Subprime Sector, Fourth-Quarter 2004, at 3 (Apr. 12, 2005)).

148. "Moody's Investors Service is among the world's most respected and widely utilized sources for credit ratings, research and risk analysis." Moody's Investor Service, *Introduction to Moody's*, http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=intro&redir_url=/cust/AboutMoodys/staticRedirect.asp (last visited Nov. 1, 2008).

149. Elliot Blair Smith, *'Race to Bottom' at Moody's, S&P Secured Subprime's Boom, Bust*, BLOOMBERG, Sept. 25, 2008, http://www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=ax3vfya_Vtdo (last visited Oct. 10, 2008).

150. Engel, *supra* note 26, at 355–60.

dollars.[151] Thus, while investors receive some protections, these come at the expense of borrowers and cities.

IV. A MENU OF INADEQUATE REMEDIES

Although the states and federal government are working towards establishing standards and regulations to redress predatory lending, as the law stands today, the remedies that exist are inadequate. "Instead, victims of predatory lending currently must rely on a loose assortment of statutes and common-law rules that were not designed to address the devastating harm [to cities, borrowers and even investors] inflicted by predatory lenders."[152] Remedies are rooted in traditional liberal notions of "informed consent and free will," and "consistent with that liberal ideology, under current remedies, predatory-lending contracts are generally enforceable except where fraud or nondisclosure has operated in some way that is inimical to free will."[153] However, "[b]arring this sort of culpable [process-oriented] misrepresentation [by the securitizer or lenders], . . . the law normally does not question the substance of predatory-loan terms."[154]

A. The Failure of Traditional Contract Law Remedies

Remedies under contract law and the Uniform Commercial Code (UCC) are inadequate. "Most contract defenses go to defects in formation of assent, rather than to disparities in bargaining power or fairness in contracts' substantive provisions."[155] Although the three doctrines of unconscionability, impracticability, and frustration under the law of contracts and the UCC permit challenges to the underlying substance of contract provisions,[156] the latter two "generally do not apply to predatory-lending cases."[157] Moreover, the doctrine of unconscionability's value in practice is nominal at best.

"If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract."[158] Further, a court "may enforce the remainder of the contract without the unconscionable clause, or . . . limit the

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151. *See* Quercia, *supra* note 25, at 5, 27; Eric Stein, *Quantifying the Economic Cost of Predatory Lending* (2001) (estimating losses from predatory lending at $9.1 billion annually) *available at* http://www.selegal.org/Cost%20of%20Predatory%20Lending.pdf.

152. *A Tale of Three Markets*, *supra* note 18, at 1298.

153. *Id.*

154. *Id.*

155. *Id.* at 1299.

156. *See id.*; *see generally* Robert A. Hillman, *An Analysis of the Cessation of Contractual Relations*, 68 CORNELL L. REV. 617 (1982) (discussing the viability of different justifications for a party seeking a cessation of contractual relations).

157. *A Tale of Three Markets*, *supra* note 18, at 1299.

158. *Id.* at 1300.

application of [the] clause to avoid any unconscionable result."[159] As applied to home loans, this attempts to account for the complexity of loan terms by voiding certain predatory terms. In addition, rules exist when parties who purchased loans on the secondary market sue delinquent borrowers.[160] "In those cases, the borrowers' ability to raise defenses is severely limited by the holder-in-due-course doctrine,"[161] which defines a holder in due course as the holder of an instrument if:

> (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and
>
> (2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in § 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in § 3-305(a).[162]

This allows a secondary-market purchaser to defeat all "personal" defenses to the loan agreement, including unconscionability, if it meets the requirements of a holder in due course.[163]

Finally, unconscionability claims and defenses are extremely expensive to litigate, dampening incentives to bring those claims, and a lender may be able to defeat the claim by adducing proof that the high price of the loan is justified by risk-based pricing, where prices rise in response to the added risk presented by the borrower.[164] As a result, these limitations make it exceedingly difficult for borrowers to challenge predatory-loan agreements as void under traditional contract law or the UCC.

