10(b) OR NOT 10(b)?: YANKING THE SECURITY BLANKET FOR ATTORNEYS IN SECURITIES LITIGATION

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I. INTRODUCTION

> Where were these professionals . . . when these clearly improper transactions were being consummated?
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> Why didn't any of them speak up or disassociate themselves from the transactions?
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> Where also were the outside accountants and attorneys when these transactions were effectuated?
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> What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.
>
> Judge Stanley Sporkin[1]

The renewed debate over whether and, if so, how defrauded investors can hold attorneys liable for perpetrating securities fraud is now a decade old. Until 1994, attorneys could be held liable by private plaintiffs when they aided and abetted violations of Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)"). In 1994, the Supreme Court, in *Central Bank of Denver v. First Interstate Bank of Denver*, held that a private plaintiff could not bring suit against a defendant for aiding and abetting a

[1] Lincoln Savings and Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

Section 10(b) violation.[2] A five-four majority of the Justices held that only primary liability under Section 10(b) was actionable by private plaintiffs. This decision was a windfall for attorneys and other non-issuer defendants such as accountants, analysts, and underwriters who had historically been brought into Section 10(b) lawsuits as aiders and abettors. After *Central Bank*, private plaintiffs could only sue these potential defendants if the defendants themselves had violated Section 10(b), as opposed to merely assisting others who were violating Section 10(b). The implications of the *Central Bank* decision were huge: the attorney conspirators who were critical to effectuating fraudulent transactions now appeared to be almost unreachable by defrauded investors.

In the decade since *Central Bank*, federal courts have struggled with this issue. Clearly, the federal courts want to adhere to the Supreme Court's edict in *Central Bank* disavowing the "aiding and abetting" liability of attorneys under Section 10(b). At the same time, the courts recognize that, at least in certain situations, attorneys should be held liable as primary violators of (as opposed to aiders and abettors under) Section 10(b). Some federal appellate courts have attempted to establish tests to categorize when to hold attorneys liable as primary violators of Section 10(b) (as opposed to unreachable aiders and abettors). Other courts have essentially preserved aiding and abetting liability in apparent contravention of *Central Bank*. Finally, certain courts have allowed clearly fraudulent behavior to escape liability. A schizophrenic jurisprudence has evolved.

The federal judiciary must take a more principled approach to resolving attorney liability under Section 10(b). On the tenth anniversary of *Central Bank*, investor confidence remains dramatically low, and corporate misconduct is rampant. Absent a principled and purposeful application of Section 10(b) to attorneys, incidents of

[2] 511 U.S. 164 (1994).

corporate misconduct will not abate. Attorneys need a compelling reason to disassociate themselves from fraudulent transactions, or investors will continue to be fleeced through attorney-aided acts of corporate deceit. The judiciary must aggressively apply Section 10(b) to attorneys as primary violators.

This Article attempts to guide the federal judiciary through a principled application of Section 10(b) to attorneys. Part II of this Article provides background on Section 10(b) and the Supreme Court's decision in *Central Bank*. Part III discusses the federal appeals courts' struggles to distinguish primary liability from aiding and abetting liability under Section 10(b) after *Central Bank*. Part IV provides suggestions to the judiciary on how to address the primary liability of attorneys under Section 10(b). Specifically, Part IV of this Article demonstrates that a strict "test"-based application of Section 10(b) to attorney conduct is unnecessarily restrictive. A flexible application of Section 10(b), still based on precedent, is a more intellectually honest application of that rule that is true to the textualist method of statutory interpretation implicitly advocated in *Central Bank*. Moreover, Part IV discusses the compelling societal and policy indicators that weigh in favor of a broader application of Section 10(b) to attorneys. In short, the federal judiciary must broadly apply Section 10(b), as its drafters intended, to help ameliorate widespread fraud in the purchase or sale of securities.

II. SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

A. Section 10(b), Rule 10b-5, and the Elements of a Cause of Action Thereunder

Section 10(b) of the Securities Exchange Act of 1934 prohibits fraud in connection with the purchase or sale of

securities.[3] Under Section 10(b), it is unlawful for any person to

> use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe as necessary or appropriate in the public interest or for the protection of investors.[4]

Rule 10b-5,[5] promulgated by the Securities and Exchange Commission ("SEC" or the "Commission") under the authority granted to it by Congress in Section 10(b), provides that

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

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[3] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j) (2000).

[4] *Id.*

[5] Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2003).

> in connection with the purchase or sale of any security.[6]

To state a claim for relief under Rule 10b-5, a plaintiff must allege that "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury."[7] The federal appeals courts have required that a claim for relief for securities fraud allege five elements: (1) scienter, (2) materiality, (3) loss causation,[8] (4) transaction causation (sometimes referred to as "reliance"), and (5) that the fraud occurred "in connection with the purchase or sale of securities."[9]

The scienter needed to state a claim under Section 10(b) is the "intent to deceive, manipulate, or defraud."[10] The federal appellate courts have reached a consensus that recklessness is sufficient to establish the necessary intent to deceive, manipulate, or defraud,[11] although the Supreme

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[6] *Id.*

[7] Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 534 (2d Cir. 1999) (internal quotations and citations omitted).

[8] Interestingly, in *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 593 (2001) the Supreme Court did not recognize loss causation as a distinct element of a Section 10(b) lawsuit. Whether that was an unintended drafting omission or whether it was a deliberate statement (by omission) that loss causation is not a separate element of a Section 10(b) lawsuit, beyond its relevance with respect to establishing damages, is both unclear and beyond the scope of this Article.

[9] Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1095 (10th Cir. 2003).

[10] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976).

[11] *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983) (citing Third Circuit opinion collecting cases). At a minimum, to establish the defendant acted recklessly, a plaintiff must make "a showing of reckless disregard for the truth, that is, 'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care.'" SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998) (quoting Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir. 1978)); *see also In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615,

Court has declined to address "whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5."[12]

The misstatement of information or the failure to disclose information is only actionable if the misstated or omitted information is material.[13] A fact is material "if there is a substantial likelihood that a reasonable shareholder would

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626 (9th Cir. 1994) ("'recklessness' is conduct 'involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'").

The federal courts of appeals have split on how scienter must be pleaded. *See* Elizabeth A. Nowicki, *A Response to Professor John Coffee: Analyst Liability Under Section 10(b)*, 72 U. CIN. L. REV. 1305, 1317-19 (2004). Congress attempted in 1995 to clarify the parameters for pleading scienter when it enacted, over a Presidential veto, the Private Securities Litigation Reform Act of 1995 ("PSLRA"), incorporated as Section 21(D)(b)(2) of the Exchange Act. *See* 15 U.S.C. § 78u-4(b)(2) (2000). The PSLRA requires that, in any private securities fraud class action under Section 21(D), the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *See id.* Congress failed in this attempt to clarify the pleading standards, however, as the federal courts of appeals remain split. *See* Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000) ("as is so often the case with legislative history generally, the legislative history of the PSLRA contains 'conflicting expressions of legislative intent' with respect to the pleading requirement") (internal citation omitted); *In re* Comshare Inc. Sec. Litig., 183 F.3d 542, 552 n.10 (6th Cir. 1999) ("Viewed in its entirety, the legislative history is ambiguous and does little to accurately reveal Congress' intent here."); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 533 (3d Cir. 1999) ("Ultimately, we believe there is little to gain in attempting to reconcile the conflicting expressions of legislative intent, including the President's veto statement. The legislative history on this point is contradictory and inconclusive, and we are reluctant to accord it much weight.").

[12] *Hochfelder*, 425 U.S. at 194 n.12.

[13] *Press*, 166 F.3d at 534.

consider it important" in making a voting or investment decision.[14]

To establish transaction causation or "reliance" under Section 10(b), a plaintiff must "demonstrate that defendants' conduct caused him to engage in the transaction in question."[15] To establish loss causation under Section 10(b),

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[14] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining materiality in the context of proxy statements and Rule 14a-9). "Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*; *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) ("expressly adopt[ing] the *TSC Industries* standard of materiality for the [Section] 10(b) and Rule 10b-5 context").

[15] Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 174 (3d Cir. 2001) (internal citations and quotations omitted); *see also Basic*, 485 U.S. at 243.

Reliance is generally easily established in face-to-face transactions where a defendant made a misrepresentation or omission directly to an individual plaintiff. In modern securities markets, however, transactions are often not face-to-face; rather, the market is interposed between the buyer and seller. As noted by the Supreme Court, it is impractical to require that reliance in an open market transaction be established in the same way it is in a face-to-face transaction. *See Basic*, 485 U.S. at 244.

In response to this concern, the "fraud on the market" theory for establishing reliance developed:

> The fraud on the market 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. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Id. at 241-42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

In affirming the use of the fraud on the market presumption of reliance, the Supreme Court has held that:

plaintiffs "must allege that they would not have suffered a loss on their investment if the facts were as they believed them to be at the time they purchased the securities."[16] "[T]he damage complained of [must] be one of the foreseeable consequences of the misrepresentation."[17] Lastly, a plaintiff must show that the complained of misstatement or omission

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> An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

Id. at 247.

The elements of materiality and reliance often collapse together, with proof of the former making unnecessary proof of the latter. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) ("Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."). *But see* Chelsea Assoc. v. Rapanos, 527 F.2d 1266, 1271 n.2 (6th Cir. 1975) ("The difference between the elements of materiality and reliance is the difference between the inquiry of whether a reasonable man would have attached importance to the misrepresentation as opposed to whether the individual plaintiff attached importance to the misrepresentation.") (citations omitted).

[16] *In re* VMS Sec. Litig., 752 F. Supp. 1373, 1399 (N.D. Ill. 1990). While a seemingly uncontroversial element of a Section 10(b) claim, this element has proved painfully difficult to establish, particularly in one-off cases where the defendant is a non-issuer. *See, e.g.*, Nowicki, *supra* note 11, at 1331-32 (discussing loss causation in the context of investment banking research analysts, noting that loss causation becomes "more difficult to establish with respect to non-issuers in part because causation is one-step removed with respect to non-issuers. It is easier to see how actions by an issuer caused a loss to investors than it is to see how actions by a third party—an analyst, an underwriter, an accountant, a lawyer—caused a loss.").

[17] AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 216 (2d Cir. 2000) (internal quotations and citations omitted).

was made "in connection with the purchase or sale of any security."[18]

Until the Supreme Court's decision in *Central Bank*, the federal judiciary recognized a private cause of action against aiders and abettors of Section 10(b) violations.[19] The federal appeals courts applied a three-part test for aider and abettor liability, requiring "(i) the existence of a primary violation of § 10(b) or Rule 10b-5, (ii) the defendant's knowledge of (or recklessness as to) that primary violation, and (iii) 'substantial assistance' of the violation by the defendant."[20] After *Central Bank*, however, aiding and abetting a violation of Section 10(b) is no longer actionable by a private plaintiff.[21]

B. *Central Bank of Denver v. First Interstate Bank of Denver*

In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority (the "Authority") issued a total of $26 million in bonds to finance a planned residential and commercial development, Stetson Hills.[22] Central Bank of

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[18] SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993) (quoting SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990)).

[19] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 194 (1994).

[20] *Id.* at 195-96.

[21] Interestingly, whether intentionally or not, the majority in *Central Bank* avoided saying that aiding and abetting a Section 10(b) violation is lawful:

> It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text. To be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances. The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute.

Id. at 177 (internal citations omitted).

[22] *Id.* at 167.

Denver ("Central Bank") was the indenture trustee for the bond issues.[23] Landowner assessment liens secured the bonds, and the bond covenants required that the land subject to the liens be worth at least 160% of the bonds' outstanding principal and interest.[24] AmWest Development ("AmWest"), the developer of Stetson Hills, was required, under the covenants, to give Central Bank an annual report substantiating the fact that the 160% test was met.[25]

In January 1988, AmWest provided Central Bank with an appraisal of the land securing the 1986 bonds and the land proposed to secure the 1988 bonds.[26] The appraisal showed that the 160% test was met; however, the senior underwriter for the 1988 bonds sent a letter to Central Bank expressing concern that the 160% test was not satisfied, as property values were declining where the land securing the liens was located.[27] Central Bank's in-house appraiser reviewed the 1988 appraisal and suggested that Central Bank retain an outside appraiser to review independently the 1988 appraisal.[28] To the in-house appraiser, the land values and resultant 1988 appraisal appeared overly optimistic.[29]

After exchanging letters with AmWest, Central Bank agreed not to conduct an independent review of the appraisal until the year's end, which was six months after the June 1988 closing on the 1988 bond issue.[30] The Authority defaulted on the 1988 bonds before the independent review was completed.[31]

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[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.* at 167-68.
[29] *Id.* at 167.
[30] *Id.* at 168.
[31] *Id.*

First Interstate Bank of Denver and Jack Naber had purchased $2.1 million of the 1988 bonds, and, after the default, they sued the Authority, the 1988 underwriter, a junior underwriter, and an AmWest director for violations of Section 10(b).[32] The complaint also alleged that Central Bank was "secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud."[33] The District Court for the District of Colorado granted summary judgment in favor of Central Bank, and the Tenth Circuit Court of Appeals reversed.[34] The Tenth Circuit Court of Appeals panel set forth elements of a Section 10(b) aiding and abetting cause of action and found that First Interstate and Naber had made allegations sufficient to present to a trier of fact.[35]

The Supreme Court "granted certiorari to resolve the continuing confusion over the existence and the scope of the § 10(b) aiding and abetting action."[36] The specific issue the Court addressed was "whether private civil liability under § 10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation."[37] The Court held that, "[b]ecause the text of § 10(b) does not prohibit aiding and abetting, . . . a private plaintiff may not maintain an aiding and abetting suit under § 10(b)."[38] The Court reasoned that "aiding and abetting

[32] *Id.*

[33] *Id.* (internal citations omitted).

[34] *Id.*

[35] *Id.* at 168-69.

[36] *Id.* at 170.

[37] *Id.* at 166. Interestingly, this issue was not the issue on which certiorari was sought. Certiorari was sought on the issue of "whether an indenture trustee could be found liable as an aider and abettor absent a breach of an indenture agreement or other duty under state law" and the issue of "whether it could be liable as an aider and abettor based only on a showing of recklessness." *Id.* at 194 (Stevens, J., dissenting). All parties, it seems, had assumed the existence of aiding and abetting liability.

[38] *Id.* at 181. For purposes of defining aiding and abetting, the Court referenced the Restatement (Second) of Torts § 876(b) (1977), noting that "[a]n actor is liable for harm resulting to a third person from the tortious

liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do," and, absent some indication from Congress that it intended to prohibit aiding and abetting, one cannot assume that it did.[39]

The Court noted that "[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement or omission on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met."[40] Hence, *Central Bank* does not preclude a lawsuit against a lawyer for primary liability under Section 10(b).[41]

Within months of the *Central Bank* decision, legislators, securities regulators, and special interest groups began responding to what they viewed as a misinterpretation of Section 10(b). At a Congressional hearing shortly after the *Central Bank* decision was issued, Senator Christopher Dodd (D-Conn.) stated that "aiding and abetting liability has been

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conduct of another 'if he . . . knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other. . . .'" *Central Bank*, 511 U.S. at 181 (internal citations omitted).

[39] *Central Bank*, 511 U.S. at 176 ("Congress knew how to impose aiding and abetting liability when it chose to do so."). Section 10(b) "prohibits only the making of a material statement (or omission) or the commission of a manipulative act. . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act." *Id.* at 177 (internal citations omitted).

[40] *Id.* at 191 (emphasis omitted).

[41] *Id.* And, to be clear, barely a majority wanted to free aiders and abettors from liability: The Court was split five to four on the issue of aiding and abetting liability under Section 10(b). *Id.* at 192. Justices Stevens, Blackmun, Souter, and Ginsburg would have supported the imposition of aiding and abetting liability under Section 10(b), for reasons including the long history of such and the policy perils to be had for other forms of secondary liability by not sustaining aiding and abetting liability with respect to Section 10(b). *Id.* Similarly, *Central Bank* does not preclude a lawsuit against an analyst, either, for primary liability under Section 10(b). *See generally* Nowicki, *supra* note 11.

critically important in deterring individuals from assisting possible fraudulent acts by others."[42] At that same hearing, the then-Chairman of the Securities Exchange Commission, Arthur Levitt, stated that

> persons who knowingly or recklessly assist the perpetration of a fraud may be insulated from liability . . . if they act behind the scenes and do not themselves make statements directly or indirectly that are relied upon by investors. Because this is conduct that should be deterred, Congress should enact legislation to restore aiding and abetting liability in private actions.[43]

Further, the North American Securities Administrators Association, the Association of States Securities Regulators, and the Association of the Bar of the City of New York endorsed the restoration of aiding and abetting liability.[44]

These sentiments resulted in a proposed amendment to the Private Securities Litigation Reform Act ("PSLRA"), known as Amendment 1474 or the Bryan Amendment. This Amendment sought to restore aiding and abetting liability to make clear that "the Senate of the United States believes that those who counsel, who aid, who provide assistance to those who perpetrate investor fraud, ought to be held responsible."[45]

Some Senators opposed the proposed amendment because they believed that aiding and abetting liability "held the business community to an incredibly high standard, particularly when they could be held liable for damages that are far greater than any damage that they have caused."[46]

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[42] 141 CONG. REC. 35,242 (1995) (statement of Sen. Sarbanes, quoting Sen. Dodd).

[43] 141 CONG. REC. 35,242 (1995) (statement of Sen. Sarbanes, quoting Arthur Levitt, Chairman, Securities and Exchange Commission).

[44] 141 CONG. REC. 35,242 (1995) (statement of Sen. Sarbanes).

[45] 141 CONG. REC. 17,225 (1995) (statement of Sen. Bryan).

[46] 141 CONG. REC. 17,224 (1995) (statement of Sen. D'Amato).

For example, Senator Alfonse M. D'Amato (R-N.Y.) mirrored the Supreme Court's concern from *Central Bank* that aiding and abetting liability "presents a danger of vexatiousness, different in degree and kind and would require secondary actors to expend large sums, even for pretrial defense and negotiations of settlements."[47]

The Bryan Amendment was rejected with sixty nays to thirty-nine yeas,[48] and the PSLRA became law without restoring aider and abettor liability in private causes of action.[49] However, in February 2002, four months after the Enron scandal became public, another legislative attempt was made to restore aiding and abetting liability under Section 10(b). Representative John J. LaFalce (D-N.Y.) introduced the Comprehensive Investor Protection Act of 2002,[50] which was intended, in part, to "provide a private right of action against anyone (auditors, lawyers and other outside professionals) who knowingly or recklessly provides substantial assistance to another person in violation of the securities laws."[51] Representative LaFalce later supplemented this initial attempt to restore aider and abettor liability when he proposed the Corporate Responsibility Act of 2002.[52]

This proposed legislation evolved into what would eventually become the Sarbanes-Oxley Act, and Representative LaFalce filed a petition to discharge House Resolution 3818 for reasons that are unclear.[53] Consequently, when Congress finally presented the

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[47] *Id.*

[48] 141 CONG. REC. 17,230 (1995).

[49] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended at 15 U.S.C. § 77z-1 (2000)).

[50] H.R. 3818, 107th Cong. (2002).

[51] 148 CONG. REC. E238-39 (daily ed. Feb. 28, 2002) (statement of Rep. LaFalce).

[52] H.R. 4083, 107th Cong. (2d Sess. 2002).

[53] 148 CONG. REC. H4478 (daily ed. July 10, 2002) (statement of Rep. LaFalce).

Sarbanes-Oxley Act to President George W. Bush for his signature on September 4, 2002, aider and abettor liability was not included in the legislation.[54]

One last attempt was made to restore a private right of action for aiding and abetting liability in October of 2002 when Representative Edward J. Markey (D-Mass.) introduced the Stop Enablers of Fraud Act.[55] This legislative proposal attempted to "eliminate the exemption that shields accounting firms, investment banks, and other professional services firms from liability in private suits when they assist their clients in committing securities fraud."[56] On October 10, 2002, this bill was sent to both the House Committee on Financial Services and to the House Committee on the Judiciary, and it apparently died a quiet death.

Neither house of Congress has made any further attempts to restore aider and abettor liability as a private right of action. Moreover, the Supreme Court has not intimated that it intends to reverse *Central Bank*. Thus, no private right of action currently exists against aiders and abettors of Section 10(b).

This is problematic, because an aiding and abetting cause of action under Section 10(b) had been the easiest way to hold liable non-issuer defendants such as outside attorneys, analysts, and accountants. It is easier for a plaintiff to argue that these "secondary actors"—outside accountants, outside counsel, underwriters, etc.—"aided and abetted" securities fraud than it is for a plaintiff to argue that these secondary parties actually committed the securities fraud themselves as "primary violators." Attorneys (and other secondary actors) are usually one step removed from the investors. The attorneys are typically neither directly soliciting investors

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[54] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

[55] H.R. 5625, 107th Cong. (2d. Sess. 2002).

[56] 148 CONG. REC. 1831 (daily ed. Oct. 10, 2002) (statement of Rep. Markey).

nor communicating with the public under their own name. It is conceptually difficult to argue then that an attorney made a materially misleading misrepresentation or omission on which an investor relied and which caused an investor's loss in connection with the purchase or sale of securities when the attorney never spoke to the investor and when the investor never knew of the attorney. For example, an issuer and its senior officials who knowingly sign and distribute directly to investors a fraudulent prospectus are easy to capture as primary violators of Section 10(b). These parties made a material misrepresentation, in connection with the purchase or sale of securities, on which the purchaser relied.[57] But it is more difficult to pursue the attorney who drafted the materially misleading prospectus at the specific direction of the senior officers because the attorney's role in the fraud is one step removed from those who actually conveyed the materially misleading statements to the public. It is much easier to argue that the attorney aided and abetted a Section 10(b) violation.

Suing "secondary actors" as "primary violators" has therefore been a less desirable course of action for plaintiffs. However, given the Supreme Court's holding in *Central Bank*, a private plaintiff can only sue a secondary actor as a primary violator under Section 10(b).[58] What follows is a discussion of the federal appellate courts' struggle with the primary liability of secondary actors and some suggestions to the judiciary to guide them through this Serbonian bog.

III. PRIMARY LIABILITY OF SECONDARY ACTORS UNDER SECTION 10(b) AFTER *CENTRAL BANK*

After *Central Bank of Denver*, an attorney can be held liable under Section 10(b) only as a primary violator. As

[57] *See generally* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 534 (2d Cir. 1999).

[58] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

noted above, it is difficult, both as a matter of fact and of proof, to establish the liability of an attorney as a primary violator because the attorney is usually one step removed from the complaining investor. The issuer, not outside counsel, communicates directly with the complaining investor.[59] The federal appellate courts have struggled with this issue with varying degrees of success. This struggle has, in part, produced two tests: the "bright line" test, used by the Second, Tenth, and Eleventh Circuits, and the "substantial participation" test, used by the Ninth Circuit.[60] These tests and other federal courts of appeals' resolutions of the secondary actor qua primary violator issue are discussed below.[61]

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[59] Cases which deal with opinion letters drafted and signed by counsel which contain materially misleading misrepresentations or omissions are not conceptually troubling under Section 10(b). *See, e.g.*, Ackerman v. Schwartz, 947 F.2d 841 (7th Cir. 1991). In these instances, particularly if counsel knew the opinion letters would be circulated to investors, establishing a Section 10(b) violation is straightforward.

[60] *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 583 (S.D. Tex. 2002) ("In sum, the Supreme Court [in *Central Bank*] left it to the lower courts to determine when the conduct of a secondary actor makes it a primary violator under the statute. In the aftermath of *Central Bank*, two divergent standards, the 'bright line' test and the 'substantial participation' test, have emerged.").

[61] Note, however, that many of the cases from which the secondary actor jurisprudence has evolved are cases involving not attorney-defendants but accountant-defendants. The case law addressing the primary liability of attorneys under Section 10(b) is remarkably thin. It appears that the few federal courts of appeals cases dealing with the primary liability of attorneys under Section 10(b) directly include only Kline v. First Western Govt. Sec., Inc., 24 F.3d 480 (3d Cir. 1994); Asdar Group v. Pillsbury, Madison & Sutro, 99 F.3d 289 (9th Cir. 1996); Anixter v. Home-Stake Prod. Co., 77 F.3d 1215 (10th Cir. 1996); and Ziemba v. Cascade Int'l, 256 F.3d 1194 (11th Cir. 2001). This might in part be because plaintiffs' attorneys recognize the difficulty of suing attorneys (for both reasons of logistics and professional courtesy), because claims against attorneys in these instances are dismissed without published opinions early in the lawsuits, or because attorneys and their insurers are savvy enough to settle these cases cheaply.

A. The "Bright Line" Test

The Second, Tenth, and Eleventh Circuits apply what has been characterized as a "bright line" test when analyzing whether a secondary actor can be liable as a primary violator of Section 10(b).[62] To be liable under this test, the secondary actor must himself make a material misstatement or omission, rather than merely participate in the creation thereof.[63] Apart from this basic requirement, the Second, Eleventh, and Tenth Circuits differ slightly. The Eleventh Circuit further requires a plaintiff to establish that "the alleged misstatement or omission upon which a plaintiff relied [was] publicly attributable to the defendant at the time that the plaintiff's investment decision was made."[64] The Tenth Circuit, however, imposes no separate requirement that the alleged misstatement or omission be publicly attributable to the defendant.[65] Rather, the Tenth Circuit requires that the defendant "know or should know" that his misrepresentation or omission "will reach potential investors."[66]

In the Second Circuit, a secondary actor defendant "must actually make a false or misleading statement in order to be held liable under Section 10(b)."[67] Moreover, "because § 10(b) and Rule 10b-5 focus on fraud made in connection with the

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[62] *In re Enron*, 235 F. Supp. 2d at 583. *See also Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998); *Anixter*, 77 F.3d at 1126-27; and *Ziemba*, 256 F.3d at 1205.

[63] *Ziemba*, 256 at 1205; *Anixter*, 77 F.3d at 1225.

[64] *Ziemba*, 256 F.3d at 1205.

[65] *Anixter*, 77 F.3d at 1225-26 ("There is no requirement that the alleged violator directly communicate misrepresentations to plaintiffs," but the plaintiffs must make a showing that the defendant "knew or should have known that his representations would be communicated to investors," and the defendant must "themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.").

[66] *Id.*

[67] *Wright*, 152 F.3d at 175.

sale or purchase of securities, a defendant must know or should know that *his* representation would be communicated to investors."[68] Further, in the Second Circuit, "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination."[69]

Of these three Circuits—the Tenth, Second, and Eleventh—only the Tenth Circuit Court of Appeals has squarely addressed the liability of attorneys as primary violators of Section 10(b) (the Second and Eleventh Circuits' jurisprudence has developed from cases where the defendants were secondary actors other than attorneys). In *Ziemba v. Cascade Int'l, Inc.*, an Eleventh Circuit panel held that a corporation's attorneys who had both drafted and edited allegedly fraudulent letters and press releases and had also communicated with analysts and the press regarding the corporation at issue could not be held primarily liable for violating Section 10(b).[70] Plaintiffs in *Ziemba* were shareholders of the then-bankrupt Cascade International, Inc., and the plaintiffs brought suit against the officers and directors of Cascade, Cascade's independent auditors, Cascade's accounting firm, and Gunster, Yoakley & Stewart, P.A. ("GY&S"), Cascade's regularly used outside counsel, alleging, among other things, violations of Section 10(b) in connection with misstatements of assets, revenues, and profits and unauthorized issuances of stock.[71]

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[68] *Id.* (internal citations and quotations omitted).

[69] *Id.* The court justified this position by noting that to hold otherwise "would circumvent the reliance requirements of the Act, as '[r]eliance only on representations made by others cannot itself form the basis of liability.'" *Id.* This is a curious justification, however, because the second half of the court's sentence does not necessarily follow the first part. Requiring reliance on representations made by the defendant does not mandate that the statements at issue be attributed to the defendant at the time of their dissemination. *See* note 133, *infra*.

[70] 256 F.3d 1194.

[71] *Id.* at 1197-98.

Specifically, with respect to GY&S, the plaintiffs alleged that (1) GY&S was aware of inaccuracies in Cascade's financial statements and press releases, (2) GY&S drafted a memorandum for Cascade's CEO suggesting statements to be made in response to and essentially disagreeing with or deflecting statements by a stock service indicating that Cascade likely had financial troubles, (3) GY&S drafted an opinion letter for Cascade, justifying on the basis of bankruptcy non-consolidation by Cascade of the financial statements of one of its subsidiaries that GY&S knew was technically just being reorganized and should have been consolidated, (4) GY&S spoke with stock analysts who were raising questions about Cascade's financial health to encourage them to stop doing so, and (5) GY&S generally deflected, in letters and otherwise, bad press about the financial condition of Cascade, notwithstanding GY&S's knowledge that Cascade's financial picture was bleak.[72]

When assessing GY&S's liability as a primary violator of Section 10(b) and dismissing the plaintiffs' claims based thereupon, the district court noted that GY&S "had no duty to disclose negative information about its client, Cascade, to third parties, such as Plaintiffs."[73] On appeal, the plaintiffs, while conceding "that no statements attributable to GY&S were made directly to Plaintiffs,"[74] maintained that liability could rest on GY&S's "significant role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases."[75] The Eleventh Circuit panel responded to the plaintiffs' contentions by noting that "[s]uch allegations of substantial assistance in the alleged fraud were the kinds of allegations that were rejected in *Central Bank*."[76] Further,

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[72] *Id.* at 1199-1200.

[73] *Id.* at 1202.

[74] *Id.*

[75] *Id.* at 1202-03 (internal quotations omitted).

[76] *Id.* at 1205.

> Plaintiffs argue that primary liability should attach to those who were never identified to investors as having played a role in the misrepresentations. We disagree. To permit Plaintiffs' allegations against GY&S to survive a motion to dismiss would permit Plaintiffs to avoid the "reliance" requirement for stating a claim under Rule 10b-5. . . . Holding GY&S primarily liable for its alleged conduct would effectively revive aiding and abetting liability under a different name, and would therefore run afoul of the Supreme Court's holding in *Central Bank*.[77]

As well, in addressing GY&S's alleged omissions, the panel refused to impose liability because (1) there was no attorney-client relationship between the plaintiffs and GY&S, (2) because of GY&S's fiduciary obligations to Cascade, it had certain privileges justifying its non-disclosure, (3) no statements were ever made by GY&S to the plaintiffs such that "[p]laintiffs could not have relied on GY&S in making their investment decisions,"[78] and (4) plaintiffs made no allegations that GY&S solicited any purchase of Cascade securities or prepared any solicitation documents.[79] Therefore, the panel affirmed the district court's dismissal of plaintiffs' claims against GY&S under Section 10(b).[80]

B. The "Substantial Participation" Test

The Ninth Circuit applies a "substantial participation" test when assessing whether a secondary actor is liable as a primary violator of Section 10(b).[81] Under this test, a

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[77] *Id.* at 1206 (internal quotations and citations omitted).

[78] *Id.* at 1207.

[79] *Id.* at 1206-07.

[80] *Id.* at 1207.

[81] Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (the Ninth Circuit imposes primary liability under Section 10(b) where there is "substantial participation or intricate involvement" of the

defendant may be liable as a primary violator of Section 10(b) based on his "substantial participation or intricate involvement" in the preparation of materially misleading or fraudulent statements, "even though the participation might not lead to the actor's actual making of the statements" at issue.[82]

The Ninth Circuit directly applied this "substantial participation" test most recently in *In re Software Toolworks Inc. Sec. Litig.*[83] In July of 1990, Software Toolworks, Inc. ("Toolworks"), a producer of personal computer software and Nintendo game systems, conducted a public offering of stock.[84] Although the offering was successful, Toolworks' stock price plummeted by nearly eighty percent only three months after the offering.[85] Plaintiffs (several investors) filed suit originally against Toolworks, Deloitte & Touche ("Deloitte"), Montgomery Securities, and PaineWebber, Inc., alleging, among other things, that the prospectus and registration statement issued for the public offering were false and misleading in violation of Section 10(b) and Rule 10b-5.[86]

The plaintiffs quickly settled with Toolworks, Montgomery Securities, and Paine Webber, Inc., and the district court granted summary judgment in favor of Deloitte, Toolworks's auditor, on all claims except one.[87] In rejecting summary judgment, the Ninth Circuit panel found

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secondary party in the preparation of fraudulent statements "even though that participation might not lead to the actor's actual making of the statements").

[82] *Id.*; *see also In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 628 n.3 (9th Cir. 1994) ("the plaintiffs presented evidence that [defendant] played a significant role in drafting and editing" the materially misleading documents at issue.).

[83] *Toolworks*, 50 F.3d at 628 n.3.

[84] *Id.* at 620.

[85] *Id.*

[86] *Id.*

[87] *Id.*

that Deloitte had access to information or had actual knowledge of information that was contrary to positions taken in the letters to the SEC.[88] The panel held that Deloitte's "extensive review and discussions" of two letters Toolworks sent to the SEC in response to issues raised by the SEC on the offering and Deloitte's "significant role" in drafting and editing one of the letters were sufficient to sustain a claim against Deloitte as a primary violator of Section 10(b).[89] Notwithstanding the fact that the Ninth Circuit panel did not use the phrase "substantial participation" in its Section 10(b) evaluation, its application has still been referred to as an application of the "substantial participation" test.[90]

C. *Klein v. Boyd*

The reasoning in the Third Circuit opinion in *Klein v. Boyd* sharply contrasts with both the "bright line" test and the "substantial participation" test.[91] *Klein* was an attorney

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[88] *Id.* at 628-29.

[89] *Id.* at 628 n.3 (internal citations and quotations omitted). The court noted specifically that one of the letters "was prepared after extensive review and discussions with . . . Deloitte and actually referred the SEC to two Deloitte partners for further information." *Id.* (internal quotations omitted). "Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing" the other letter to the SEC. *Id.*

[90] *See In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 585 (S.D. Tex. 2002) (referring to *Toolworks*, stating that the "'substantial participation' test provides for primary liability where there is 'substantial participation or intricate involvement' of the secondary party in the preparation of fraudulent statements even though that participation might not lead to the actor's actual making of the statements") (internal citations and quotations omitted).

[91] Klein v. Boyd, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998). Unfortunately, one will not find in the federal reporters the Third Circuit opinion in *Klein*, as the opinion was vacated within a month after its issuance, when the Third Circuit agreed to take the case en banc. Before the en banc panel could hear the case, the parties settled. While many attorneys practicing in the Third Circuit are

liability case brought under Section 10(b) in which the panel of Third Circuit judges applied Section 10(b) almost literally, unbounded by the constraints of a formalized test.

Plaintiff Elyse Klein was an investor in Mercer L.P. ("Mercer"), a securities brokerage business held in the form of a limited partnership; Klein made her first investments in Mercer in the fall of 1992.[92] Defendant Robert Strouse was a partner in the law firm of Drinker Biddle & Reath ("Drinker").[93] Strouse and Drinker advised Mercer and William Coleman, one of the founders of Mercer and a financial expert active in the running of and solicitation of funds for Mercer, during its start-up and investor solicitations.[94] Strouse drafted the partnership and subscription agreements for Mercer, and Strouse drafted the disclosure statements provided to investors by Mercer and Coleman.[95]

Coleman had a lengthy record of securities fraud-related censures, consent orders, and regulatory sanctions, of which Strouse was fully aware when he drafted the initial disclosure documents for Mercer or of which he was later informed.[96] Although some of the disclosure documents drafted by Strouse shortly after the initial formation and funding of Mercer discussed Coleman's checkered past, Strouse knew or should have known that Coleman and the other principals in Mercer never gave these initial disclosure documents to Klein and other investors in Mercer.[97]

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surely delighted that the opinion in *Klein v. Boyd* never made it into the federal reporters, attorney liability jurisprudence is not well served by the loss of the opinion, as it dealt with attorney liability in a much less contrived way than do the current "bright line" versus "substantial participation" opinions.

[92] *Id.* at 90,319.

[93] *Id.*

[94] *Id.*

[95] *Id.* at 90,319-20.

[96] *Id.* at 90,320.

[97] *Id.* at 90,319.

Over the next year, Coleman's legal woes escalated, and he received more securities-related sanctions including state bars from holding positions as a broker-dealer or investment adviser.[98] Coleman eventually had to exit his investment and position in Mercer and its corporate general partner, Mercer Securities, Inc., so that several state securities regulators would allow Mercer to do business in their states.[99] To reflect these changes in Mercer's capital and control structure, Drinker prepared a new partnership agreement which was circulated to and signed by Klein.[100] Shortly thereafter, in approximately November 1993, Drinker prepared a new disclosure packet for distribution to Mercer investors, but these disclosure documents did not include information about Coleman's historical or recent legal problems, nor did the package disclose that another principal of Mercer, William Boyd, had been censured for permitting the subordinated debt of a prior failed law firm to exceed appropriate levels.[101]

Shortly over a year later, Mercer failed, and Klein and other investors lost their investment.[102] They brought suit against Mercer Securities, Inc., Mercer, Coleman, and others, and the investors later amended their complaint to assert claims against Drinker for securities fraud under Section 10(b) and Rule 10b-5.[103] The district court granted Drinker's motion for summary judgment on all counts, and the investors subsequently settled with the remaining defendants.[104] The investors appealed the district court's

[98] *Id.* at 90,320.

[99] *Id.*

[100] *Id.*

[101] *Id.* Nor did the packet disclose that Steven Schappel, a broker at Mercer, had once pleaded guilty to possession of cocaine, a fact of which the court found Strouse was aware at the time. *Id.*

[102] *Id.* at 90,319.

[103] *Id.*

[104] *Id.*

final order granting Drinker's motion for summary judgment.[105]

On appeal, the Third Circuit panel reversed the district court's grant of summary judgment, finding that the plaintiffs had put forward sufficient evidence to create an issue of material fact as to whether (1) Drinker was an author or co-author of the misleading documents, (2) Drinker knew those documents would be relied upon by the investors, and (3) Drinker knew that material information was omitted from the documents.[106] The panel stated that these three facts would create a duty for Drinker to ensure that the documents did not contain any misstatements or omissions of material fact.[107]

The panel held that

> a lawyer who can fairly be characterized as an author or a co-author of a client's fraudulent document may be held primarily liable to a third-party investor under the federal securities laws for the material misstatements or omissions contained in the document, even when the lawyer did not sign or endorse the document and the investor is therefore unaware of the lawyer's role in the fraud.[108]

And the panel distinguished its holding from the law as disavowed in *Central Bank*:

> We do not suggest that a lawyer who merely provides "substantial assistance" to a client may be liable under Section 10(b) and Rule 10b-5. Such a holding would be inconsistent with the Supreme Court's rejection of a private cause of action for aiding and abetting. Rather, we believe that a person may be liable for a primary violation of section 10(b) and Rule 10b-5 when the person's participation in the

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[105] *Id.* at 90,321.

[106] *Id.* at 90,326.

[107] *Id.*

[108] *Id.* at 90,318.

> creation of a statement containing a misrepresentation or omission of material fact is sufficiently significant that the statement can properly be attributed to the person as its author or co-author. At that point, the person has done more than provide mere substantial assistance; the person has become a primary violator of section 10(b) and Rule 10b-5, assuming that the other requirements of section 10(b) and Rule 10b-5 are satisfied. This is true even if the investor is unable to attribute the statement to the person at the time of the transaction.[109]

After the panel in *Klein* issued its opinion, the defendant appellee asked the Third Circuit to hear the case en banc.[110] The Third Circuit agreed to take the case en banc and vacated the initial panel opinion.[111] Before the en banc panel could hear the case, the parties settled.[112] The Third Circuit has not addressed the primary liability of attorneys under Section 10(b) since the *Klein* opinion was withdrawn. Some practitioners expect the rationale from *Klein* to live on in the Third Circuit,[113] although, obviously, it is no longer controlling precedent in the Circuit.