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159. *Id.* Unconscionability has been defined to include "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.C. Cir. 1965). For a number of reasons, many courts have been reluctant to condemn excessive prices as unconscionable, without more. *See id.*

160. *A Tale of Three Markets*, *supra* note 18, at 1300.

161. This doctrine is contained in U.C.C. § 3-302 (2005).

162. *Id.*

163. *A Tale of Three Markets*, *supra* note 18, at 1300.

164. *See* Creola Johnson, *Welfare Reform and Asset Accumulation: First We Need a Bed and a Car*, 2000 WIS. L. REV. 1221, 1256 (2000) ("[D]isgruntled consumers are not likely to succeed in ligation on grounds of unconscionability"); Arthur Allen Leff, *Unconscionability and the Crowd – Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349, 354–57 (1970).

B. ANTIQUATED AND INEFFECTIVE

Antifraud laws are designed to redress information asymmetries in the formation of contracts.[165] However, their extensive proof requirements and limited scope make them antiquated and ineffective. "Common-law fraud requires proof of affirmative misrepresentation and does not encompass misleading omissions or manipulation," in addition to requiring "proof of detrimental reliance by the borrower,"[166] which victims of predatory lending must show for the protection of these laws. Thus the "limited scope of common-law fraud, coupled with pragmatic concerns, has constrained the number of criminal fraud prosecutions against predatory lenders and brokers."[167] Moreover, "[e]ffective criminal fraud prosecution depends on the willingness of district attorneys to prosecute predatory-lending fraud," and "limited local expertise, constrained resources, and other pressing prosecutorial demands—such as violent crime and drug trafficking—combine to militate against prosecuting predatory lenders."[168]

Although private causes of action for common-law fraud are an alternative route for victims of predatory lending, "fraud" is narrowly defined in common law, making it difficult to pursue such an action.[169] Moreover, common-law fraud actions may not afford victims full relief in the form of loan forgiveness.[170] This, coupled with the high cost of attorneys' fees, makes incentives to file suits for equitable relief (such as rescission or loan forgiveness) inadequate for private action, as these cases generally do not generate sufficient funds to compensate plaintiffs' counsel.[171] Furthermore, the need to prove individual reliance in fraud cases often makes it difficult to bring class actions, so potential plaintiffs have difficulty working together to protect their rights.[172] In addition, "mandatory-arbitration clauses in many predatory loan-agreements preclude resort to court altogether."[173] These problems have not been solved despite federal and state attempts at protective legislation.

As a response to the limitations of common-law fraud, the unfair and deceptive acts and practices legislation (UDAP) has been passed in all fifty

165. *A Tale of Three Markets*, *supra* note 18, at 1301.
166. *Id. See also, e.g.*, RESTATEMENT (SECOND) OF TORTS §§ 525, 537–45 (1977).
167. *A Tale of Three Markets*, *supra* note 18, at 1302.
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. These difficulties are both practical and legal. From a practical standpoint, in a very large class with plaintiffs from all over the country, it is difficult to show individual detrimental reliance for each borrower, as one would have to go above and beyond the normal requirements in certifying a class for such an action and actually handle each class member's case on an almost individual basis to show such reliance. From a legal standpoint, this could cause a case to last such a long time as to threaten the judicial economy that class actions are meant to serve. *See id.*
173. *Id.* at 1302–03.

states, the District of Columbia, and in Congress.[174] Although the federal statute, which prohibits unfair or deceptive acts or practices in or affecting trade or commerce,[175] grants enforcement to the Federal Trade Commission[176] (FTC), it does not provide a private right of action (either express or implied).[177] Moreover, while state UDAP statutes usually allow for private damage actions as well as state enforcement, they are sometimes restricted in their scope.[178]

C. STATUTORY FAILURE

While several federal statutes mandate the disclosure of standardized price information on loans in consumer lending,[179] these statutes all have major weaknesses. Although more recently states have responded to the problem of evading HOEPA by adopting measures that lower the coverage triggers for lenders in those states,[180] this increased disclosure is not enough because lenders will always find ways to evade disclosure requirements. Furthermore, the majority of victims of predatory lending already find

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174. *See generally* National Consumer Law Center, Unfair and Deceptive Acts and Practices 1.1. (4th ed. 1997 & Supp. 2000) [hereinafter UNFAIR AND DECEPTIVE ACTS AND PRACTICES].

175. *See* Section 5(a)(1) of the Federal Trade Commission Act, 15 U.S.C. 45(a)(2) (2000).

176. While the FTC has filed a number of recent enforcement actions challenging actions by predatory lenders as unfair and deceptive under Section 5 of the Federal Trade Commission Act, with some resulting in monetary relief to borrowers, the absence of a private cause of action, shifting political winds, and constraints on the FTC's enforcement resources "make private relief under the Federal Trade Commission Act highly unlikely for the vast majority of victimized borrowers." *A Tale of Three Markets*, *supra* note 18, at 1304.

177. *See* UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 174, at 9.1; *A Tale of Three Markets*, *supra* note 18, at 1304.

178. For example, some state statutes exclude credit and insurance transactions, often because financial institutions are exempted or because credit and insurance are deemed not to be "goods and services." This essentially would exempt the lenders and SPVs who are involved in these transactions from liability under such a statute. Moreover, weak attorneys' fees provisions in some state UDAP statutes discourage the private bar from bringing state UDAP claims, leaving plaintiffs with little recourse, even in instances of fraud. *See A Tale of Three Markets*, *supra* note 18, at 1304; UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note 174, at 8.1.

179. For example, TILA requires lenders to disclose finance charges and annual percentage rates to applicants for home mortgages, and the Real Estate Settlement Procedures Act (RESPA) entitles home-mortgage borrowers to good-faith estimates of settlement costs (GFEs) and statements of their actual closing costs in HUD-1 settlement statements. *See A Tale of Three Markets*, *supra* note 18, at 1304; 15 U.S.C. 1601-1693(c) (2000) (TILA); *see also* 12 U.S.C. 2601-2617 (2000) (RESPA).

180. Enacted in 1999, North Carolina's predatory-lending statute was the first. It retained the federal trigger for APRs of ten percent, but lowered the trigger for total points and fees to five percent for total loan amounts greater than or equal to $ 20,000, or the lesser of $ 1000 or eight percent of principal for smaller loans. The statute is also broader than HOEPA in that it covers home mortgages with prepayment penalties that either exceed two percent of the amount prepaid or are payable more than thirty months after closing. In 2000, the New York Banking Board amended part 41 of its regulations to lower the APR trigger from ten to eight percent and the trigger for total points and fees from eight to five percent. *See A Tale of Three Markets*, *supra* note 18, at 1304; N.C. Gen. Stat. 24-1.1E(a)(4), (a)(6) (1999); N.Y. Comp. Codes R. & Regs. Tit. 3, 41.1(d)-(3) (2000).

current disclosures incomprehensible, and piling on more disclosures will not help.[181]

Federal statutes have not succeeded in filling in the gaps left by state law. For high-cost, closed-end mortgages (other than purchase money-mortgages), HOEPA requires additional disclosures three days before closing.[182] Although violations of the Truth in Lending Act (TILA), the Real Estate Settlement Procedures Act (RESPA), and HOEPA are subject to agency enforcement, violators of TILA and HOEPA are also subject to criminal penalties.[183] "In addition, TILA,[184] RESPA,[185] and HOEPA[186] authorize private rights of action, but differ significantly in the types of relief they afford borrowers."[187] These statutes do not succeed in the activities they seek to prohibit and the relief they provide.[188] For example, TILA "has not lived up to its goal of standardizing disclosures on the total cost of credit because a long list of closing costs are currently excluded

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181. *A Tale of Three Markets*, *supra* note 18, at 1309.