IV. SUGGESTIONS FOR ADDRESSING THE PRIMARY LIABILITY OF ATTORNEYS

While it is useful to understand how the federal courts of appeals have addressed the primary liability of secondary actors since *Central Bank*, it is not clear that any of the federal courts of appeals have thus far gotten the analysis correct. Therefore, it is more important to work through the

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[109] *Id.* at 90,325.

[110] *See* Lawrence M. Rolnick & Edward T. Dartley, *"Klein v. Boyd" Rationale May Still Be Argued In Other Cases*, N.Y. L.J., Feb. 8, 1999, at 9.

[111] *Id.*

[112] *Id.*

[113] *Id.*

mechanics of how the judiciary *should* address the primary liability of attorneys under Section 10(b). Is it a misapplication of Section 10(b) to hold liable for securities fraud an attorney who drafted portions of a materially misleading disclosure document in conjunction with the CEO of a corporation?[114] What about an attorney who was specifically told what to include in a prospectus by the CEO and who merely acted as an expensive scrivener?[115] And what about an attorney who advised a CEO on structuring issues that were specifically designed to mislead investors about the debt a corporation carried?[116] Are these attorneys primary violators of Section 10(b)?[117] Or are they aiders and abettors who are unreachable under *Central Bank*?[118] Where should the lines be drawn, and on what basis?

Rigid application of any of the liability tests for secondary actors that the federal appellate courts currently use is not optimal. The federal judiciary can and should address the primary liability of attorneys under Section 10(b) without employing the "bright line" or "substantial participation" test. The judiciary should simply interpret and apply the elements of Section 10(b) and Rule 10b-5 in a broad, policy-oriented way, with due deference to relevant precedent.[119]

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[114] *See, e.g., In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 704 (S.D. Tex. 2002).

[115] *Id.*

[116] *Id.*

[117] *See* Klein v. Boyd, [1998 Transfer Binder] Fed. Sec.L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998).

[118] Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) ("if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting. . . .").

[119] The elements, as discussed in Section IIA, *supra*, of a Section 10(b) claim are scienter (intent to deceive, manipulate or defraud, commonly pleaded as recklessness), materiality (of the misstatement or omission), reliance (transaction causation), loss causation, and "in connection with a purchase or sale of securities."

This sort of application of Section 10(b) and Rule 10b-5, based on prior cases and the basics of statutory interpretation, is both necessary and justifiable for reasons of stare decisis, policy, and deference to both Congress and the executive branch.

For purposes of discussing this application of Section 10(b) and Rule 10b-5, it is useful to work with the facts from *Klein v. Boyd*. In *Klein*, an attorney (Strouse) prepared disclosure documents at a client's direction and included in the documents only the information specified by the client.[120] These documents failed to disclose the securities fraud background of the principal in the entity in which the investors (including Plaintiff Klein) were making their investment.[121] The entity in which the investors were making their investments was a securities brokerage firm. The attorney knew about the damning facts that were omitted, and, indeed, the attorney had previously suggested to the principal that the damning securities fraud background be included in the disclosure documents.[122] The attorney did not sign the disclosure documents that were later circulated to the investors, and, at best, the attorney had de minimis contact with the investors.[123] When the entity in which the investors had made their investment ultimately failed, the investors sued, among others, the attorney who failed to disclose in the solicitation documents the facts pertaining to the principal's background.

On these facts, as discussed below, the judiciary can and should hold the attorney liable as a primary violator of Section 10(b). This result can be achieved by adhering to Section 10(b) precedent and by being true to a textualist

[120] *Klein*, Fed. Sec. L. Rep. (CCH) at ¶ 90,320.

[121] *Id.*

[122] *Id.*

[123] *Id.* at 90,320-21 (noting that the only direct contact from Drinker to the investors was a one-line cover memo to the investors, accompanying the executed partnership documents, stating "Enclosed for your records is an original set of partnership documents.").

interpretation of Section 10(b). Moreover, from a policy and economic standpoint, as will be discussed, this result is sensible.

A. Stare Decisis and Respecting Precedent

"[T]he doctrine of stare decisis is essential to the respect accorded to the judgments of the Court and to the stability of the law."[124] Stare decisis and respect for settled precedent in the context of Section 10(b) dictates that the judiciary apply the elements of a Section 10(b) and Rule 10b-5 claim in the broad manner which has evolved among the federal courts of appeals.[125] This application will favor a result against the attorney in *Klein*.

The first element a plaintiff must establish to prove that an attorney violated Rule 10b-5 is "materiality"—the omitted or misrepresented information needs to have been material in order to sustain a claim under Section 10(b) and Rule 10b-5.[126] Information is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made

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[124] Lawrence v. Texas, 123 S.Ct. 2472, 2483 (2003); Planned Parenthood of S.E. Pa. v. Casey, 505 U.S. 833, 854 (1992) ("Indeed, the very concept of the rule of law underlying our own Constitution requires such continuity over time that a respect for precedent is, by definition, indispensable."); *but see Lawrence*, 123 S.Ct. at 2483 (stare decisis is not "an inexorable command"). "Stare decisis" means in Latin "to stand by things decided." BRYAN A. GARNER, A DICTIONARY OF MODERN LEGAL USAGE 515 (1987). *See, e.g.*, *In re* Sealed Case No. 97-3112, 181 F.3d 128, 147 (D.C. Cir. 1999) (citing same). *"Stare decisis* is defined in *Black's Law Dictionary* as meaning 'to abide by, or adhere to, decided cases.'" *Casey*, 505 U.S. at 854 (quoting BLACK'S LAW DICTIONARY 1406 (6th ed. 1990) (italics in original)).

[125] SEC v. Zandford, 535 U.S. 813, 819 (2002) (stating that section 10(b) should be read flexibly in order to effectuate the remedial purpose of the statute).

[126] TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

available."[127] With respect to the fact at issue that was omitted (the principal's securities fraud background in *Klein*), there was certainly such a "substantial likelihood."[128] The fact that the principal in an *investment* entity has a background of *securities fraud* undeniably alters the total mix of information made available: "Who would knowingly roll the dice in a crooked crap game?"[129]

Another element to be established to sustain a Section 10(b) claim is reliance.[130] The plaintiff must "demonstrate that defendants' conduct caused him to engage in the transaction in question."[131] It is not difficult to establish reliance in *Klein*. Had the plaintiff, who was investing in a securities firm, known the truth about the principal's securities fraud background, it would have been illogical for her to have invested.[132] She relied on the fact that no such background existed.[133]

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[127] *Id.* at 450 (defining materiality in the context of proxy statements and Rule 14a-9); *see also* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) ("expressly adopt[ing] the TSC Industries standard of materiality for the [Section] 10(b) and Rule 10b-5 context").

[128] *Id.*

[129] Schlanger v. Four-Phase Sys., Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

[130] *Basic*, 485 U.S. at 243.

[131] Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 174 (3d Cir. 2001) (internal citations and quotations omitted); *see also Basic*, 485 U.S. at 243.

[132] "Reliance is a causa sine qua non, a type of 'but for' requirement: had the investor known the truth he would not have acted." Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981).

[133] Oddly, some cases dealing with accountant, attorney, or underwriter liability under Section 10(b) appear to misinterpret the reliance element of a Section 10(b) claim. For example, in *Wright v. Ernst & Young, LLP*, the Second Circuit panel declined to hold an accounting firm liable for violating Section 10(b) when the accounting firm had not communicated directly with the investors. 152 F.3d 169, 175 (2d Cir. 1998). The panel justified their position by noting that "[s]uch a holding would circumvent the reliance requirements of the Act, as '[r]eliance only on representations made by others cannot itself form the basis of liability.'"

The next element that a plaintiff must plead in order to sustain a Section 10(b) and Rule 10b-5 claim is scienter.[134] The plaintiff investor must establish that the attorney acted with intent "to deceive, manipulate, or defraud."[135] Recklessness is sufficient to establish the necessary intent to deceive, manipulate, or defraud,[136] and recklessness "is conduct involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of

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Id. This, however, reveals a misunderstanding of the "reliance" element of a Section 10(b) claim. What a defrauded plaintiff is relying on is a representation that has turned out to be false or incomplete. What the defrauded investor is not relying on is the identity of the speaker. Phrased differently, the identity of the speaker is, in most cases, a non sequitur.

Apparently this non sequitur is used as a red herring by defendants in this sort of litigation. *See* Brief of the Securities and Exchange Commission, Amicus Curiae at 19, Klein v. Boyd, [1998 Transfer Binder] Fed. Sec.L. Rep. (CCH) ¶ 90,165 (3d Cir. Mar. 9, 1998) [hereinafter *Klein* brief] (noting that defendant law firm "contends that imposing liability on it when the investors did not know of its involvement in the creation of the misrepresentation would negate the element of reliance required in a private action for securities fraud. . . . This contention is incorrect. The reliance a plaintiff in a securities fraud action must plead is reliance on a misrepresentation, not on the fact that a particular person made that misrepresentation.").

[134] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); *see also* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 534 (2d Cir. 1999) (a plaintiff must allege that "in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff] injury") (internal quotations and citations omitted).

[135] *Press*, 166 F.3d at 534.

[136] *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983). At a minimum, to establish the defendant acted recklessly, a plaintiff must make "a showing of reckless disregard for the truth, that is . . . 'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care.'" SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998) (quoting Rolf v. Blyth, 570 F.2d 38, 46 (2d Cir. 1978)); *see also In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 626 (9th Cir. 1994).

ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[137] In keeping with this precedent, the plaintiff investor in *Klein* needs to establish that Strouse, in failing to disclose the principal's background, acted in a way that presented "a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[138] The defendant attorney must have known[139] that the failure to disclose such a critical fact would mislead the investor into believing such a fact did not exist. When viewed in context—the investment was being made in a securities entity and the principal had had recent problems involving securities fraud—the danger of misleading investors could not have been negligently overlooked by Strouse.[140] What investor in a securities firm would not want to know about the sketchy securities fraud-related background of a principal?[141]

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[137] *Toolworks*, 50 F.3d at 626 (internal citations and quotations omitted).

[138] *Id.*

[139] Or should have known.

[140] The argument could easily be made that in the *Klein* case, the non-disclosure was deliberately intended to mislead. Strouse tried to include the facts about Coleman's shady background, but Coleman and the other principals in the securities firm balked. Klein v. Boyd, [1998 Transfer Binder] Fed. Sec.L. Rep. (CCH) ¶ 90,136, 90,320 (3d Cir. Feb. 12, 1998). The next time a disclosure document was prepared by Strouse, the facts about Coleman's background were not included. *Id.*

[141] SEC Commissioner Harvey Goldschmid, himself an attorney and corporate law professor, observed that "when no red flags are flying . . . it will be difficult to spot fraud that is concealed and hard-core." Harvey Goldschmid, *Post-Enron America: An SEC Perspective*, 8 FORDHAM J. CORP. & FIN. L. 335, 344 (2003). Professor Koniak responds to this volley as it pertains to Enron, questioning whether one can credibly contend that the outside counsel implicated in the Enron scandal did not notice anything amiss: "Are we . . . to believe that all the lawyers who worked on these deals were incapable of grasping just what it was they were doing?"

To plead successfully the element of loss causation, the plaintiff "must allege that they would not have suffered a loss on their investment if the facts were as they believed them to be at the time they purchased the securities."[142] In *Klein*, the plaintiff believed the facts, at the time she made her investment, not to include management of her investment by someone with a propensity to engage in conduct that arguably amounted to securities fraud. Were the plaintiff's investment monitored by someone who had a successful, honorable background in the securities industry, one could argue that the securities firm would not have failed. Were the facts as the plaintiff believed them to be at the time she made her investment, one could argue that she would not have suffered her loss.

A more broadly applicable loss causation analysis to consider when addressing the liability of secondary actors such as attorneys is that advocated by then-Chief Judge Ralph K. Winter in *AUSA Life Insurance Co. v. Ernst & Young*.[143] When assessing the liability under Section 10(b) of auditors who certified "cooked" books, Chief Judge Winter noted that "[i]n a suit on a statute liability does [not] depend on whether there is proximate causation as that term is used at common law. With statutory claims, the issue is, instead, one of statutory intent."[144]

Chief Judge Winter opined:

> Loss causation in the context of federal securities law thus requires consideration of the significance to a reasonable investor of the truth compared to the content of the mis-representations or omissions. If the significance of the truth is such as to cause a

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Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle With The SEC*, 103 COLUM. L. REV. 1236, 1242-43 (2003).

[142] *In re* VMS Sec. Litig., 752 F. Supp. 1373, 1399 (N.D. Ill. 1990).

[143] AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202. 230-39 (2d Cir. 2000) (Winter, C.J., dissenting).

[144] *Id.* at 233 (internal citations and quotations omitted).

> reasonable investor to consider seriously a zone of risk that would be perceived as remote or highly unlikely by one believing the fraud, and the loss ultimately suffered is within that zone, then a misrepresentation or omission as to that information may be deemed a foreseeable or proximate cause of the loss.[145]

With respect to *Klein*, "would the truth have caused the investor to consider seriously a zone of risk that would be perceived as remote by one believing the fraud, and did the loss suffered fall within the zone of undisclosed risk?" Yes: An investor, believing that the principal in the investment entity did not have a history of securities fraud, would not have contemplated a zone of risk that included the principal's inclination to make risky decisions, to act in a way that violates the relevant securities laws, to make investment decisions that push the law to an extreme degree, etc. A reasonable investor would not contemplate such abnormal risks, absent a reason to believe otherwise. The realization of these undisclosed risks establishes the element of loss causation.

Lastly, the plaintiff in *Klein* must establish that the fraud alleged occurred "in connection with the purchase or sale of any security."[146] The plaintiff must show that "the defendant's alleged fraud was 'integral to the purchase and sale of the security in question.'"[147] To establish this link, the plaintiff must prove "that the act complained of somehow induced the purchaser to purchase the security at issue."[148] An investor in Klein's situation would likely not invest in a securities-related entity if the principal of the entity had a securities fraud background. The failure of the defendant

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[145] *Id.* at 235.

[146] Flickinger v. Harold C. Brown & Co., 947 F.2d 595, 598 (2d Cir. 1991).

[147] *Id.* (internal citations omitted).

[148] Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 537 (2d Cir. 1999).

attorney to reveal this fact in the disclosure he drafted was therefore integral to the plaintiff's investment as it "induced the purchaser to purchase the security at issue."[149] Had the truth been disclosed, the investor likely would not have invested.

In conclusion, then, a court can hold an attorney liable as a primary violator of Section 10(b) and Rule 10b-5 simply by working through the elements of a Section 10(b)/Rule 10b-5 claim as developed through common law and by adhering to precedent without artificially forcing an application of the "bright line" or "substantial participation" test. A deliberate application of the elements of a Section 10(b) claim would reach an attorney who acted in a way similar or analogous to the attorney in the *Klein* case.

The question then becomes whether it is *sensible* to hold an attorney liable as a primary violator under Section 10(b) in circumstances similar to those in *Klein*, conceding that the judiciary technically *can* hold such an attorney liable. Some would argue that, notwithstanding precedent and a pure application of the elements of Section 10(b) as discussed above, holding an attorney liable as a primary violator of Section 10(b) essentially imposes aiding and abetting liability in a way that was prohibited by *Central Bank*.[150] Indeed, this concern is often voiced by federal appellate panels that employ the bright-line test to assess the primary

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[149] *Id.*

[150] Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998). The court notes that

> if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).

Id. (quoting Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997)). *See also* Ziemba v. Cascade Int'l, 256 F.3d 1194, 1205-06 (11th Cir. 2001).

liability of secondary actors.[151] This argument, however, substitutes a glance at the end result of the Section 10(b) litigation for careful consideration of the components of a primary liability claim. Primary violator liability and aiding and abetting liability have not collapsed together just because the same defendants, in some instances, can be reached under both. Moreover, there are good policy reasons and sound statutory interpretation bases, discussed below, on which to justify the imposition of primary liability under Section 10(b) on attorney defendants in certain circumstances, regardless of how similar to aiding and abetting liability the end result seems to be.

B. Fidelity to Sound Principles of Statutory Interpretation

> It can be of no weight to say that the courts, on the pretense of a repugnancy, may substitute their own pleasure to the constitutional intentions of the legislature. This might as well happen in the case of two contradictory statutes; or it might as well happen in every adjudication upon any single statute. The courts must declare the sense of the law; and if they should be disposed to exercise WILL instead of JUDGMENT, the consequence would equally be the substitution of their pleasure to that of the legislative body.[152]
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> —Alexander Hamilton

As a matter of constitutional dictate, the United States Congress is charged with enacting the laws[153] and the

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[151] *Wright*, 152 F.3d at 175.

[152] THE FEDERALIST NO. 78, at 468-69 (Alexander Hamilton) (Clinton Rossiter ed., 1961).

[153] Article I of the Constitution vests legislative power in Congress; bicameral action through both the Senate and the House of Representatives, coupled in most instances with Presidential approval, is necessary for a bill to become a law. *See* U.S. CONST. art. I, § 7, cl. 1-2.

judiciary is charged with the application thereof.[154] Issues of statutory interpretation arise when the text of a statute does not specify how to address a particular situation.[155] There are many methods of statutory interpretation,[156] and reasonable minds can differ on the "right" way to interpret statutes,[157] and even those using the same tools of statutory interpretation can reach differing results.[158]

Three main theories of statutory interpretation are often employed in securities cases: textualism, intentionalism, and purposivism.[159] Since the appointment of Justice Antonin Scalia to the Supreme Court, the textualist approach to statutory interpretation has been frequently relied upon.[160] Indeed, the Supreme Court in *Central Bank* has been characterized as using a textualist approach to interpreting Section 10(b).[161] Because some may argue that textualism is a major obstacle to the application of Section 10(b) to attorneys, it is useful to re-examine 10(b) from a textualist perspective.

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[154] *See* John F. Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 5 (2001) ("In our constitutional system, it is widely assumed that federal judges must act as Congress's faithful agents.").

[155] *See generally* Robert J. Gregory, *Overcoming Text in an Age of Textualism: A Practitioner's Guide to Arguing Cases of Statutory Interpretation*, 35 AKRON L. REV. 451 (2002).

[156] Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes are to be Construed*, 3 VAND. L. REV. 395, 401-06 (1950).

[157] *See generally* Manning, *supra* note 154.

[158] *See* Llewellyn, *supra* note 156, at 401-06.

[159] Ediberto Roman, *Statutory Interpretation in Securities Jurisprudence: A Failure of Textualism*, 75 NEB. L. REV. 377, 385-90 (1996).

[160] Thomas W. Merrill, *Textualism and the Future of the Chevron Doctrine*, 72 WASH. U. L.Q. 351 (1994); Manning, *supra* note 154, at 3-4 (citing Merrill).

[161] Melvin Aron Eisenberg, *Strict Textualism*, 29 LOY. L.A. L. REV. 13, 14 (1995).

1. Textualism Defined

A textualist court confines itself to a literal reading of the statutory text to control the text's application to the factual situation at hand.[162] If the text of the statute is clear and its application would not lead to an absurd result, the text of the statute alone—without reference to legislative history or any other considerations—will govern.[163] If the text of the statute is not clear, however, the court can consult other sources for clarification.[164] To that end, "[i]f the text [of a statute] is ambiguous and so open to interpretation in some respects, a degree of deference is granted to the agency [charged with effectuating the statute], though a reviewing court need not accept an [agency] interpretation which is unreasonable."[165]

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[162] *Id.*; *see generally* Manning, *supra* note 154, at 4 ("[J]udges must enforce the conventional meaning of a clear text, even if it does not appear to make perfect sense of the statute's overall policy.").

[163] Eisenberg, *supra* note 161, at 13; *see also* Stephen Breyer, *On the Uses of Legislative History in Interpreting Statutes*, 65 S. CAL. L. REV. 845, 845-47 (1992).

[164] Eisenberg, *supra* note 161, at 14. For example, when an ambiguity is found, textualists often look to the remainder of the statutory scheme as a means to clarify the isolated ambiguity. *See* Richard J. Pierce, Jr., *The Supreme Court's New Hypertextualism: An Invocation to Cacophony and Incoherence in the Administrative State*, 95 COLUM. L. REV. 749, 777 (1995).

[165] Nat'l R.R. Passenger Corp. v. Boston & Maine Corp., 503 U.S. 407, 417-18 (1992) (citations omitted). However, devout textualists more often than not will be able to resolve (by reference to the language of the statute or regulation in question or by reference to the context of the overall statutory or regulatory scheme) what appears to be an ambiguity such that the seeming ambiguity turns out to not be an ambiguity after all. *See* Pierce, *supra* note 164, at 777-78 (discussing the Supreme Court Justices' passionate efforts to avoid "finding" ambiguities). Indeed, according to Justice Scalia:

> One who finds *more* often (as I do) that the meaning of a statute is apparent from its text and from its relationship with other laws, thereby finds *less* often that the triggering requirement for *Chevron* deference exists. It is thus

2. Textualism Applied

a. The Text of Section 10(b)

When employing a textualist approach in applying Section 10(b), the appropriate place to begin is with the text of the statute.[166] In *Central Bank*, the majority looked only to the text of Section 10(b) to determine that there was no cause of action for aiding and abetting a violation of Section 10(b).[167] The Court stated that a "private plaintiff may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)."[168] The Court reached "the uncontroversial conclusion . . . that the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation . . . [and w]e think that conclusion resolves the case."[169]

Yet even if one concedes that Section 10(b) is clear in that it does not speak to aiding and abetting liability,[170] the statute is clear about little else.[171] The specific parameters of what is unlawful under Section 10(b) are not defined in the

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> relatively rare that *Chevron* will require me to accept an interpretation which, though reasonable, I would not personally adopt.

Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 DUKE L.J. 511, 521 (1989).

[166] Eisenberg, *supra* note 161, at 13.

[167] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994).

[168] *Id.* at 173.

[169] *Id.* at 177.

[170] One would have to ignore the "directly or indirectly" language of Section 10(b) to so concede, yet a majority of the Supreme Court Justices in *Central Bank* had little problem in so doing. *Id.* at 175-76. Unfortunate that.

[171] *See* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 386 (1990).

statute, but were left to the SEC's discretion.[172] Section 10(b) only provides that it shall be unlawful for any person, "directly or indirectly," to "use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."[173]

So when assessing the liability of an attorney who, for example, drafts portions of a client's disclosure documents that the attorney knows are materially misleading, a bald reading of only the text of Section 10(b) leads the textualist to one of two conclusions: Either (a) the attorney is *not* using or employing "any manipulative or deceptive device" in connection with the purchase or sale of any security such that the attorney cannot possibly be violating Section 10(b) or (b) the attorney *is* employing or using a manipulative or deceptive device within the initial reach of Section 10(b) such that further inquiry into whether the usage violates "such rules and regulations as the Commission may prescribe"[174] (e.g. Rule 10b-5) is warranted.

To make these threshold determinations, the textualist would consider what it means to "use or employ" a deceptive or manipulative device.[175] To "employ" means "to make use

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[172] It is only unlawful to use a deceptive device "in contravention of such rules and regulations as the [SEC] may prescribe. . . ." 15 U.S.C. § 78j(b) (2000). This vagueness and deference to agency administration was deliberate. *See* S. REP. NO. 73-792, at 5 (1934), stating that "[f]rom the outset, the committee has proceeded on the theory that so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program. . . . Accordingly it is essential to entrust the administration of the act to an agency vested with power to eliminate undue hardship and to prevent and punish evasion."

[173] 15 U.S.C. § 78(j)(b) (2000).

[174] *Id.*

[175] *See, e.g.*, Amoco Prod. Co. v. S. Ute Indian Tribe, 526 U.S. 865, 874 (1999) (The Supreme Court consults a dictionary to determine the plain meaning of the word "coal."). *See generally* Manning, *supra* note 154.

of,"[176] and to "use" means "to put into action or service."[177] "Manipulate" means "to change by artful or unfair means so as to serve one's purpose,"[178] and "deceptive" means "tending or having power to deceive."[179] Using these definitions, the inquiry for the textualist who is assessing the liability of an attorney becomes whether the attorney at issue was putting into action a device or contrivance (e.g. scheme) that was tending to have the power to cause someone to accept as true something that was false.

Consider why Strouse in the *Klein* case would deliberately *omit* negative information regarding his client's background or business or industry or earnings from disclosure documents. The obvious answer is that the client would not want that information included.[180] The client would not want damning facts disclosed because the client would not want the investor to know such facts exist. In the *Klein* case, for example, the investor would be unlikely to participate in an investment with a person who had a history of problems involving securities fraud. If the attorney agrees not to

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[176] MERRIAM WEBSTER'S COLLEGIATE DICTIONARY 379 (10th ed. 1997).

[177] *Id.* at 1301.

[178] *Id.* at 708. Manipulative is the adjective form of manipulate. *Id.*

[179] *Id.* at 298. "Deceive" means, among other things, "to cause to accept as true or valid what is false or invalid." *Id. See generally* 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3421-22 (3d ed. 1989) ("hornbook elements of 'deceit' . . . in large measure carry over to" fraud concepts under SEC statutes).

[180] Klein v. Boyd, [1998 Transfer Binder] Fed. Sec.L. Rep. (CCH) ¶ 90,136, 90,319 (3d Cir. Feb. 12, 1998). Indeed, Strouse, the Third Circuit panel intimates, took grief from the principals of Mercer for having initially included the information about Coleman's background in the first disclosure document (which Strouse knew was never circulated to the investors). *Id.* at 90,320 (after noting that Strouse included a description of the various orders against Coleman in the disclosure documents Strouse drafted for Mercer and noting that "Strouse advised that the package should be delivered and that all necessary signatures should be obtained," the court stated that "Coleman and Tarantino balked at Strouse's suggestion.").

include such information, the attorney is agreeing to mislead the investor in order to appease the client. This meets the literal definition of the terms "any manipulative or deceptive device" used in Section 10(b).[181]

Therefore, Strouse's deliberate decision to omit information about Coleman's background is an act that is designed to cause an investor to believe Coleman does not have a securities fraud background, and Strouse is within the reach of the textualist's reading the literal terms of Section 10(b). Similarly, so is the attorney who hides losses for a client on financial statements,[182] and so is the attorney who structures deals intended to hide from investors a client's precarious financial position.[183]

The next question for the textualist court is whether the deceptive contrivance used by Strouse or any attorney is in contravention of the rules promulgated by the SEC under Section 10(b).[184] The text of Section 10(b) only makes

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[181] Professor Koniak notes that "[f]raud is . . . lying to someone to get them to give you their stuff." Susan Koniak, *Corporate Fraud: See Lawyers*, 26 HARV. J.L. & PUB. POL'Y 195, 197 (2003).

[182] *See generally In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002). Professor Koniak discusses the critical role of attorneys in structuring and implementing Enron's legion of sophisticated shell entities to move debt off of Enron's balance sheets, noting that "it should be apparent . . . that the involvement of lawyers was necessary to implement" the allegedly fraudulent schemes involving Enron's special purpose entities. Koniak, *supra* note 141, at 1240. Professor Koniak notes specifically that Enron's web of financial lies could not have been woven without the attorneys providing the threads of "true sale" and "nonconsolidation" opinion letters. *Id.* at 1242.

[183] *See generally* AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202 (2d Cir. 2000). *AUSA* was a case dealing with the liability for securities fraud of auditors who facilitated and concealed a client's cash-bleeding transactions that were dangerous to the client's investors.

[184] 15 U.S.C. § 78(j) (2000). Rule 10b-5 was promulgated by the SEC in 1942 in response to Section 10(b). *See* Securities Exchange Act Release No. 3230 (May 21, 1942), 7 Fed. Reg. 3804 (1942). Rule 10b-5 was initially titled "Rule X-10B-5." Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1121 (1950).

unlawful the usage of a deceptive device if such usage is "in contravention of such rules and regulations as the [SEC] may prescribe."[185] The textualist inquiry, then, of whether Strouse's action in the *Klein* case or an attorney's alleged fraud violates Section 10(b) goes beyond the terms of Section 10(b) to the terms of the SEC's responsive rulemaking.

b. A Textualist Court, Rule 10b-5, and Agency Deference

Rule 10b-5, promulgated by the SEC under Section 10(b), makes it unlawful for any person:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[186]

One could make the case in *Klein* that Strouse's acts fell within any one of subsections a, b, or c of Rule 10b-5.[187] It is

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[185] 15 U.S.C. § 78(j) (2000).

[186] 17 C.F.R. § 240.10b-5 (2003).

[187] Rule 10b-5 is viewed as a "catchall" antifraud provision because its terms are "notoriously vague." SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990). That attorney misconduct often fits within all or more than one of the sub-provisions of Rule 10b-5 is not surprising. Indeed, the terms used in Rule 10b-5, as the discussion in the accompanying text will make clear, "provide a broad linguistic frame within which a large number of practices may fit." *Id.* This facet of the Rule—whether viewed as a weakness or a

easiest in light of the above discussion about manipulative devices and the text of Section 10(b) to begin with subsection c of Rule 10b-5, however, as the terms used in that subsection mirror the actual terms in Section 10(b).[188]

Subsection c of Rule 10b-5 prohibits acts which operate as a fraud or deceit (in connection with the purchase or sale of securities).[189] "Fraud" is an "intentional perversion of truth

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strength—seems to reflect the intent of the drafters of the rule. Indeed, the oft repeated story of the adoption of the Rule is as follows, as described by former SEC Assistant Solicitor Milton Freeman, who drafted the Rule:

> I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.
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> We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Remarks of Milton Freeman, Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793, 922 (1967).

[188] 17 C.F.R. § 240.10b-5(c) (2003).

[189] *Id.*

in order to induce another to part with something of value or to surrender a legal right."[190] "Deceit" is "the act or practice of deceiving."[191] "Deceiving" means "to cause to accept as true or valid what is false or invalid."[192]

If an attorney engages in conduct that violates the text of Section 10(b), this same conduct is going to qualify as "an act . . . which operates or would operate as a fraud or deceit upon any person" in contravention of subsection c of Rule 10b-5,[193] because the words used in both Section 10(b) and subsection c of Rule 10b-5 are parallel, relating to deceit.[194] Therefore, the deliberate failure to include negative material information (such as Coleman's prior securities fraud history in *Klein*) in a disclosure or selling document will indeed "operate as a fraud or deceit upon any person" in violation of Rule 10b-5.[195] The acts that put Strouse within the reach of

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[190] WEBSTER'S NEW COLLEGIATE DICTIONARY 490 (9th ed. 1983).

[191] *Id.* at 329.

[192] *Id.*

[193] 17 C.F.R. § 240.10b-5(c).

[194] *Compare* 15 U.S.C. § 78j(b) (2000), which makes unlawful the use of "any manipulative or deceptive device," *with* 17 C.F.R. § 240.10b-5(c), which provides that it shall be unlawful for any person to "engage in any act . . . which operates . . . as a fraud or deceit." Both provisions make unlawful material deceit and deception in connection with the purchase or sale of securities.

[195] That said, if one focuses on the "fraud" aspect of subsection (c) as opposed to that subsection's deceit aspect, one needs to inquire into Strouse's state of mind in order to assess whether his actions as described in *Klein* acted as "an intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right." To the extent that the definition of fraud includes "an intentional perversion of truth" to the end of inducing another to part with something of value, the mental state of Strouse is relevant. Deducing that Strouse intentionally perverted the truth is easy, based on the facts as the Third Circuit presented them. Strouse knew of Coleman's background (not to mention Boyd's background and Schappell's cocaine issue). Strouse, as an attorney with the ability to make himself informed of the disclosure requirements in the securities context, knew or was reckless in not knowing that he should disclose that information to investors. As

the text of Section 10(b) itself similarly place him squarely within the reach of the literal terms of Rule 10b-5(c).

An attorney can also be reached with relative ease under subsection b of Rule 10b-5, which makes it unlawful for a person "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[196] An issue arises, however, under subsection b of Rule 10b-5 regarding the definition of "make." What does it mean to "make" an untrue statement in violation of Rule 10b-5(b)? In the context of a disclosure document drafted by an attorney, for example, does "make" mean simply "draft" or does "make" mean "draft and then release to the public, with attribution to the scrivener attorney himself?"

The SEC takes the position that the word "makes" in Rule 10b-5 means "creates a misrepresentation, acting alone or with others."[197] When participating as amicus in *Klein* on the issue of whether "a person who makes a material misrepresentation, while acting with the requisite scienter,

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previously noted (*see* note 180, *supra*), "Coleman and Tarantino balked at Strouse's suggestion" that Coleman's background be disclosed. Klein v. Boyd, [1998 Transfer Binder] Fed. Sec.L. Rep. (CCH) ¶ 90,319, 320 (3d Cir. Feb. 12, 1998).

[196] 17 C.F.R. § 240.10b-5(b).

[197] *Klein* brief, *supra* note 133, at 19 (internal quotations omitted). The SEC takes this position both with regard to the word "make" as referenced in Rule 10b-5 and with regard to the word "makes" as used by the Supreme Court in *Central Bank*. *Id.* at 10 n.3. In defining the term in controversy, the SEC refers to the term as "makes," notwithstanding the fact that the actual problematic word in Rule 10b-5 is "make." *Id.* This is because the Supreme Court language from *Central Bank* permits liability for a person who "makes a material misstatement (or omission)" in violation of Rule 10b-5. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). So even though the word at issue in Rule 10b-5 is "make" as opposed to "makes," references to this vexing word usually take the form "makes." *Klein* brief, *supra* note 133, at 10 n.3.

but who does not himself disseminate the misrepresentation to investors, and whose name is not made known to them" is only an aider and abettor of securities fraud or is a primary violator,[198] the SEC maintained that that person is indeed "making" a misstatement and is therefore a primary violator of Section 10(b) and Rule 10b-5.[199]

The question, then, becomes whether the (textualist) judiciary should adopt the SEC's interpretation of the word "make." This question is uncomplicated in light of the Supreme Court's guidance in *Thomas Jefferson University v. Shalala*.[200] In *Shalala*, the Supreme Court held that when an agency is interpreting its own regulations, "controlling weight" should be given to that agency's interpretation, unless the interpretation is "plainly erroneous or inconsistent with the regulation."[201] In this regard, the SEC's definition of "makes" pertains to the agency's interpretation of its own regulation, Rule 10b-5.[202] And the SEC appears never to have wavered from its interpretation in a way that would make that reading assailable,[203] nor is its interpretation of "makes" inconsistent with the regulation or

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[198] *Klein* brief, *supra* note 133, at 1-2.

[199] *Id.* at 2.

[200] 512 U.S. 504 (1994).

[201] *Id.* at 512 (quoting Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 414 (1945)). The deference afforded to an agency's interpretation of its own regulations in these circumstances is even more than that afforded under the *Chevron* doctrine. *See* Sigma-Tau Pharmaceuticals v. Schwetz, 288 F.3d 141, 146 (4th Cir. 2002); *see also* Beaver Plant Operations, Inc. v. Herman, 223 F.3d 25, 29 (1st Cir. 2000) (an agency's interpretation of its own rule will be given full effect if it is reasonable).

[202] 17 C.F.R. § 240.10b-5.

[203] "[A]n agency's interpretation of a statute or regulation that conflicts with a prior interpretation is entitled to considerably less deference than a consistently held agency view." *Thomas Jefferson Univ.* 512 U.S. at 515 (internal citations and quotations omitted).

the underlying statute.[204] Therefore, the SEC's definition of the word "makes" as used in Rule 10b-5 should be adopted by the judiciary.[205]

Thus, the federal judiciary can interpret and apply Section 10(b) and Rule 10b-5 with a textualist bent as the Supreme Court did in *Central Bank*, tempered with deference to the SEC similar to that afforded in *Shalala*, and the judiciary can thereby reach an attorney on facts similar to those in *Klein*. The text of Section 10(b) permits such a result, and, indeed, Rule 10b-5 is easily read to achieve that

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[204] *See generally* Nowicki, *supra* note 11 (detailing the deliberately broad reach of Section 10(b), designed to prevent almost all instances of investor deceit).

[205] The legislative history of Section 10(b) makes clear that the legislators designed the statute to give significant administrative and enforcement latitude to the SEC. Contemporary reports on the bill note that:

> From the outset, the committee has proceeded on the theory that so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program. . . . Accordingly it is essential to entrust the administration of the act to an agency vested with power to eliminate undue hardship and to prevent and punish evasion.

S. Rep. No. 73-792, at 5 (1934).

In describing how this broad discretion came to exist, Dean Seligman notes:

> [T]he Securities Exchange Act of 1934 was a marvel of irresolution. On most controversial substantive issues, Congress had been stalemated. Rather than providing the new [Securities and Exchange] Commission with a clear mandate, the legislators had granted the agency authority to study the controversy or issue its own rules. In effect, Congress had broadly defined the Commission's areas of expertise and invited it to forge its own mandate.

JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET, A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE, 99 (1995).

result.[206] The final issue is whether this result makes sense from a policy standpoint.

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[206] Some naysayers will likely continue to maintain that holding attorneys liable as primary violators of Section 10(b) in the manner just discussed where the attorney did not speak to the investors directly or where the materially misleading disclosure documents the attorney drafted were not directly attributed to him is just too close to imposing aiding and abetting liability, and, as such, is in contravention of *Central Bank*. *See, e.g.*, Wright v. Ernst & Young, 152 F.3d 169, 175 (2d Cir. 1998) (quoting *In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995)). For example, the court in *Wright* opined that

> [I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).

Wright, 152 F.3d at 175. To put to rest this argument for good, it makes sense to take one final backward technical glance at the scorned aiding and abetting liability under Section 10(b).

The federal circuit courts of appeals had, prior to the Supreme Court's edict in *Central Bank*, consistently applied a three-part test for aider and abettor liability under Section 10(b), requiring "(i) the existence of a primary violation of § 10(b) or Rule 10b-5, (ii) the defendant's knowledge of (or recklessness as to) that primary violation, and (iii) 'substantial assistance' of the violation by the defendant." Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 194 (1994). The requirement of "substantial assistance" in aiding and abetting schemes, however, is replaced in primary liability cases by a requirement that the defendant actually make, in connection with the purchase or sale of securities, a material misstatement or omission. *Id.* at 191 (noting that a secondary actor can be liable under Rule 10b-5 if he "employs a manipulative device or makes a material misstatement (or omission)" that is relied upon and all requirements for primary liability under Rule 10b-5 are met).

So then the question becomes, one final time: What does "make" mean, as that word is used by the Court in *Central Bank* in defining which defendants can be reached under Section 10(b)? *Id.* What does "make" mean, as the SEC used the term in drafting Rule 10b-5? What does it mean to "make" a materially untrue statement (or omission), and did the attorney in *Klein* "make" a material misstatement or omission?