182. Under HOEPA's advance disclosure provisions, the lender must inform the borrower of the annual percentage rate ("APR"), which is the effective interest rate the borrower will pay on a loan, the dollar amount of the periodic payments, the size of any balloon payments, the amount borrowed, and any charges for optional credit insurance or debt-cancellation coverage. HOEPA lenders must also advise borrowers in writing that they may lose their homes and are not obligated to proceed to closing simply because they signed a loan application or received disclosures. Lastly, for adjustable-rate mortgages that fall within HOEPA, lenders must disclose that the interest rate and monthly payment could increase, plus the amount of the single maximum monthly payment. *See A Tale of Three Markets*, *supra* note 18, at 1305; 15 U.S.C. 1601, 1602(aa), 1639(a)-(b) (2000) (TILA).

183. "Lenders who willfully and knowingly violate any requirement of TILA or HOEPA, for example, face a maximum fine of $ 5000 and imprisonment for up to one year." *A Tale of Three Markets*, *supra* note 18, at 1305 n.212; *see also* 15 U.S.C. 1611 (2000) (TILA).

184. "Under TILA, injured borrowers may seek actual damages, statutory damages, and attorneys' fees, either individually or in class actions, and may stave off foreclosure for up to three years after closing under TILA's provisions, where specified disclosures were not correctly made at closing." *A Tale of Three Markets*, *supra* note 18, at 1306; *see generally* NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING ch. 8 (4th ed. 1999) [hereinafter TRUTH IN LENDING].

185. "Under RESPA, private damages for erroneous disclosures generally cannot be awarded unless borrowers can prove that lenders: (1) failed to inform them that their loans could be transferred, (2) received kickbacks, or (3) steered them to title companies. Specifically lenders have no liability under RESPA for errors in GFEs or HUD-1 settlement statements, thereby weakening their incentives for accuracy." *See A Tale of Three Markets*, *supra* note 18, at 1306; 12 U.S.C. 2605(f)-2608 (2000) (RESPA).

186. "HOEPA's private remedies include all of the remedies that are available under TILA, plus special enhanced damages consisting of all finance charges and fees paid by the borrower and expanded rights of rescission." *A Tale of Three Markets*, *supra* note 18, at 1306; *see also* 15 U.S.C. 1640(a)(4) (2000) (TILA); *see generally* TRUTH IN LENDING, *supra* note 184, at 10.3.3, 10.6.

187. *A Tale of Three Markets*, *supra* note 18, at 1306–07.

188. HUD and the Federal Reserve Board raised concerns about the efficacy of these statutes in a joint report to Congress. *See* DEP'T OF HOUS. & URBAN DEV. & FED. RES. BOARD, JOINT REPORT TO CONGRESS, TRUTH IN LENDING ACT AND THE REAL ESTATE PROCEDURES ACT, EXECUTIVE SUMMARY II (1998), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf.

when computing financial charges and annual percentage rates."[189] In addition, although HOEPA has made improvements, it is easy to evade because of its narrow coverage, and it does not apply to purchase-money mortgages, reverse mortgages, or open-end credit lines of any kind.[190] More importantly, HOEPA only applies if (1) the annual percentage rate at consummation exceeds the yield on Treasury securities of comparable maturity plus eight percent for first-lien loans (or ten percent for subordinate-lien loans); or (2) the total points and fees exceed eight percent of the total loan amount or $400 (subject to annual indexing), whichever is greater.[191] As a result, to evade HOEPA, a lender can either style a loan as an open-end extension of credit, or keep the interest or total points and fees below the respective ten-and eight-percent triggers, which are so high that most lenders, including predatory lenders, are able to price their loans below them.[192]

V. IT'S NOT THEIR FAULT: WHY ASSIGNEES SHOULD NOT BE HELD LIABLE

In their March 2007 article, Engel and McCoy argue that, given "securitization's role in enabling and perpetuating predatory lending . . . the law should impose full, quantifiable assignee liability on securitized trusts that do not adopt adequate controls to filter out predatory loans from loan pools."[193] In addition, they argue that assignee liability should apply to suitability violations and certain other legal violations by mortgage brokers and lenders.[194] Their proposal seeks to hold the secondary market responsible for policing lenders.[195] A system of assignee liability is used whereby entities that engage in due diligence designed to detect loans with abusive terms have their liability capped.[196] Further, they propose extending assignee liability only to specific causes of action, including: (1) common law tort claims, such as fraud and improvident lending; (2) contract claims such as unconscionability; and (3) claims under state and local anti-predatory lending laws.[197] Additionally, they would impose liability on assignees for violations of a national suitability standard that they previously proposed in an earlier article.[198]