C. Consideration of Policy Issues

The Supreme Court has said that Section 10(b) should be flexibly applied to promote its broad prophylactic purpose.[207] The Court's retreat from this position in *Central Bank* betrays the investing public.[208] Section 10(b) and Rule 10b-5

Unless the naysayers ignore the dictionary definition of "make" and unless the naysayers find bootless the Supreme Court's justification in *Shalala* and *Chevron*, *see supra* notes 200-206 and accompanying text, for deferring to an agency's interpretation of its own rules and the statutes which it is charged to administer, the naysayers cannot avoid the conclusion that the SEC's definition of "makes," that is, "creates a misrepresentation, acting alone or with others," must be adopted. So "making" a material misstatement or omission does not only mean drafting and signing a fraudulent opinion letter or an opinion letter that the attorney knows is based on lies. *See* Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1300 (1999). The meaning of "making" a material misstatement or omission also reaches drafting a disclosure document (signed only by officers of the corporation) that the drafter attorney knows includes material misstatements or omissions, that includes "fudged" numbers provided by the CFO (that the attorney knows are fudged), or that has numbers that are stated in a way deliberately intended to mislead figures (that the attorney knows are so stated). "Making" a material misstatement or omission would also include creating or structuring a misleading transaction, designed to hide debt or executive conflicts.

Notwithstanding the discomfort of some with reaching overlapping defendants under either aiding and abetting liability or primary violator liability, the fact is that the justifiable definition of "makes" permits this. That the SEC's interpretation of "makes" allows a plaintiff to reach defendants that would otherwise have only been reachable as aiders and abettors is fortuitous, but it is not damning to the definition of "makes" or its application.

[207] Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972). Similarly, in *SEC v. Zandford*, 535 U.S. 813, 819 (2002), the Supreme Court noted that Section 10(b) should be read flexibly to effectuate the remedial purpose of the statute.

[208] The slim majority in *Central Bank* acknowledges the clear, broad purpose of Section 10(b) and the Securities Exchange Act of 1934, notwithstanding how they ultimately thwarted that purpose. *Central*

are broad and far-reaching: They are broader in scope than common law fraud,[209] and they are broad to an extent that some have argued is unconstitutional.[210] The decision to adopt expansive legislation that affords significant discretion to the administering agency, however, is a policy decision made by an elected legislature.[211] Therefore, the statute and its reach are essentially beyond attack.[212] Moreover, the policy bases underlying the '34 Act as discussed below clearly

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Bank, 511 U.S. at 171 ("Together, the ['33 and '34] Acts 'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.'") (internal citations omitted). That said, while acknowledging the purpose of Section 10(b), the majority simultaneously ignored their historical pattern of cultivating the "judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

And as inconsistent and dubious as the slim majority's position is in *Central Bank*, there is oddly little academic literature criticizing the case. *But see* Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429 (1994). Perhaps this is because the dissent in *Central Bank* themselves constructed the most coherent attack on the majority opinion, *see Central Bank*, 511 U.S. at 192-201 (dissenting opinion authored by Justice Stevens, joined by Justices Blackmun, Souter, and Ginsburg), and there is little left to say, save ruing the misfortune that the correct position in *Central Bank* was supported by four as opposed to five justices.

[209] *The Prospects for Rule X-10B-5, supra note 184*, at 1124-33, 1142 ("the courts have held that X-10B-5 is not bound by common law standards.").

[210] *See* Charles Hughes & Co. v. SEC, 139 F.2d 434, 436 (2d Cir. 1943); Coplin v. United States, 88 F.2d 652, 656 (9th Cir. 1937).

[211] *See* Ferguson v. Skrupa, 372 U.S. 726, 730 (1963) ("[C]ourts do not substitute their social and economic beliefs for the judgment of legislative bodies, who are elected to pass laws."); *accord.* SELIGMAN, *supra* note 205 (discussing the deliberate legislative decision to draft Section 10(b) broadly to allow the administering agency (ultimately the newly-formed SEC) the discretion to adopt responsive, effective rules).

[212] *Ferguson*, 372 U.S. at 731-32. Academics debate, however, over whether "judges may deviate from even the clearest statutory text when a given application would otherwise produce 'absurd' results." *See* John F. Manning, *The Absurdity Doctrine*, 116 HARV. L. REV. 2387, 2388 (2003).

demonstrate that the breadth of Section 10(b)'s reach is both necessary and defensible.[213]

1. "There Must Be Confidence Not to Sell"[214]

Congress drafted the Securities Exchange Act of 1934 in response to the devastating market and economy decline of the late 1920's and early 1930's.[215] Congress intended for the '33 and the '34 Acts to stimulate and stabilize the markets through a mandate of full disclosure, which would inspire investor confidence in the integrity of the markets:[216]

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[213] Interestingly, while the legislative history of the '34 Act is rich, specific discussion of Section 10(b) within the '34 Act's legislative history is thin. *See* Thel, *supra* note 171, at 385 ("Section 10(b) is seldom mentioned in the committee reports, floor statements and published hearings on the Exchange Act. . . ."). So it is bootless to try to argue that Section 10(b) was specifically intended to apply to attorney conduct in the situations discussed in this Article.

Moreover, the disclosure scheme in which attorneys often have leave to weave webs of (perhaps client-directed) lies did not exist when the '34 Act and Section 10(b) were adopted. The issues of attorney liability under Section 10(b) when an attorney, for example, crafted a misleading Form 8-K, a misleading Form 10-K, a false 10(b) opinion, an inaccurate "true sale" letter, etc., justifiably were not in the minds of the '34 Act drafting Congress. These potential vehicles for attorney misconduct—these disclosure methodologies—either did not then exist or were not then widely employed. What instead is useful to consider, then, is whether the whole of the '34 Act generally was directed at issues similar to today's attorney misconduct.

[214] Report to Accompany S. 3420, Federal Securities Exchange Act of 1934, 73d Congress, Senate Report No. 792, at 5 (April 17, 1934) [hereinafter Report No. 792].

[215] The adoption of the '33 and '34 Acts was not quite as uncontroversial as the text of this Article might imply. For a terrific, detailed exposition of the controversy surrounding the adoption of the '33 Act and the '34 Act, see SELIGMAN, *supra* note 205.

[216] *See* Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 171 (1994); *see also* LOUIS BRANDEIS, OTHER PEOPLE'S MONEY 92 ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."); Report No. 792, *supra* note

> If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. . . . [I]t becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect . . . ordinary citizen's dependent position. . . . When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.[217]

The goals underlying the '33 and '34 Acts—full disclosure to promote market integrity, investor protection, and investor confidence—are as compelling today as they were seven decades ago.[218] Investor confidence is perhaps as depressed now as it was then, given the recent stock market decline, the economic hiccups over the past few years, and the recent, seemingly continual, revelations of massive corporate misconduct and accounting fraud.[219] If investor

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214, at 4 ("A rise in the security markets stimulates economic activity in all lines of business, a fall in the market precipitates a decline."). *Accord* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ("The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.") (internal citations omitted).

[217] Report No. 792, *supra* note 214, at 5.

[218] "The American economy—our economy—is built on confidence." George W. Bush, *President Announces Tough New Enforcement Initiatives for Reform* (July 9, 2002), *at* http://www.whitehouse.gov/news/releases/2002/07/print/20020709-4.html.

[219] *See* Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 144 (2002) ("The Enron affair and the flood of other recent corporate scandals . . . have led to a loss of investor and public confidence in the integrity of the securities and other markets that make American capitalism work."). Indeed, a renewed interest in the role legislatively-mandated honesty plays in the capital markets is evinced by the recent adoption of the Sarbanes-Oxley Act. *See*

confidence is dependent on a belief in the market's integrity,[220] and if investors now believe—after the spate of recent corporate scandals such as Tyco, Enron, and Adelphia[221]—that the information incorporated into the market is suspect, who will have confidence to continue to invest in the market?[222]

Attorneys put together (either conceptually, in terms of structuring, or logistically, with agreements and filings) most sizable contemporary transactions and deals,[223] and the

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Sarbanes-Oxley Act of 2002, 15 U.S.C.A. 7201, Pub. L. No. 107-204, 116 Stat. 745 (2002) (defining its purpose as '[a]n act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes").

[220] *See, e.g.*, John A. Byrne et al., *Restoring Trust in Corporate America*, BUS. WK., June 24, 2002, at 30 ("A seemingly endless stream of bad news alleging widespread management negligence and malfeasance is chipping away at the trust vital to a free-market system.").

[221] In one day alone, on one page alone, *The New York Times* detailed developments in three separate major corporate scandals. *See* N.Y. TIMES, July 9, 2004, at C5 (articles discussing Martha Stewart's failed bid for a new trial, guilty verdicts in the Adelphia trials, and former Enron CEO Ken Lay's indictment).

[222] "Who would knowingly roll the dice in a crooked crap game?" Schlanger v. Four-Phases Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982); *see also* Barbara Hagenbaugh, *Scandals Make It Harder for Companies to Raise Cash*, USA TODAY, July 5, 2002, at B1 ("The investor confidence sag stemming from corporate accounting scandals is making it harder for companies, even those unrelated to the firms in question, to raise cash in the key corporate bond market. . . . 'Investors have found they can't trust anybody,' says Stephen Slifer, chief U.S. economist at Lehman Bros.").

[223] "The hidden dirty secret of corporate scandals is that without lawyers, few corporate scandals would exist and fewer still would succeed long enough to cause any significant damage." Koniak, *supra* note 141, at 195. *Accord* 148 Cong. Rec. S6556 (daily ed. July 10, 2002) (statement of Sen. Jon Corzine (D-N.J.)) ("In fact, in our corporate world today—and I can verify this by my own experiences [as a former executive at Goldman Sachs]—executives and accountants work day to day with lawyers. They give them advice on almost each and every transaction.").

recent corporate scandals that partially underlie current investor fears were, indeed, in large part, attorney-facilitated corporate scandals.[224] Each time an attorney participates in a client's material misrepresentation or omission or sham transaction, the value of the shareholder's investment stands to decrease, and, as a result, some portion of defrauded investors will lose their confidence and withdraw their capital.[225] The alternative, then, to imposing broader liability

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Unfortunately, attorneys are not likely to spontaneously re-evaluate their willingness to continue working on questionable transactions or disclosure:

> Lawyers continue to believe, probably with good reason, that if they are too nosy and picky with their corporate constituents, the business will simply go down the street to a law firm that knows how to keep the CEO happy. If change is going to come anytime soon, it will require an overhaul of liability rules that makes 'seeing no evil' much more costly to the lawyers. Such a development is not on the horizon.

Thomas Ross, *Lawyers and Fraud: A Better Question*, 43 WASHBURN L.J. 45, 59 (2003).

[224] *See* 148 CONG. REC. S6554 (daily ed. July 10, 2002) (statement of Sen. Michael Enzi (R-Wyo.) ("[O]ne of the thoughts that occurred to me was that probably in every transaction there was a lawyer who drew up the documents involved in that procedure."). For example, the transactions that led to Enron's bankruptcy likely would not have been possible without the participation of outside counsel. Koniak, *supra* note 141, at 1240 ("it should be apparent . . . that the involvement of lawyers was necessary to implement" the allegedly fraudulent schemes involving Enron's special purpose entities). Enron's house of cards was built on its special purpose entities, which could not have been structured without attorneys laying the appropriate foundation with "true sale" and "nonconsolidation" opinion letters. *Id.* at 1242. Without the participation of Enron's outside counsel by providing these "true sale" opinions which attested to sales that really did not exist, it is not clear that Enron could have built the scaffolding of deceit that led to its collapse. *Id.*

[225] If outside counsel in the Enron situation feared liability under Section 10(b), perhaps the counsel would have refused to participate in and bless Enron's fraud. Perhaps Enron, therefore, would not have been able to build its house of cards and bilk thousands of investors out of

on attorneys is losing investor confidence and suffering the deleterious consequences.[226] Yet that result, as discussed above, is the *antithesis* of the goals of the '34 Act.[227]

Further, there is nothing in Section 10(b)'s legislative history to indicate that the 1934 Congress's mandate of full and fair disclosure should not bind enabling attorneys.[228] The opposite conclusion is more reasonable: The phrase "any person" in Section 10(b) has been interpreted to indicate that Section 10(b) was intended to reach any fraudster, regardless of his relationship to a defrauded buyer or seller of securities.[229] Indeed, Section 10(b) was viewed as a gap-

billions of dollars. *See* Koniak, *supra* note 181, at 195 ("No reform directed at other groups or institutions that is enacted by Congress, the SEC, or any other body, private or public, will accomplish its intended result as long as lawyers are allowed to roam in a law-free zone where legal fees know no bounds and the bankruptcy of one firm's corporate client only provides more legal fees to another.").

[226] *See, e.g., Shell Sinks as Report Shocks Investors*, CABLE NEWS NETWORK (Jan. 10, 2004), *at* http://www.erieindymedia.org/news/2004/01/291.php (last visited Mar. 4, 2004); *see also* Deborah Rhode & Paul Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J.L. BUS. & FIN. 9, 10 (2002).

[227] "When everything everyone owns can be sold at once, there must be confidence not to sell." Report No. 792, *supra* note 214, at 5; *see also* Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 171 (1994) ("Together, the ['33 and '34] Acts 'embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.'") (internal citations omitted); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ("The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges.") (internal citations omitted).

[228] The issue of attorney liability for securities fraud appears not to have arisen in the context of the drafting on the Securities Exchange Act of 1934. *See supra* note 213.

[229] *The Prospects for Rule X-10B-5*, *supra* note 184, at 1143.

filling provision within the Securities Act of 1933 and Securities Exchange Act of 1934 schemes.[230]

Purposeful application of Section 10(b) to all those who commit securities fraud, including attorneys, therefore, is both (a) sensible and (b) critical to serve the general goals of the '34 Act, to foster full disclosure, to restore investor confidence, and to ensure that fraudsters will be prosecuted.[231] But notwithstanding the legislative history of the '34 Act and the goals of the '33 Act and '34 Act statutory schemes, pragmatic concerns may arise when contemplating the aggressive application of Section 10(b) to attorneys. While this Article does not respond in full to every concern, some warrant consideration, as discussed below.

2. Blowing the Whistle on Whistleblowing Fears

One might argue that broader application of Section 10(b) to attorneys will harm the attorney-client relationship by making the attorney more likely to be a deal killer[232] and the

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[230] Section 10(b) and Rule 10b-5 filled '33 and '34 Act gaps by giving "both buyers and sellers a right to sue persons who are not immediate parties to an offending transaction," *id.* at 1137, and by providing to defrauded buyers and sellers "a broader slate of potential defendants." *Id.* at 1138. *See also* SELIGMAN, *supra* note 210, at 345 ("Section 10(b) of the 1934 Securities Exchange Act was a catch-all or residual antifraud provision meant to outlaw types of manipulation not specifically proscribed by the act's more precise denunciation. . . .").

[231] *See generally* John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015, 1034, 1049-52 (2001).

[232] Tina L. Stark refers to the "deal killer" phenomenon in her article *Thinking Like a Deal Lawyer*, 54 J. LEGAL EDUC. No. 2, at 229 (June 2004):

> Ferreting out risks is not usually a problem for most lawyers. They have been taught issue spotting. But if that is all that a lawyer does, she will justly earn a reputation as a deal killer. To be effective, she must assess the probability that a risk will occur and, if it is significant, find a way to limit it.

client therefore less likely to make full disclosure to the attorney.[233] Corporate officers will be less forthcoming with their outside counsel, the argument goes, to avoid objections from counsel, to avoid being "tattled on" to the board of directors, and to avoid closer scrutiny.[234] The effectiveness of outside counsel will therefore decrease,[235] and the value of a stockholder's investment will be negatively affected because the corporation will be unable to retain useful counsel.[236] The

[233] *See* Lisa H. Nicholson, *A Hobson's Choice For Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 129 (2002) ("It is believed that lawyers will more likely be able to provide better legal counsel that may include advice tending to dissuade clients from their improper conduct where clients are able to speak freely. Clients would otherwise be less candid about their conduct and intentions, thereby affording lawyers fewer opportunities to counsel them against pursuing unlawful courses of action.").

[234] *See generally* United States v. Chen, 99 F.3d 1495, 1500 (9th Cir. 1996) ("This valuable social service of counseling clients and bringing them into compliance with the law cannot be performed effectively if clients are scared to tell their lawyers what they are doing, for fear that their lawyers will be turned into government informants."); *see also* Cramton, *supra* note 219, at 181 (noting that one objection to requiring lawyers to report fraud is that it "will distort the lawyer-client relationship").

[235] *See Chen*, 99 F.3d at 1499 ("People need lawyers to guide them through thickets of complex government requirements, and, to get useful advice, they have to be able to talk to their lawyers candidly without fear that what they say to their own lawyers will be transmitted to the government."). *See also* Lisa H. Nicholson, *supra* note 233, at 129 ("It is believed that lawyers will more likely be able to provide better legal counsel that may include advice tending to dissuade clients from their improper conduct where clients are able to speak freely. Clients would otherwise be less candid about their conduct and intentions, thereby affording lawyers fewer opportunities to counsel them against pursuing unlawful courses of action.").

[236] *See generally* DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990). When noting that an accounting firm has no duty "to search and sing" about a client's improper conduct, Judge Easterbrook, writing for the Seventh Circuit panel in *DiLeo*, further stated:

very essence and value of the attorney-client relationship is at stake, the cynic could argue.[237]

> Such a duty would prevent the client from reposing in the accountant the trust that is essential to an accurate audit. Firms would withhold documents, allow auditors to see but not copy, and otherwise emulate the CIA, if they feared that access might lead to destructive disclosure—for even an honest firm may fear that one of its accountant's many auditors would misunderstand the situation and ring the tocsin needlessly, with great loss to the firm. Duties to disclose or pay damages would raise the costs of all audits, as accountants increased fees to cover anticipated liabilities. Honest enterprises would pay these fees no less than dishonest (for until the audit ended, an accountant could not tell which was which). So firms would purchase less accounting service, and investors in all firms would lose at both ends: the price would go up as the amount of oversight went down.

Id.

See also Comments of American Bar Association on Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys (Dec. 18, 2002), *at* http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm (the ABA opinioned that the SEC's proposed rules would "adversely affect issuers' ability to obtain sound legal advice. . . .").

[237] *See* Scott A. Crist, *Walking on Thin Ice: The Changing Liability of Attorneys in the Securities Area*, 27 J. MARSHALL L. REV. 909, 938 (1994) (expanding potential scope of liability for securities lawyers would "render the securities lawyer incapable of maintaining a traditional attorney-client relationship").

True doomsayers might even go further and argue that imposing liability under Section 10(b) when an attorney has co-authored or otherwise created a misrepresentation or omission will burden attorneys with the obligation to "blow the whistle" on clients who themselves draft and circulate materially misleading materials, even against the advice of their counsel. *See* Rolnick & Dartley, *supra* note 110, at 9 (stating that the opinion in *Klein* raised the issue of whether lawyers had "a duty to 'blow the whistle' on their clients"). This Chicken Little argument is hard to give credence to, as the Third Circuit Court of Appeals panel in *Klein* noted:

> Drinker contends that it did not have a duty to 'blow the whistle' on Mercer LP. It is reasonably clear that mere

The realistic response to this potential concern is that only time will definitively tell how a few successful private litigant securities fraud cases against attorneys will impact the attorney-client relationship. There are, however, reasons to believe that the threat to attorneys of primary liability for securities fraud will not erode the confidential attorney-client relationship.

First, from the mid-1960's until 1994, a private cause of action for aiding and abetting a violation Section 10(b) did exist.[238] Yet there is no historical evidence that this liability significantly impacted disclosure by clients to attorneys. Moreover, aiding and abetting liability as it existed in the 1960's and 1970's was remarkably far-reaching. For example, in *Brennan v. Midwestern United Life Ins. Co.*,[239]

> silence, absent a duty to speak, is not actionable under Section 10(b) or Rule 10b-5. . . . We do not disagree. Our analysis does not end there, however. The investors contend, and we agree, that a duty to disclose may arise *either* from a fiduciary relationship *or* from affirmative representatives that omit a material fact such that the representations made are misleading.
>
> We need not address the issue of whether a lawyer has an absolute duty to "blow the whistle" on his client. Instead, we are convinced that, as with the facts alleged here, when a lawyer elects to speak, the lawyer does have the duty to speak truthfully . . . . The fact that the lawyer is speaking 'behind the scenes' does not absolve the lawyer of his duty . . . . While Drinker did not owe a fiduciary duty to the investors to "blow the whistle" on Mercer LP, Drinker did have a duty to correct material omissions contained in *its* statements.

Klein, at 90,325.

[238] *See* Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 680-81 (N.D. Ind. 1966) ("[i]n the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes"), *aff'd*, 417 F.2d 147 (7th Cir. 1969); *see also* Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983); Kerbs v. Falls River Indus., 502 F.2d 731, 740 (10th Cir. 1974).

[239] 259 F. Supp. 673, 680-81 (N.D. Ind. 1966).

the court denied the defendant corporation's motion to dismiss a private litigant's aiding and abetting claim under Section 10(b).[240] The facts on which the aiding and abetting claim were based, however, were not egregious.[241] The defendant corporation was accused of aiding and abetting securities fraud by failing to report to the Indiana Securities Commission or the SEC "improper activities of a brokerage firm" regarding the stock of the defendant corporation.[242] The brokerage firm that was charged with the primary Section 10(b) violation was engaged in the sale of the defendant corporation's stock.[243] The brokerage firm would sell the stock to investors but then not actually transfer and deliver the stock.[244] The defendant corporation, because it was acting as its own transfer agent, knew of the brokerage firm's failure to deliver the stock, but the defendant corporation did nothing, allegedly because it served the defendant corporation to have a limited amount of its stock circulating in the market.[245] The defendant corporation's failure to report the brokerage firm's illegal activity was found by the court to be sufficient to sustain an aiding and abetting claim under Section 10(b).[246]

Aiding and abetting liability as in *Brennan* should therefore be of more concern to an attorney than primary violator liability under Section 10(b). The latter reaches far fewer defendants with its requirement of venal action by the defendant attorney than does aiding and abetting liability.[247] Yet, again, there appears to be no evidence of a crisis in attorney-client communication when aiding and abetting

[240] *Id.* at 675.

[241] *Id.*

[242] *Id.*

[243] *Id.*

[244] *Id.*

[245] *Id.*

[246] *Id.*

[247] *See supra* note 206 (discussing the differences between aiding and abetting liability under Section 10(b) and primary violator liability).

liability under Section 10(b) actually existed as a private cause of action prior to *Central Bank*. There is also no evidence that communication by corporate officers to outside counsel became more candid after the Supreme Court's repudiation of a private cause of action for aiding and abetting a Section 10(b) violation in *Central Bank* in 1994. And while it is hard to prove (or disprove) the existence of a negative, it seems that if there (a) had been a crisis in attorney-client communication in the 1960's and 1970's as aiding and abetting liability under Section 10(b) evolved or (b) had been a huge upsurge in attorney-client communication after *Central Bank* was decided in 1994, there would be some evidence of such, if only anecdotally.[248]

Second, a corporate officer's own fear of liability will weigh against the chilling of attorney-client communication. A corporate officer cannot afford to refuse to discuss questionable transactions, disclosures, and structuring with outside counsel. Outside counsel generally provides expertise on the securities laws. The benefit of the guidance given, and its liability-insulating value, is dependent on disclosure of the underlying relevant facts. Realistically, a corporate officer will be loath to reveal too few of the relevant facts pertaining to a transaction or disclosure to outside counsel because this might expose the officer personally to greater liability.

Finally, the SEC recently adopted rules that could chill attorney-client communication well before (and beyond) the indirect impact of the not-yet-aggressively evolving primary liability of attorneys for securities fraud likely could

[248] To further confuse the issue, the SEC can still prosecute aiders and abettors of Section 10(b) violations. *See* Section 20(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t (1994). Indeed, Stephen M. Cutler, director of the SEC's Enforcement Division, has reminded secondary actors that "[i]f you know or have reason to know that you are helping a company mislead its investors, you are in violation of the federal securities laws." Jerry Knight, *SEC: Look Out, Aiders and Abettors*, WASH. POST, Aug. 4, 2003, at E1.

(assuming the risk of communication-chilling actually has any merit to begin with). In Section 307 of the Sarbanes-Oxley Act of 2002, Congress instructed the SEC to issue rules "setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers."[249] Congress specified that the rules to be issued by the SEC must include a rule "requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty" to the chief legal counsel or chief executive officer of the issuer, and, barring appropriate response therefrom, to the audit committee, other independent directors, or the board of directors.[250] On January 23, 2003, the SEC adopted the rules Congress required.[251] These rules are "reporting up" rules, and they generally obligate an attorney (who is appearing before the SEC to represent an issuer) in instances where he knows or should know of corporate misconduct[252] to report such to the issuer's chief legal officer or the equivalent.[253] If the attorney believes he has not received an "appropriate response within a reasonable time" from the person to whom he reported the violation, the attorney must report the material violation (or evidence thereof) to the board of directors (or an appropriate

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[249] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified at 15 U.S.C.A. § 7245 (2002)).

[250] 15 U.S.C.A. § 7245 (2002).

[251] Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8185, 34-47276, 17 C.F.R. § 205 (Jan. 29, 2003) *available at* http://www.sec.gov/rules/final/33-8185.htm.

[252] Specifically, a material violation of securities law or breach of fiduciary duty or similar violation. 17 C.F.R. §§ 205.2(i) & 205.3(b)(1) (2003).

[253] 17 C.F.R. § 205.3(b)(1) (2003) (stating that attorneys who become aware of material violations must report such violations to issuer's chief legal officer "forthwith").

committee thereof) of the issuer, and, in instances of continued director non-response, resign.[254]

These reporting-up rules are more drastic than the threat of Section 10(b) liability because the rules obligate the attorney to act. The reporting-up rules obligate an attorney who is witnessing securities fraud or a client's breach of a fiduciary duty to report such to either the chief legal officer or the board of directors.[255] Contrariwise, the threat of Section 10(b) liability simply obligates the attorney to be careful not to put himself in a situation where he would otherwise be "creating" a fraud; the attorney has no affirmative Section 10(b)-related obligation to inform on a corporate officer.[256] Thus, the SEC's new rules appear to have the potential to skew the attorney-client relationship more than Section 10(b) does.

That said, in the wake of the SEC's adoption of its reporting-up rules, a lively debate has ensued among corporate scholars on the issue of client communication and the sanctity of the attorney-client confidential relationship.[257] The consensus appears to be that the "reporting up" rules are not likely to erode the attorney-client relationship,[258] in part

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[254] 17 C.F.R. § 205.3(b)(3) (2003).

[255] 17 C.F.R. §§ 205.3(b)(1), (3) (2003).

[256] Indeed, the Third Circuit panel in *Klein* spoke to this exact issue. *See supra* note 237.

[257] *See, e.g.*, Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 WASHBURN L.J. 1, 38 (2003); Marc I. Steinberg, *Lawyer Liability After Sarbanes-Oxley—Has the Landscape Changed?*, 3 WYO. L. REV. 371 (2003); Koniak, *supra* note 181, at 228-30.

[258] *See* Steinberg, *supra* note 257, at 375-77. "As a general proposition, the promulgation of SEC standards in this context will not greatly impact counsel's obligations under applicable state ethical rules as well as liability exposure under federal and state law." *Id.* at 372. *See generally* Sargent, *supra* note 257, at 38 (stating that "[t]he up-the-ladder reporting requirement . . . does not do any violence to the confidence and trust a corporate client should be able to place in its advocate, and might make lawyers more effective advocates for the real client by making sure that those involved in violating the law know that their lawyers ultimately will

have to raise questions with disinterested decision makers."); Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J. L. BUS. & FIN. 9, 32 (2002); *see also* John C. Coffee, Jr., *The Attorney As Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1307-08 (2003) (noting that the communication that might, potentially, be chilled is the communication by a manager to counsel about an unlawful act already committed, and this chilling is not particularly compelling); *accord* Roger C. Cramton, George M. Cohen, & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725 (2004); Mark A. Sargent, *Lawyers in the Moral Maze*, 49 VILL. L. REV. 867 (2004); *but see* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1125-26 (2003) ("In many corporations, the decision [to report to the board] is likely to jeopardize the lawyer's future relationship with that client. . . . Managers may reasonably be concerned about the lack of trust evidenced by the lawyer's behavior and the resulting effect on the quality of representation.").

At the same time the SEC proposed its "reporting up" rules, it also proposed a "noisy withdrawal" rule. *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8185 (proposed Nov. 21, 2002). Section 205.3(d) of the proposed rules provided, among other things, that an attorney (either internal or external) who had not received an appropriate response to his "reporting up" and who believed that a material violation of the law was continuing or was likely to occur and was "likely to result in substantial injury to the financial interest or property of the issuer or of the investors" was obligated to withdraw from representing the issuer and, within one business day of withdrawing, give written notice to the SEC of the withdrawal. *See* 17 C.F.R. § 205.3(d)(i)(A)-(B) (2003).

Notwithstanding the level of comfort academics have that the "reporting up" rule will not squelch the flow of information to attorneys from their clients, the proposed "noisy withdrawal" rule was not similarly well-received. *See* M. Peter Moser & Stanley Keller, *Sarbanes-Oxley 307: Trusted Counselors or Informers?*, 49 VILL. L. REV 833, 837-38, 840 (2004); David J. Beck, *The Legal Profession at the Crossroads: Who Will Write the Future Rules Governing the Conduct of Lawyers Representing Public Corporations?*, 34 ST. MARY'S L.J. 873, 911 (2003) ("The notion that a 'noisy withdrawal' would not constitute a breach of the attorney client privilege is unsupportable."). The noisy withdrawal rules were not adopted when

because the rules generally mirror most state bars' existing ethical rules.[259] To the extent that the fear of liability under Section 10(b) is a less direct influence on attorneys than the new SEC rules (as discussed above), it is difficult to see how the threat of liability under Section 10(b) would change the attorney-client any more than will the new reporting-up rules.

3. SEC Rulemaking Versus State Bar Regulation Versus Section 10(b)

A related issue is whether the broad application of Section 10(b) is necessary in light of the SEC's reporting-up rulemaking. Section 10(b) appears still to be necessary, because the new reporting-up rules seem to be insufficient at best, and irrelevant at worst, with respect to the goal of influencing the behavior of attorneys in a way that could preclude future massive corporate scandals.[260] The SEC's rules are insufficient because the sanctions and penalties for violation of these rules lie only with the SEC.[261] The SEC is, by its own admission, overworked and unable to detect and

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the "reporting up" rule was adopted, and it is unclear whether the proposed rules will ever be adopted in any form.

[259] *See* Steinberg, *supra* note 257, at 375-77 (noting that forty-two states, including Wyoming, New York, and Texas, have state ethical rules that permit or require an attorney to reveal a client's crime or fraud in some instances). Therefore, in many instances, the SEC's reporting up rules require that which an attorney faced with a client's fraud is already obligated (or at least permitted) to do. For example, ABA Model Rule 1.6(b) permits an attorney to reveal information through actions such as reporting up in order to prevent a fraud when the fraud is "reasonably certain" to result in substantial financial loss to another. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2) (2004).

[260] "Out of scandal comes reform," yet sometimes the reforms adopted by the SEC stop short of what is optimal. Goldschmid, *supra* note 141, at 342.

[261] 17 C.F.R. § 205.6 (2003); *see* § 205.7(a) (2003) ("Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer. . . .").

prosecute all instances of misconduct.[262] Moreover, the rules do not apply to attorneys who are not appearing and practicing before the SEC.[263]

But even if the rules reached non-appearing attorneys and even if the SEC had unlimited resources with which to vindicate its rules, the rules are somewhat irrelevant because they neither reach nor deter the sort of attorney misconduct shown recently to have been the most venal and damaging. Dean Mark Sargent makes this point in a recent article, noting that the presumption underlying Section 307 of the Sarbanes-Oxley Act and the SEC's reporting-up rules is that the Enron fiasco and other instances of egregious corporate misconduct could have been avoided were there sufficient incentives for the attorneys involved to blow the whistle.[264] Dean Sargent questions this presumption, because the attorneys who contributed to Enron's failure (for example) by drafting false "true sale" letters and other documents were actually "partners in crime" with Enron as opposed to gatekeepers in a position to blow the whistle on a client's fraud.[265] Phrased differently, once an attorney has

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[262] *Securities Fraud Hearings Before the Subcomm. of the Senate Comm. on Banking, Housing & Urban Affairs*, 103d Cong. 113 (1993) (statement of William R. McLucas, SEC Director of Enforcement, that the SEC "does not have the resources to investigate every instance in which a public company's disclosure is questionable," and such "would continue to be the case even if the Commission's resources were substantially increased"); *see also* Berner v. Lazzaro, 730 F.2d 1319, 1322-23 (9th Cir. 1984) ("The resources of the Securities Exchange Commission are adequate to prosecute only the most flagrant abuses. To this end, private actions brought by investors have long been viewed as a necessary supplement to SEC enforcement actions.") (citation omitted).

Interestingly, it appears that the SEC has long struggled with an insufficient budget, which hamstrings enforcement and other agency activity. *See* SELIGMAN, *supra* note 205, at 268 (discussing SEC budget cuts in the 1950's that resulted in reduced enforcement activity).

[263] 17 C.F.R. § 205.1 (2003).

[264] Sargent, *supra* note 257, at 19.

[265] *Id.* at 20-21.

crossed the line and either (a) agreed to help facilitate his client's fraud or (b) decided the client's proposed conduct is not fraudulent and, therefore, the attorney can facilitate the transaction, the attorney is unlikely to "inform on himself."[266] If the attorney thinks that the transactions he is structuring are aggressive but legal, he has no reason to report up, as there is no corporate misconduct to report.[267] If the attorney instead is knowingly participating in a fraud, he will not be fool enough to report himself up.[268] Reporting rules, then, are unlikely to have value in situations analogous to those underlying the recent corporate scandals. Rather, fear of extensive liability under Section 10(b) might prevent attorneys from crossing the line from aggressive lawyering to actual fraud.[269]

As a related query, is the broad application of Section 10(b) to attorneys just general overkill? Some might say that Section 10(b) is an unnecessary motivator because the attorney is already obligated to act in the best interests of the corporation he represents.[270] Acting in the best interests

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[266] *Id.* at 22-23.

[267] *See* Fisch & Rosen, *supra* note 258, at 1115-16 (noting that if Enron's outside counsel believed that they had assisted their client in structuring legal transactions, they would have nothing to report up, and if they believed that they had assisted their client in committing fraud, they would be very unlikely to report up).

[268] *Id.* at 1116.

[269] "No reform directed at other groups or institutions that is enacted by Congress, the SEC, or any other body, private or public, will accomplish its intended result as long as lawyers are allowed to roam in a law-free zone where legal fees know no bounds and the bankruptcy of one firm's corporate client only provides more legal fees to another." Koniak, *supra* note 181, at 195; *accord* Beck, *supra* note 258, at 912-13 ("There can be no doubt that the conduct of attorneys is naturally shaped by the fear that his or her rendition of legal services will result in civil liability.").

[270] *See, e.g.*, H. Lowell Brown, *The Dilemma of Corporate Counsel Faced With Client Misconduct: Disclosure of Client Confidences or Constructive Discharge*, 44 BUFF. L. REV. 777, 779-82 (1996). *See also* John S. Dzienkowski, *Lawyers as Intermediaries: The Representation of*

of his client, the corporate entity, seems to, at least theoretically, obligate the attorney to refuse to participate in, and, indeed, attempt to prevent, acts of deceit which could damage the corporation.[271]

But this obligation to the corporate entity is apparently not compelling to all attorneys: Vinson & Elkins attorneys were surely aware of their corporate fideles when representing Enron. Yet these attorneys structured transactions for Enron that hid debt of a level that compromised the very financial viability[272] of the corporation.[273] The ethical obligation to the corporation itself

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Multiple Clients in the Legal Profession, 1992 U. ILL. L. REV. 741, 742-43 (1992); Brian D. Forrow, *The Corporate Law Department Lawyer: Counsel to the Entity*, 34 BUS. LAW. 1797, 1800 (1979); Ralph Jonas, *Who is the Client? The Corporate Lawyer's Dilemma,* 39 HASTINGS L.J. 617 (1988); Robert J. Kutak, *Proposed Model Rules of Professional Conduct*, 36 BUS. LAW. 573, 577-79 (1981); MODEL CODE OF PROF'L RESPONSIBILITY EC 5-18 (1980); *accord* 17 C.F.R. § 205 (2003) ("Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer"). *See also* Fisch & Rosen, *supra* note 258, at 1123 (noting that the corporation itself is the attorney's client, notwithstanding management pressures contrariwise).

[271] Some appear, however, to take issue with this broad interpretation of an attorney's obligations, noting that "[r]equiring lawyers to serve as the social conscience of the client, however, obviously raises fundamental questions about the nature of the attorney-client relationship and the traditional presumption of the primacy of the client's claims on the lawyer's loyalties." Sargent, *supra* note 257, at 26.

[272] *See* Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy*, WALL ST. J., Dec. 3, 2001, at A3 (stating that Enron was, at the time, the largest bankruptcy filing in United States history).

[273] Professor Ross discusses this issue in a recent article, noting

> When the spotlight drifted on occasion to [Enron's lawyers at Vinson & Elkins], the lawyers responded with the assertion that their representation was consistent with their professional norms, stressing confidentiality as a central obligation.
>
> Yet, the great glaring weakness in the argument that the Enron lawyers were simply too devoted to the client and

appears to not always be compelling enough when weighed against the opportunity for an attorney to generate huge fees by acceding to the wishes of a corporate manager.[274] The threat of Section 10(b) liability can be a useful counterbalance to the sometimes overwhelming desire of the attorney to line his pockets with gold at the expense of the faceless investor.[275]

> bound in any event by the strictures of confidentiality is the central fact that the entity, Enron, was the client and not Ken Lay or Andy Fastow or any of the other human constituents. The lawyers owed their loyalty to the entity and not to the constituents. In essence, *their task as lawyers was to help the entity become as successful as it could, while making sure that they and their client stayed on the right side of the . . . law. In this task, the Enron lawyers were a colossal failure.*

Ross, *supra* note 223, at 53-54 (emphasis added).

[274] The District Judge in the *Enron* case addressed exactly this issue:

> A number of Defendants argue that Lead Plaintiff's allegations that Defendants knew of the Ponzi scheme and yet poured millions of dollars into it or risked their reputations to conceal the scheme merely for fees, payments and profits, and subsequently, once caught in the scheme, shored it up in order to limit their exposure to liability and obtain what payments they could on Enron's debts to them, are inherently irrational, implausible, and/or illogical and the alleged actions are against Defendants' own self-interest. This Court notes that what may have been implausible two or three years ago is hardly so today, in light of a plethora of revelations, investigations, evidence, indictments, guilty pleas, and confessions of widespread corporate corruption and fraud by companies, auditors, brokerage houses, and banks. *Lining one's pockets with gold, at the expense of investors, employees, and the public, appears too often to be a dominating ambition, and public scepticism about the market is very prevalent.*

In re Enron Corp., 235 F. Supp. 2d at 686 (emphasis added).

[275] "Lining one's pockets with gold, at the expense of investors, employees, and the public, appears too often to be a dominating ambition,

This, however, leads to interesting questions: In the area of attorney-assisted corporate misconduct, who is the best watchdog group? Who should be regulating attorneys? Should attorney-assisted fraud be battled through SEC or bar organization rulemaking? Though an exhaustive discussion of these issues is beyond the scope of this Article,[276] a few observations are in order: Attorneys who are charged with drafting rules to regulate themselves are not going to be the most compelling rulemakers—they are conflicted. So while a state bar association might be in a good theoretical position to regulate attorneys, it is difficult to believe that a committee of attorneys from that organization is going to is going to draft effective and appropriately restrictive conduct-governance rules with attendant compelling penalties for infractions.[277] Self-

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and public scepticism about the market is very prevalent." *Id.* at 686. Professor Koniak goes further than this cynical assessment from the District Court judge in *Enron*, and asserts that:

> No reform directed at other groups or institutions that is enacted by Congress, the SEC, or any other body, private or public, will accomplish its intended result as long as lawyers are allowed to roam in a law-free zone where legal fees know no bounds and the bankruptcy of one firm's corporate client only provides more legal fees to another firm.

Koniak, *supra* note 181, at 195. *See generally* Beck, *supra* note 258, at 912-13 ("There can be no doubt that the conduct of attorneys is naturally shaped by the fear that his or her rendition of legal services will result in civil liability.").

[276] Indeed, entire articles have been recently written on just this issue. *See generally* Beck, *supra* note 258; *see also* Deborah Rhode & Paul Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J. L. BUS. & FIN. 9, 27-33 (2002).

[277] *See* Michael A. Perino, *SEC Enforcement of Attorney Up-the-Ladder Reporting Rules: An Analysis of Institutional Constraints, Norms and Biases*, 49 VILL. L. REV. 851, 857 (2004); *see also* Koniak, *supra* note 181, at 215.

governance by the bar just cannot be the most effective way of preventing attorney-assisted fraud.[278]

To a degree, such is the case with the SEC.[279] Although the SEC is an independent agency, (a) its Commissioners are often attorneys who may be hesitant to regulate their peers,[280] (b) lower-level SEC attorneys likely want to avoid burning bridges with the private bar,[281] and (c) the SEC is chronically understaffed, such that any rulemaking regarding attorneys might well lack teeth in terms of

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[278] Professor Koniak observes that "[i]n all my years of research into the law governing lawyers, I have come across no case in which a state bar authority has successfully challenged the conduct of a big-time securities or corporate lawyer." Koniak, *supra* note 181, at 215.

[279] *See* Perino, *supra* note 277, at 860 (critiquing state bar authorities' lax enforcement of professional responsibility standards and noting that "the SEC's enforcement of disciplinary rules against lawyers has looked remarkably similar to state bar authorities' enforcement efforts.").

[280] Note that among the SEC's current five commissioners, three are attorneys: Paul S. Atkins, Roel C. Campos, and Harvey J. Goldschmid. James Landis noted that "[t]he pressing problem today, however, is to get the administrative to assume the responsibilities that it properly should assume. . . . The assumption of responsibility by an agency is always a gamble that may well make more enemies than friends. The easiest course is frequently that of inaction." JAMES LANDIS, THE ADMINISTRATIVE PROCESS 75 (1938). *Accord* Perino, *supra* note 277, at 862-63; *id.* at 860 ("From its inception and throughout its history, the SEC has been a lawyer-dominated agency.").

[281] Professor Perino notes that

> typical SEC enforcement staffers are young attorneys who spend only a few years at the SEC before pursuing more lucrative careers in private practice, often at large prestigious law firms. While one way to enhance career advancement within the agency and post-government employment opportunities is to bring high profile cases, attorneys may, quite frankly, be leery of bringing disciplinary proceedings against lawyers from the kind of firms that they hope to join in the future.

Perino, *supra* note 277, at 863.

enforcement.[282] The SEC is staffed with smart, competent people, to be sure, but pressures on the agency appear to compromise its effectiveness in this area.[283] To boot, given that the funding and staffing of the agency depends on the largess of Congress, and given that the benevolence of Congress often depends on the happiness of the legislators' constituencies, and given that attorneys represent a significant portion of the legislators' wealthy constituencies (not to mention lobbyists), strict attorney regulation may just be too delicate of an issue for the SEC to take on aggressively any time in the future.[284]

4. Increasing the Cost of Capital?

Some might argue that imposing liability on attorneys for Section 10(b) violations is undesirable because it will increase the cost of capital.[285] Attorneys who view

[282] *Id.* at 854 (noting that from 1990 through 2000, the number of complaints filed with the SEC grew 100% while the SEC's enforcement staff grew by only 16%); *see generally* Thomas Rose, *Lawyers and Fraud: A Better Question*, 43 WASHBURN L. J. 45, 59 (2003) ("Tough sounding rules applied with weak commitment will probably change nothing.").

[283] Former SEC Chairman Harvey L. Pitt alluded to such, noting that the SEC has been "circumspect" in monitoring and penalizing attorney conduct, instead leaving such to the state bar associations. *See* SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), *available at* http://www.sec.gov/news/speech/spch579.htm.

[284] Indeed, recent former SEC Chairman Harvey Pitt resigned under pressure, in part due to problems resulting from his being perhaps too tied to the professionals he was obligated to regulate. *See generally* Michael Schroeder, *Arthur Levitt Finds Himself on the Outs*, WALL ST. J., Nov. 29, 2002, at A4. For an interesting discussion of the related tensions at the SEC shortly before and after Chairman Pitt's resignation, see Bill Deener, *Securities and Exchange Commission Faces Unprecedented Turmoil*, KNIGHT-RIDDER TRIB. BUS. NEWS, Nov. 24, 2002, *available at* 2002 WL 103645773.

[285] *See generally* Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945 (1993).

themselves as increasingly vulnerable under Section 10(b) might (a) increase their liability insurance and raise their fees to offset the higher premiums, (b) bill more time for due diligence, or (c) stop being corporate and securities attorneys (such that the limited number of corporate and securities attorneys who remain in the field can demand higher fees). These potential response to increased attorney liability could raise the corporation's outside legal counsel costs and therefore could directly impact shareholders by decreasing the available capital surplus for dividends, by decreasing annual earnings, or by generally increasing the cost of capital.

Yet trading off better legal work at higher fees for a lower incidence of Enron-type scandals still creates an overall gain for investors.[286] Moreover, it is not clear that attorneys will be able to demand increased fees to compensate for potentially increased liability exposure. There is enough competition in the legal services market to almost guarantee that law firms that significantly increase their fees to compensate for increased liability exposure will be underpriced by their competitors.[287] Many corporations appear already to be in a position to refuse to pay increased

[286] The scandals involving Sunbeam, Waste Management, Enron, Global Crossing, Qwest, and WorldCom, for example, have cost investors more than $300 billion combined and have put tens of thousands of people out of work. *See* John A. Byrne, *Fall From Grace*, BUS. WK., Aug. 12, 2002, at 50. Indeed, some would estimate investor losses from the Enron scandal alone at $29 billion. *See* Mary Flood, *The Fall of Enron*, HOUS. CHRON., July 25, 2003, at 2. Surely increased attorney bills would have been a valuable corporate expenditure to forestall such losses.

[287] *See, e.g.*, Robert J. Zeitlinger, *Law Firms with Corporate Clients Facing Changes in Time and Billing Procedures*, 12 No. 2 LEGAL MGMT. 64, 64-69, *reprinted in Alternative Pricing Practices: How to Competitively Price Your Firm's Services*, at 77, 77-82 (PLI Commercial Law & Practice Handbook Series No. A-712, 1995). To that end, Professor John Coffee notes that corporate general counsels "have learned to move their legal business around to foster price competition among law firms." Coffee, *supra* note 258, at 1305.

fees,[288] particularly given that skilled, high-profile corporate attorneys already charge rates of at least $300-$500 per hour.[289]

And while the issue of whether attorneys will begin refusing to structure transactions, write opinion letters, and draft disclosure filings for fear of Section 10(b) liability exposure if Section 10(b) is applied more aggressively to attorneys is difficult to address because it involves predicting the future,[290] there are at least a few points that suggest that

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[288] Coffee, *supra* note 258, at 1305.

[289] In the same vein, in response to the argument made by some lawyers that the transactions at issue in the Enron fiasco were "so complex that no one could expect a lawyer to understand them," Professor Murdock, likely cachinnating, notes that "in a jury trial, a lawyer who earns $500,000 a year and pleads ignorance as a defense is not going to be a very sympathetic defendant." Charles Murdock, *The Attorney as "Creator" or "Author,"* 17 CBA RECORD 34, 36 (Apr. 2003).

[290] The legal scholarship in the area of attorney liability does not seem focused on this concern. However, the significance of the issue has been alluded to:

> [E]ven if the risk of judgment against law firms is discounted by the low probability of success based on the bars to recovery. . . , the specter of being named in a securities fraud lawsuit remains costly to the law firm because of the risk of loss to the firm's 'reputational capital,' as well as the financial exposure to the firm.

Beck, *supra* note 258, at 913.

Indeed, Professor Painter and Jennifer Duggan note that:

> Whereas for a large accounting firm a securities suit is simply one more suit to be settled or litigated, for most law firms any lawsuit is a crisis calling into question the integrity of the firm's lawyers. The reputational paradigm in the legal profession is thus particularly sensitive to an allegation of improper professional conduct, and a lawyer who has been sued or named as a respondent in a SEC disciplinary proceeding has a lot more to worry about than monetary loss. A securities practice that took years to build can dissolve almost overnight as clients, with plenty of lawyers and law firms to choose from, depart for one of

such an attorney retreat is unlikely (at least for reasons related to attorney liability under Section 10(b)). First, a successfully-pleaded Section 10(b) complaint requires a specific pleading of scienter.[291] If an attorney did not intend to defraud the public or investors, he simply will not be liable for securities fraud because he did not commit securities fraud.[292] And while it is often difficult for a plaintiff to prove, even after full discovery, that a defendant acted with the intent to deceive or defraud, it is much more difficult to plead, before full discovery, the intent to deceive, manipulate, or defraud.[293] Moreover, the thoughtful, cautious attorney who vehemently counsels his client against, for example, inclusion of materially misleading information in a disclosure document or other communication with investors (and keeps confidential records of such), is unlikely to even be viewed as a potential Section 10(b) defendant once his protests come to light.[294]

> many competitors who have managed to avoid disciplinary actions or civil suits, regardless of how those proceedings are ultimately resolved.

Richard W. Painter & Jennifer E. Duggan, *Lawyers Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 239 (1996).

[291] In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), over a Presidential veto, in part to respond to concerns of frivolous securities litigation. Among other things, the PSLRA requires that in any private securities fraud class action the plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *See* 15 U.S.C. § 78u-4(b)(2), Pub.L. No. 104-67, 109 Stat. 737 (1995) ("the complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

[292] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976).

[293] *See, e.g.*, Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999) (conceding the difficulty for plaintiffs to meet the scienter pleading standards).

[294] Indeed, given the recent proposed revisions to Rule 11 of the Federal Rules of Civil Procedure, plaintiffs' attorneys are sure to be more careful in the near future not to over-aggressively name defendants (on

What's more, attorneys can already be prosecuted by the SEC for aiding and abetting violations of Section 10(b).[295] Securities fraud by attorneys is already prohibited.[296] So there is nothing "new" being advocated in this Article (in terms of liability) substantively to scare a transactional attorney into abandoning his practice, nor are there any new prohibitions on activity. Moreover, if an attorney is so afraid of liability that he is willing to stop doing corporate and securities work, it is likely that the SEC's reporting-up rules will impact the attorney sooner than any evolving Section 10(b) jurisprudence will for the reasons previously discussed.[297]

In short, while a more aggressive application of Section 10(b) to attorneys might raise some concerns—about costs, about confidentiality, about the future of the practice of corporate law—not all of these concerns hold up under closer scrutiny. Even if some of the concerns prove realistic, the benefits of increased Section 10(b) liability appear to outweigh the detriments.

September 14, 2004, HR 4571 ("Lawsuit Abuse Reduction Act of 2004") was passed by the House of Representatives to amend Rule 11 of the Federal Rules of Civil Procedure. 150 Cong. Rec. 7080 (Sept. 14, 2004). Specifically, this bill makes mandatory, as opposed to discretionary, Rule 11 sanctions against attorneys who file frivolous lawsuits. *Id.* at 7080 (Statement of Rep. Sessions). The bill also removes the Rule 11 safe harbor that allows attorneys to avoid Rule 11 sanctions by withdrawing frivolous claims within twenty-one days after a motion for sanctions was filed. *Id.* Lastly, the bill also implements a "three strikes and you're out" rule that provides for a one-year disbarment for any attorney who has filed three frivolous lawsuits in federal court. *Id.* The bill has been received in the Senate and referred to the Committee on the Judiciary, which, as of the time of publication, has not acted thereon.)

[295] *See* Section 20(e), Securities Exchange Act of 1934, *supra* note 248.

[296] *Id.*

[297] *See supra* notes 249-256 and accompanying text. Interestingly, some scholars would argue that even the SEC's new rulemaking will have no impact. *See generally* Steinberg, *supra* note 257, at 372.

V. CONCLUSION

> [J]ustice [is] a certain rectitude of the mind, whereby a man does what he ought in any matters.
>
> —St. Thomas Aquinas[298]

When questioning the role of attorneys in the Lincoln Savings and Loan debacle who did not object to or attempt to stop the widespread fraud at issue, Judge Sporkin did not ask questions that should be hard to answer.[299] Attorneys who constantly try to stymie the deals their clients propose will find themselves with few clients.[300] A reluctant attorney will not be economically vindicated in many instances for taking a conservative position, because there are enough other attorneys who will be willing to structure and paper deals intended to hide debt, shelter income from tax, or the like.[301] This is at least in part because Section 10(b) liability rests, if at all, with issuers (and perhaps accountants) in these instances. There is currently no compelling legal disincentive to motivate attorneys to refrain from actions such as structuring deals specifically designed to mislead, drafting misleading press releases for their clients to sign, turning a blind eye to "cooked" numbers when providing opinion letters, and ignoring all sorts of sham transactions when drafting "true sale" letters.

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[298] ST. THOMAS AQUINAS, SUMMA THEOLOGICA, pt. II-II, q. 61, art. 4.

[299] *See supra* note 1 and accompanying text.

[300] "Lawyers continue to believe, probably with good reason, that if they are too nosy and picky with their corporate constituents, the business will simply go down the street to a law firm that knows how to keep the CEO happy." Ross, *supra* note 222, at 59. "The practical problem . . . is that of angering the person within the organization with the power to fire the lawyer." Cramton, *supra* note 218, at 156.

[301] Ross, *supra* note 222, at 54 ("Law firms operate in a competitive market in which. . . there are always other firms ready to be more aggressive to get the business. The limiting factor, in theory, is the penalty suffered by firms when they go too far.").

And therein lies the conundrum with which this Article has grappled. Attorneys have minimal, if any, legal incentives to loudly object to their clients' questionable special purpose entity structure, fuzzy risk disclosure, or overly optimistic press release. Absent a strong personal moral compass, there is no meaningful reason for an attorney to risk alienating a client by refusing to structure a deal or draft a disclosure that other attorneys would handle willingly. That is why the federal judiciary must apply Section 10(b) to attorneys in the broad manner that this Article advocates.[302] Such an application of 10(b) honors precedent, accords with sound statutory interpretation principles, and effectuates the policy goals underlying the Securities Exchange Act of 1934.

Assuming that society as a whole, like Judge Sporkin, wants to encourage attorneys to "speak up or disassociate themselves from [deceitful] transactions,"[303] the judiciary needs to look beyond ethical rules and limited SEC rules. Attorneys need meaningful disincentives to creating for a client deceitful transactions or vehicles for deceit. Simply hoping that social pressure will encourage attorneys to "do the right thing" or expecting attorneys to rely on their own good conscience is not enough.[304] Attorneys appear to be a

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[302] "As one Congressman put it, '[w]e cannot legislate honesty into Wall Street, but we can legislate to make that gang toe the mark.'" John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015, 1050 (2001) (citing 78 CONG. REC. 8103 (1934), statement of Rep. Johnson).

[303] Lincoln Savings and Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

[304] *See generally* MONROE H. FREEDMAN & ABBE SMITH, UNDERSTANDING LAWYERS' ETHICS 51-77 (2d ed. 2002) (Chapter 3, entitled "The Lawyer's Virtue and the Client's Autonomy," discusses the ethical and moral tensions inherent in a lawyer's relationship with a client.).

In a nutshell, "[p]reaching to lawyers and bar groups about their moral and public responsibilities has proven to be ineffective." Cramton, *supra* note 218, at 175.

thick-skinned sort, more impervious to social pressure regarding their professional actions than most.[305] The best way to exert influence over attorneys is to penalize them quickly and ruthlessly for crossing the line and engaging in securities fraud. A few successful Section 10(b) lawsuits will likely "encourage" attorneys to begin refusing to structure, negotiate, paper, and consummate deals designed to conceal debt, avoid tax in a manipulative way, or lead non-insiders to believe that the health of a corporation is something other than what it truly is.[306]

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[305] Lawyers have good reasons for developing such thick skin. They are the butt of hundreds of thousands of jokes, quips, and quibbles: A quick search of the internet will find over 797,000 different sites containing lawyer jokes. One anonymous joke perhaps best relates the feeling behind many people's thoughts regarding lawyers:

> A physician, an engineer and a lawyer were arguing about whose profession was the oldest.
>
> The surgeon announced, "Remember how God removed a rib from Adam to create Eve? Obviously, medicine is the oldest profession."
>
> The engineer replied, "But before that, God created the heavens and the earth from chaos, in less than a week. You have to admit that was a remarkable feat of engineering, and that makes engineering an older profession than medicine."
>
> The lawyer smirked, and said, "Who do you think created the chaos?"

"The Oldest Profession," *available at* http://www.xpertlaw.com/humor/profession/theoldest.html. Other notable jabs at lawyers are prevalent. *See, e.g.*, CHARLES HENNING, THE WIT AND WISDOM OF POLITICS 117 (1989) (quoting Clarence Darrow: "The trouble with law is lawyers."); ANDREW ROTH & JONATHAN ROTH, DEVIL'S ADVOCATES: THE UNNATURAL HISTORY OF LAWYERS 82 (1989) (quoting John Keats: "I think we may class the lawyer in the natural history of monsters."); WILLIAM SHAKESPEARE, THE SECOND PART OF KING HENRY THE SIXTH, act 4, sc. 2, ln. 71 ("The first thing we do, let's kill all the lawyers.").

[306] Congress, in adopting the PSLRA, was well aware of lawyers' roles in corporate fraud, as the legislature recognized that private lawsuits "promote public and global confidence in our capital markets and help to

This encouragement is necessary. In an ideal world, one could expect an attorney to voluntarily do "what he ought to do in circumstances confronting him."[307] This world, however, is not ideal.

deter wrongdoing and guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." H.R. REP. NO. 104-369, at 31 (1995) (conference committee report to accompany H.R. 1058, Private Securities Litigation Reform Act of 1995).

[307] Professors Monroe Freedman and Abbe Smith note:

> There is significant sentiment within the bar . . . that a lawyer has both a moral and a professional duty to conduct a client's matter in accordance with the lawyer's views of right and wrong, even though the client wants to do something that is both lawful and ethical. Oddly enough, most critics of the legal profession argue not that such attitudes are paternalistic, elitist, and even arrogant; rather, they complain that not enough lawyers conduct themselves that way.

FREEDMAN & SMITH, *supra* note 305, at 52.

THE U.S. JURISDICTION OVER TRANSFERS OF U.S. DOLLARS BETWEEN FOREIGNERS AND OVER OWNERSHIP OF U.S. DOLLAR ACCOUNTS IN FOREIGN BANKS

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I. INTRODUCTION

For a long time, the blocking or freeze of U.S. dollar transfers, including transfers taking place outside the United States, has been an important tool of U.S. foreign policy. After the attack on the United States on September 11, 2001, the U.S. government raised the issue of international terrorism and its financial aspects to a level of primary concern for the international community. The U.S. government has adopted a series of controls on domestic and foreign banking and other financial institutions that might facilitate or assist designated terrorist groups. To prevent the funding of terrorist activities, the United States not only may order the freeze of U.S. dollar transfers but also the seizure of dollar accounts that are maintained by foreign banks outside the United States. These measures against foreign transfers and foreign accounts have a great impact because fifty-five to seventy percent of all U.S. dollars are held abroad.[1] This Article examines the legal basis for the

[1] *See* Hale E. Sheppard, *Dollarization of Ecuador: Sound Policy Dictates U.S. Assistance to this Economic Guinea Pig of Latin America*, 11 IND. INT'L & COMP. L. REV. 79, 82 n.7 (2000); Richard D. Porter & Ruth A. Judson, *The Location of U.S. Currency: How Much is Abroad?*, 82 Fed. Reserve Bull. 883 (1996); Edwin S. Rubenstein, *The Globalization of the U.S. Dollar*, AMERICAN OUTLOOK (1999), *available at* http://www.americanoutlook.org/index.cfm?fuseaction=article_detail&id=1239 (last visited Sept. 1, 2004). *See also* Letter from Richard D. Porter &

jurisdiction of the United States over U.S. dollar assets that are either transferred through the international payment system or deposited at banks outside the United States.

II. DISTINCTION BETWEEN THE JURISDICTION OVER THE U.S. DOLLAR AND THE *LEX MONETAE*

The jurisdiction of U.S. authorities over money transfers in U.S. dollars and over U.S. dollar accounts does not follow from the doctrine of *lex monetae.*

The doctrine of the *lex monetae* states that each sovereign state possesses the exclusive sovereign power to determine what constitutes legal tender within its territory, and the nominal value of the currency.[2] According to Mann, each country also has exclusive authority to replace its currency with a new currency and to fix the conversion rate of the old currency.[3] Other countries must recognize that determination.[4]

However, the issue of U.S. jurisdiction over transfers of U.S. dollars and over U.S. dollar accounts does not relate to the value or the existence of the U.S. dollar as a currency or legal tender. The jurisdiction over money transfers in U.S. dollar and U.S. dollar accounts refers merely to the questions of who can use the U.S. dollar as legal tender and how the U.S. dollar should be used. Furthermore, *lex monetae* refers only to the sovereign power of a state over its currency within the country of such currency and not outside such country,[5] whereas U.S. jurisdiction over transfers of U.S.

Ruth A. Judson, Division of Monetary Affairs of the Federal Reserve Board, to Sam Karnick, Editor-in-Chief, American Outlook, The Hudson Institute (July 30, 1999) (available in the files of the author).

[2] *See* FREDERICK A. MANN, THE LEGAL ASPECT OF MONEY 266-67 & 271-79 (5th ed. 1992). *See also* ARTHUR NUSSBAUM, MONEY IN THE LAW—NATIONAL AND INTERNATIONAL 353-59 (2d ed. 1950); PHILIP R. WOOD, COMPARATIVE FINANCIAL LAW 177 (1995); HUGO J. HAHN, WÄHRUNGSRECHT 382-83 (9th ed. 1990).

[3] *See* MANN, *supra* note 2, at 266-67 & 271-79.

[4] *Id.* at 271-79.

[5] The rule of *lex monetae* has an effect outside the territory of the country of a currency only if another country applies the rule through application of its own conflict of laws rules. The relevant conflict of laws

dollars and U.S. dollar accounts is exercised regardless of where the transfer is executed or the account is held.

III. FREEZING OF DOLLARS MOVING THROUGH THE INTERNATIONAL PAYMENT SYSTEM

Undoubtedly, the United States can block or "freeze" a dollar transfer in which a bank located in the United States is involved. A question about the basis for U.S. jurisdiction arises only where dollars are transferred from one non-U.S. bank to another non-U.S. bank. The assertion of U.S. jurisdiction in the latter case is based on the nature of the Eurodollar.

Eurodollars are deposits of U.S. dollars with foreign banks or foreign branches of U.S. banks located outside the United States. Eurodollars are created when a U.S. or foreign depositor with a bank in the United States transfers a U.S. dollar credit balance to a foreign bank (or to a foreign branch of a U.S. bank) located outside of the United States. The foreign bank assumes a deposit liability to the transferor payable in U.S. dollars, and itself has a corresponding claim in U.S. dollars against the bank in the United States (owns a deposit or credit balance with that bank). The foreign bank may transfer its U.S. dollar deposits to a second foreign bank, the second foreign bank may transfer the deposit to a third foreign bank, and so forth. In each case the transferee foreign bank becomes the owner of the dollar deposit in the United States and assumes a deposit liability payable in U.S. dollars to the transferor foreign bank. The dollars originally deposited with a bank in the United States never leave the U.S. bank or the United States, so that the total of the bank

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rule (also frequently called *lex monetae*) provides that if the law of the contract is not the law of the country of the currency in which the contract must be performed, the court must nevertheless apply the monetary law of the country of the currency in the event of a substitution of currencies. *See* Michael Gruson, *The Scope of Lex Monetae in International Transactions: A United States Perspective*, *in* INTERNATIONAL MONETARY LAW—ISSUES FOR THE NEW MILLENNIUM 433, 456 (Mario Giovanoli ed., 2000).

deposits in the United States remains unchanged, but additional dollar deposits are created abroad.[6]

In connection with blocking of dollar transfers between two non-U.S. banks, three fact situations must be distinguished:

A. Case 1: U.S. Dollar Transfers Cleared at a Federal Reserve Bank in the United States

A transfer of money by a customer (the Payor) of a non-U.S. bank (Bank A) to a customer (the Payee) of another non-U.S. bank (Bank B) in many cases involves ultimately a transfer between two U.S. banks, namely, a transfer from Bank A's U.S. correspondent bank (Bank C) to Bank B's U.S. correspondent bank (Bank D) by way of the Clearing House Interbank Payment System (CHIPS), and clearance of such transfers in the New York Clearing House[7] or the Fed wire payment system and clearance of such transfer in the

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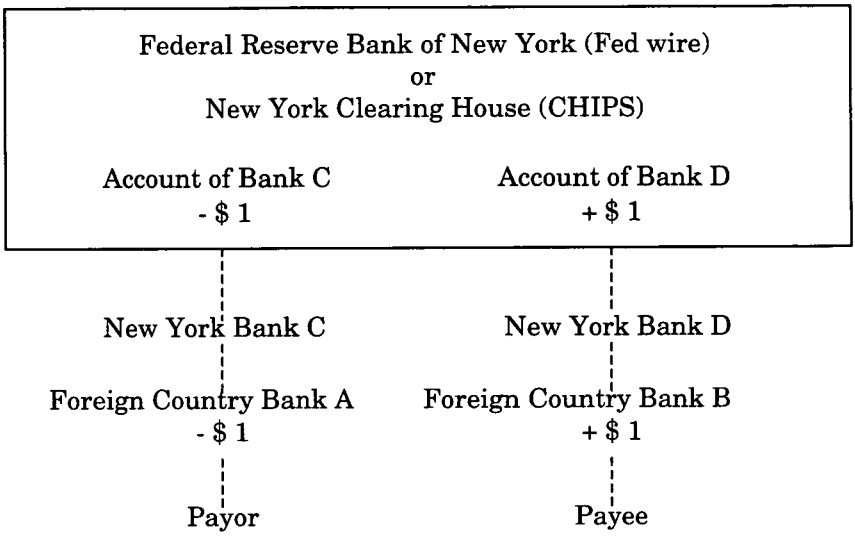
[6] *See* Michael Gruson, *Legal Aspects of International Lending*, *in* HANDBOOK OF INTERNATIONAL MANAGEMENT (Ingo Walter ed., 1988). The seminal article on Eurodollars is Robert C. Effros, *The Whys and Wherefores of Eurodollars*, 23 BUS. LAW. 629 (1968). *See also* Alexander D. Calhoun, Jr., *Eurodollar Loan Agreements: An Introduction and Discussion of Some Special Problems*, 32 BUS. LAW. 1785 (1977); Henry Harfield, *International Money Management: The Eurodollar*, 89 BANKING L.J. 579 (1972); MANN, *supra* note 2, at 63-64, 199-200. In *Citibank, N.A. v. Wells Fargo Asia Ltd.*, 495 U.S. 660, 663 (1990), the U.S. Supreme Court defined Eurodollars as "United States dollars that have been deposited with a banking institution located outside the United States, with a corresponding obligation on the part of the banking institution to repay the deposit in United States dollars."

[7] For a discussion of the CHIPS payment system, *see* MARCIA STIGUM, THE MONEY MARKET 580 (3d ed. 1990). *See* CHIPS Rules and Administrative Procedures (November 2003) [hereinafter CHIPS rules and procedures], *at* http://www.chips.org. (last visited Sept. 1, 2004). Each settling bank that, on a net-net basis, has a debit balance with CHIPS sends over the Fed wire to the account that CHIPS maintains at the Federal Reserve Bank of New York the sum required for it to settle. After CHIPS has received these monies, it in turn wires out, again over the Fed wire, all monies it owes settling banks who have ended the day on a net-net basis with a credit balance at CHIPS. *See* STIGUM, *supra*, at 581.

Federal Reserve Bank of New York.[8] This process is demonstrated by the following diagram:



In this case, a person who maintains a U.S. dollar account at a bank outside the United States transfers U.S. dollars to a person who maintains a U.S. dollar account at another bank outside the United States. Both foreign country banks use their U.S. correspondent banks to effectuate the transfer

[8] For an example of this system and its applications, *see* Libyan Arab Foreign Bank v. Bankers Trust Co., 3 All E.R. 252, 270 (Q.B. 1989) (discussing complex transactions). The case involved a bank account maintained by the London branch of Bankers Trust, a U.S. bank, for a Libyan bank. On January 8, 1986, the U.S. president froze all Libyan assets in the United States or in the possession or control of U.S. persons, including U.S. banks and their overseas branches. Bankers Trust refused to honor the Libyan bank's demand for payment because of the freeze order. The court held that performance of a contract would be excused if it had become illegal by the proper law of the contract or necessarily involved doing an act that was unlawful by the law of the place where the act had to be done. The court found that English law governed the deposit relationship and that performance of the payment demand did not require an act in New York (i.e., clearance) because the demand could be performed by payment in cash. For a discussion of this case, *see* Peter S. Smedresman & Andreas F. Lowenfeld, *Eurodollars, Multinational Banks, and National Laws*, 64 N.Y.U. L. REV. 733, 751-61 (1989).

and the money transfer takes place through the U.S. clearing system in the United States. Any U.S. dollar transferred in such a way anywhere in the world will be cleared ultimately at the Federal Reserve Bank in the United States.[9] Money transfers that use Federal Reserve Banks by way of the Fed wire payment system are subject to U.S. federal law.[10]

If the U.S. portion of the money transfer uses CHIPS, U.S. law governs that portion of the transfer. Pursuant to Rule 3 of the Rules and Administrative Procedures of the CHIPS,[11] the rights and obligations of participants in CHIPS and all other parties to a funds transfer of which a CHIPS payment message is a part, that arise from the funds transfer or from the CHIPS Rules, are governed by the law of the State of New York. A "funds transfer" is defined in Rule 3 as the series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order and includes any payment order issued by the originator's bank or an intermediary bank intended to carry out the originator's payment order.

U.S. commercial banking institutions may only participate in CHIPS if their offices in the United States are subject to regulation by a federal or state bank authority. Furthermore, foreign banks must agree that the obligations of their branches or agencies in the United States through which the clearing occurs, are the legal, valid, and binding obligations of the foreign bank itself and are enforceable against the foreign bank.[12]

Case 1 describes the most frequent transfer scenario. Such transfers are subject to U.S. law and, consequently, can be blocked under U.S. law.

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[9] *See* MANN, *supra* note 2, at 200; R.M. GOODE, PAYMENT OBLIGATIONS IN COMMERCIAL AND FINANCIAL TRANSACTIONS 120 (1983); Thomas C. Baxter, Jr., *Dollarization and its Impact on U.S. Law*, 35 INT'L LAW. 1427, 1430 (2001).

[10] 12 C.F.R. § 210.25 (2004) (subpart B of Regulation J). *See infra* note 18 for a discussion of 12 C.F.R. § 210.25.

[11] CHIPS rules and procedures, *supra* note 7.

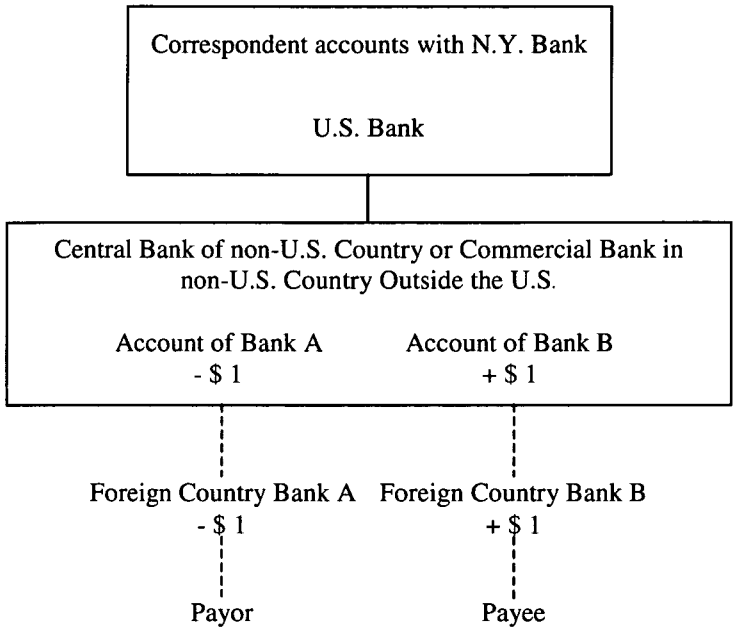
[12] *Id.*, Rule 19(a) & (b).

B. Case 2: U.S. Dollar Transfers Not Cleared at a Federal Reserve Bank in the United States

Dollar transfers are not necessarily cleared in the United States. They are not cleared in the United States if the foreign bank of the payor and the foreign bank of the payee both have correspondent accounts with a third bank also located outside of the United States. In this case, transfers are not processed through CHIPS or Fed wire, but by account transfer at the third bank outside the United States. Furthermore, nothing would prevent the central bank of a country other than the United States from clearing dollar transfers among banks of its country. It remains correct that U.S. dollars held in the banking system of the foreign country are ultimately reflected in a dollar deposit with a U.S. bank and that these dollars (other than cash) "never leave the United States." However, if clearing takes place outside of the United States, no money transfer takes place in the United States. This situation was discussed in *Libyan Arab Foreign Bank*[13], in which the U.S. government claimed jurisdiction over foreign money transfers. This case is demonstrated by the following diagram:

[13] Libyan Arab Foreign Bank, 3 All E.R. at 270-71 & 278. The court said at 270:

> Any account transfer must ultimately be achieved by means of two accounts held by different beneficiaries with the same institution. In a simple case the beneficiaries can be the immediate parties to the transfer. If Bankers Trust held an account with the A bank which was in credit to the extent of at least $131m, and the Libyan bank also held an account at the A bank, it would require only book entries to achieve an account transfer. But still no property is actually *transferred*. The obligation of Bankers Trust is extinguished, and the obligation of A bank to Bankers Trust extinguished or reduced; the obligation of A bank to the Libyan bank is increased by the like amount.



C. Case 3: U.S. Dollar Transfer Without Interbank Clearing

Finally, it is possible that U.S. dollar money transfers may occur without clearance through another bank or a Federal Reserve Bank in the United States. This occurs when the Payor and the Payee both have a U.S. dollar account with the same non-U.S. bank. This bank merely debits the account of the Payor and credits the account of the Payee ("intra-bank-clearing") without involving another bank or a Federal Reserve Bank. In this case, transfers are not processed through CHIPS, because funds are not transferred but merely rebooked.[14] Obviously, if a payor who

[14] HERBERT SCHIMANSKY, HERMANN-JOSEF BUNTE & HANS-JUERGEN LWOWSKI, BANKRECHTS-HANDBUCH, vol. III, § 116, margin no. 32 (2d ed. 2001). *See also* Libyan Arab Foreign Bank, 3 All E.R. at 270-71 & 278. The court said at 270:

> On occasion a method of account transfer which is even simpler may be used. If X Ltd. also hold an account with Bankers Trust London, and the Libyan bank desire to benefit X Ltd., they instruct Bankers Trust to transfer

maintains a U.S. dollar account at a bank outside the United States withdraws a sum of dollars and hands it over to the payee, no U.S. dollar transfer that touches the United States takes place.[15]

In all three cases, clearing ultimately occurs by way of an "in-house transfer" at an institution which maintains accounts for the transferor and the transferee or the bank of the transferor and the bank of the transferee, so that the credit balance of one can be increased and that of the other reduced.[16] The three cases differ only in the location of the institution that holds accounts for both parties, in that the institution is located inside or outside of the United States. Only in case 1 are the transfers of U.S. dollars cleared through a Federal Reserve Bank in the United States. In cases 2 and 3, a clearance occurs outside the United States, without the involvement of any U.S. Federal Reserve Bank or any U.S. commercial bank. In cases 2 and 3, the dollar that is being transferred is reflected by a dollar located in the United States; however, that dollar does not move. If no dollars are moved through CHIPS or Fed wire, U.S. law does not apply to such a transfer. The transfers in cases 2 and 3 do not touch the United States and unless the parties agree on U.S. law to govern the non-U.S. transfer, U.S. law does not apply. If the parties in cases 2 and 3 agreed on the application of U.S. law, they also agreed on the application of those laws that permit the blocking of money transfers.[17] Even in case 1, U.S. law does not apply to the contractual relationship between Payor and Foreign Country Bank A, to the contractual relationship between Payee and Foreign

> $131 [million] to the account of X Ltd. The obligation of Bankers Trust to the Libyan bank is extinguished once they decide to comply with the instruction, and their obligation to X Ltd is increased by the like amount. That method of account transfer is featured in *Momm v. Barclays Bank Int'l Ltd.*, [3 All E.R. 588 (Q.B. 1976)].

[15] *See* Libyan Arab Foreign Bank, 3 All E.R. at 273 & 280. *See also* MANN, *supra* note 2, at 200-01.

[16] *See* Libyan Arab Foreign Bank, 3 All E.R. at 270.

[17] *See* discussion *infra* Part III.D.

Country Bank B, and to the contractual relationship between Payor and Payee.[18]

[18] 12 C.F.R. § 210.25 *et seq.* (2004), subpt. B of Regulation J (the rules on Fed wire) apply to relations between the Federal Reserve Bank and *senders* and *receiving banks* that send or receive a payment order *directly* to and from a Federal Reserve Bank, 12 C.F.R. § 210.25(b)(2) (2004). Both the sender and the receiving bank must have an account with a Federal Reserve Bank. The rules also apply to other parties to a funds transfer any part of which is carried out through Fed wire to the extent provided in U.C.C. § 4A-507. 12 C.F.R. § 210.25(b)(2)(v) (2004). U.C.C. § 4A-507(c), *reprinted in* 12 C.F.R. pt. 210, subpt. B, App. B, provides that a choice of law rule provided for in 12 C.F.R. § 210.25(b)(2)(v) (2004) is binding on the originator, other sender, or a receiving bank having notice that the funds-transfer system might be used in the funds transfer and of the choice of law by the system when the originator, other sender or receiving bank issued or accepted a payment order. The beneficiary of a funds transfer is bound by the choice of law if, when the funds transfer is initiated, the beneficiary has notice that the funds-transfer system might be used in the funds transfer and of the choice of law of the system. As to notice, *see* U.C.C. § 1-201(25). However, under U.C.C. § 4A-507(b) & (d), a choice of law by agreement of the parties takes precedence over a choice of law made by the funds-transfer system rules. A Commentary published in App. A to 12 C.F.R. pt. 210 subpt. B states under Section 210.25 *sub* (b)(3):

> If originators, receiving banks, and beneficiaries that are not in privity with a Federal Reserve Bank have the notice contemplated by Section 4A-507(c) or if those parties agree to be bound by Subpart B, Subpart B generally would apply to payment orders between those remote parties, including participants in other funds-transfer systems.