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189. *A Tale of Three Markets*, *supra* note 18, at 1306–07.
190. *Id.* at 1307. *See also* 15 U.S.C. 1602(i), (w), (bb) (2000) (TILA).
191. *See* 15 U.S.C. 1602(aa)(1)-(4) (2000) (TILA); TRUTH IN LENDING, *supra* note 184, 3.9.
192. *See A Tale of Three Markets*, *supra* note 18, at 1307–08; *see also* HUD-TREASURY REPORT, *supra* note 17, at 85; TRUTH IN LENDING, *supra* note 184, at 10.1.1.
193. *Turning a Blind Eye*, *supra* note 21, at 2042.
194. *Id.* at 2081.
195. *Id.*
196. *Id.*
197. *Id.* at 2089.
198. *See A Tale of Three Markets*, *supra* note 18, at 1366.

Although their proposal would provide new forms of redress for borrowers who have been victims of predatory lending, it seeks to do so by holding liable those who have purchased these securitized predatory loans on the secondary market.[199] This seems counterintuitive, in that borrowers have had no contact whatsoever with these purchasers, nor were the purchasers involved at any stage of the lending process.[200] While Engel and McCoy insist that this proposal would not espouse radical changes to the secondary market by comparing the due diligence proposed to that currently adopted by GSEs Fannie Mae and Freddie Mac,[201] those organizations are substantially larger than many of the private actors involved in this market, so the proposal could drive out many of these actors from the market. Through increased costs of due diligence, there is a danger of driving out legitimate credit if such a proposal were imposed. As stated earlier, legitimate subprime lending is necessary to provide a source of credit to borrowers that otherwise may have no such access to credit.[202] By imposing such heightened due diligence requirements on secondary market actors, actors that had nothing to do with the original loan process would subject themselves to substantial potential liability to borrowers, in addition to the high costs of such heightened due diligence. Engel and McCoy state that there is evidence that state anti-predatory lending laws have not had an adverse impact on the flow of subprime credit.[203] However, as they themselves made clear in this and an earlier article,[204] the current state anti-predatory lending laws are quite ineffective, and as such, one would not "expect them to have had too strong of an impact on 'the flow of subprime credit.'"[205]

As a result, although Engel and McCoy are truly experts in this field, their most recent proposal seems, at this point, to go too far in looking to impose assignee liability on secondary market actors. However, it remains to be seen whether, if there is a regulator either created or assigned to this industry, their proposal could be in turn adopted.[206] If there were such a regulator for the industry, then at least some of the costs associated with

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199. *See generally Turning a Blind Eye*, *supra* note 21.

200. Purchasers on the secondary market buy securities that include loans made by banks and SPVs to borrowers that already contain the predatory loans. This is because the "lenders [don't] care," because they have sold the mortgages and "their hands [are] clean." *See* David Hendricks, *Financing of Homes Must Change*, MY SA BUSINESS, Sept. 9, 2008, http://www.mysanantonio.com/business/columnists/david_hendricks/Financing_of_homes_must_change.html.

201. *See Turning a Blind Eye*, *supra* note 21, at 2095.

202. *See supra* Part I.

203. *Turning a Blind Eye*, *supra* note 21, at 2098.

204. *See generally*, *A Tale of Three Markets*, *supra* note 18.

205. *Turning a Blind Eye*, *supra* note 21, at 2096–7.

206. A regulator was proposed in Engel & McCoy's earlier article *A Tale of Three Markets*, *supra* note 18.

their proposal would be reduced, and there would be much lower risk of losing critical actors in what was at one time a profitable and vital industry.

VI. HELP IS AROUND THE CORNER

Current regulation and remedies in the subprime industry do not address the grave problems in the subprime lending industry. Remedies and regulations, some of which allow actors like extant SPVs to avoid any liability despite being involved in the securitization of loan pools that include predatory loans, are one major problem.[207] Coupled with the lack of a true regulator for the subprime lending industry, these matters have allowed the entities involved in this industry to continue to avoid liability despite dealing in illegal predatory loans. Although there are agencies that regulate certain entities involved in securitization,[208] these agencies do not regulate the subprime lending industry as a whole. Legislation should thus be passed to either create a new regulatory organization to oversee the lending industry and resulting securitization, or designate the U.S. Securities and Exchange Commission (SEC) as the industry's regulator. By having a regulator specifically for the lending and securitization industry, consumer-protection mechanisms or remedies that do have potential to be effective may be more properly applied, in addition to creating true accountability for those who continue to violate proper lending practices. This, in turn, would allow for SPVs to be held accountable for engaging in securitization of loan pools that contain predatory loans, without leaving it in the hands of secondary market actors, or lenders themselves to comply with proper lending practices. Therefore, legislation must be passed to cover this industry and force industry actors to comply with appropriate lending practice standards.

A. THE NEED FOR A REGULATOR

First, all entities that desire to be involved in the lending industry and resulting securitization should be required to register with this new regulator, similar to member firms who register with the Financial Regulatory Authority (FINRA) in order to participate in trading securities.[209] In conjunction with this requirement, these actors should be required to adopt the "best practice standards" that were created by the

207. *See generally Turning a Blind Eye*, *supra* note 21.

208. For example, the Office of the Comptroller of the Currency "charters, regulates, and supervises all national banks." As a result, although they have worked towards identifying predatory practices within their regulation of national banks, most mortgage creating institutions are outside this scope, and other agencies have to fill this regulatory gap in order to be successful in stopping predatory lending practices. *See* Comptroller of the Currency Administrator of National Banks, About the OCC, http://www.occtreas.gov/aboutocc.htm (last visited Oct. 29, 2007).

209. "FINRA is the largest independent regulator for all securities firms doing business in the United States." *See* FINRA homepage, http://www.finra.org/index.htm.

GSEs involved in this industry, Fannie Mae and Freddie Mac. This would require, for example, that lenders eliminate certain prepayment terms and balloon clauses that make their loans predatory. As stated above, those currently outside of the "conforming market" are free to adopt internal standards of their own, which has resulted in very few actors adopting the "best practices."[210] By requiring all entities in this industry to adopt the best practices in order to qualify to participate in this market, there would finally be a new sheriff in town.

To ensure compliance with the "best practice" standards, the SPVs' securitized products should be subject to a thorough investigation prior to being sold on the secondary market to investors (assignees). A regulator could apply the fraud provisions[211] from the Securities Exchange Act of 1934 to these securities if they have not complied with the required standards, thus subjecting them to criminal liability, in addition to a private right of action that courts have implied in cases under this statute.[212] The best practice standards would require heightened disclosure by the SPVs of the quality of loans being securitized, as well as an explanation by lenders to borrowers of the clear meanings of the various loan terms. By subjecting the entities involved in subprime lending to such standards, in addition to regulation by an industry regulator, those that did not comply with the disclosure requirements would violate the fraud provisions for making a material misstatement. This would incentivize SPVs to fulfill their due diligence and disclosure requirements more properly and not just engage in aggregation of acceptable loans and predatory loans in order to assemble more diversified loan pools, without increasing significantly the costs of secondary market actors to participate in this industry.[213]

B. EVENING THE PLAYING FIELD

Moreover, SPVs should be exempted from the protection of the "holder-in-due-course" rule that reduces SPV's legal risk. The new regulator of this industry should apply a rebuttable presumption of bad faith when an SPV attempts to sell securitized loan pools that contain predatory loans to investors. This would be fair, as the SPVs would be aware that they were subject to heightened due diligence requirements in selling these loans, and as a result should have screened out such predatory loans prior to securitizing and attempting to sell the product to investors. Thus, the SPV

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210. *See supra* Part III, C.

211. *See* Securites and Exchange Act of 1934, § 2B, 15 U.S.C. §78(j)(b) (2000); *see also* 17 C.F.R. §240.10b-5 (2007).