U.C.C. § 4A-507 does not follow the approach of U.C.C. art. 8, which permits the application of a different law for each step in the indirect holding system involved in a transfer of securities. *See* U.C.C. § 8-110(b) (in the indirect holding system the acquisition of a person's security entitlement is governed by the law of the jurisdiction of that person's securities intermediary, and the termination of a person's security entitlement is governed by the law of that person's securities intermediary). Different laws may apply to each step of a transfer in the indirect holding system. *See* Michael Gruson, *Global Shares of German Corporations and Their Dual Listings on the Frankfurt and New York Stock Exchanges*, 22 U. PA. J. INT'L ECON. L. 185, 241-43 (2001) [hereinafter Gruson, *Global Shares*].

D. Legal Authority Under the International Emergency Economic Powers Act to Freeze U.S. Dollar Transfers

The ability of U.S. authorities to freeze assets at one time were issued under Section 5(b) of the Trading with the Enemy Act of 1917 ("TWEA") after the president had declared a national emergency.[19] Since December 28, 1977, however, TWEA provides authority for new sanctions only during times of war by permitting the president to suspend or prohibit economic contracts with an enemy during wartime.[20] Since 1977, each freeze of assets has been implemented by an executive order based on Sections 1701 and 1702 of the International Emergency Economic Powers Act of 1977 ("IEEPA").[21]

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[19] 50 U.S.C. app. §§ 1-44 (2000). Asset freezes, e.g., were imposed against North Korea, Vietnam, and Kampuchea on Dec. 17, 1950 (31 C.F.R. 500.23, 15 Fed. Reg. 9,040), against Cuba on July 8, 1963 (31 C.F.R. 515.313, 28 Fed. Reg. 6,974) and against Rhodesia on Jan. 5, 1967 (Exec. Order No. 11,322, 32 Fed. Reg. 119).

[20] Removal of National Emergency Powers under the Trading with the Enemy Act, Pub. L. No. 95-223, § 101, 91 Stat. 1625 (1977).

[21] 50 U.S.C. §§ 1701-1706 (2000). *See, e.g.*, asset freezes imposed against Iran on Nov. 15, 1979 (31 C.F.R. 535.203, 44 Fed. Reg. 65,956), against Libya on Jan. 8, 1986 (Exec. Order No. 12,544, 51 Fed. Reg. 1,235), against Panama on Apr. 8, 1988 (Exec. Order No. 12,635, 53 Fed. Reg. 12,134), against Iraq on Aug. 2, 1990 (Exec. Order No. 12,722, 55 Fed. Reg. 31,803), against Yugoslavia (Serbia and Montenegro) on May 30, 1992 (Exec. Order No. 12,808, 57 Fed. Reg. 23,299), against Haiti on June 30, 1993 (Exec. Order No. 12,853, 58 Fed. Reg. 35,843), against Sudan on Nov. 3, 1997 (Exec. Order No. 13,067, 62 Fed. Reg. 59,989), against Burma on May 20, 1997 (Exec. Order No. 13,047, 62 Fed. Reg. 28,301), against Angola on Aug. 18, 1998 (Exec. Order 13,098, 63 Fed. Reg. 44,771) and against the Taliban on July 4, 1999 (Exec. Order 13,129, 64 Fed. Reg. 36,759).

President Bush issued Executive Order No. 13,224 on Sept. 23, 2001 (66 Fed. Reg. 49,079), that imposed financial sanctions on banks, financial institutions and any persons or business entities (domestic or foreign) that provide material support for individuals or groups involved in international terrorism. In addition to the persons subject to U.S. jurisdiction, the order also prohibits all foreign third parties from assisting or providing material support for, or associating with, terrorists. This order attempts to freeze assets belonging to terrorist groups that are being

IEEPA is the primary legal authority for the establishment of economic sanctions by the executive branch.[22] It authorizes the president to impose sanctions in response to circumstances deemed by the president to constitute an "unusual and extraordinary threat" to the national security, foreign policy, or economy of the United States.[23] Since the enactment in 1977, presidents of the United States have extensively relied on IEEPA to establish broad economic embargos against and freeze assets of countries and entities.[24] Economic sanctions maintained under IEEPA include, among others, asset-blocking orders and other embargo measures against Iran, Libya, Panama, Iraq, Cuba and Sudan.[25] Authority to implement the sanctions is generally granted to the Treasury Department,

held by third parties, such as banks or business entities, on behalf of terrorist groups within or outside the United States. With this order, the United States exerts its authority over the international dollar payment system.

[22] Besides IEEPA, the United Nations Participation Act, 22 U.S.C. § 287c (2000), gives the president the authority to freeze assets that are deposited in the United States. 22 U.S.C. § 287c(a) (2000) gives the president the authority to regulate or prohibit a wide range of economic relations if the U.N. Security Council calls on the United States to apply such measures.

[23] Section 1701(a) of the IEEPA, 50 U.S.C. § 1701(a) (2000). However, note that according to § 1701(a) of IEEPA the president must have declared a national emergency, pursuant to Section 1621 of the National Emergency Act, 50 U.S.C. §§ 1601 *et seq.* IEEPA further grants the president the authority to "nullify" or "prohibit" any "transaction" in which a foreign country or national has any interest. Section 1702(a)(1)(B) of the IEEPA, 50 U.S.C. § 1702(a)(1)(B) (2000). *See* Dames & Moore v. Regan, 453 U.S. 654 (1981). IEEPA provides for criminal penalties of up to ten years' imprisonment and fines of up to $50,000 for each violation of a freeze order. Section 1705(b) of the IEEPA, 50 U.S.C. § 1705(b) (2000).

[24] For instance, the Executive Orders mentioned *supra* note 21.

[25] Assets subject to a freeze order are not expropriated. Consequently, the owner of blocked or frozen funds cannot withdraw the funds but they continue to accrue interest in accordance with the pre-freeze agreement of the parties. The owner is not even precluded during the freeze from designating investments of the funds. *See* Bank Markazi Iran and The Federal Reserve Bank of New York, Iran-United States Claims Tribunal, Case No. 823, Award No. 595-823-3 (Nov. 16, 1999), *sub* The Merits, II, C & D.

which acts through its Office of Foreign Assets Control ("OFAC").[26]

The executive orders on the basis of IEEPA properly limit their reach to property within the United States. The executive orders typically block "all property and interest in property that are in the United States or that hereafter come within the United States, or that are or hereafter come within the possession or control of a United States person."[27] If a dollar transfer is cleared, as shown above in case 1, at a Federal Reserve Bank in the United States, there is little doubt that the dollars being transferred are under the control of a U.S. person and that the transferor and the transferee have an interest in the funds being transferred. Thus, the executive orders apply and do not have any extraterritorial effect. If a dollar transfer is ultimately not cleared in the United States (cases 2 and 3), the funds transferred are never within the United States, are not under the control of a U.S. person and are not covered by the executive order. The United States might argue that each dollar held in a bank account outside the United States is reflected by a dollar held by a U.S. bank in the United States[28] and that therefore the United States has jurisdiction also over transfers in cases 2 and 3. However, the dollar held in the United States is neither owned by the transferor or the transferee, nor does either have a contractual right to or interest in that dollar. The dollar is owned by the U.S. bank and the foreign bank that has an account with the U.S. bank has a contractual right to have that money returned to

[26] OFAC administers and enforces economic and trade sanctions against targeted foreign countries, terrorists and their sponsors and international narcotics traffickers. OFAC plays a key role on the inter-agency working group, chaired by the Treasury, that has been targeting and listing individuals and entities pursuant to Executive Order No. 13,224, *supra* note 21.

[27] *See, e.g.*, Exec. Order No. 13,224, *supra* note 21, (Terrorists) and Exec. Order No. 13,129, *supra* note 21, (Taliban). Some executive orders expressly specify that overseas branches of U.S. banks are U.S. persons, e.g., Exec. Order No. 12,853, *supra* note 21, (Haiti) and Exec. Order No. 12,544, *supra* note 21, (Libya).

[28] *See supra* text accompanying note 6.

it or transferred in accordance with its instructions.[29] Since the Queen's Bench decided in *Libyan Arab Foreign Bank*[30] that the United States has no jurisdiction over U.S. dollar transfers that are not cleared through a Federal Reserve Bank, the U.S. government has not publicly claimed or tried to enforce jurisdiction under its executive orders over dollar transfers that take place wholly outside the United States. Even if the United States asserted jurisdiction in cases 2 and 3, it could not enforce the executive orders outside the United States.

Furthermore, the U.S. government has not asserted jurisdiction under IEEPA over the mere holding of U.S. dollars by non-U.S. residents in accounts at foreign banks or in cash.

IV. SEIZURE OF DOLLARS DEPOSITED AT A FOREIGN BANK

The Patriot Act, enacted on October 26, 2001,[31] extends the jurisdiction of U.S. authorities beyond the scope of IEEPA. Title III of the Patriot Act[32] contains the authority to take actions against countries, institutions, transactions, or types of accounts that the Secretary of the Treasury (the "Secretary") finds to be of primary money laundering

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[29] For further discussion of this issue, *see infra* Part IV.D.

[30] *Supra* note 8.

[31] President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, H.R. 3162 [hereinafter Patriot Act]. The Patriot Act terminates on or after the first day of the fiscal year 2005, if Congress enacts a resolution to that effect. Section 303(a) of the Patriot Act. Thus, Section 303(a) of the Patriot Act is not a sunset clause. The sunset clause of Section 224 of the Patriot Act relates only to Title II of the Patriot Act, which is not being discussed in this article.

[32] Title III of the Patriot Act is entitled International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001. Section 301 of the Patriot Act. The Patriot Act amends, *inter alia,* certain provisions of the Bank Secrecy Act of 1970, 31 U.S.C. §§ 5311-5330 (2000), and the Money Laundering Control Act of 1986, 18 U.S.C. §§ 1956-1957 (2000).

concern. It also contains a significant extension of the jurisdictional authority of U.S. financial regulators to supervise the activities of foreign banks and their customers. The aim is to disrupt and eliminate the financial framework that supports terrorism as well as the abatement of money laundering. This can be achieved by cutting off supporting persons or organizations from funding and transferring money and freezing their assets.

A. Measures against U.S. Banks Having Dealings with Foreign Banks

1. Authority of the Secretary to Impose Special Measures

Section 311(a) of the Patriot Act[33] authorizes the Secretary to require U.S. financial institutions[34] and financial agencies[35] to take special measures if the Secretary finds that reasonable grounds exist for concluding that (1) a foreign jurisdiction, (2) a foreign financial institution operating outside the United States, (3) a class of transactions within or involving a foreign jurisdiction, or (4) a type of account, *is of primary money laundering concern*. This authorization is remarkably broad. A very wide range of businesses fall under the definition of financial institution,[36] and the Secretary is authorized to add by

[33] 31 U.S.C. § 5318A(a)(1), added by Section 311(a) of the Patriot Act.

[34] The term *financial institution* is defined in 31 U.S.C. § 5312(a)(2) (2000). *See infra* note 36.

[35] A *financial agency* is a person acting for a person as a financial institution, bailee, depository trustee, or agent, or acting in a similar way related to money, credit, securities, gold, or a transaction in money, credit, securities, or gold. 31 U.S.C. § 5312(a)(1) (2000).

[36] 31 U.S.C. § 5312(a)(2)(A)-(X) (2000), as amended by §§ 321(a) & 359(a) of the Patriot Act, defines *financial institution* as (A) an insured bank (as defined in § 3(h) of the Federal Deposit Insurance Act, 12 U.S.C. § 1813(h) (2000)); (B) a commercial bank or trust company; (C) a private banker; (D) an agency or branch of a foreign bank in the United States; (E) any credit union; (F) a thrift institution; (G) a broker or dealer registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a *et seq.*); (H) a broker or

regulation further businesses to the definition of financial institutions.[37] The *account* that could be of primary money laundering concern means any banking or business relationship under which services are provided;[38] the account need not be related to a foreign jurisdiction. In making a finding that reasonable grounds exist for concluding that any

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dealer in securities or commodities; (I) an investment banker or investment company; (J) a currency exchange; (K) an issuer, redeemer, or cashier of travelers' checks, checks, money orders, or similar instruments; (L) an operator of a credit card system; (M) an insurance company; (N) a dealer in precious metals, stones, or jewels; (O) a pawnbroker; (P) a loan or finance company; (Q) a travel agency; (R) a licensed sender of money or any other person who engages as a business in the transmission of funds, including any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system; (S) a telegraph company; (T) a business engaged in vehicle sales, including automobile, airplane, and boat sales; (U) persons involved in real estate closings and settlements; (V) the United States Postal Service; (W) an agency of the United States Government or of a State or local government carrying out a duty or power of a business described in this paragraph; (X) a casino, gambling casino, or gaming establishment with an annual gaming revenue of more than $1,000,000 which is licensed as a casino, gambling casino, or gaming establishment under the laws of any State or any political subdivision of any State, or is an Indian gaming operation conducted under or pursuant to the Indian Gaming Regulatory Act other than operation which is limited to class I gaming (as defined in Section 4(6) of such Act).

[37] *Financial institution* also means: (Y) any business or agency which engages in any activity which the Secretary determines, by regulation, to be an activity which is similar to, related to, or a substitute for any activity in which any business described in this paragraph is authorized to engage; or (Z) any other business designated by the Secretary whose cash transactions have a high degree of usefulness in criminal, tax, or regulatory matters. 31 U.S.C. § 5312(a)(2)(Y), (Z) (2000).

[38] The term *account* is defined in 31 U.S.C. § 5318A(e)(1)(A), added by § 311(a) of the Patriot Act, as a formal banking or business relationship established to provide regular services, dealings, and other financial transactions. The term includes a demand deposit, savings deposit, or other transaction or asset account and a credit account or other extension of credit. The term *account* for purposes of financial institutions other than banks will be defined by regulation. 31 U.S.C. § 5318A(e)(2), added by § 311(a) of the Patriot Act.

of the above-mentioned foreign jurisdictions, foreign financial institutions, foreign transactions or accounts is of primary money laundering concern,[39] the Secretary must consider the so-called jurisdictional[40] and institutional[41] factors. Upon such finding of primary money laundering

[39] 31 U.S.C. § 5318A(c)(1), added by Section 311(a) of the Patriot Act. In making such finding of primary money laundering concern, the Secretary shall consult with the Secretary of State and the Attorney General. *Id.*

[40] The jurisdictional factors are relevant for a finding of primary money laundering concern with respect to a foreign jurisdiction. The jurisdictional factors are: evidence that organized criminal groups, international terrorists, or both, have transacted business in that jurisdiction; the extent to which that jurisdiction or financial institutions operating in that jurisdiction offer bank secrecy or special regulatory advantages to nonresidents or nondomiciliaries of that jurisdiction; the substance and quality of administration of the bank supervisory and counter-money laundering laws of that jurisdiction; the relationship between the volume of financial transactions occurring in that jurisdiction and the size of the economy of the jurisdiction; the extent to which that jurisdiction is characterized as an offshore banking or secrecy haven by credible international organizations or multilateral expert groups; whether the United States has a mutual legal assistance treaty with that jurisdiction, and the experience of United States law enforcement officials and regulatory officials in obtaining information about transactions originating in or routed through or to such jurisdiction; and the extent to which that jurisdiction is characterized by high levels of official or institutional corruption. 31 U.S.C. § 5318A(c)(2)(A), added by Section 311(a) of the Patriot Act.

[41] The institutional factors are relevant for a finding of primary money laundering concern with respect to foreign financial institutions, foreign transactions and types of accounts. The institutional factors are: the extent to which such financial institutions, transactions, or types of accounts are used to facilitate or promote money laundering in or through the jurisdiction; the extent to which such institutions, transactions, or types of accounts are used for legitimate business purposes in the jurisdiction; and the extent to which such action is sufficient to ensure, with respect to transactions involving the jurisdiction and institutions operating in the jurisdiction, that the purposes of subchapter II (31 U.S.C. §§ 5311-5332) continue to be fulfilled, and to guard against international money laundering and other financial crimes. 31 U.S.C. § 5318A(c)(2)(B), added by Section 311(a) of the Patriot Act.

concern, the Secretary decides whether and which measures shall be implemented.[42]

When selecting a special measure, the Secretary shall take into account whether similar action has been or is being taken by other nations or multilateral groups; whether the imposition of any particular measure would create a significant competitive disadvantage, including any undue cost or burden, for U.S. financial institutions.[43] Furthermore, the Secretary shall consider the extent to which the action or the timing of the action would have a significant adverse systemic impact on the international payment, clearance and settlement system, or on legitimate business activities involving the particular jurisdiction, institution, or class of transactions, and the effect of the action on United States national security and foreign policy.[44]

2. Special Measures That May Be Taken by the Secretary

If the Secretary finds primary money laundering concerns with respect to a foreign jurisdiction, foreign financial institution, foreign transaction or an account, he can request domestic financial institutions or domestic financial agencies[45] to:

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[42] 31 U.S.C. § 5318A(a)(1) & (4), added by Section 311(a) of the Patriot Act. In making the selection of special measures, the Secretary must consult with certain governmental agencies. 31 U.S.C. § 5318A(a)(4)(A), added by Section 311(a) of the Patriot Act.

[43] 31 U.S.C. § 5318A(a)(4)(B)(i) & (ii), added by Section 311(a) of the Patriot Act.

[44] 31 U.S.C. § 5318A(a)(4)(B)(iii) & (iv), added by Section 311(a) of the Patriot Act. No later than ten days after the date the Secretary of the Treasury has imposed any special measure, he shall notify, in writing, the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing and Urban Affairs of the Senate of any such action. 31 U.S.C. § 5318A(d), added by Section 311(a) of the Patriot Act.

[45] The terms *domestic financial institution* and *domestic financial agency* apply to an action in the United States of a financial institution or agency. 31 U.S.C. § 5312(b)(1) (2000).

- maintain records and file reports concerning the transactions with respect to a foreign jurisdiction or foreign financial institution, foreign transactions or a type of account, including the identity, address and legal capacity of the participants in a transaction or relationship, the identity of the originator of a funds transfer and the identity of the beneficial owner of the funds involved;[46]
- obtain, retain and disclose information concerning the beneficial ownership[47] of an account opened or maintained in the United States by a foreign person or a representative of such a foreign person that involves a foreign jurisdiction, a foreign financial institution, a foreign transaction or a type of account;[48]
- identify each customer (and representative of such customer) of a foreign financial institution that opens or maintains a payable-through account[49] or a correspondent account[50]

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[46] 31 U.S.C. § 5318A(b)(1)(A) & (B), added by Section 311(a) of the Patriot Act. 31 U.S.C. § 5318(*l*), added by Section 326(a) of the Patriot Act, instructs the Secretary to promulgate regulations setting forth minimum standards regarding the identity of customers opening accounts.

[47] 31 U.S.C. § 5318A(e)(3), added by Section 311(a) of the Patriot Act, requires the Secretary to issue regulations defining beneficial ownership of an account for purposes of 31 U.S.C. § 5318A and for purposes of 31 U.S.C. §§ 5318(i) & (j).

[48] 31 U.S.C. § 5318A(b)(2), added by Section 311(a) of the Patriot Act.

[49] *Payable-through account* means an account, including a transaction account (as defined in Section 19(b)(1)(C) of the Federal Reserve Act), opened at a depository institution by a foreign financial institution by means of which the foreign financial institution permits its customers to engage, either directly or through a subaccount, in banking activities usual in connection with the business of banking in the United States. 31 U.S.C. § 5318A(e)(1)(C), added by Section 311(a) of the Patriot Act. A payable-through account is a checking account established by a U.S. bank for a foreign bank. The foreign bank solicits customers ("subaccount holders") that reside outside the United States who (for a fee) are provided with the means (frequently by the use of checks) to conduct banking transactions in the U.S. payment system through the foreign bank's account at the U.S. bank. *See* Alexander Kern, *Extraterritorial U.S.*

in the United States who is permitted to use, or whose transactions are routed through, such payable-through account or correspondent account;[51] and obtain, with respect to each such customer (and each such representative), information that is substantially comparable to that which the depository institution obtains in the ordinary course of business with respect to its customers residing in the United States;[52] and

- to prohibit, or impose conditions upon, the opening or maintenance of a correspondent account or a payable-through account in the United States by any domestic financial institution or domestic financial agency for or on behalf of a foreign banking institution if such account involves a foreign jurisdiction, foreign banking institution or if transactions may be conducted through such accounts that have been found to be of primary money laundering concern.[53]

The prohibition, or the imposition of conditions upon, the opening or maintenance of accounts may be imposed only by regulation, while each of the other above-mentioned measures may be imposed by regulation, order, or otherwise

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Banking Regulation and International Terrorism: The Patriot Act and the International Response, 3 J. INT'L BANKING REG. 307, 316 (2002).

[50] *Correspondent account* means an account established to receive deposits from, make payments on behalf of a foreign financial institution, or handle other financial transactions related to such institution. 31 U.S.C. § 5318A(e)(1)(B), added by Section 311(a) of the Patriot Act.

[51] 31 U.S.C. § 5318A(b)(3)(A) & (4)(A), added by Section 311(a) of the Patriot Act.

[52] 31 U.S.C. § 5318A(b)(3)(B) & (4)(B), added by Section 311(a) of the Patriot Act. (It follows from the context that the term *depository institution* refers to the domestic financial institution or domestic financial agency that opens the payable-through or correspondent account.)

[53] 31 U.S.C. § 5318A(b)(5), added by Section 311(a) of the Patriot Act. The Secretary must consult with the Secretary of State, the Attorney General, and the Chairman of the Board of Governors of the Federal Reserve System before imposing such prohibitions or restrictions. *Id.*

as permitted by law.[54] An order may not remain in effect for more than 120 days, except pursuant to a rule promulgated on or before the end of a 120-day period beginning on the date of issuance of such order.[55] The various measures may be imposed in such sequence or combination as the Secretary shall determine.[56]

Furthermore, U.S. financial institutions that establish a private banking account[57] or correspondent account in the United States for a non-U.S. person must establish due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering through such accounts.[58] Enhanced due diligence policies, procedures and controls apply if a U.S. financial institution establishes a correspondent account for a foreign bank operating under an offshore banking license[59] or a license issued by a country that has been designated by an intergovernmental organization as being uncooperative with international money laundering principles or by the Secretary as warranting special measures due to money laundering concerns.[60] Finally, a covered U.S. financial

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[54] 31 U.S.C. § 5318A(a)(2)(B) & (C), added by Section 311(a) of the Patriot Act.

[55] 31 U.S.C. § 5318A(a)(3), added by Section 311(a) of the Patriot Act.

[56] 31 U.S.C. § 5318A(a)(2)(A), added by Section 311(a) of the Patriot Act.

[57] *Private banking account* is defined in 31 U.S.C. § 5318(i)(4)(B), added by Section 312(a) of the Patriot Act, as an account that requires a minimum deposit of $1 million, is established on behalf of one or more individuals who have a direct or beneficial ownership interest in the account and is assigned to, or administered by, an officer of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

[58] 31 U.S.C. § 5318(i)(1), added by Section 312(a) of the Patriot Act. Minimum due diligence standards for private banking accounts are set forth in 31 U.S.C. § 5318(i)(3), added by Section 312(a) of the Patriot Act.

[59] *Offshore banking license* is defined in 31 U.S.C. § 5318(i)(4)(A), added by Section 312(a) of the Patriot Act.

[60] 31 U.S.C. § 5318(i)(2)(A), added by Section 312(a) of the Patriot Act. The enhanced policies, procedures and controls are described in 31 U.S.C. § 5318(i)(2)(B), added by Section 312(a) of the Patriot Act.

institution[61] is prohibited from opening correspondent accounts for a shell bank,[62] i.e., a bank that has no physical presence in any country.[63]

B. Authority to Request Records from Foreign Banks

A foreign bank that maintains a correspondent account[64] in the United States may be the addressee of a summons or subpoena of the Secretary or the Attorney General requesting from the foreign bank records related to such accounts, including records maintained outside of the United States relating to the deposit of funds *into the foreign bank*.[65] If the foreign bank fails to comply with the summons or with the subpoena to provide records or to contest in a U.S. court such summons or subpoena, the Secretary or the Attorney General may instruct the domestic covered financial institution[66] to terminate any correspondent relationship with the foreign bank.[67] A U.S. financial institution that

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[61] 31 U.S.C. § 5318(j)(1), added by Section 313(a) of the Patriot Act, defines *covered financial institutions* as the financial institutions referred to in 31 U.S.C. § 5312(a)(2)(A)-(G), i.e., an insured bank; a commercial bank or trust company; a private banker; an agency or branch of a foreign bank in the United States; any credit union; a thrift institution; and a registered broker-dealer. The term *covered financial institution*s is narrower than the term *financial institution* defined in 31 U.S.C. § 5312(2). In effect, covered financial institutions are "real banks" and registered broker-dealers.

[62] 31 U.S.C. § 5318(j), added by Section 313(a) of the Patriot Act.

[63] 31 U.S.C. § 5318(j)(1), added by Section 313(a) of the Patriot Act.

[64] For the definition of *correspondent account, see supra* note 50. 31 U.S.C. § 5318(k)(1)(B), added by Section 319(b) of the Patriot Act.

[65] 31 U.S.C. § 5318(k)(3)(A)(i), added by Section 319(b) of the Patriot Act. If the foreign bank does not have a representative in the United States, the summons may be served in the foreign country pursuant to any treaty regarding international law enforcement assistance. 31 U.S.C. § 5318(k)(3)(A)(ii), added by Section 319(b) of the Patriot Act.

[66] For the definition of *covered financial institution*, *see supra* note 61.

[67] 31 U.S.C. § 5318(k)(3)(C), added by Section 319(b) of the Patriot Act.

disregards the aforementioned instruction is liable for a civil penalty.[68]

C. Forfeiture of Funds Deposited at Foreign Financial Institutions

1. Legal Authority

Under 18 U.S.C. § 981(a), which predates the Patriot Act, property that is involved in, constitutes, is derived from or is traceable to proceeds obtained directly or indirectly from certain criminal offenses[69] is subject to civil forfeiture in the United States.[70] Furthermore, 18 U.S.C. § 981(a) includes all assets, foreign or domestic, of persons engaged in

[68] 31 U.S.C. § 5318(k)(3)(C)(iii), added by Section 319(b) of the Patriot Act, provides for a civil penalty of up to $10,000 per day until the correspondent relationship is terminated.

[69] An extensive list of offenses is set forth in 18 U.S.C. § 981(a)(1)(A)-(F), as amended by Sections 320, 372(b)(1) & 373(b) of the Patriot Act, and by Pub. L. No. 106-185 (2000), §§ 2(c)(1)(A) & 20(a), 114 Stat. 210, including, e.g., laundering of monetary instruments; engaging in monetary transactions in property derived from specified unlawful activities; prohibition of illegal money transmitting businesses; receipt of commissions or gifts by employees of financial institutions for procuring loans; forgery of obligations, securities or coins; smuggling; theft, embezzlement or misapplication by bank employees; various types of fraud against U.S. financial institutions; unlawful acts in connection with explosive materials; and unlawful acts in connection with motor vehicles. 18 U.S.C. § 981(a)(1)(A)-(F) make it clear that there must be a connection with the criminal offense and the funds in the account. The statute uses words such as "involved," "derived from," and "traceable to." It should be noted that the authority to take special measures against U.S. institutions maintaining a *correspondent account* under 31 U.S.C. § 5318A, added by Section 311(a) of the Patriot Act, depends on reasonable grounds for a conclusion of primary money laundering concern, whereas the authority of forfeiture of 31 U.S.C. § 981(k)(1), added by Section 319(a) of the Patriot Act, is based on a more comprehensive group of offenses. However, all offenses must be violations of U.S. statutes, except 18 U.S.C. § 981(a)(1)(B), which refers to offenses against a foreign nation or involving controlled substances (defined in the Controlled Substances Act, 18 U.S.C. § 1956 (2000), and that are punishable by the foreign nation *and* under the laws of the United States.

[70] For the procedure regarding forfeiture, *see* 18 U.S.C. § 981(b), added by Pub. L. No. 106-185 (2000), § 5(a), 114 Stat. 213-14.

international terrorism, acquired by a person with the intent of engaging in international terrorism or derived from, involved in, or used or intended to be used in any way for acts of terrorism or for the financing of terrorism.[71] Finally, any property involved in a violation or attempted violation, or which constitutes or is derived from proceeds traceable to a violation, of 18 U.S.C. § 2339C (prohibitions against the financing of terrorism), is subject to civil forfeiture in the United States.[72] The property and assets referred to in 18 U.S.C. § 981(a) are not limited to assets located in the United States;[73] however, if property or assets subject to civil forfeiture under 18 U.S.C. § 981(a) consists of funds

[71] 18 U.S.C. § 981(a)(1)(G), added by Pub. L. No. 107-56 (2001), § 806, 115 Stat. 378. The term *international terrorism* is defined in 18 U.S.C. § 2331(1), as amended by Section 802(a)(1) of the Patriot Act, as activities that (A) involve violent acts or acts dangerous to human life that are a violation of the criminal laws of the United States or of any State, or that would be a criminal violation if committed within the jurisdiction of the United States or of any State; (B) appear to be intended (i) to intimidate or coerce a civilian population; (ii) to influence the policy of a government by intimidation or coercion; or (iii) to affect the conduct of a government by mass destruction, assassination, or kidnapping; and (C) occur primarily outside the territorial jurisdiction of the United States, or transcend national boundaries in terms of the means by which they are accomplished, the persons they appear intended to intimidate or coerce, or the locale in which their perpetrators operate or seek asylum.

[72] 18 U.S.C. § 981(a)(1)(H), added by Pub. L. No. 107-197 (2002), § 301(d), 116 Stat. 728. 18 U.S.C. § 2339C is violated if a person provides or collects funds with the intention that such funds be used, or with the knowledge that such funds are to be used in order to carry out either an act which constitutes an offense within the scope of a treaty specified in 18 U.S.C. § 2339C(e)(7) or any other act intended to cause death or serious bodily injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or to abstain from doing any act.

[73] There is one exception to this rule. The property derived from, or traceable to, any proceeds obtained directly or indirectly from an offense against a foreign nation, if the offence would be punishable in the foreign nation and under the laws of the United States, is subject to forfeiture only if within the jurisdiction of the United States. 18 U.S.C. § 981(a)(1)(B), amended by Section 320 of the Patriot Act.

deposited at a foreign bank outside the United States, the United States could not enforce the forfeiture.

Section 319(a) of the Patriot Act[74] goes beyond 18 U.S.C. § 981(a) in that it enables U.S. enforcement authorities to seize funds held for a foreign bank in a U.S. interbank account[75] at a U.S. financial institution[76] without the need to trace the funds to an illegal act. The Patriot Act now provides that if tainted funds are deposited into an account at a foreign bank that has an interbank or correspondent account in the United States with a *covered financial institution*,[77] the funds so deposited "shall be deemed [for purposes of a forfeiture under 18 U.S.C. § 981(a)] to have been deposited into an interbank account in the United States."[78] This is irrespective of the country where the targeted depositor's account is held and irrespective of whether there has been a money transfer or not. As 18 U.S.C. § 981(a) merely refers to funds traceable to a specified criminal act, it does not matter whether the funds in the foreign account are held in U.S. dollars or in a foreign currency.[79] The new jurisdiction introduced by the Patriot

[74] 18 U.S.C. § 981(k)(1)(A), added by Section 319(a) of the Patriot Act. Section 319(a) adds a new subsection (k) on "interbank accounts" to 18 U.S.C. § 981, thereby expanding the circumstances under which money deposited in a U.S. interbank account may be subject to forfeiture.

[75] The term *interbank account* is defined in 18 U.S.C. § 981(k)(4)(A), added by Section 319(a) of the Patriot Act, by reference to 18 U.S.C. § 984(c)(2)(B), as amended by Section 13(a) of Pub. L. No. 106-185 (2000), 114 Stat. 218-19, as an account held by one financial institution at another financial institution primarily for the purpose of facilitating customer transactions.

[76] 18 U.S.C. § 981(k)(1)(A), added by Section 319(a) of the Patriot Act, refers to *covered financial institution* as defined in 31 U.S.C. § 5318(j)(1), in other words, to "real banks" and registered broker-dealers. *See supra* note 61.

[77] 18 U.S.C. § 981(k)(1), added by Section 319(a) of the Patriot Act, in conjunction with 31 U.S.C. § 5318(j)(1) referring to 31 U.S.C. § 5312(a)(2)(A)-(G). *See supra* note 61.

[78] 18 U.S.C. § 981(k)(1)(A), added by Section 319(a) of the Patriot Act.

[79] It seems obvious that the funds in the interbank account are held in U.S. dollars as the account is usually maintained by the foreign bank to

Act seems to be based merely on the fact that the foreign depositor's foreign bank maintains an interbank account in the United States, regardless of the place of the deposit, the currency of the deposit or any transfer related to the deposit. Obviously, the aim is to allow U.S. law enforcement authorities to seize funds in the U.S. account as a substitute for the funds held in a foreign account over which the U.S. authorities have no jurisdiction, irrespective of whether the funds in the interbank account are derived from or related to or traceable to a criminal act.[80] Herein lies a significant change of the law in favor of the U.S. government.[81]

The Patriot Act uses a fiction, namely, that funds deposited in a foreign account are deemed to have been

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facilitate dollar transactions. However, it seems that the foreign funds can be denominated in any currency.

[80] 18 U.S.C. § 981(k)(2), added by Section 319(a) of the Patriot Act, provides that in the event of a forfeiture action against funds in the interbank account it shall not be necessary for the Government to establish that the funds are directly traceable to the funds that were deposited into the foreign bank. This provision only clarifies what 18 U.S.C. § 981(k)(1)(A), added by Section 319(a) of the Patriot Act, already implies, namely that there does not need to be any connection between the funds deposited at the foreign bank account and those deposited at the U.S. interbank account. This needs to be distinguished from the necessary connection between the funds deposited in the foreign account and the criminal or terrorist activities as laid out by 18 U.S.C. § 981(a)(1), *see supra* notes 69 & 70 and accompanying text.

[81] Prior to the Patriot Act, the U.S. government was required to show a nexus between the illegal conduct and the funds seized from an interbank account (in other words, the proceeds in the interbank account had to be directly traceable to the criminal conduct, unless the financial institution in holding the account knowingly engaged in the offense). This followed from 18 U.S.C. § 984(d)(1) (2000), dealing with civil forfeiture of fungible property. Thus, in a forfeiture trial concerning the seizure of interbank account funds, the government must have had at least probable cause to connect the interbank account to criminal activity. *See* Marine Midland Bank, N.A. v. United States, 11 F.3d 1119 (2d Cir. 1993). The Patriot Act explicitly eliminates this tracing or nexus requirement for interbank accounts in 18 U.S.C. § 981(k)(2), added by Section 319(a) of the Patriot Act. 18 U.S.C. § 984 (2000) was rewritten by Pub. L. No. 106-185 (2000), § 13(a), 114 Stat. 218-19.

deposited in a U.S. account.[82] The question is whether there are limits on the legislative use of such fictions. In particular, can Congress create jurisdiction over an extra-territorial act with the help of the fiction that the act took place in the United States? If the United States cannot seize certain illegal funds because they are located outside the territory of the United States, can Congress seize an equal amount of funds from a third person who is not involved in the illegal act by establishing a fiction that the funds of the third person are the funds of the person involved in the illegal act? The amount of funds that can be seized in the interbank account is limited by the value of the funds deposited into the account at the foreign bank.[83]

Seizures of these funds shall generally be made pursuant to a warrant obtained in the same manner as provided for a search warrant under Rule 41(d) of the Federal Rules of Criminal Procedure.[84]

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[82] A fiction assumes the existence of a state of facts irrespective of their truth or falsity. *See* WEBSTER'S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 844 (1933). *Fictio idem operatur quod veritas* (a fiction has the same effect as the truth), *see* S. Dionysius Gothofredus, *quoted in* LATEINISCHE RECHTSREGELN UND RECHTSSPRICHWÖRTER 84, No. 25 (Detlef Liebs ed., 6th ed. 1998) [hereinafter Liebs].

[83] 18 U.S.C. § 981(k)(1)(A), added by Section 319(a) of the Patriot Act.

[84] 18 U.S.C. § 981(b)(2), as amended by Pub. L. No. 106-185 (2000), § 5(a), 114 Stat. 213. Pursuant to Rule 41(d)(1) of the Federal Rules of Criminal Procedure, a magistrate judge or a judge of a state court of record must issue the warrant if there is probable cause to search for and seize a person or property in one of the following cases: (1) evidence of a crime; (2) contraband, fruits of crime, or other items illegally possessed; (3) property designed for the use, intended for use, or used in committing a crime; or (4) a person to be arrested or a person who is unlawfully restrained. Rule 41(d)(2) includes provisions regarding the warrant on an affidavit or on sworn testimony. Pursuant to Rule 41(d)(3) a magistrate judge may issue a warrant based on information communicated by telephone or other appropriate means.

Seizure may be made without a warrant if a complaint for forfeiture has been filed in the United States district court and the court issued an arrest warrant in rem, or if there is probable cause to believe that the property is subject to forfeiture, or if the property was lawfully seized by a State or local law enforcement agency and transferred to a Federal agency. 18 U.S.C. § 981(b)(2)(A)-(C).

Unlike under IEEPA, there is no requirement of a genuine link between the seized funds and the targeted foreign funds. In other words, there is no requirement of genuine link between the foreign funds and U.S. territory. The link is created by a fiction, that property located abroad is deemed to be located in the United States, or, to be more precise, that an account relationship abroad is deemed to be an account relationship in the United States. With such kind of fiction, the United States could extend its jurisdiction to practically all foreign property or acts. Although fictions are a recognized legislative tool, it is doubtful whether they are appropriate in jurisdictional provisions. Jurisdiction, in particular personal jurisdiction and in rem jurisdiction, by nature, is based on contacts; if these contacts can be fictionally created, there would be no limit whatsoever to the assertion of jurisdiction.

2. Judicial Remedy in Case of Forfeiture

The person who deposited the funds in the account at the foreign bank may contest the forfeiture by filing a claim under Section 316(a) of the Patriot Act in conjunction with Section 319(a) of the Patriot Act[85] and 18 U.S.C. § 983(d) (innocent owner defense). Section 319(a) of the Patriot Act restricts the group of persons, which pursuant to 18 U.S.C. § 983(a)(2) are allowed to file a claim by defining the owner as follows. *Owner* means a person with an ownership interest[86] in the funds that were deposited into the foreign

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Probable cause exists if apparent facts are such that a reasonably discreet and prudent man would be led to believe that law was being violated. *See* Dumbra v. United States, 268 U.S. 435 (1925); Locke v. United States, 11 U.S. 339, 348 (1813); Steele v. United States, 267 U.S. 498, 504-05 (1925). It may rest upon evidence that is not legally competent in a criminal trial, *see* Draper v. United States, 358 U.S. 307 (1959); and it need not be sufficient to prove guilt in a criminal trial, *see* Brinegar v. United States, 338 U.S. 160 (1949); United States v. Ventresca, 380 U.S. 102 (1965).

[85] 18 U.S.C. § 981(k)(3), added by Section 319(a) of the Patriot Act.

[86] The ownership interest, pursuant to 18 U.S.C. § 983(d)(6)(A), includes a leasehold, lien, mortgage, recorded security interest, or valid assignment of an ownership interest.

bank *at the time such funds were deposited.*[87] A general unsecured interest in, or claim against, the funds, however, is not sufficient.[88] This definition makes the targeted foreign depositor the owner.

The foreign bank or any financial institution acting as an intermediary in the transfer of the funds into the interbank account is specifically excluded from the scope of the term owner.[89] Only in two exceptional cases may the foreign bank be considered to be the owner of the funds: first, if the basis for the forfeiture is wrongdoing committed by the foreign bank,[90] or second, if the foreign bank establishes, by a preponderance of the evidence, that prior to the restraint, arrest or seizure of the funds, the foreign bank had discharged all or part of its obligation to the prior owner of the funds, in which case the foreign bank shall be deemed the owner of the funds to the extent of such discharged obligation.[91] Thus, in most cases, the innocent owner defense

[87] 18 U.S.C. § 981(k)(4)(B)(i)(I), added by Section 319(a) of the Patriot Act, in conjunction with 18 U.S.C. § 983(d)(6).

[88] 18 U.S.C. § 983(d)(6)(B), which provides that the term *owner* does not include (i) a person with only a general unsecured interest in, or claim against, the property or estate of another; (ii) a bailee unless the bailor is identified and the bailee shows a colorable legitimate interest in the property seized; or (iii) a nominee who exercises no dominion or control over the property.

[89] 18 U.S.C. § 981(k)(4)(B)(i)(II), added by Section 319(a) of the Patriot Act, provides that the term *owner* does not include either the foreign bank or any financial institution acting as an intermediary in the transfer of the funds into the interbank account.

[90] 18 U.S.C. § 981(k)(4)(B)(ii)(I), added by Section 319(a) of the Patriot Act.

[91] 18 U.S.C. § 981(k)(4)(B)(ii)(II), added by Section 319(a) of the Patriot Act. If the foreign bank has discharged its obligations to the prior owner of the funds, i.e., repaid the tainted funds to the depositor, the fiction of 18 U.S.C. § 981(k)(1)(A), added by Section 319(a) of the Patriot Act, *see supra* text accompanying note 78, no longer applies. Funds that were deposited with a foreign bank and later withdrawn can no longer be deemed to have been deposited into an interbank account in the United States. *Id.* It is conceivable that 18 U.S.C. § 981(k)(4)(B)(ii)(II) implies that once tainted funds have been deposited with a foreign bank but were later withdrawn or the account relationship between the foreign bank and the targeted foreign depositor has been terminated, the correspondent

can only be brought by the customer of the foreign bank but not by the foreign bank itself. This creates a problem for the foreign bank in the event a seizure occurs before it has discharged its obligation to its customer: under most foreign laws the foreign bank would still be liable to its customer, the depositor of the funds, but it cannot contest the seizure of the funds under the Patriot Act.

By excluding the foreign bank from the definition of owner, Section 319(a) of the Patriot Act[92] seems to deny the foreign bank standing to sue.[93] However, even if the relevant

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account remains subject to seizure. It is more likely, however, that 18 U.S.C. § 981(k)(4)(B)(ii)(II) should be read as permitting the defense that the targeted depositor no longer has a deposit claim against the foreign bank. It is logical that only the foreign bank can make this claim.

[92] 18 U.S.C. § 981(k)(4)(B)(i)(II), added by Section 319(a) of the Patriot Act.

[93] Under U.S. law, standing to sue is a federal constitutional principle, grounded in Article III of the U.S. Constitution and also governed by prudential principles. Standing addresses the question of whether a party has a sufficient stake in an otherwise justiciable controversy to obtain judicial resolution of that controversy, *see* Sierra Club v. Morton, 405 U.S. 727 (1972), and focuses primarily on the party seeking to get its complaint before a federal court, *see* Flast v. Cohen, 392 U.S. 83 (1968). For a more comprehensive account of the law of standing, see generally CHARLES ALAN WRIGHT & MARY KAY KANE, LAW OF FEDERAL COURTS ch. 2, §§ 12 & 13 (6th ed. 2002); 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 3-14, at 385-92 (3d ed. 2000).

It seems that the U.S. Supreme Court has arrived at a three-part standing test, which sums up the previous case law and is outlined, e.g., in Lujan v. Defenders of Wildlife, 504 U.S. 555 (1992). As stated in that case, the minimum requirements for standing under Article III are that (1) the plaintiff has suffered an injury in fact—an invasion of a legally protected interest which is (a) concrete and particularized and (b) actual or imminent, and not conjectural or hypothetical; (2) there is a causal connection between the injury and the conduct complained of—the injury has to be fairly traceable to the challenged action of the defendant, and not the result of the independent action of some third party not before the court; and (3) it is likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision.

Even when these requirements are met, a plaintiff may still lack standing under the prudential principles by which the judiciary seeks to avoid deciding questions of broad social import where no individual rights would be vindicated and to limit access to the federal courts to those

provision of Section 319(a) of the Patriot Act[94] were not applicable, the foreign bank, under the general principles of banking law, would not be able to rely on the innocent owner defense. The relevant banking law principle is that with the deposit of the funds a debtor-creditor relationship between the depositor (here the foreign bank) and the deposit taker (here the U.S. bank administering the interbank account) is established.[95] Even in the absence of the specific exclusion of the foreign bank from the owner definition by Section 319(a) of the Patriot Act,[96] the depositing foreign bank merely has an unsecured claim for the funds held in the interbank account at the U.S. bank. There is no fiction that the foreign bank that deposited funds into the U.S. correspondent bank is the owner of such funds. Such an unsecured claim does not create an ownership interest.[97] Furthermore, even the savings clause of Section 316(c)(2) of the Patriot Act[98] does not help the foreign bank as another remedy does not seem to be available.[99] This lack of a remedy violates the general

litigants best suited to assert a particular claim, *see* Gladstone, Realtors v. Bellwood, 441 U.S. 91 (1979). These prudential principles are that (1) the plaintiff's interest must come within the zone of interests arguably protected or regulated by the law in question, *see* Ass'n of Data Processing Serv. Orgs., Inc. v. Camp, 397 U.S. 150 (1970); (2) the courts will not hear generalized grievances shared in substantially equal measure by all or a large class of citizens, *see* United States v. Richardson, 418 U.S. 166 (1974), *as well as* Schlesinger v. Reservists Comm. to Stop the War, 418 U.S. 208 (1974); and (3) the plaintiff must assert its own legal interests rather than those of third parties, *see* Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985).

[94] 18 U.S.C. § 981(k)(4)(B)(i)(II), added by Section 319(a) of the Patriot Act.

[95] *See infra* Part IV.D. for further discussion of this issue.

[96] 18 U.S.C. § 981(k)(4)(B)(i)(II), added by Section 319(a) of the Patriot Act.

[97] *See supra* notes 86 & 88 and accompanying text.

[98] Section 316(c)(2) of the Patriot Act provides that nothing in Section 316 of the Patriot Act shall limit or otherwise affect any other remedies that may be available to an owner of property under 18 U.S.C. § 983 or any other provision of law.

[99] 5 U.S.C. § 702 (2000) (part of the Administrative Procedure Act), which provides that "a person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the

proposition that there should be a judicial remedy for every legal injury, reflected in the common law maxim *ubi jus, ibi remedium.*[100] The provisions of the Patriot Act do not specifically refer to the necessary (when applying the principles of the debtor-creditor relationship) seizure of the foreign bank's claims against the correspondent bank in addition to the forfeiture of the funds in the correspondent account and certainly do not provide the affected foreign bank with a remedy applicable in the most likely case, i.e., the situation where the foreign depositor still has a valid claim against the foreign bank under foreign law and the foreign bank cannot therefore argue the exceptional circumstances set out in Section 319(a) of the Patriot Act.[101] Practically, the foreign bank would not receive any kind of compensation for the seizure of its claims as a depositor against the U.S. bank. The Patriot Act does not exclude the foreign bank's standing to sue as owner of the claim of a depositor, rather than as owner of the deposited funds.

Furthermore, the savings clause of Section 316(c)(2) of the Patriot Act[102] could be read as indicating that general constitutional principles still apply and the foreign bank's

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meaning of a relevant statute, is entitled to judicial review thereof," would probably not provide another remedy. The judicial officer issuing the seizure warrant arguably would not qualify as an agency, i.e., as an authority of the Government of the United States pursuant to 5 U.S.C. § 701(b)(1). As an officer of the judiciary, the judicial officer would fall outside the scope of the Administrative Procedure Act pursuant to 5 U.S.C. § 701(b)(1)(B). Moreover, the judicial officer would act pursuant to the provisions introduced by the Patriot Act and presumably do so in a formally correct way. A court may well find the action to be consistent with the written law at the time. The underlying act of Congress, however, cannot be challenged under 5 U.S.C. § 702 as, pursuant to 5 U.S.C. § 701(b)(1)(A), Congress is also not considered an agency within the scope of 5 U.S.C. § 702.

[100] *See* TRIBE, *supra* note 93, § 3-31, at 601. *See* Liebs, *supra* note 82, at 232, No. 12. The same idea is expressed in the maxim *lex semper dabit remedium*. *See id.* at 124, No. 48.

[101] 18 U.S.C. § 981(k)(4)(B)(ii), added by Section 319(a) of the Patriot Act. *See also supra* notes 90 & 91 and accompanying text.

[102] *See supra* note 98.

standing to sue even as innocent owner of the funds deposited in the interbank account is not denied.

In any event, the foreign bank should be able to rely on the doctrine of judicial review.[103] In light of the fact that the principles of standing to sue and judicial review are based on the U.S. Constitution, one would have to conclude that Congress could not, and did not intend to, deny these rights. A statute should not be interpreted as intending to do so.

In order to counter the explicit exclusion of the foreign bank from the group of possible claimants it seems appropriate to conclude that under the principles of standing and judicial review, the foreign bank may contest the measure in question in the relevant federal court.[104] Arguably, the provisions of Section 319(a) of the Patriot Act[105] and 18 U.S.C. § 983(d)(6)(B)(i)[106] would seem to violate the doctrine of judicial review, and standing to sue would have to be granted. One may even argue that the seizure of the funds and the claim of the foreign bank against the U.S. correspondent bank is inconsistent with the Fourth as well as the Fifth Amendment.[107]

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[103] The doctrine of judicial review derives from the Supreme Court's early case, Marbury v. Madison, 5 U.S. 137 (1803), where the Court held that "the very essence of civil liberty certainly consists in the right of every individual to claim the protection of the laws, whenever he receives an injury."

[104] This would usually be the district court as court of first instance.

[105] 18 U.S.C. § 981(k)(4)(B)(i), added by Section 319(a) of the Patriot Act.

[106] *See supra* note 88.

[107] The Fourth Amendment guarantees the right to be secure in one's effects against unreasonable seizures. The Fifth Amendment protects against the deprivation of property without due process of law and such deprivation without just compensation. Both Amendments apply also to alien corporations, *see* RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW, SUBSTANCE AND PROCEDURE § 14.5, 528 (3d ed. 1999). The claims that the foreign bank has against the U.S. bank with whom it maintains its interbank account should qualify as property protected by the Constitution. Thus, the foreign bank could possibly rely on the provisions of the Fourth and Fifth Amendments. However, substantial obstacles to this approach will be met in case the foreign bank has no further links of residence or establishment with the United States other than the mere position as creditor regarding the correspondent

However, even if one were to argue that the foreign bank should be denied standing, redress may be found in 28 U.S.C. § 1491(a)(1).[108] This provision grants the United States Court of Federal Claims jurisdiction over, among others, "any claim against the United States founded either upon the Constitution, or any Act of Congress."[109] Authorized are "actions based on constitutional provisions that mandate the payment of compensation by the United States, such as the Fifth Amendment prohibition against takings without just compensation."[110] If the foreign bank is able to show that the forfeiture violating its rights under the Fifth Amendment does not come with adequate compensation, it may successfully sue the United States for money damages. Accordingly, a judgment may be rendered holding Section

account. Whether in such case the foreign bank may be able to invoke rights under the U.S. Constitution would have to be analyzed carefully. Furthermore, one would have to examine whether the seizure amounts to a taking under the Fifth Amendment or whether it merely constitutes a provisional measure.

[108] 28 U.S.C. § 1491 (2000) is also referred to as the Tucker Act.

[109] Note that concerning claims not exceeding $10,000 in amount, the U.S. district courts have original jurisdiction, concurrent with the jurisdiction of the United States Court of Federal Claims. 28 U.S.C. § 1346(a)(2). Furthermore, the Tucker Act is a jurisdictional statute only and does not create any substantive rights to money damages enforceable against the United States. *See* United States v. Testan, 424 U.S. 392 (1976). It is a general grant of jurisdiction and is superseded when a more specific federal statute provides for jurisdiction over a particular cause of action. *See* People of Enewetak v. United States, 864 F.2d 134 (Fed. Cir. 1988), where it was held that because the United States had withdrawn its consent to be sued and established an alternate tribunal, the Tucker Act could not apply. However, in the forfeiture scenario discussed in this article, there is neither a more specific statute providing for jurisdiction, nor has the United States withdrawn its consent to be sued. *See supra* notes 98 & 99 and accompanying text. For further information on 28 U.S.C. § 1491, *see* 1 CIVIL ACTIONS AGAINST THE UNITED STATES—ITS AGENCIES, OFFICERS, AND EMPLOYEES (Trial Practice Series) §§ 1:16 *et seq.* (2d ed. 2002) [hereinafter CIVIL ACTIONS AGAINST THE UNITED STATES].

[110] *See* CIVIL ACTIONS AGAINST THE UNITED STATES, *supra* note 109, § 1:20, referring to United States v. Riverside Bayview Homes, Inc., 474 U.S. 121 (1985). It seems possible that the forfeiture of the funds constitutes a taking under the Fifth Amendment. *See supra* note 107.

319(a) of the Patriot Act[111] and 18 U.S.C. § 983(d)(6)(B)(i) unconstitutional.[112]

Finally, another way of addressing a forfeiture under Section 319(a) of the Patriot Act would be for the foreign bank to enter into negotiations with the Attorney General. If the Attorney General determines that a conflict of law exists between the laws of the jurisdiction in which the foreign bank is located and the laws of the United States, he, after consulting the Secretary, may suspend or terminate the forfeiture.[113]

D. The Patriot Act Violates Basic Principles of U.S. Commercial Law

Section 319(a) of the Patriot Act[114] modifies a basic rule of the law. Under U.S. law it is a long-standing principle that if a customer "deposits money with a bank, the title to the money passes to the bank, and the latter becomes the debtor . . . to that amount."[115] "[T]he depositor receives a contract claim against the bank for an amount equal to the account balance."[116] The same principle is applied in other jurisdictions, e.g., under English law,[117] as well as under German law.[118] Accordingly, at the time of the seizure, the

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[111] 18 U.S.C. § 981(k)(4)(B)(i), added by Section 319(a) of the Patriot Act.

[112] *See supra* note 88. Again, one should note that further scrutiny as to the applicability and scope of the takings clause of the Fifth Amendment may be necessary. *See supra* notes 107 & 110.

[113] 18 U.S.C. § 981(k)(1)(B), added by Section 319(a) of the Patriot Act.

[114] 18 U.S.C. § 981(k)(4)(B)(i)(I), added by Section 319(a) of the Patriot Act.

[115] *See* Thompson v. Riggs, 72 U.S. 663 (1866).

[116] *See* Parker v. Community First Bank (*In re* Bakersfield Westar Ambulance, Inc.), 123 F.3d 1243 (9th Cir. 1997). For an extensive overview of this issue, *see* 5A MICHIE ON BANKS AND BANKING ch. 9, § 1 (2003).

[117] *See* Libyan Arab Foreign Bank v. Bankers Trust Co., 3 All E.R. 252, 276 (Q.B. 1989).

[118] *See* SIEGFRIED KÜMPEL, BANK- UND KAPITALMARKTRECHT, margin nos. 3.33-3.44, 342-345 (3d ed. 2004).

U.S. correspondent bank holds title to the funds in the interbank account.

Justice Staughton states this universal rule very clearly in *Libyan Arab Foreign Bank*:[119]

> It is elementary, or hornbook law to use an American expression, that the customer does not own any money in a bank. He has a personal and not a real right. Students are taught at an early stage of their studies in the law that it is incorrect to speak of "all my money in the bank:" see *Foley v Hill* (1848) 2 HL Cas 28 at 36, [1943–60] All E.R. Rep 16 at 19, where Lord Cottenham LC said:
>
> > Money, when paid into a bank, ceases altogether to be the money of the principal. . . . It is then the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. . . . The money placed in the custody of a banker is, to all intents and purposes, the money of the banker, to do with as he pleases.

Owner is defined in the context of the civil forfeiture provision of 18 U.S.C. § 981 as a person with an ownership interest in the specific property sought to be forfeited.[120] Section 319(a) of the Patriot Act recognizes that the depositor of funds at the foreign bank is no longer owner of such funds after the deposit. This recognition is reflected in Section 319(a),[121] which explicitly refers to the depositor's ownership at the time the funds *were* deposited and not at the time of the seizure. The reference to the ownership in the past reflects not only a recognition of the fact that the foreign bank at the time of the seizure, under accepted legal principles, is not the owner of the funds, but also a rejection of that rule.

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[119] *See Libyan Arab Foreign Bank*, 3 All E.R. at 268.

[120] 18 U.S.C. § 983(d)(6)(A), Pub. L. No. 106-185 (2000), § 2(a), 114 Stat. 202.

[121] 18 U.S.C. § 981(k)(4)(B)(i)(I), added by Section 319(a) of the Patriot Act.

If a depositor transfers $1 to his dollar account at a non-U.S. bank, the U.S. correspondent account that the non-U.S. bank maintains with a U.S. bank will increase by $1 (unless the $1 was transferred from another account at the same bank). Immediately after receipt of the $1 transfer, the bank may have made a $1 loan to another customer by crediting the borrower's dollar account. The U.S. correspondent account still shows the $1, but it reflects money owed to the other customer. This $1 in the correspondent account may be seized under the Patriot Act. If the bank transfers the $1 to another bank designated by the borrower or if it purchases goods for $1 and transfers $1 to the bank of the seller, the bank's correspondent account will be reduced by $1. However, $1 may still be seized under the Patriot Act. It is important to note that a bank is not required to hold funds in cash or in bank accounts in the amount of all claims of its depositors, nor is a bank required to match its foreign currency assets with foreign currency liabilities. The bank may wish to decrease the gap between dollar assets and dollar liabilities and borrow $1 from another bank. In that case its correspondent account would increase by the amount borrowed. The bank may sell dollars against euros, in which case its correspondent account would decrease. The important point is that there is no relationship between the dollar deposits of customers at the foreign bank and the dollar balance of the foreign bank at its U.S. correspondent account. The well-established debtor-creditor relationship between the bank and its deposit customer is negated by the Patriot Act. Despite the lack of an ownership link between the seized funds and the targeted criminal customer, Section 319(a) of the Patriot Act creates a fiction of law that assigns ownership to a person contrary to an essential principle of commercial law.[122]

If one projects the Patriot Act's view regarding the ownership of the funds onto other areas of law, consequences will be serious. To illustrate this, one may simply examine the possible effects on bankruptcy law. Section 541(a) of the

[122] 18 U.S.C. § 981(k)(4)(B)(i)(I), added by Section 319(a) of the Patriot Act.

U.S. Bankruptcy Code provides that the bankrupt's estate in general comprises the debtor's interests in property.[123] Any power that the debtor may exercise solely for the benefit of an entity other than the debtor is excluded from the estate.[124] Applying the view of the Patriot Act that the depositor remains owner of the deposited funds to depositors of a bankrupt U.S. bank, the bankrupt's estate would be vastly diminished and a substantial disadvantage of the bankrupt's remaining creditors would result. A limitation of this fiction to foreign depositors, on the other hand, would result in reverse discrimination, putting all U.S. depositors in a detrimental position. In any event, consequences would be far-reaching. It seems that Congress has not fully thought through the possible implications of the ownership fiction.

If the view that a depositor has an ownership interest in funds deposited at a bank prevails, the bank could not use such funds freely in its banking business and modern banking business would come to a halt. Like a broker-dealer who is obligated to maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its customers,[125] the bank would be obligated to keep available liquid funds equal to its deposit liabilities and matching the currencies of its deposit liabilities.[126]

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[123] *See* 11 U.S.C. § 541(a) (2000). Again, this U.S. provision reflects established international standards. German law, e.g., provides that the bankrupt's estate only consists of the debtor's legal estate. Section 35 of the Insolvenzordnung (Insolvency Act) of Oct. 5, 1994, 1994 BGBl. I 2866, as amended [hereinafter InsO]. Another person's property that is not subject to execution pursuant to the Zivilprozessordnung (Civil Procedure Statute) of Sept. 12, 1950, 1950 BGBl. III 533, as amended, is excluded from the bankrupt's estate. Section 36(I) of the InsO.

[124] 11 U.S.C. § 541(b)(1) (2000).

[125] N.Y.U.C.C. § 8-504 (McKinney 2002 & Supp. 2004).

[126] With respect to deposits, commercial banks would be in the same position as brokers are with respect to customer securities. *Supra* note 125. *See also* N.Y.U.C.C. §§ 8-503 to 508. N.Y.U.C.C. § 8-503 expresses the understanding that securities that a broker holds for its customers are not general assets of the broker subject to a claim of the broker's creditors. N.Y.U.C.C. § 8-503(a) provides that, to the extent necessary to satisfy all customer claims, all units of a security held by the broker are held for the

E. Double Jeopardy of the Foreign Bank

If the U.S. government seizes funds of a U.S. criminal held in an account at a U.S. bank, the U.S. government in effect seizes the right of the criminal arising from the deposit relationship with the bank. The bank now owes the money to the U.S. government. Under the theory of the Patriot Act, the U.S. government would seize assets of the bank but leave the foreign law right of the (foreign) criminal to demand repayment of the deposit untouched. Thus, the seizure only affects an innocent bystander.

In most cases, a foreign bank whose deposits in a U.S. correspondent account have been seized will lose the seized amount twice. The foreign alleged criminal depositor still has a claim under foreign law against the bank for repayment of the deposit. In other cases, particularly in money laundering cases, the foreign bank must under foreign law deliver the tainted money to the foreign government. The U.S. government still can seize the funds from the U.S. correspondent bank account. The author is aware of one case in which the double seizure actually occurred.

F. Violation of the Principle of Territoriality as a Doctrine of International Law

Section 319(a) of the Patriot Act provides U.S. enforcement agencies with a powerful new tool but the authority for this indirect seizure of foreign U.S. dollar accounts must be questioned under international law.[127] Arguably, Section 319(a) of the Patriot Act violates the principle of territoriality.

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entitlement holders (customers), are not property of the securities intermediary (broker), and are not subject to creditors' claims, except as otherwise provided in Section 8-511 of the N.Y.U.C.C. *See* Gruson, *Global Shares*, *supra* note 18, at 235. The customer of a broker is not an owner of the securities in the meaning of the common law property concept. Art. 8 of the U.C.C. has created a sui generis form of property interest. *See* N.Y.U.C.C. § 8-503 cmts. 1-2, § 8-104 cmt. 2.

[127] 18 U.S.C. § 981(k), added by Section 319(a) of the Patriot Act.

The principle of territoriality is a generally recognized basis for jurisdiction.[128] It provides that each nation has the exclusive right to regulate the conduct of all residents, individuals, and corporations within its borders.[129] A corollary to the territorial principle is that foreign governments do not have the right to interfere in the affairs of another state. Therefore, under an absolutist interpretation of the territorial principle, the United States would never have the right to exercise jurisdiction over, for example, a foreign subsidiary of a U.S. bank because such action would impinge on sovereign interests of the country in which the subsidiary operates.

The capacity to legislate in respect of the persons, property or events in question, so-called prescriptive jurisdiction, is primarily territorial. In the *S.S. Lotus* case,[130] which is one of the fundamental cases in regard to the principle of territorial jurisdiction, the Permanent Court of International Justice (the "P.C.I.J.") examined and expressly supported this principle.

The principle of territoriality, however, is not absolute.[131] To some extent, jurisdiction may be based on other grounds as well. In the *Lotus* case, the P.C.I.J. observed on the question of jurisdiction in general that besides the principle of territorial jurisdiction, every state remains free to adopt the principles which it regards as best and most suitable and that, in respect of jurisdiction outside its territory, there is a wide measure of discretion which is only limited in special

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[128] *See* IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 310 (4th ed. 1990).

[129] *See* MALCOLM N. SHAW, INTERNATIONAL LAW 574 (5th ed. 2003); BROWNLIE, *supra* note 128, at 298; GERHARD KEGEL & KLAUS SCHURIG, INTERNATIONALES PRIVATRECHT 939 (8th ed. 2000).

[130] S.S. Lotus (Fr. v. Turk.), 1927 P.C.I.J. (ser. A) No. 10, at 18 (Sept. 7, 1927), *cited in* WORLD COURT REPORTS, vol. II, 20 *et seq.* (Manley O. Hudson ed. 1935).

[131] *See Lotus* case, 1927 P.C.I.J. at 20, in which the P.C.I.J. observed this view on the specific question of criminal jurisdiction. However, it has to be noted that in the case of prescriptive jurisdiction, there is no major distinction between the civil, criminal, fiscal or monetary jurisdictions. *See* BROWNLIE, *supra* note 128, at 309-10.

cases by prohibitive rules.[132] Thus, the P.C.I.J. did not lay down a general prohibition to the effect that states may not extend their jurisdiction outside their territory. In essence, according to the P.C.I.J., what is not prohibited by international law is permitted. Today, this early approach of the P.C.I.J. is not accepted anymore, as several later decisions of the P.C.I.J.[133] point out. Now a general presumption against the extraterritorial application of municipal legislation exists[134] and extraterritorial jurisdiction is generally seen to be illegitimate.[135] This follows from the principle of sovereignty of states. As an exception, extraterritorial jurisdiction is allowed if the other state granted a permit, or if the exercise of jurisdiction does not involve interference with the legitimate affairs of that other state.[136] In addition to these exceptions, the view has evolved that, especially in the interest of national security, a country has the right to extend its jurisdiction outside its borders.[137]

According to the effects doctrine (which is controversial), a state may exceptionally exercise its jurisdiction on a basis other than territoriality if the conduct of a party is producing effects within its territory, even though the conduct complained of takes place abroad.[138] This doctrine requires that (1) a substantial connection between the specific matter and the state's sovereign authority exists and (2) the exercise of jurisdiction be reasonable.[139] The United States has relied

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[132] *See supra* note 130, at 19.

[133] *See, e.g.*, Fisheries case (U.K. v. Nor.), 1951 I.C.J. 116 (Dec. 18) and Nottebohm case (Liech. v. Guat.), 1955 I.C.J. 4 (Apr. 6).

[134] *See* SHAW, *supra* note 129, at 612 n.202 with further reference to relevant cases.

[135] *See* Claus Kress & Jochen Herbst, *Der Helms-Burton-Act aus völkerrechtlicher Sicht*, (1997) RECHT DER INTERNATIONALEN WIRTSCHAFT 630, 634 [hereinafter Kress & Herbst].

[136] *See* BROWNLIE, *supra* note 128, at 310.

[137] *See id.* at 304. *See also* SHAW, *supra* note 129, at 591-92.

[138] *See* SHAW, *supra* note 129, at 612. *See also* BROWNLIE, *supra* note 128, at 304.

[139] This has been pointed out in the Resolution on the Opinion of the Inter-American Juridical Committee in Fulfillment of Resolution AG/DOC. 3375/96 of the General Assembly of the Organization of American States;

on the effects doctrine, especially in the area of antitrust laws.[140]

The principle of protection recognizes a country's right to extend its jurisdiction outside its borders if an action threatens the national security or the functioning of government activities.[141] Prior to the Patriot Act, the principle of protection has never been applied in the context of national business law.[142]

In the case of the forfeiture of funds held in interbank accounts under Section 319(a) of the Patriot Act,[143] the U.S. authorities will assert a threat from the outside. Even if the threat does not stem from the country in which the foreign funds are located, the United States would argue that the availability of the funds would cause an indirect threat to the United States, because this money could be used to support terrorist activities. This argument is not persuasive because the foreign funds are still available to support illegal activities. The seizure of an equivalent amount of money from the foreign bank does not extinguish the depositor's foreign law claim against the bank for payment of the deposited money.

The principles permitting extraterritorial action do not apply in the context of terrorism financing. The U.N. Security Council may, in case of a "threat to international peace and security," make an exception from the principle of territoriality by binding resolution.[144] Following September 11, 2001, the U.N. Security Council decided in Resolution

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reprinted in 35 I.L.M. 1329, 1333 (1996). The opinion was rendered in respect of the 1996 Helms-Burton Act. *See* Kress & Herbst, *supra* note 135, at 632. *See also* SHAW, *supra* note 129, at 613.

[140] *See* SHAW, *supra* note 129, at 612, with further reference in n.204.

[141] *See* SHAW, *supra* note 129, at 591. *See also* BROWNLIE, *supra* note 128, at 304. The principle of protection is a well-established concept, although in most of the cases it is connected with the question of criminal jurisdiction. Regarding the distinction between the different types of prescriptive jurisdiction, *see* BROWNLIE, *supra* note 128, at 309-10.

[142] *See* Kress & Herbst, *supra* note 135, at 635, with further reference in n.86.

[143] 18 U.S.C. § 981(k), added by Section 319(a) of the Patriot Act.

[144] U.N. CHARTER arts. 39 *et seq*.

1373[145] that all U.N. Member States are obligated[146] to prevent and suppress the financing of terrorist acts, as well as to freeze funds and other financial assets or economic resources of persons who commit, or attempt to commit, terrorist acts or participate in or facilitate the commission of terrorist acts. Thus, all U.N. Member States are under an obligation to take necessary measures to implement this Resolution and to accept that other Member States implement this Resolution and may not claim that such foreign legislation violates their own sovereignty. However, if a U.N. Member State properly implements Resolution 1373, there seems to be no justification for the position that, in addition, it has to permit an extraterritorial application of Resolution 1373 as implemented by another Member State, such as the United States. If the citizens of a U.N. Member State were subject to the legislation implementing Resolution 1373 of their home country and also to the laws implementing Resolution 1373, applied extraterritorially, of all other 190 U.N. Member States, chaos would reign. Even if only all U.N. Member States in which a bank maintains correspondent accounts adopted their own version of the Patriot Act or fashioned some other fiction creating jurisdiction over the bank, international banking would be seriously impeded.

At any rate, the assertion that a country's statutes violate the principle of territoriality is of little consequence because there is no forum and no procedure to sue the violating country. Extraterritoriality of a statute could be argued only if it becomes an issue in a private law suit. A U.S. court would probably hold that the seizure of the foreign bank's interest in the U.S. correspondent account took place in the

[145] U.N. Security Council Resolution 1373 (2001) of Sept. 28, 2001, U.N. Doc. S/RES/1373 (2001).

[146] Pursuant to U.N. CHARTER arts. 25 & 48, all Member States are obligated to take all necessary measures, in particular by way of national legislation, in order to implement such binding U.N. Security Council Resolution.

United States because the correspondent account has its situs in the United States.[147]

G. Retaliatory Legislation and Dispute Settlement under GATS

Besides the legal issues already mentioned, the U.S. legislation contains the potential for political conflict with foreign governments. In particular, the extraterritorial impact resulting from the U.S. attempt to seize money held in foreign bank accounts is likely to be perceived as a U.S. intrusion into the internal affairs of foreign countries.[148] Foreign countries could consider retaliatory legislation against U.S. banks doing business in their territory, for instance by seizing from accounts of such U.S. banks, with the help of appropriate fictions, amounts equivalent to the amounts seized from their banks under the Patriot Act. It would not be the first time that foreign governments may be tempted to implement retaliatory legislation to counter U.S. measures.[149] However, whether it will be done, and more

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[147] *See* Republic of Iraq v. First National City Bank, 353 F.2d 47 (2d Cir. 1965), *cert. denied*, 382 U.S. 1027 (1966). *See* the discussion of this case in Michael Gruson, *The Act of State Doctrine in Contract Cases as a Conflict-of-Laws Rule*, 1988 U. ILL. L. REV. 519, 536 & 550-51.

[148] *See* JAMES R. ATWOOD, KINGMAN BREWSTER & SPENCER WEBER WALLER, ANTITRUST AND AMERICAN BUSINESS ABROAD § 4:1 (3d ed. 2002).

[149] The use of retaliatory legislation is well demonstrated by disputes in the area of antitrust law. Beyond mere diplomatic protests and the non-cooperation by foreign courts as, e.g., in the British case Rio Tinto Zinc Corp. v. Westinghouse Elec. Corp., 1 All E.R. 434 (H.L. 1978), blocking laws have frequently been enacted by foreign governments to contain the extraterritorial reach of U.S. antitrust law and relevant jurisprudence. Early examples are (1) the Dutch Economic Competition Act (June 28, 1956), as amended (July 16, 1958), which apparently resulted from Dutch outrage over the successful effort of the United States to prosecute Philips [*see* United States v. Gen. Elec. Co., 115 F. Supp. 835 (D.N.J. 1953)] and the attempt of the United States to investigate the activities of oil companies incorporated in the Netherlands (*see* ATWOOD, *supra* note 148, § 4:16), (2) the British Shipping Documents and Commercial Documents Act [1964, c. 87] and the German Act of May 24, 1965, [1965 BGBl II 835], which were a response to a U.S. antitrust investigation of the shipping industry (*see* ATWOOD, *supra* note 148, § 4:16), or (3) the New Zealand

Evidence Amendment Act (No. 2) 1980 [1980 NZ Stat. 173 (No. 27)] that also resulted from an investigative demand directed at the shipping industry (*see* ATWOOD, *supra* note 148, § 4:16). Triggered by the threat of treble damages being imposed on a major U.K. minerals company—again Rio Tinto Zinc, which as a foreign producer had no access to the then protected U.S. uranium market (for further background information, *see* A.V. Lowe, *Blocking Extraterritorial Jurisdiction: The British Protection of Trading Interests Act, 1980,* 75 AM. J. INT'L L. 257, 269 (1981))—as a result of a suit under U.S. antitrust law alleging participation in an international uranium cartel, in the early 1980s, the United Kingdom enacted the Protection of Trading Interests Act 1980 [hereinafter PTIA]. *See* Exchange of Diplomatic Notes Concerning the Act, *reprinted in* 21 I.L.M. 834, 840 (1982). The PTIA repealed and superseded the Shipping Documents and Commercial Documents Act of 1964. The PTIA enabled the British Government to prohibit compliance by persons in the United Kingdom with foreign laws regulating or controlling international trade outside the country concerned which damage or threaten to damage the trading interests of the United Kingdom, as well as to prohibit U.K. persons from providing information or documents to a foreign court or authority where doing so would infringe U.K. jurisdiction. Additionally, the PTIA prevented U.K. courts from ordering the production of evidence in the United Kingdom requested by a foreign court where the request infringes U.K. jurisdiction and from enforcing awards of multiple damages by foreign courts. Furthermore, as a so-called "clawback" provision, it enabled British citizens and corporations and other persons carrying on business in the United Kingdom to recover in U.K. courts the multiple part of multiple damages awarded against them in an overseas court. *See* Nicholas Davidson, *U.S. Secondary Sanctions: the U.K. and E.U. Response,* 27 STETSON L. REV. 1425, 1428 (1997-1998) [hereinafter Davidson, *Sanctions*]. During antitrust proceedings, the PTIA had been successfully used by the U.K. in the case of Laker Airways (*see* the British orders in 267 Av. Daily 330-36 (1983), upheld in In re Application by Laker Airways for Leave to Apply for Judicial Review, 3 W.L.R. 545, 588-91 (C.A. 1983), *aff'd*, 3 W.L.R. 413 (1984), *reprinted in* 23 I.L.M. 727 (1984)), but also in other circumstances, such as the 1982 dispute over the Trans-Siberian pipeline. *See* Davidson, *Sanctions*, *supra*, at 1428-29. To give a further example, Canada as another major trading partner of the United States enacted a blocking law on Feb. 14, 1985: the Foreign Extraterritorial Measures Act, R.S.C. ch. F-29 (1985) (Can.), *available at* http://www.canlii.org/ca/sta/f-29 (last visited Sept. 1, 2004).

Counteractive legislative measures had also been used extensively in the controversy over U.S. anti-Cuba trade laws as, *inter alia*, established by Section 1706(a)(1) of the Cuban Democracy Act of 1992 and the Helms-Burton Act (officially, the Cuban Liberty and Democratic Solidarity (LIBERTAD) Act of 1996, Pub. L. No. 104-114, 110 Stat. 785, codified as amended in scattered sections of 22 U.S.C.). Section 1706(a)(1) of the

Cuban Democracy Act of 1992 prohibited licenses for transactions involving the export to Cuba of goods produced outside the United States by foreign subsidiaries of U.S. companies, as well as the import of Cuban goods by foreign subsidiaries into foreign territories, from being issued under the U.S. Regulations. The Helms-Burton Act imposed sanctions against natural or legal persons, regardless of their nationality, who traffic in property expropriated by Cuba. Similarly, concerning trade with Libya and Iran, the Iran and Libya Sanctions Act of 1996 [hereinafter ILSA] Pub. L. No. 104-172, § 1, 110 Stat. 1541 (1996)—also known as the D'Amato Bill—represented another U.S. attempt to influence investment decisions of non-U.S. companies. This legislation required the President of the United States to impose sanctions against any person who would invest more than 40 million U.S. dollars a year in the petroleum industries of Iran and Libya. Already on Oct. 9, 1992, the Canadian government issued the Foreign Extraterritorial Measures (United States) Order, 1992 [SOR/92-584] under the Foreign Extraterritorial Measures Act, which made it an offence for Canadians to comply with the U.S. legislation. This Order had been revised on Jan. 15, 1996 to counteract directly the Helms-Burton Act. *See* Paul D. Burns, *Canada: U.S. Embargo Against Cuba—The Canadian Response* (1996), *available at* http://www.natlaw.com/pubs/spcacu1.htm (last visited Sept. 1, 2004). In a similar way, the United Kingdom reacted by issuing a blocking order under its existing blocking legislation [The Protection of Trading Interests (US Cuban Assets Control Regulations) Order 1992, No. 2449, *available at* http://www.legislation.hmso.gov.uk/si/si1992/Uksi_19922449_en_1.htm (last visited Sept. 1, 2004)]. Mexico enacted blocking legislation in 1996 [*Ley de proteccion al comercio y la inversion de normas extranjeras que contravengan el derecho internacional*—Law for the Protection of Business and Investment from Foreign Standards that Contravene International Law, D.O. Oct. 23, 1996]. The response of the European Union (E.U.) came in 1996, when the Council adopted Council Regulation 2271/96 1996 O.J. (L 309) 1 [hereinafter Council Regulation 2271/96] that provided protection against effects of the extraterritorial application of legislation adopted by a third country, and actions based thereon or resulting therefrom. This Regulation was applied immediately to Helms-Burton, ILSA and other Cuban embargo laws and regulations. *See* art. 1 in conjunction with the Annex of Council Regulation 2271/96, *supra*. Its key provisions (1) required E.U. companies affected by the covered laws to submit to the Commission information relevant for the purposes of the Regulation, (2) blocked recognition or enforcement of decisions or judgments giving effect to the covered laws, (3) prohibited compliance with requirements or prohibitions based on or resulting from the covered laws, unless otherwise authorized by the E.U. Commission, (4) provided for the recovery of damages caused by the application of the covered laws and (5) required

importantly, whether it could be done lawfully in the case of fund seizures, is a different issue. In particular, the European Union (the "E.U.") as well as its member states could find it difficult to reconcile retaliatory legislation with the provisions and the underlying ideas of the (European) Convention for the Protection of Human Rights and Fundamental Freedoms (the "ECHR") and its accompanying protocols.[150] Another possible, if unlikely, reaction to the U.S. approach could be the redress to the dispute settlement system established by the General Agreement on Trade in

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Member States to determine the sanctions to be imposed for breach of the Regulation. *See* Davidson, *Sanctions*, *supra*, at 1434-35.