212. *Id.*

213. This is because if the regulator would be responsible for investigating loan pools to make sure they comply with the requisite standards as opposed to the secondary market actor being solely responsible for ensuring compliance, the overall costs can be reduced for the secondary market actors, shared with the regulator. Further, if the regulator is funded by the government, then costs will be spread throughout the nation from United States tax dollars.

would not qualify as a "holder-in-due-course," because to do so, holders of an instrument must be doing so in good faith.[214] It could be argued that this would disincentivize SPVs from participating in the lending industry because of the potential liability and increased costs. However, because of the potential for lucrative profits, and the marginal costs in requiring SPVs to conduct proper due diligence and comply with best practice standards (when they would be doing so in conjunction with a regulator also using its resources to screen loan pools), this would help curb the predatory lending problem, without removing these entities from this profitable market.

C. WE NEED DILIGENCE

In conjunction with removing SPVs from the "holder-in-due-course" exemption, there should be changes made in the due diligence requirements that currently exist in this industry. SPVs must be incentivized to insist on proper due diligence compliance by lenders, such as subjecting them to liability along with lenders[215] (for example a substantial fine, and after multiple violations a bar from participating in the lending and securitization markets). Moreover, in cases of Rule 144A offerings, substantive due diligence on the part of the institutional investor (the SPV) should be required apart from any conducted by the lenders, underwriters, or rating agencies. As stated above, predatory loans may avoid SEC regulation if they qualify for the Rule 144A exemption, which can be easily achieved. It is necessary to remove Rule 144A offerings from this exemption, and subject them to SEC regulation or at least to that of a new industry regulator.

Another change that should be made is to require lenders to retain their interest in the subordinated tranches that they helped create in securitizing the loan pools. By forcing these lenders to retain their residuals, they would be incentivized to make sure that they were safe loans in the first place. The central purpose of residuals is to force lenders to retain the bulk of the credit risk they create and by forcing them to retain the residuals, they would not be able to avoid the credit risk of improper loans and the potential defaults on re-payment of such loans. As a result, this would allow the market discipline that residuals were meant to exert on lenders to actually be effective.

As stated above, the current federal and state law regimes have numerous holes that allow predatory lenders to escape their reach.[216] Although some states have begun to resolve this problem by lowering coverage triggers within their state, states are not equipped with the

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214. U.C.C. § 3-302 (2005).

215. As stated above, this would at least in part be due to SPVs exemption from the protections of the holder-in-due-course rule, whenever predatory loans comprised part of a securitized loan pool that was being sold to investors.

216. *See supra* Part IV.C.

financial experience and regulatory capacity necessary to combat the creativity of predatory lenders.[217] Thus, the SEC, or a regulator that would be specifically created for this industry, would apply its expertise in this area to determine whether an appropriate coverage trigger for applying HOEPA would be nationwide.

Moreover, even where due diligence is required, there is an inherent conflict of interest when the underwriters who appraise the scrutinized loans work for the lenders. "Securitization may be the only business in the world where the appraiser is hired by, paid by, and thus works for, the seller rather than the buyer."[218] For example, "it would be unthinkable in a real estate transaction for the seller of a property to expect that the buyer would accept a seller-provided appraisal as the basis of the buyer's valuation, and yet this is exactly what transpires in the bond market."[219] Thus, this conflict of interest must be removed and realigned. This could be accomplished by either requiring the rating agencies to work for the bond buyers, or at the very least by requiring full disclosure to the borrowers that the agencies work for or with the lenders. If these agencies do not comply with such disclosure requirements, they should be subject to criminal liability brought by the regulator of the industry, as well as a private cause of action brought by a victimized borrower.

D. GIVING BORROWERS A CHANCE

Another necessary change in the current remedial structure is an adjustment of the requirements for common law fraud actions pursued by borrowers against lenders who have purveyed predatory loans. As stated previously, the current state of the law makes it very difficult for borrowers to successfully bring individual anti-fraud actions, as they are costly and have difficult proof requirements for plaintiffs. The "American Rule,"[220] in which each party bears it own attorneys' fees and costs, provides incentives to file suits for injunctive relief, such as rescission or loan forgiveness inadequate for the private bar. This, coupled with the need to prove individual reliance in fraud cases, often makes it difficult to bring class actions.[221] However, there are solutions to these complex problems.

One solution would be to adjust the traditional "American Rule" in the context of cases involving fraudulent predatory loans to borrowers. If legislation is passed to allow recovery of attorneys' fees and costs by the prevailing party for specifically these circumstances, borrowers with legitimate suits could afford to bring claims against a fraudulent lender who

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217. *See A Tale of Three Markets*, *supra* note 18, at 1305.
218. Penner, *supra* note 91, at A11.
219. *Id.*
220. *See* The 'Lectric Law Library's Lexicon On, "American Rule," http://www.lectlaw.com/def/a107.htm.
221. *See supra* note 172, and accompanying text.

has purveyed a predatory loan. This would not threaten the judicial economy, as borrowers with frivolous suits would be deterred from bringing such a suit for fear of having to pay the other side's attorney's fees and costs, while incentivizing those with legitimate suits to come forward and help combat the predatory lenders that exist throughout the nation.

Another solution to these complex problems of bringing a loan fraud action for borrowers is to change the proof requirements when bringing a class action. Instead of requiring proof of individual reliance in fraud cases, which is quite impractical, this area of the law could adopt the fraud-on-the-market theory, which is applied in the case of materially misleading statements made by directors on a corporation's behalf to the detriment of shareholders.[222] This theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.[223] Thus, misleading statements will defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.[224] As applied to the lending industry, this would allow for class action borrowers to avoid having to show direct reliance on a fraudulent misstatement regarding the loan terms. Instead, a rebuttable presumption of reliance would be applied. It would then be the lenders' burden to rebut such a presumption. The policy behind this theory is that requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would prevent these plaintiffs (borrowers) from proceeding with a class action, since individual issues then would overwhelm the common ones.[225] While this is a different situation than the case in which the doctrine developed, the central principle remains the same: investors or borrowers rely on the integrity of the price set by the market, and forcing plaintiffs in these cases to show a speculative state of facts (for example, how he or she would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made), would place an unrealistic evidentiary burden on the plaintiffs. The presumption of reliance employed in these instances is consistent with congressional policy embodied in the Securities Exchange Act of 1934.[226]

222. This theory was applied in Basic Inc. v. Levinson, 485 U.S. 224 (1988), where a corporation issued three public statements denying that it was engaged in merger negotiations when it really was, and as a result, plaintiffs alleged they had sold their shares at artificially depressed prices in a market affected by the corporation's misleading statements in reliance thereon.
223. *Id.*
224. *Id.*
225. *See Basic*, 485 U.S. at 224.
226. *Id.*

VII. CONCLUSION

Consequently, it is apparent that in the current state of affairs, the subprime lending industry will not fix itself through self-regulation or existing remedies. There are significant gaps existing in the current law, and the remedies that are available for borrowers are inadequate. Further, the entities involved in predatory subprime lending and securitization of loan pools that include predatory loans have no incentives to divert from their current behaviors, as they have not been faced with liability for noncompliance with the standards and practices of proper subprime lending. Thus, it is clear that these entities need to be regulated, and through SRO regulation, current standards and mechanisms that exist to prevent predatory subprime lending must be adjusted to properly combat this harmful practice. In addition to this regulation, if at least some of the aforementioned changes are made to the current remedial system in place, borrowers and investors will receive meaningful recourse, without subjecting profit-seeking actors in the subprime lending and securitization industry to prohibitive costs. Furthermore, going forward, noncompliance with new regulations and rules would subject the entities in this industry to fines, a bar from the industry, and criminal or substantial civil liability. Inscribed on the pediment of Winston Churchill's statute at the site of the Winston Churchill Memorial and Library is the epigraph from Churchill's *History of the Second World War:* "In war, resolution. In defeat, defiance. In victory, magnanimity. In peace, good will."[227]

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227. *See* University of Missouri Press, http://press.umsystem.edu/fall1995/kemper.htm (last visited Nov. 2, 2008).

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