[150] The original text of the ECHR does not apply to corporations. However, Article 1 of the Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms of March 20, 1952 [hereinafter Protocol] provides that "every natural or legal person is entitled to the peaceful enjoyment of his possessions." Through Art. 5 of the Protocol, Art. 1 of the Protocol is incorporated in the ECHR. Exceptions to the peaceful enjoyment principle are permissible on grounds of public interest. *See* Article 1 of the Protocol. Whether such exceptions could be invoked in the situation discussed in this article, however, remains doubtful as retaliation to the detriment of U.S. banks or their affiliates would not seem to fulfill the public interest requirement. Moreover, Art. 14 of the ECHR sets forth the prohibition of discrimination. Again, the retaliatory seizure of funds would hardly seem to be non-discriminatory because it would only affect U.S. banks or their affiliates. Similarly, the justification under Art. 15 of the ECHR, i.e., the derogation from obligations under the ECHR in time of war or other public emergency, seems very unlikely as the relevant extraterritorial U.S. measures hardly justify a characterization as war or emergency. However, as a legal technicality it should be noted that the European Union itself is not party to the ECHR and therefore not bound by its provisions. *See* European Court of Justice, Opinion 2/94 (March 28, 1996), 1996 O.J. (C180), 1, *reprinted in* 33 Common Mkt. L. Rev. 973 (1996). The ECHR is merely binding on the Member States that ratified it, which would at least exclude retaliatory legislation on the part of one or more of the Member States. The European Union itself could only be held accountable with respect to the Charter of Fundamental Rights of the European Union [hereinafter Charter]. This Charter, though, is neither legally binding nor does its wording apply to corporate entities. Provided the European Union acts within the limitations of its jurisdiction under the E.U. treaties, retaliatory legislation could well be permissible. However, any execution of such legislation by the Member States could create substantial conflicts for them as they are bound by the ECHR and possibly their own constitutions.

Services ("GATS"). Generally, at least some part of the foreign bank's business would seem to qualify as financial services as defined in the Annex on Financial Services to the GATS. However, any member state to the GATS agreement that wanted to address the issue successfully has to show that the United States failed to carry out its obligations or specific commitments under the GATS. As the U.S. provisions discussed here apply to any bank, regardless of nationality or other factors, this seems rather difficult to achieve.

Since the forfeiture provisions of Section 319(a) of the Patriot Act apply only to non-U.S. banks, they may constitute a discrimination of banks licensed by member states of the European Union because the Patriot Act does not treat such banks in the same way it treats U.S. domestic banks (denial of national treatment).[151] If a country outside the European Union discriminates against credit institutions licensed in a member state of the European Union, the European Commission may initiate negotiations with that country to remedy the situation.[152] The European Commission may also decide that, in addition to initiating negotiations, the European Union member states must limit or suspend their decisions regarding pending or future requests by United States entities for the authorizations of credit institution subsidiaries in the European Union or for the approval of the acquisition of holdings in credit institutions authorized by European Union member states.[153]

V. CONCLUSIONS

The IEEPA only grants authority to act within the United States in the case of an international emergency involving

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[151] Art. 23(5), Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, O.J. L. 126, 1 (2000).

[152] *Id.*

[153] *Id.* *See* Michael Gruson, *Banking Regulation of the European Union*, in 2 REGULATION OF FOREIGN BANKS, BANKING LAWS OF MAJOR COUNTRIES AND THE EUROPEAN UNION (Michael Gruson & Ralph Reisner, eds.), § 5.03[5][b] (4th ed. to be published in 2004.)

the United States. It does not provide a legal foundation to take measures like the freezing of assets in foreign countries. Therefore, the direct extraterritorial effects of the IEEPA are rather limited.

However, the linking of jurisdiction to the clearing of money transfers through CHIPS and Fed wire leads to an extraterritorial effect of the IEEPA. Dollar accounts located in foreign countries are drawn under U.S. jurisdiction by way of making the final clearing transaction through CHIPS or Fed wire the decisive factor. Nevertheless, this seems to constitute a genuine link of the frozen funds with U.S. territory, at least in those cases in which the clearing actually took place in the United States. Because of this genuine link, there should be little concern, from a legal perspective, about this assumption of jurisdiction under the IEEPA.

An evaluation of the provisions introduced by the Patriot Act that apply U.S. jurisdiction over funds held abroad with a foreign bank would have to reach a different conclusion. Although the aim of preventing and cutting off the funding for international terrorism is laudable, the means employed by the U.S. legislature raises doubts. Section 319(a) of the Patriot Act[154] violates established legal principles. Unlike under the IEEPA, there is no genuine link between the seized funds and the targeted foreign funds. In other words, there is no genuine link between the foreign funds and U.S. territory. The link is created by a fiction that property located abroad is deemed to be located in the United States, or, to be more precise, that an account relationship abroad is deemed to be an account relationship in the United States. With such kind of fiction, the United States could extend its jurisdiction to practically all foreign property or acts. Although fictions are a recognized legislative tool, it is doubtful whether they are appropriate in jurisdictional provisions. It is in the nature of personal jurisdiction and in rem jurisdiction that it is based on contacts; if these contacts are fictionally created, there would be no limit whatsoever to the assertion of jurisdiction.

[154] 18 U.S.C. §§ 981 *et seq.*, added by Section 319(a) of the Patriot Act.

The Patriot Act takes a unilateralist approach that inherently bears potential for political conflict and for injustice to foreign banks. First and foremost, however, the foreign banks maintaining a correspondent account in the United States may suffer the full consequences of this U.S. legislation. It is their money at risk when funds in their interbank accounts are seized unilaterally without adequate protection against the depositors' claims in their domestic jurisdiction. The foreign banks' possibilities to meet these new difficulties without directly challenging the underlying U.S. legislation seem largely impracticable.[155]

The misguided provision of § 319(a) of the Patriot Act alone is probably not going to weaken the United States' role in the international monetary system; however, danger could lie in cumulative effects of the provision and the constant use of freeze orders as a political tool. These measures, in the long run, may send out negative signals to the international business community, which, as stated above, holds fifty-five

[155] One way could be a contractual agreement between the foreign bank and the depositor waiving the bank's obligation to repay the deposit to the depositor in case the depositor is the cause for a seizure of funds in a U.S. correspondent account under the Patriot Act. At least from a German perspective this approach seems to be difficult to achieve as the inclusion of such waivers would render the general terms and conditions underlying the deposit contract so complicated that they are very unlikely to withstand review under the German provisions concerning general terms and conditions, *see* §§ 305 *et seq.* Bürgerliches Gesetzbuch (Civil Code), (2002) BGBl. I 42, 45, as amended. Another option could be the assignment to the bank of the depositor's procedural claim pursuant to Section 316(a) of the Patriot Act, in conjunction with 18 U.S.C. § 981(k)(3) and 18 U.S.C. § 983(d) (innocent owner defense). However, this would have to face similar concerns regarding the bank's general terms and conditions. In any event, it would seem that customers may rarely be willing to give up their rights against their bank. They might rather prefer to do business with a bank without an interbank correspondent account in the United States. If foreign bank A has no correspondent account with a U.S. bank, it must hold dollar deposits at a correspondent account with another foreign bank that, in turn, has a U.S. correspondent account. Judged by the wording of the statute, bank A is probably not covered by 18 U.S.C. §§ 981 *et seq.* However, whether the U.S. judiciary would take the same view is open to question.

to seventy percent of all dollars. The already weak U.S. currency may well suffer in the long run.

An internationally accepted approach to the fight against the financing of terrorism could be based on a distinction between countries that have comprehensive rules dealing with the financing of terrorism and those that do not. If a country has such rules, there is no need to apply the correspondent account provision of the Patriot Act. If a country does not have such rules, banks from such country should be prevented from maintaining U.S. correspondent accounts. There is precedent for such an approach. Only banks from countries that, in the view of the Board of Governors of the Federal Reserve System, have a system of "comprehensive supervision on a consolidated basis" may open branches in the United States.[156]

The extremely short time period between the terrorist attacks on September 11, 2001 and the enactment of the Patriot Act on October 26, 2001 indicates that the political pressure to react quickly and rigorously was greater than the pressure to present a deliberate legal response to the new international threat. Ultimately, the analysis of the U.S. approach to jurisdiction shows once again that today's international problems and issues cannot be solved on a unilateral basis.

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[156] 12 C.F.R. § 211.24(c)(1)(i)(A) (2004) (Regulation K). *See also* 12 C.F.R. § 225.92(e)(2)(i) & (ii) (2004) (Regulation Y) (election by foreign bank to become a financial holding company) and 12 C.F.R. § 225.13(a)(4) (2004) (Regulation Y) (acquisition of U.S. bank by foreign bank). *See* Michael Gruson, *Consolidated and Supplementary Supervision of Financial Groups in the European Union* (part II), (2004) DER KONZERN 249, 258 n.352 and accompanying text.

ENRONITIS: WHY GOOD CORPORATIONS GO BAD

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I. INTRODUCTION

We begin with a proposed definition of Enronitis:

> *Enronitis.* (n., neologism derived from Enron, a large company that went bankrupt amid allegations of market manipulation, phony accounting, looting, and other corporate misbehavior)
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> 1. A malfunction of corporate governance in which top managers become extraordinarily wealthy while misleading shareholders, creditors, employees and the general public about the company's prospects and practices, eventually resulting in share price collapse, loss of jobs, and, in extreme cases, the corporation's bankruptcy. Thought to have

> characterized a non-trivial portion of the American corporate economy in the "bubble economy" around the turn of the twenty-first century. Often accompanied by sudden collapse of the reputations of seemingly upstanding corporate citizens who turn out to have been routinely lying, not only to shareholders, but to their own board members, employees, tax authorities, etc.

The Enron problem is widely understood to be the result of too weak of a legal mandate supporting the share-centered paradigm of corporate law. Paradoxically, however, it is in fact the predictable result of too strong of a share-centered view of the public corporation; share-centered corporate law creates the very problems it is meant to police.[1] The single-valued profit maximization ethos of the share-centered corporation demands that managers teach themselves to exploit everyone around them. It is inevitable that some will learn this lesson so well that they will exploit even those for whose benefit they are supposed to be exploiting.

Corporate law demands that managers simultaneously be selfless servants and selfish masters. On the one hand, it directs managers to be faithful agents, setting aside their own interests entirely in order to act only on behalf of their principals, the shares. On the other hand, in the service of this extreme altruism, they must ruthlessly exploit everyone around them, projecting on to the shares an extreme selfishness that takes no account of any interests but the shares themselves. Having maximally exploited their fellow human corporate participants, managers are then expected to selflessly hand over their gains, ill and justly gotten, to the

[1] Much confusion in our law results from the unfortunate fact that we use the same term to refer to public corporations and closely held ones. In closely held corporations, a controlling shareholder (or small group of shareholders) has most of the rights of an "owner" in the normal sense of the word; in public corporations, shareholders have such rights only in potential, and the potential is only as real as the takeover market is free, uninhibited and vibrant. This Article discusses only public corporations; most of its analytic framework is inapplicable to firms with human owners.

faceless legal abstraction of the fictional shareholder. Altruism and rationally self-interested exploitation are extreme and radically opposed positions, psychologically and politically. The managerial role is deeply unstable and unlikely to hold.

For managers, one easy resolution of these tensions is a simple, cynical selfishness in which managers see themselves as entitled, and perhaps even required, to exploit shareholders as ruthlessly as they understand the law to require them to exploit everyone else. Another likely resolution conveniently switches between market and fiduciary norms to allow managers to view themselves—in good faith—as underpaid and exploited even as they increase their pay to previously unheard of levels. Enronitis, thus, is the result of the very share-centered paradigm current reform seeks to strengthen.

The damage caused by the share-centered paradigm goes beyond the share-manager conflict, however. On the simplest level, the share-centered paradigm encourages managers to see their job as requiring them to ignore all political, moral and human values but one: profit. This view urges managers to see the world in purely instrumental terms. However, this makes managers, who perform their roles as we tell them to, into one-sided, anti-social outsiders to civil society. Citizens do not treat fellow citizens as mere strangers and tools. Our corporate law, paradoxically, tells managers that to be good managers they must be bad citizens.

Internally, the share-centered paradigm is just as self-destructive. Corporations succeed because they are not markets and do not follow market norms of behavior. Rather, they operate under fiduciary norms as a matter of law and team norms as a matter of sociology. However, the share-centered paradigm of corporate law teaches managers to treat employees as outsiders and tools to corporate ends with no intrinsic value. Just as managers are unlikely to learn simultaneously to be selfish maximizers and selfless altruists, they are unlikely to be simultaneously cooperative team players and self-interested defectors. Thus, the share-

centered view undermines the prerequisite to operating the firm in the interests of shareholders. Share-centeredness can both accentuate the pathologies of teams—especially the tendency to disregard the interests of non-team members in an excess of we/them competitiveness—and undermine the mutual solidarity that is vital to maintain the team's advantages.

A story about Enron's CEO Jeffrey Skilling epitomizes the problem so well it seems too good to be true:

> As a [Harvard Business School] student, Jeffrey Skilling was asked what he would do if his company were producing a product that might cause harm—or even death—to the customers that used it. . . . Skilling replied, "I'd keep making and selling the product. My job as a businessman is to be a profit center and to maximize return to the shareholders. It's the government's job to step in if a product is dangerous.[2]

Skilling's statement foreshadows both the internal corporate law and external regulatory perversities of Enronitis. On the one hand, even as a student Skilling had fully internalized the share-centered view that role morality requires managers to ignore ordinary responsibility for their fellows in favor of pursuit of profit. On the other hand, the extraordinary distortions that view creates (even within its own narrow framework) are already apparent: how likely is it that murdering your customers could be profit maximizing?

What is needed is a new paradigm for understanding corporate law, one that emphasizes the collective, corporate nature of the public corporation without falling into the trap of assuming that easy professionalism can resolve difficult value choices. Corporations are governance structures as complex as any other and deserve to be analyzed as such. Reforms emanating from a new understanding of the public

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[2] PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON: EVERYONE'S GUIDE TO THE LARGEST BANKRUPTCY IN U.S. HISTORY 28 (2002).

corporation as polis are more likely to ameliorate the dangers of Enronitis and other corporate dysfunctions.

This Article proceeds as follows: Part II reviews a few of the recent scandals and some of the reforms proposed in response. Part III sets out the basic theoretical framework of the share-centered corporation and the fictional shareholder as applied to the problem of managerial incentives and loyalty: managers are directed to work for fictional shareholders who are, in turn, imagined to have no relationships with the rest of us. The law teaches managers to act as if they were fiduciaries for foreigners interested only in using us and our world, not as fellow citizens in a common enterprise. Instead of acting as the representatives of a major part of our collective governance system, they are told to treat us much as a not-too-benevolent colonial power might, as tools for a stranger's projects.

Part IV applies and expands this framework in the contexts of both internal corporate law and external regulatory law. First, corporate law creates an oasis of agency or fiduciary law using norms appropriate to co-adventurers, within a greater environment of disinterested arm's-length market relations. The fictional shareholder is an unsatisfactory partner or principal in the fiduciary oasis because it is incapable of the loyalty or mutuality such relationships demand. The usual attempt to rescue the special relationship with shares is a metaphor of ownership; because the fictional shareholders "own" the firm they are entitled to special consideration and rights as the end, rather than the means, of the corporate enterprise. This metaphor, however, is not powerful enough to do the work demanded of it in the share-centered corporation. Shares do not have enough of the usual attributes of ownership to plausibly appear (or demand treatment as) corporate ends. Moreover, even though shareholders are sometimes (and incorrectly) called "owners," they are simultaneously viewed as factors of production like all other means to corporate ends.

Second, managerial attempts to resolve the tensions of the share-centered view can lead to a series of corporate

malfunctions in addition to corporate betrayal of shareholders:

- corporate decisions to treat regulatory and criminal law as merely prudential, additional elements to be taken into calculation in making a profit-maximization decision;
- ever-increasing managerial pay; and
- distortions of the team spirit that drives corporations as sociological entities.

Part V briefly considers some of the proposed reforms intended to strengthen the share-centered framework. It concludes that, although they are likely to be helpful in preventing a repeat of the current scandals, any reform that leaves the basic incentive structure in place is likely to result in corporate managers finding new, creative, and unexpected routes to scandal.

Finally, Part VI outlines a new conceptual framework—corporation as polis—that would allow us to think of corporate managers as explicitly political participants in an explicitly political conflict over public values and private money. The dominant share-centered view seeks to pretend corporations are apolitical by claiming that values, safety, and citizenship are, as Skilling said, "the government's job."[3] Its historic opponent, benevolent managerialism, is equally obfuscatory, pretending that professional ethics will suffice to resolve genuine value conflicts. Corporation as polis, in contrast, seeks to frankly acknowledge the multiple value conflicts inherent in any corporate enterprise. By taking the corporation seriously as a locus of both value debate and interest group conflict over scarce resources, we will be better able to tie our most powerful economic engines to private wealth generation, social good, and the public interest.

[3] *Id.*

II. THE PROBLEM: CORPORATE FAILURE

We live in an age of corporate scandal. Publicly traded corporations are the core of our economy, essential building blocks of our society, and centers of our individual and collective lives. They provide nearly half of our non-governmental jobs[4] and probably account for an even larger portion of our GNP.[5] The largest operate on every continent;[6] a new form of empire on which "the sun never sets."[7] We work for them, buy from them, listen to them, depend on them and glorify them. Yet we seem unable to control them satisfactorily. Our major corporations violate law and civility on a routine basis.

Often we sharply distinguish two types of corporate scandal. On the one hand are scandals of corporate law

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[4] Of the 110 million Americans employed by private industry in 1999, just under half were employed by enterprises with 500 or more employees. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 483 No. 716 (2002), *available at* http://www.census.gov/prod/2003pubs/02statab/ business.pdf [hereinafter 2002 STATISTICAL ABSTRACT]. Although the abstract was silent on this point, it seems safe to assume that virtually all these large private employers are publicly traded corporations.

[5] Precisely what portion of the economy is comprised of publicly traded firms turns out to be surprisingly difficult to determine. That it is large is clear: total stock market capitalization on the New York Stock Exchange alone is roughly $15 trillion. Press Release, New York Stock Exchange, Barclays Global Investors and the New York Stock Exchange Introduce New Exchange Traded Funds Based on NYSE Indexes (April 2, 2004), *available at* http://www.nyse.com/press/1080904515942.html. However, it is hard to find numbers comparable to the total economy. In 2002, corporate business as a whole (including closely-held private corporations) accounted for $6.2 trillion, or about sixty percent of the $10.4 trillion GDP that year. *See* BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMMERCE, NAT'L INCOME AND PROD. ACCOUNTS tbls. 1.1.5 and 1.14, *available at* http://www.bea.doc.gov/bea/dn/nipaweb/SelectTable.asp.

[6] In 1999, non-bank multinational corporations alone accounted for roughly fifteen percent of our economy: 21.3 million U.S. jobs and gross U.S. product of $1.8 trillion. *Compare* 2002 STATISTICAL ABSTRACT, *supra* note 4, at 497 No. 749 (multinationals) *with id.* at 393 No. 602 (stating that total non-farm U.S. employment was about 132 million in 2001) *and id.* at 834 No. 1320 (U.S. GDP in 1999 was $9.2 trillion).

[7] JOHANN CHRISTOPH FRIEDRICH VON SCHILLER, DON CARLOS act 1, sc. 6.

proper, in which internal corporate law norms are violated. Generally, these involve managers who help themselves instead of the corporation, or help themselves at the expense of the corporation. In a familiar pattern, stock prices rise and then collapse based on information that later turns out to be false or distorted, managers get rich, the company goes bankrupt, employees lose their jobs and pensions, and customers and suppliers must struggle to pick up the pieces in disrupted markets. In the aftermath of the late 1990s stock market rise, one giant company after another (along with plenty of small ones) had stock price collapses, allegations of shady accounting or dishonest managers, questions raised about directors asleep at the wheel or managers paid enormous sums while profits disappeared.[8]

[8] According to a General Accounting Office ("GAO," now called the Government Accountability Office) study, 845 listed companies restated their financial results to correct previous material misrepresentations between January 1997 and June 2002. This is an extraordinary admission of wrongdoing by 9.95% of the total number of companies listed on the NYSE, Amex and NASDAQ. GENERAL ACCOUNTING OFFICE, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES, GAO 03-138, 15-18 (2002), *available at* http://www.gao.gov/news_items/d03138.pdf [hereinafter GENERAL ACCOUNTING OFFICE]. The GAO study period includes the dot-com boom as well as part of the clean-up period afterwards. Booms typically allow some companies to grow out of lies and make concealment of the remaining problems easier. Accordingly, it is safe to assume that the study understates the true extent of the problem. *See* John C. Coffee, *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002) (suggesting that restatements are an indication that earlier earnings management had gotten out of hand); *see also* GENERAL ACCOUNTING OFFICE, *supra*, at 43 (quoting Sept. 1998 speech by then-SEC Chair Arthur Levitt raising concerns about degeneration in quality of reported earnings).

Under the Securities and Exchange Act regimes, companies have affirmative obligations to disclose financial statements that are not materially misleading. For example, Section 11 of the Securities Act imposes liability for untrue statements of a material fact in a registration statement without any scienter requirement. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder make unlawful "any untrue statement of a material fact . . . in connection with the purchase or sale of any security." Form 10-K requires various officers to certify that annual

The second, often more important, type are the regulatory scandals, in which corporations take actions that harm those around them in violation of regulatory law or societal norms that ought to restrain predatory or negligent behavior. These include corporations that produce dangerous products either without adequate testing or in the face of known safety concerns, such as asbestos, tobacco, l-tryptophan, ephedra, the Ford Pinto exploding gas tank, or SUVs. They include abuse of the environment by routine pollution in large or small scale, from global warming to low mileage, and environmental disasters classified as accidents, such as Bhopal or Exxon Valdez. They include human rights violations, such as Enron's alleged complicity in police suppression of dissidence in connection with its Dabhol project,[9] or Unocal's alleged benefitting from slave labor on its Yadana gas pipeline in Burma.[10] Of most importance to this Article, the regulatory scandals include numerous instances where corporate managers felt constrained to do things they knew were wrong because of their belief that they were obligated to pursue profit at all costs.

Corporate law scandals, my central focus here, are generally understood to be failures of the corporate profit

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reports contain no untrue statements of material fact or material omissions. Each of these and other disclosure obligations has various additional requirements before liability can be established, so the restatements reported in the GAO report are not admissions of legal liability. But there can be no question that each one reflects a failure to fulfill the intent of the law and a company's fiduciary obligation to deal with its shareholders honestly.

[9] *See* HUMAN RIGHTS WATCH, THE ENRON CORPORATION: CORPORATE COMPLICITY IN HUMAN RIGHTS VIOLATIONS 1 (1999) *available at* http://www.hrw.org/reports/1999/enron/. The Enron Dabhol project is discussed *infra* note 37.

[10] John Doe I v. Unocal Corp., Nos. 00-56603, 00-57197, 00-56628, 00-57195, 2002 WL 31063976, at *1 (9th Cir. Sept. 18, 2002) (partially reversing the district court's dismissal of claims under the Alien Tort Claims Act arising from allegations that Unocal benefited from forced labor, murder, rape, and torture in constructing the Yadana gasline). *See also* HUMAN RIGHTS WATCH, WORLD REPORTS, *available at* http://www.hrw.org/worldreport99/special/corporations.html *and* http://www.hrw.org/wr2k1/special/corporations3.html (summarizing allegations).

norm, thought to occur when managers put their own gain ahead of the corporation's best interests. Regulatory scandals, in contrast, are generally understood as resulting from too strong a pursuit of profit, thought to occur when the corporation has put its profit ahead of law, morality, safety, the environment, or the social good.

The distinction between corporate law scandals and regulatory scandals is overdrawn. As we shall see, corporate law scandals stem from the same underlying weaknesses in corporate law and organization as regulatory scandals. Therefore, paradoxical though it may seem, corporate law reforms that seek to tame self-interested managers by increasing the power of the share-centered profit norm ultimately will exacerbate the problem rather than solve it. As managers teach themselves to treat the law, morality, and fellow citizens as mere costs of doing business, some will learn this lesson so well that they will exploit even those for whose benefit they are supposed to be exploiting.

A. Enron and Enronitis

Perhaps the best known of the turn of the century corporate law scandals is Enron.[11] In the 1990s, Enron was held up as a model of the new economy, deeply involved in the deregulatory agenda and symbolizing the efficiency of markets in enriching itself and those around it.[12] The

[11] *See, e.g.*, BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003); MIMI SWARTZ & SHERRON WATKINS, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (2003); ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON (2003).

[12] *See, e.g.*, MCLEAN & ELKIND, *supra* note 11; Malcolm Gladwell, *The Talent Myth: Are Smart People Overrated?*, NEW YORKER, July 22, 2002, at 28 (critiquing a McKinsey & Co. study concluding that Enron was a model of the new business built on the "war for talent" and an "open market for hiring"); RICHARD N. FORSTER & SARAH KAPLAN, CREATIVE DESTRUCTION 150 (2001) (celebrating the Enron system: "[w]e hire very smart people and we pay them more than they think they are worth"); GARY HAMEL, LEADING THE REVOLUTION (2000) (lauding Enron as a revolution in the way

nation's seventh-largest company by stock market capitalization, it was run by pillars of respectability, charitable and political leaders, and friends of the President.[13] Suddenly, seemingly overnight, it collapsed amid disclosures of off-balance sheet transactions that created hundreds of millions of dollars of reported income that apparently never existed in fact.[14] Its bankruptcy was the second largest in U.S. history,[15] taking with it 10,000 jobs and over $1 billion in its employees' retirement savings.[16] In the last year before the collapse, meanwhile, its two senior managers sold Enron stock worth over $150 million.[17]

Enron's economic innovations, praised one day in the business press, became headline examples of fraud and excess the next. Two years of investigations have led to a series of indictments, guilty pleas and multi-million dollar fines.[18] No doubt more will follow. As I write, the

businesses are run); James Surowiecki, *Drexel 2.0*, NEW YORKER, Dec. 17, 2001, at 39.

[13] *See, e.g.*, MCLEAN & ELKIND, *supra* note 11; Gladwell, *supra* note 12; FORSTER & KAPLAN, *supra* note 12; HAMEL, *supra* note 12.

[14] *See, e.g.*, Rebecca Smith & John R. Emshwiller, *24 Days: Behind Enron's Demise—How Confusing Earnings Figures and a Fortuitous Break Helped the Journal Uncover the Fraud*, WALL ST. J., Aug. 8, 2003, at C1.

[15] Jeffrey Toobin, *Annals of Law: End Run at Enron*, NEW YORKER, Oct. 27, 2003, at 48.

[16] *Id.*

[17] *Id.* CEO Kenneth Lay managed to lose most of this money in Enron's collapse. *See id.* This does not change the fact that he had succeeded in paying himself this much in the first place. Moreover, he was encouraging other Enron employees to hold on to their stock even as he was selling his own. *Id.*

[18] Inter alia, CEO Kenneth Lay, famous for his political connections, was targeted for investigation and possible indictment. His successor, Jeffrey Skilling, was indicted in February 2003. CFO Andrew Fastow and his wife pled guilty to criminal charges, accepting ten year and six month prison sentences and a $23 million forfeiture; three Merrill Lynch employees were indicted in connection with transactions that apparently allowed Enron to improve the appearance of its financial statements; Merrill Lynch settled criminal charges with an acknowledgment that its employees may have violated federal criminal law, former Enron treasurer Ben Glisan pleaded guilty to criminal charges for concealing Enron's losses in a "special purpose vehicle," and Citigroup and J.P. Morgan Chase

investigation has not reached all the top executives and prosecutors have said nothing public about the company's use of its political connections during its heyday or after.

If Exxon's Valdez,[19] Ford's Pinto,[20] the asbestos bankruptcies and the tobacco industry symbolize corporate

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accepted fines of roughly $120 million and $200 million in SEC civil proceedings for assisting Enron and another company in reporting borrowed funds as if they were earned income. *See* United States v. Fastow, Cr. No. H-02-0665 (S.D. Tex., filed Jan. 14, 2004), *available at* http://news.findlaw.com/hdocs/docs/enron/usafastow11404 plea.pdf (guilty plea agreement to one count of conspiracy to commit wire fraud and one count of conspiracy to commit wire and securities fraud, discussed in *Fastows Enter Guilty Pleas over Roles in Enron Financial Fraud,* 36 SEC. REG & L. REP. 123 (Jan. 19, 2004)); Toobin, *supra* note 15 (incorrectly stating that, in the end, no crime may have been committed in a company characterized by a "culture of dishonesty"); United States v. Bayly, Cr. No. H-02-0665 (S.D. Tex., filed Oct. 31, 2002), *available at* http://news.findlaw.com/hdocs/docs/enron/usbaylyetal91603ind.pdf (indictment and settlement agreement with Merrill, Sept. 16-17, 2003); United States v. Glisan, Cr. No. H-02-0665 (S.D. Tex., filed on Sept. 10, 2003), *available at* http://news.findlaw.com/hdocs/docs/enron/usglisan 91003plea.pdf (settlement agreement and statement); *In the Matter of* Citigroup, Inc., SEC Admin. Proceeding No. 3-11192, 2003 SEC LEXIS 1778 (July 28, 2003), *available at* http://news.findlaw.com/hdocs/docs/sec/secciti72803ord.html; SEC v. J.P. Morgan Chase, Cr. No. H-03-38-77 (S.D. Tex., filed July 28, 2003), *available at* http://news.findlaw.com/hdocs/docs/sec/secjpmorgan72803cmp.html. On-line legal database Findlaw lists over twenty-five different complaints, reports, indictments and plea agreements as of February 2004. Enron has filed a 275-page complaint against several investment banks, alleging that they actively participated in its officers' use of special purpose entities to defraud the company and its shareholders. Enron Corp. v. Citigroup Inc., Cr. No. B 01-16034 (S.D.N.Y., filed Sept. 24, 2003), *available at* http://news.findlaw.com/hdocs/docs/enron/eciti92403advprcd.pdf.

[19] The National Oceanic and Atmospheric Administration, which organized the Exxon Valdez clean-up effort and has monitored the damage for the last decade, has a website devoted to the spill at http://response.restoration.noaa.gov/spotlight/spotlight.html. A five-page bibliography of legal writings on the incident and its aftermath appears at http://www.evostc.state.ak.us/pdf/biblio_legal.pdf.

[20] Grimshaw v. Ford Motor Co., 174 Cal. Rptr. 348 (1981) (civil suit, reversing jury award of astronomical punitive damages); State of Indiana v. Ford Motor Co., No. 11-431 (March 10, 1980) (criminal case); Gary T.

abuse of customers and other outsiders, Enron stands for the same lack of concern for corporate shareholders and employees. Other corporate law scandals followed the Enron model closely. In Tyco, for example, the company showed its willingness to go to extraordinary lengths to avoid its civic responsibilities, even reincorporating in a foreign tax haven to avoid corporate income taxes.[21] Its collapse was precipitated by the discovery that its CEO had been evading state sales taxes as well.[22] This disclosure was followed rapidly by allegations that top managers had been using corporate assets for personal expenses and that reported profits were non-existent. CEO Dennis Kozlowski was charged with stealing $400 million from the company.[23] In Adelphia, the CEO and controlling shareholders are accused

Schwartz, *The Myth of the Ford Pinto Case*, 43 RUTGERS L. REV. 1013 (1991); Mark Dowie, *Pinto Madness*, MOTHER JONES, Sept./Oct. 1977, at 18 (the muckraking article that created the scandal).

[21] Rahm Emanuel, *The Democrats Can Win on Taxes*, WALL ST. J., Oct. 15, 2003, at A20 (reporting that Tyco avoided $400 million in U.S. taxes in three years by reincorporating in Bermuda).

[22] Mark Maremont & Jerry Markon, *Ex-Tyco Chief Evaded $1 Million in Taxes on Art, Indictment Says*, WALL ST. J., June 5, 2002, at A1.

[23] Kozlowski and his CFO Mark Swartz are being criminally prosecuted in New York's Supreme Court for looting the company; Tyco is suing Kozlowski civilly to attempt to reclaim some of the lootings; and the SEC has brought an enforcement action. The defendants have denied wrongdoing. People v. Kozlowski, No. 5259/02 (N.Y. Sup. Ct., filed Sept. 12, 2002), *available at* http://news.findlaw.com/hdocs/docs/tyco/nykozlowski91202ind.pdf; SEC v. Kozlowski, No. 02 Civ. 7312 (S.D.N.Y., filed Sept. 12 2002), *available at* http://news.findlaw.com/hdocs/docs/sec/uskowzlowski91202cmp.pdf. Videos, shown at the New York criminal trial, of his apartment with its famous company-paid $6000 shower curtain and a $2 million birthday party for his wife, have become internet smash hits. *See, e.g.*, Kevin McCoy, *Jury Sees Kozlowski's Posh Digs Via Video*, USA TODAY, Nov. 26, 2003, at 2B. Kozlowski, like the central figures of so many recent scandals, had been a hero of the business press. A 1999 cover story in *Barron's* called him "the next Jack Welch." Jonathan R. Laing, *Tyco's Titan: How Dennis Kozlowski Is Creating a Lean, Profitable Giant*, BARRON'S, Apr. 12, 1999, at 27, 32. For a lengthy profile of Kozlowski, see James B. Stewart, *Where Did Tyco's Money Go?*, NEW YORKER, Feb. 17, 2003, at 132.

of looting the company for personal interests.[24] Nine billion dollars of WorldCom's reported profits turned out to be non-existent; the result of simple accounting fraud and manipulation known to many members of its internal accounting department,[25] although its top executives' $100 million in gains was real enough.[26] HealthSouth allegedly cooked its books to the tune of $2.7 billion.[27]

In other instances, corporate executives appeared to be bringing to life the old joke about trading a million-dollar cat for a million-dollar dog. Major telecommunications firms and internet start-ups sold "capacity" and bought essentially identical capacity back or sold expensive advertisements,

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[24] *In re* Adelphia Communications Corp., No. 02-41729 (REG), 2004 WL 2186582, at *1 (S.D.N.Y. Sept. 27, 2004) (detailing history of investigation and lawsuit).

[25] *See* Dennis Bereford, et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc.*, Mar. 31, 2003, *available at* http://news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf (describing false entries amounting to $9 billion on WorldCom's books made, with little or no apparent attempt to achieve accuracy, and with the knowledge and at least passive acquiescence of numerous employees who cooperated because they feared for their jobs); Richard C. Breedan, *Restoring Trust: Report to the Hon. Jed Rakoff, U.S.D.Ct., S.D.N.Y., on Corporate Governance for the Future of MCI,* (Aug. 2003), *available at* http://news.findlaw.com/hdocs/docs/worldcom/corpgov82603rpt.pdf (describing what appeared to be the largest accounting fraud in history, characterizing it as a result of an absence of "checks and balances" on an "imperial" CEO and proposing a "blueprint for action").

[26] *See* Bereford et al., *supra* note 25; Breedan, *supra* note 25. Following the share-centered approach, Breedan describes $400 million the company extended to Ebbers as "loans" from shareholders, although he and his readers are surely aware of the difference between corporate and shareholder assets. *Id.* at 2. He similarly describes other abuses of the company as abuses of "shareholder interests." *Id.* In accordance with this understanding of the problem, Breedan details a massive set of proposed reforms, which he accurately summarizes as an "important shift in power from the board to the shareholders." *Id.*

[27] *See, e.g.*, Carrick Mollenkamp & Ann Davis, *HealthSouth Ex-CFO Helps Suit*, WALL ST. J., July 26, 2004, at C1 (describing CFO's statement of his role in $2.7 billion accounting fraud); SEC v. HealthSouth Corp., 261 F. Supp. 2d, 1298, 1303 n.5 (N.D. Ala. 2003) (listing pending actions).

accepting as "payment in kind" equally expensive advertisements on their customers' websites.[28] The companies reported the sale as income even though nothing of substance had happened, and, in the more egregious cases, even found ways to conceal the associated expense.[29]

The drama of these headline scandals should not hide from view the many other companies that overpaid their executives during the boom or re-stated earnings (or should have done so) after the bubble's collapse.[30] While some of these companies may have been within the letter of the law, they nevertheless acted dishonestly. For example, scores of publicly traded firms granted executives stock options without reporting any associated expense. Although apparently legal, this accounting treatment is clearly dishonest, since it allows the company to give away value without reporting any expense.[31] Similarly, many publicly

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[28] *See, e.g.*, Stewart Baker, *The Other Bubble*, WALL ST. J., July 17, 2003, at D8 (describing "capacity swaps" and similar gimmicks); *In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319 (S.D.N.Y. 2004) (describing Global Crossing's alleged use of "capacity swaps" to create the misleading appearance of sales); Dennis K. Berman & Deborah Soloman, *Qwest May Settle SEC Swaps Case*, WALL ST. J., May 19, 2003, at A3 (describing twenty public companies' use of "capacity swaps" to report large revenue gains that the SEC views as improper); Dennis K. Berman et al., *What's Wrong*, WALL ST. J., Dec. 23, 2002, at A1 (describing examples of widespread use of "bogus swaps" and "round trip trades of advertising" near end of bubble).

[29] *See, e.g.*, Berman et al., *supra* note 28 (describing how Global Crossing booked "sales" as revenue, but listed the other side of the swap as a "capital expense" which doesn't show up in operating revenue).

[30] *See, e.g.*, Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811 (2003) (describing excessive CEO compensation); Susan J. Stabile, *One for A, Two for B and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115 (2002) (describing excessive CEO compensation); GENERAL ACCOUNTING OFFICE, *supra* note 8, at 108 (indicating that ten percent of publicly traded companies restated their earnings between Jan. 1997 and June 2002).

[31] The practice facially violates the general requirement of GAAP that the company's books fairly present its financial condition and the Rule 10(b)(5) requirement that the company's financial disclosures not be false

traded companies routinely report higher profits to the public than to the IRS. This practice of keeping double books, once thought to be patently dishonest, necessarily means that corporations are being less candid or honest in one or the other set of their books and in particular in their public disclosures. Any investor would surely consider a company's equivocation to be material information and would want to know whether the company is lying to the IRS or taxpayers or to its shareholders.[32]

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or misleading. However, in 1999 a specific attempt to change GAAP to require disclosure of granted options as an expense was defeated after a highly publicized and politically charged debate. *See, e.g.*, Matthew A. Melone, *United States Accounting Standards—Rules or Principles? The Devil Is Not in the Details*, 58 U. MIAMI L. REV. 1161, 1216-21 (2004). Arguably, this debate over the specific rule leads to the inference that, common sense notwithstanding, it is not (legally) misleading to take the position that the grant of stock options is not an expense to the company—even though the recipient ends up with value and the company's other shareholders lose an equal amount. As I write, it seems possible that the 2000 battle will be revisited and reversed.

[32] *See, e.g.*, Alan Murray, *Inflated Profits in Corporate Books Is Half the Story*, WALL ST. J., July 2, 2002, at A4 (arguing that corporate tax returns should be public and that a single measure of corporate income should apply for both tax and securities disclosure purposes); David Cay Johnston, *Wall Street Firms Are Faulted in Report on Enron's Taxes*, N.Y. TIMES, Feb. 14, 2003, at C1 (reporting that Enron was able to simultaneously increase its publicly reported income and cut its taxable income by the use of complex tax shelters, and that "the use of tax shelters has become so widespread among the 10,000 largest corporations that their effective tax rate was just twenty percent in 1999, according to the IRS").

Note that the Internal Revenue Code already provides that large corporate shareholders may inspect corporate tax returns. I.R.C. § 6103(e)(1)(D)(iii) (2003) (providing that corporate tax returns are open to shareholders of record holding more than one percent of the corporation's outstanding stock). It is not clear why this provision is insufficient to make tax returns generally available to Wall Street analysts. One would expect that if companies regularly take a different position to the IRS than to the SEC, analysts would be interested in the former as well as the latter, and that large shareholders could make a side business of selling access to the returns. But perhaps analysts have not focused on the usefulness of tax returns or perhaps there is another aspect of the regulatory regime that I do not understand.

Anecdotal evidence testifies to the extent of the scandals. The companies involved have supplied enough "bad guys" to fill up at least two competing sets of playing cards imitating the military's Iraq deck.[33] Indeed, by September 2002, *Business Week* thought it newsworthy that they had found six examples of "The Good CEO."[34] Executive honesty was entering the ranks of "man bites dog."

Enron exemplified an era. At its peak, it was celebrated as a new and better way of doing business, making shareholders and employees money by the bushel while increasing the efficiency of our energy markets to everyone's benefit. Enron seemed to demonstrate the power of the market to overcome the inefficiencies of government regulation and internal corporate bureaucracy alike. In retrospect, its economic successes appear to have been mostly smoke and mirrors, with just enough reality to allow a handful of top managers to become seriously rich by lightening the pockets of consumers, shareholders, and employees alike. It is only slightly unfair, then, to name the general phenomenon after its one of its most flagrant practitioners.

Treating Enron as the symbolic center is also appropriate because Enron's misbehavior was not restricted to corporate law violations. If Enron's economic successes were mainly illusions, its successes in evading the regulatory power of government that was supposed to restrain its pursuit of profit unfortunately were all too real. Not only did Jeffrey Skilling leave "step[ping] in if a product is dangerous" to the

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It should also be noted that under some circumstances, differences in tax and GAAP accounting may require two sets of books. This of course does not make the *practice* any less deceptive, although it may suggest that the *practitioners* are not necessarily wrongdoers. There is no reason I am aware of that companies keeping two sets of books could not supply both sets side-by-side to their investors and the IRS.

[33] *See, e.g.*, http://shareholdersmostwanted.com ("The original greedy executive card deck"); http://www.thestackeddeck.com (playing cards featuring "America's least wanted" executives from thirty-four entities involved in scandals).

[34] Nanette Byrnes et al., *The Good CEO*, BUS. WK., Sept. 23, 2002, at 80.

government, his firm excelled at convincing (or misleading) the government not to object to danger, either.

Thus, Enron was involved in classic regulatory corporate scandals—most famously, manipulating the California energy market in ways that appear to have cost Californians huge sums and former California Governor Gray Davis his job.[35] The Senate Committee on Governmental Affairs blamed regulatory failure, but it clearly saw the problem to be attributable as well to the other side: "what Committee staff for the majority found was an agency that was no match for a determined Enron."[36] The report goes on to detail extensive, deliberate violation of clear rules and norms by Enron, including a possible $1 billion transfer from ratepayers to Enron just before its bankruptcy, market manipulation, illegal trades and so on. Other investigators implicated Enron in other scandals, including major human rights violations abroad.[37]

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[35] *See* Rebecca Smith, *Schwarzenegger May Return to Energy-Deregulation Model*, WALL ST. J., Oct. 10, 2002, at A5.

[36] Committee Staff Investigation of FERC's Oversight of Enron Corp., Nov. 12, 2002, *available at* http://news.findlaw.com/hdocs/docs/enron/111202fercmemo.pdf. "Regulatory failure" of this type is entirely predictable. Corporations that are bent on breaking the law have stronger incentives and greater resources to do so than their regulators have to catch them. The question is why we endow institutions with anti-social incentives and resources, not why we cannot catch them later.

[37] *See* HUMAN RIGHTS WATCH, *supra* note 9, at 109 (reporting that villagers' opposition to Enron's $3 billion gas-powered Dabhol electric power plant in the Indian state of Maharashtra was "met with serious, sometimes brutal human rights violations carried out on behalf of the state's and the company's interests"). Although most of the violence described in that report was by state actors, the report charges (1) that Enron "benefited directly from an official policy of suppressing dissent through misuse of the law, harassment of anti-Enron protest leaders and prominent environmental activists, and police practices ranging from arbitrary to brutal," *id.* at 106-07; (2) that Enron "pa[id] the state forces that committed human rights violations [and] it provided other material support to these forces" including use of its helicopters, etc., *id.* at 106; and (3) that Enron "failed to act on credible allegations that its own contractors were engaged in criminal activity" *id.*, including "engag[ing] in a pattern of harassment, intimidation, and attacks on individuals opposed to the

Finally, Enron was famous for its political connections, which it used, possibly legally but clearly in violation of basic republican principles of a self-governing democracy, to win favors for itself and its favored politicians and, of course, to reduce the likelihood of the government "step[ping] in."[38] The House Committee on Governance Reform minority staff reports that, "Enron Corporation was President George W. Bush's number-one career patron. Since 1993, Enron and its employees gave the President $736,800 in political and related contributions."[39] Even without White House cooperation, that report was able to document at least 40 direct contacts between Enron and White House officials in 2001, over $3 million spent on thirty-six outside registered lobbyists at fourteen lobbying firms and seventy-three contacts between the Army Secretary and Enron officials and other alleged close connections between the company and the upper reaches of the Bush Administration, including deep

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Dabhol Power project," *id.* at 3, with Enron's knowledge, *id.* at 110-11. The report also describes widespread allegations of corruption and financial impropriety in connection with the project, the largest electric power plant in the world, which was a centerpiece of a highly controversial energy privatization plan and a key issue in several hotly contested elections.

[38] MINORITY STAFF, HOUSE COMMITTEE ON GOVERNMENT REFORM 107th CONG., BUSH ADMINISTRATION CONTACTS WITH ENRON (May 2002), *available at* http://www.democrats.house.reform.gov/documents/20040817122823-67561.pdf. I have argued elsewhere that corporate interventions into our political debate, whether by (legal) lobbying, (constitutionally protected) direct communications to the electorate, or (illegal) contributions to candidates, should always be viewed as deeply problematic in a self-governing republic. Corporations, like government in classic liberal theory, can never be trusted fully to represent those for whom they purport to speak—all the more so since corporations are directed by both law and market to speak for the principle of profit maximization, not for any citizen. *See generally*, Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech Is Not Free,* 83 IOWA L. REV. 995 (1998), *available at* http://www.law.utah.edu/greenwood/pdf/Essential Speech.pdf [hereinafter *Essential Speech*].

[39] MINORITY STAFF, HOUSE COMM. ON GOV'T REFORM 107th CONG., BUSH ADMINISTRATION CONTACTS WITH ENRON (May 2002), *available at* http://www.democrats.house.reform.gov/documents/20040817122823-67561.pdf.

influence on the Vice-President's National Energy Policy Development Group.[40]

But the President was far from Enron's only protégé or patron. The last report the Enron Political Action Committee filed with the Federal Elections Commission is 967 pages long.[41] The FEC, of course, regulates only direct electoral intervention, not conventional lobbying, so this may be only the tip of the iceberg.

Enron, as Skilling's student-era quote foreshadows, was acting in the interests of profit, not the public. At least, one might so conclude from a different staff report created for Representative Henry Waxman (D-CA).[42] Some of the regulatory failure may yet turn out to be the crude result of pressure from Enron's friends in high places. More of the failure seems to have been the result of a climate of businesses-can-do-no-wrong that Enron, and other companies like it, helped to create and finance. As the Senate Committee staff reported, "Enron was very aggressive about using . . . the regulatory process to further its own strategic business goals and protect its own economic interests," and FERC and other regulators were unable to

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[40] *Id.* *See also In re* Cheney, 334 F.3d 1096 (D.C. Cir. 2003) (describing allegation that Enron CEO Kenneth Lay participated in non-public meetings of the NEPDG as if he were a member); Walker v. Cheney, 230 F. Supp. 2d 51 (D.D.C. 2002) (denying standing to comptroller general in case involving similar allegations).

[41] Enron Corp. Political Action Comm., Inc., July 21, 2001 Report of Receipts and Disbursements, *available at* http://news.findlaw.com/hdcos/docs/enron/epacrpt072701.pdf.

[42] MINORITY STAFF OF HOUSE COMM. ON GOV'T REFORM 107th CONG., REPORT ON HOW THE WHITE HOUSE ENERGY PLAN BENEFITED ENRON (Jan. 16, 2002), *available at* http://www.democrats.reform.house.gov/documents/20040830154930-11712.pdf; *see also* MINORITY STAFF OF HOUSE COMM. ON GOV'T REFORM 107th CONG., FACT SHEET: WHITE HOUSE ENERGY PLAN REFLECTS SEVEN OF EIGHT RECOMMENDATIONS IN ENRON MEMO (Jan 31, 2002), *available at* http://www.democrats.reform.house.gov/documents/20040830150832-54097.pdf (both detailing extensive and effective political lobbying by Enron).

redirect Enron's influence in socially useful directions.[43] Representative Waxman's staff prepared a thirteen-page listing of regulatory events that contributed to Enron's failure, nearly all of which are instances in which Enron successfully lobbied for a particular rule or result that later turned out not to be in the public interest (in the staff's assessment).[44] Although that report blames "lax regulation" for the problems, surely primary responsibility lies with the malefactor Enron rather than the government.

So we can add to the definition of Enronitis:

> 2. A malfunction of corporate governance in which corporations in the pursuit of profit, manipulate markets, deceive consumers, create unsafe or polluting conditions, lobby to change the regulations meant to keep them operating in socially productive ways, commit human rights violations abroad or otherwise act in anti-social, dangerous, or socially inefficient manners. Particularly referring to instances in which corporate actors justify the firm's anti-social behavior or anti-republican political interventions by appealing to the norm of profit maximization.

Corporate law, in its share-centered version, teaches that the sole responsibility of the corporate manager is to increase returns to shares. It is "the government's job to step in if a product is dangerous,"[45] but the firm, acting in the imagined interests of its fictional shareholders, views itself as justified in taking any possible action to deflect, distract or avoid the government. We have set the strong forces of the market at war with the weak ones of regulation.

Skilling's statement clearly epitomizes the share-centered view. Managers have one responsibility and one alone. On

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[43] COMMITTEE STAFF INVESTIGATION OF FERC'S OVERSIGHT OF ENRON CORP, *supra* note 36, at 7, 8.

[44] MINORITY STAFF, HOUSE COMM. ON GOV'T REFORM 107th CONG., FACT SHEET: HOW LAX REGULATION AND INADEQUATE OVERSIGHT CONTRIBUTED TO THE ENRON COLLAPSE (Feb. 7, 2002, revised June 4, 2002), *available at* http://www.democrats.reform.house.gov/documents/20040830150815-39986.pdf.

[45] FUSARO & MILLER, *supra* note 2, at 28.

this view, managers serve the market, and government makes the market serve the people. But markets are powerful and regulators generally are weak. If we tell our corporate managers that they should pursue profit by any means they can, they are likely to do it and get away with it.

B. Reform, Regulation and Repression

In the wake of the 2000 stock market collapse, numerous corporate reform proposals have been made. While it appears that little will change in state corporate law on the books, practice is already different. Corporations are adding "independent" directors; the British norm of separating the CEO from the Chairman of the Board is receiving additional attention;[46] and companies are scrambling to adopt new and presumably more accurate accounting standards. At the Federal level, the Sarbanes-Oxley Act dramatically changes disclosure responsibilities and imposes new obligations on managers.[47] The stock exchanges have enacted some mandatory changes and urged others.[48] The accounting

[46] *See, e.g.*, CORPORATE LIBRARY, EXCLUSIVE SPECIAL REPORT ON CEO/CHAIRMAN SPLITS IN THE S&P 500, *available at* http://www.thecorporatelibrary.com/Governance-Research/spotlight-topics/spotlight/boardsanddirectors/SplitChairs2004.html (Mar. 2004) (chart detailing the relationships of current officials to the companies they head).

[47] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (imposing many new requirements, including CEO certification as to the accuracy of disclosures. *See, e.g.*, §§ 302, 906, 404).

[48] *See, e.g.*, Final NYSE Corporate Governance Rules (approved Nov. 4, 2003) (to be codified at NYSE Listed Company Manual § 303A), *available at* http://www.nyse.com/pdfs/finalcorpgovrules.pdf (requiring that shareholders be given the opportunity to vote on all equity-compensation plans; requiring listed companies to have a majority of independent directors; tightening the definition of independent director to exclude recently retired employees, certain professionals and certain interlocking board memberships; requiring non-management directors to meet without managers present; requiring independent nominating/corporate governance, compensation, and audit committees; setting minimum audit committee standards; requiring internal audit functions; requiring and setting standards for corporate governance

profession's self-regulatory body, the FASB, with solid political backing decisively rejected expensing stock option grants in 1994 on the multiple (and contradictory) grounds that (1) they are too difficult to value, (2) they are already fully disclosed, (3) they are not really expenses, and (4) expensing them would hurt reported profits. Subsequently it has discovered that the undoubted difficulties of valuation are not a reason to ignore stock option grants after all.[49] Many other proposals to increase the power, responsibility or independence of "gatekeepers" such as accountants, stock analysts, lawyers and the SEC are on the table.[50] It is even possible that reforms of the tax code or IRS procedures will prevent future instances of the IRS discovering and failing to act on misleading SEC disclosures, or will align tax and securities income accounting.[51]

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guidelines; requiring a code of business ethics; requiring certain disclosures and CEO certification of compliance; and authorizing NYSE sanctions for violation).

[49] *See* Financial Accounting Series: Share Based Payment, Amendment of FASB Statements No. 123 and 95 (proposed Mar. 31, 2004) (comment deadline June 30, 2004), *available at* http://www.fasb.org/draft/ed_share-based_payment.pdf. *See also* Cassell Bryan-Low, *S&P Sheds Light On Accounting For Pension Costs*, WALL ST. J., Oct. 24, 2002, at C1. Expensing stock option grants would have reduced the reported earnings of the S&P 500 by almost twenty percent in 2001-2002. *Id.*

[50] See, e.g., GEN. ACCOUNTING OFFICE, *supra* note 8, at 63 (advocating strengthening independence of gatekeepers); Coffee, *supra* note 8 (discussing gatekeeper failures); Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185 (2003) (discussing failures of lawyers as gatekeepers and proposing reforms to increase independent counselor role).

[51] *See* Johnston, *supra* note 32 (reporting that Enron took advantage of the differences between tax and accounting rules to report tax losses and accounting profits, and that when "an unnamed IRS appeals officer concluded that Enron's reports to shareholders 'fooled' both investors and securities regulators about its financial condition . . . [t]he IRS settled the audit issues in tax court, without any disclosure of the suspicions about Enron's financial statements").

These reforms are important, widely debated and even possibly still under-analyzed.[52] This Article, however, approaches the reforms from a more abstract or theoretical perspective.

To date, the Enronitis problem has been diagnosed as a disease of managers who are insufficiently attentive to the interests of shareholders.[53] The medicine has flowed from the diagnosis: the proposed remedies are intended to tie managers more closely to the needs of the stock market.[54] If the Enron problem is the result of too weak a legal mandate supporting the share-centered paradigm of corporate law, the law should step in to support that paradigm. There is much truth to this diagnosis, and the reforms may mitigate the symptoms, particularly in the short run. The reforms may well make directors more independent so that they can ensure that managers work for the market, shares may be allowed to vote on managerial equity compensation so that compensation plans will be more closely tied to the will of the

[52] Although a recent Westlaw search on the Sarbanes-Oxley Act alone turned up 1990 hits in Westlaw's law journal database, first principles suggest that something must remain to be said.

[53] *See, e.g.*, J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317 (2004) ("The scandals arose in large part out of a failure of managerial oversight. Officers and directors did not adequately protect the interests of the corporation.").

[54] *See, e.g.*, Breedan, *supra* note 25, at 45-147 (making seventy-eight specific suggestions for corporate governance reform designed to empower shares of the former WorldCom, including embedding some in Articles that can only be changed with share consent; increasing shareholder access to the proxy contest system beyond SEC standards; increasing the frequency of director elections and allowing shareholders to nominate candidates directly with access to the company's proxy solicitation statement; increasing the independence of board members, board training and board ability to act independently of management; changing board compensation; creating a non-executive board chair; adding board term limits; limiting executive compensation over $15 million or by stock option grants without share approval; increasing financial transparency and, by increasing dividend payouts and limiting anti-takeover provisions, increasing company dependence on the financial markets; and strengthening internal legal compliance controls).

market and accounting may become more transparent and disclosure more accurate to help the financial markets control managers.

Paradoxically, however, and less widely recognized, Enronitis is also the predictable result of too strong a share-centered view of the corporation. The profit maximization ethos of the conventional share-centered corporation demands that managers teach themselves to exploit everyone around them. It is inevitable that some will learn this lesson so well that they will exploit even those for whose benefit they are supposed to be exploiting. The more we reform to ensure that managers serve only the profit-maximization ethos, the more we can expect to see managers who will hunt for new ways to evade the reforms. The share-centered view of the corporation makes the corporation into a machine, efficiently promoting one value at the expense of all others, even when the humans involved would long ago have decided that the interests of the nation, individuals, the environment, legality or simple human decency should prevail.[55] The power of strong market incentives assures that, all too often, the pressures we are creating to act badly will overcome the will (and enforcement powers) to act in society's interests.[56]

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[55] I have discussed the corporation's inability to act like a citizen at greater length elsewhere. *See generally* Daniel J.H. Greenwood, *Delaware and Democracy: The Puzzle of Corporate Law*, *at* http://www.law.utah.edu/greenwood/pdf/PuzzleofCorporateLaw.pdf (May 14, 2003); Daniel J.H. Greenwood, *Lawrence Mitchell's Corporate Responsibility*, 12 LAW. & POL. BOOK REV. 201-04 (2002), *available at* http://www.bsos.umd.edu/gvpt/lpbr/subpages/reviews/mitchellci.html (book review); Greenwood, *Essential Speech*, *supra* note 38; Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996), *available at* http://www.law.utah.edu/greenwood/pdf/FictionalShareholders.pdf [hereinafter *Fictional Shareholders*]. For a powerful and accessible representation of the problem, *see* THE CORPORATION (Big Picture Media Corp. 2003), website *at* http://www.thecorporation.com (a documentary film that argues that corporations should be understood as psychopaths).

[56] The power of market incentives to press actors towards socially destructive action is widely noted. *See, e.g.*, John C. Coffee, *Limited Options*, LEGAL AFF. 52 (Dec. 2003) (comparing perverse incentives that

III. THE SHARE-CENTERED PARADIGM: MUTUALLY ASSURED EXPLOITATION

A. Shares, Not Shareholders

According to the share-centered view of the corporation, the corporation has only one legitimate goal: maximization of share value.[57] Standard terminology states that corporate directors and managers have a fiduciary obligation to act in the interests of the shareholders. In fact, however, the only interests that are considered are those of the *role* of a theoretical shareholder, not of the people who own shares.

It is a dangerous fiction to pretend that human shareholders are necessarily better off if their shares increase in price, regardless of the impact of the company's share-value maximizing behavior on other aspects of their lives. The phrase "maximization of shareholder value" misleadingly suggests that share prices are the only values

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created the Savings and Loans scandal to perverse incentives behind Enron); GEN. ACCOUNTING OFFICE, *supra* note 8, at 57 (describing perverse incentives to distort financial statements or overemphasize short-term results, including stock market reliance on quarterly results and executive compensation schemes). The terminology of "perverse," however, suggests that such incentives are anomalous and unusual. The best modern evolutionary theory suggests that "perverse" incentives are pervasive. *See, e.g.*, JOSHUA M. EPSTEIN & ROBERT AXTELL, GROWING ARTIFICIAL SOCIETIES - SOCIAL SCIENCE FROM THE BOTTOM UP 136-37 (1996) (describing the Sugarscape studies as showing that market-like structures result in attractive results under special circumstances and unattractive ones under many other plausible ones).

[57] The most famous judicial statement of the share-centered view is Dodge v. Ford Motor Co., 170 N.W. 668, 683 (Mich. 1919) (opining that a business corporation may not be operated as a "semi-eleemosynary institution" serving the perceived public good of managers and majority shareholders even if it also generates extraordinary profits for shareholders). *See also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (holding that, once the corporation is up for sale, directors must act to maximize short-term share value regardless of other considerations, even in circumstances where shareholders clearly also have a large financial interest in bond values).

that human shareholders hold. But people have many interests, often conflicting, and few people will consider their interest in maximizing share value to be the most important of all their goals at all times.

The share-centered view of the corporation excludes all those other shareholder views. Corporations are directed to pursue their shareholders' interests only insofar as they are the interests of shareholders, not bond investors, employees, customers, consumers, neighbors, family members, citizens, carriers of particular cultures, or inhabitants of a limited earth with limited pollution absorption ability. Financial and non-financial interests shareholders might have outside their role in the firm are simply ignored.

Indeed, the share-centered view directs managers to limit their consideration still further. Shareholders investing according to modern portfolio theory are likely to be highly diversified and, as a result, their interests even as shareholders (of many companies) may diverge from the single goal of the share-centered corporation. If a firm increases its market share and profits at the expense of a competitor (with some benefits to consumers), a pure shareholder who owns shares of both firms will be worse off to the extent that consumers are better off. Only rarely do proponents of the share-centered view of the corporation suggest that corporate managers take into account this type of shareholder interest, perhaps because this shareholder interest in anti-competitive collusion is so obviously opposed to any social interest that might justify allowing publicly held corporations to limit themselves to considering share interests alone.[58]

The share-centered view, in short, models shareholders as if they were aliens, with no connection to the corporation, its participants, or their fellow citizens except as undiversified

[58] For further discussion of the implications of taking a share-centered view seriously while acknowledging the actual reality of institutional shareholders, see Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273 (1991); Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277 (1990).

stockholders. The shareholders of the share-centered corporation are not people but legal fictions, roles rather than realities. To emphasize the narrow view of shareholder interests taken by firms seeking to maximize share value, I will speak of share-centeredness, share value and share democracy rather than the more euphonious but seriously misleading term, "shareholder" interests.[59]

B. From Share-Centeredness to Enronitis

In the conventional view, the legitimate function of corporate directors and managers is to work for the shares.[60] All other goals and participants in the firm should be considered as mere tools towards this end. In particular, professional managers acting as the share value norm directs them to should consider all firm participants (other than the shares) as outsiders, with respect to whom one should decide to cooperate, defect or exploit according to a rational analysis of which practice will maximize share value.

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[59] The difference between shares and shareholders is the central theme of Greenwood, *Fictional Shareholders*, *supra* note 55; it is also the key reason why I argue in Greenwood, *Essential Speech*, *supra* note 38, that corporations, as representatives of a legal fiction, are not appropriate holders of the rights of citizens; and a key reason why I argue that market processes are only imperfect and partial correctives to democratic failures. *See* Daniel J.H. Greenwood, *Beyond the Counter-Majoritarian Difficulty: Judicial Decision-Making in a Polynomic World*, 53 RUTGERS L. REV. 781 (2001), *available at* http://www.law.utah.edu/greenwood/pdf/Rutgers.pdf [hereinafter *Beyond the Counter-Majoritarian Difficulty*].

[60] How to do this is of course difficult and often controversial. In particular, long term and short term views will often conflict. With the exception of firms in the limited "Revlon Mode" (when the company's sale or dissolution is inevitable, *see Revlon*, 506 A.2d 173), courts generally allow directors to choose freely between long and short-term share interests without fear of judicial second-guessing. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) ("a board may reasonably consider the basic shareholder interests at stake including . . . short term speculators [and] the long term investors"); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989) ("The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals.").

Even when the decision is to cooperate, however, the relationship is basically exploitative. The only reason a manager acting in good faith as a professional dedicated to share value maximization would give anything to any corporate participant (other than the shares) is because he or she believes that doing so will result in more profits for the firm's shares.[61]

The share-centered view of the corporation, thus, directs managers to take an amoral, instrumental view of the relationships in which they are enmeshed. Under this view, all relationships are for an ulterior purpose, and when they cease to serve that purpose they should be abandoned. Indeed, the share-centered profit maximization view suggests that a manager who treats corporate participants in any other way is acting wrongfully, violating role morality and perhaps even the law (although the business judgment rule may make enforcement rather difficult).[62] For example, it is improper—a violation of role morality—to view employees or suppliers as members of a team to whom long term commitments have been made. Managers are expected to treat all of the firm's relationships as arm's-length bargaining between competitors.

The short trek from the conventional share-centered view of the managerial role to Enronitis is over-determined. Several independent aspects link the two. The central theme that ties together the routes to Enronitis is the paradox of the managerial role in a share-centered corporation.

Corporate law demands that managers simultaneously be selfless servants and selfish masters. On the one hand, it directs managers to be faithful agents, setting aside their own interests entirely in order to act only on behalf of their principals, the shares. But on the other hand, in the service

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[61] For further discussion of the role obligations of professionals, see Greenwood, *Beyond the Counter-Majoritarian Difficulty*, *supra* note 59.

[62] The business judgment rule "posits a powerful presumption . . . of protect[ion of] corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). Thus many actions that may be in breach of the director's duties will not be actionable.

of this extreme altruism, they must ruthlessly exploit everyone around them, projecting onto the shares an extreme selfishness that takes no account of any interests but the shares themselves, narrowly understood. Having maximally exploited their fellow human corporate participants, managers are then expected to selflessly hand over their gains, ill and justly gotten, to the faceless legal abstraction of the fictional shareholder. Altruism and rationally self-interested exploitation are extreme and radically opposed positions, psychologically and politically. The managerial role is deeply unstable and unlikely to hold.

C. Selfish Shares

In acting altruistically towards the interests of their principals (the shares), the manager-agents are directed to ignore the actual human beings who own (often indirectly) the shares.[63] In reality, many publicly held shares are held by pension funds representing the very employees (and their predecessors) whom managers are directed to treat as arm's-length opponents in a competitive negotiating game. More generally, shareholders are the citizenry, or at least the richer half of it. Roughly half of the shares of publicly traded corporations are held by institutions[64] that, in turn, represent roughly the top half of the American income distribution.[65]

For most of these indirect shareholders, shareholdings are only a small portion of their wealth (most of which is their future earning capacity).[66] Thus, actions that are in their

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[63] *See supra*, Part II.B.

[64] *See, e.g.*, MICHAEL USEEM, INVESTOR CAPITALISM (1996); JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM (2000) (fiduciary institutions own about half of the publicly traded stock of U.S. corporations).

[65] *See, e.g.*, EDWARD WOLFF, TOP HEAVY 27 (2000); LAWRENCE MISHEL ET AL., THE STATE OF WORKING AMERICA 2000/2001 (2001).

[66] Most shareholders hold very small amounts of stock directly or indirectly. *See, e.g.*, WOLFF, *supra* note 65 (stating that in 1998, 48% of households owned stocks directly or indirectly, but the poorest 99% of households owned only about as much as the wealthiest 1%); MISHEL, *supra* note 65, at 260 tbl. 4.3 (indicating that median net worth, including

all assets and liabilities, for Americans was about $60,700 in 1998); *id.* at tbl. 4.4 (indicating that median financial wealth was less than $37,000); *id.* at tbl. 4.7 (while nearly half of Americans held equities in 1998, directly or indirectly, only 36.3% of households held more than $5000 worth).

The very rich own most stock, and for those few individuals, equities are a major part of their wealth. *See* WOLFF, *supra* note 65 (stating that in 1998, almost half of all stock by value was held by the richest 1%, those with net worth over $3.35 million. This number, however, does not include pension wealth, which is somewhat less skewed); Edward Wolff, *Recent Trends in Wealth Ownership, 1983-1998*, Jerome Levy Econ. Inst. of Bard Coll. Working Paper No. 300, tbl. 6 *available at* http://www.levy.org, (in 1998, the richest 1% held 49.4% of stocks and mutual funds, or 42.1% if retirement funds are included); MISHEL, *supra* note 65, at tbl. 4.9 (indicating that in 1998 households in the top 1.6% of incomes held roughly half of all publicly traded stock. Including indirectly held stock and pension plans, households in the top 8.5% held two-thirds of equities).

By lumping together the entire wealthiest 1% these numbers understate the true extent of inequality in stock holdings. Piketty & Saez's work on income indicates that, even within the upper classes, income is extremely skewed: about 42% of income is received by the top 10% of the household income distribution (fig. 1), but of the income received by that upper decile, about one-third goes to the top 1% (fig. 3 and fig. 15), about 40% of that is received by the top .1% (fig. 16) and about half of that is received by the top .01% (calculated from tbl. 1, fig. 4). Thomas Piketty & Emmanuel Saez, *Income Inequality in the US, 1913-1998,* Nat'l Bureau of Econ. Research Working Paper Series No. 8467, *available at* http://www.nber.org/papers/w8467. Even this may understate the true inequality of the income distribution, since Piketty & Saez's work is derived from income tax returns and the rich are more likely to have the sorts of income that are harder to define and capture in an income tax regime. Wealth is distributed far more unequally than income, and financial wealth is more concentrated than wealth generally. *See e.g.*, Edward Wolff et al., *Household Wealth, Public Consumption and Economic Well-Being in the United States*, Jerome Levy Econ. Inst. at Bard Coll. Working Paper No. 386, *available at* http://www.levy.org (demonstrating that measured inequality increases when imputed income from wealth is added to standard income measures); Arthur B. Kennickell, *A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001*, Fed. Reserve Bd. Fin. & Econ. Discussion Series 2003, *available at* http://www.federalreserve.gov/pubs/feds/2003/200324/200324abs.html (indicating that in 2001 the richest 400 households controlled approximately 2% of U.S. financial and non-financial wealth, and that the richest 1%—those with a net worth exceeding $5.8 million—controlled about one-third); MISHEL, *supra* note 65, at tbl. 4.1 (top 1% receive 16.6% of all income but hold 47.3% of financial assets). Thus, it is safe to assume

interests as a shareholder are likely often to be in conflict with other, more important, interests. If a firm increases share value by $1 per share by compromising its environmental standards or reducing employee benefits, a shareholder holding 100 shares would lose value if she cares more than $100 worth about the environmental damage or the benefits. Thus, maximization of share value may or may not maximize value to the human shareholders, depending on the relative importance of the individual shareholder's share value as opposed to his or her other relationships with the firm.

Even if maximization of share value were in a particular human shareholder's financial interests, real human beings have interests beyond their finances. Few real people are as disconnected from social relationships as the fiction that drives the share value maximization model. It is virtually inconceivable that the entire half of America that holds shares would agree on how to balance their desire for profits in the stock market, on the one hand, with their desires for the many political goods that may conflict with profit, on the other.

Although it may not be immediately obvious in market centered politics, eventually nearly every human value will conflict with profit, and nearly everyone will find some value that is more important than profit at some point. Thus:

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that the fractal character of inequality is even more extreme with respect to wealth, so that if half our financial wealth is held by the top 1%, the bulk of that is held by the top .1%, and so on. The great concentration of wealth in a small part of the population again suggests that most shareholders would find their shares to be a relatively small part of even their financial interests.

Moreover, even among the very rich, most income is from wages (suggesting, but not by any means demonstrating, that even for many of the extremely rich most wealth is in the form of job prospects). *See* Piketty & Saez, *supra*, at fig. 6 (indicating that in 1998, approximately 60% of the income of households in the top .1% of taxpayers was from salary. Note, however, that Piketty & Saez's figures may overstate the influence of salary income since they do not include capital gains in income and they appear to include stock grants as salary.

- Safety regulations (whether protecting the environment, consumers, employees or innocent bystanders) generally increase private costs to the hazard-creator, thereby reducing its profits, even as those regulations are reducing social costs. Fictional shareholders will always choose profits when they conflict with safety. No real person is that one-sided.
- Advertising increases demand for products, and therefore, usually, profits. But most human shareholders will be able to identify some product made by a publicly traded company that they wish the world had less of—violent movies, cigarettes, junk food, global warming gases, the music their kids listen to, direct mail, internet pornography and even shoddy plastic toys. Fictional shareholders will always attempt to increase demand even for unattractive products. This is not true for real citizens—even citizens inclined to leave the matter to the market.
- Particular companies may find foreign trade (or limits on it) profit enhancing. Their individual shareholders may find that position conflicts with other values they hold, even values as simple as whether the trading partners who are enriched (or impoverished) are countries or elites that should be our allies or enemies.
- Maximum profit often will require that a company pick up and abandon a particular locale (especially since, under the perverse American labor unionization rules, relocation is usually the easiest way to escape unionization and because American localism encourages localities to invite companies to jump ship as they compete in lowering effective enterprise taxation). Fictional shareholders interested only in the value of their shares will always applaud such moves in the name of profit. But human investors live in particular places, as do employees and other human beings associated with the corporation. Often, the human beings behind the fiction will share the needs of those particular people

in the forsaken places or will empathize with them. Real human investors often prefer more stability than profit maximization demands.

- Perhaps what is most significant for American politics as a whole is that maximum profit requires employees who are maximally flexible: the famous American flexible labor market. But that means that we must be willing to be at work rather than raising children or caring for parents; that we must be willing to move locations rather than build deeply rooted communities or multi-generational families; that we must be willing to put one or two careers ahead of marital depth. Largely, we Americans are willing to do those things (at least by comparison, for example, with the French). Even so, there is some limit to our flexibility. The share value maximization directive does not have such a limit.

Managers are required to ignore these human complexities, instead imagining their shareholders to be essentialized, fictionalized, one-dimensional investors with no commitments, values or relationships beyond the desire that their shares increase in value.[67] Thus, managers are directed to de-humanize even the one group they are not explicitly directed to treat as exploitable resources. Thinking of shareholders as if they were no more than shares—thin fictions interested in nothing but increasing the value of a particular stockholding at any cost despite other moral, political or even financial values—managers step out of relationship even with their alleged beneficiaries.

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[67] Indeed, managers are urged even to ignore the complexities of shareholders' investment role. A diversified shareholder is likely to have a different financial interest, even in the narrowest sense, than the undiversified fiction. A publicly traded company successfully seizing market share from another publicly traded company does nothing whatsoever for the finances of an index investor; what the stock of the one company gains, the stock of the other will lose. *See* Greenwood, *Fictional Shareholders*, *supra* note 55; Hu, *New Financial Products*, *supra* note 58; Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, *supra* note 58.

Surely everyone can find something that is profitable but nonetheless aesthetically, morally or politically unattractive. Maximum profit for given companies inevitably will require decisions that will conflict with particular values of individual investors. Shares as constructed by corporate law, in contrast, value nothing but increasing the present discounted value of their long-term cash flows (future dividends and final period payment).[68] These shares represent the selfish gene, the single-minded money maximizer of introductory economic theory, anti-social monomania, all taken to the logical extreme.[69] To shares and their fictional shareholders, the people, cultures, and ideas Americans value are just resources to be maximally exploited, never values in themselves. If these shares were people, Americans would ostracize them, lock them up, or even fight a Revolutionary War of Independence against them.

In the end, the fictional shareholder resembles nothing more than a classic imperialist oppressor. The fiction we have created treats us as if we were a colonized people—to be befriended, used, or discarded only according to the interests of the colonizing power. In this case, the colonizer is us and we are the colonized. Our needs and interests should count for more to us than mere means to the profit-maximization end. Managers serving in this imaginary role are serving no human being.

[68] For an accessible summary of modern corporate finance theory, see KLEIN & COFFEE, BUSINESS ORGANIZATIONS AND FINANCE (West Group Publishing 1996).

[69] *Compare* THE CORPORATION, *supra* note 55 (arguing that corporations act like psychopaths), *with* Greenwood, *Fictional Shareholders*, *supra* note 55.

IV. APPLICATIONS: PERVERSE RESULTS

A. Market v. Agency: Strangers in the Bazaar or Fellow Citizens of the Republic

To better understand how decent Americans working in fine institutions can end up treating their fellow citizens as colonized aliens to be maximally exploited, or as mere means to the end of profit, let us step back to examine some unexpected aspects of the well-known legal norms by which we live. American law, and, more generally, American culture, present at least two radically different norms for treating others. Corporate law attempts to mediate the irreconcilable conflicts between them.

1. Market

The market norm is deeply impersonal, individualistic and competitive. In the market, each person can expect to be able to buy or sell on the same terms as everyone else, without regard for personal relationships or individual characteristics. My money is as green is yours, and therefore all sumptuary laws, caste privileges, or guild restrictions are presumptively improper in a capitalist market. All that counts is the product that is offered for sale and the money that is offered to purchase it.

At the limit, a fully competitive market, such as our stock market, should be anonymous. Since personal characteristics, including even personal identity, are irrelevant and should not affect the bargains struck, there is no legitimate reason to know with whom you are doing business.

Of course, sometimes the product being sold is inseparable from the person selling it. For example, there is no way for me to sell my labor skills or expertise or team-building abilities anonymously. Yet even where anonymity is impossible, market norms seek to exclude personal relationships and personal characteristics to the extent possible, creating a notion of "merit" that is independent of

the personal characteristics of the market participant. For this reason, nepotism is illegal in the public sector and questionable if not disreputable in the private one. Discrimination that allows irrelevant personal or status characteristics to influence a market transaction is presumptively improper. The market should be not only color-blind but also blind to all irrelevant characteristics. In the market, only skills and cash count. The person carrying them should not.[70]

In short, the market is the world of Sir Henry Maine's contract, in which status and relationship have no place.[71] Similarly, it is the world of Burke's "sophisters, economists, and calculators" with no room for sentiment, tradition or "sensibility of principle, that chastity of honor which felt a stain like a wound, which inspired courage whilst it mitigated ferocity, which ennobled whatever it touched, and under which vice itself lost half its evil by losing all its grossness."[72]

Market norms are not only impersonal but also self-interested. In this sphere, it is acceptable and even commendable for persons with superior information to act on it to the detriment of their trading counterparts. If, for example, I recognize that a painting in the flea market is a Rembrandt, I am entitled to the coup of buying it for the price of a remnant. In the world of the market, people are imagined to be isolated monads, strangers interested only in getting ahead, with no interest in others except as instruments to their own good.[73]

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[70] I have elaborated this point elsewhere. *See, e.g.*, Greenwood, *Fictional Shareholders*, *supra* note 55. This concept is far from original; rather, it is the core of the liberal market attack on medieval caste status and its Jim Crow successors.

[71] SIR HENRY SUMNER MAINE, ANCIENT LAW: ITS CONNECTION WITH THE EARLY HISTORY OF SOCIETY AND ITS RELATION TO MODERN IDEAS (E.P. Dutton 1954) (1878) (elaborating the status vs. contract distinction).

[72] EDMUND BURKE, REFLECTIONS ON THE REVOLUTION IN FRANCE 86 (Th. Mahoney, ed. 1955) (1790).

[73] This section summarizes views I expounded at length in Greenwood, *Beyond the Counter-Majoritarian Difficulty*, *supra* note 59.

2. Agency

In contrast, the agency norm is relationship- (and status-) based, altruistic and cooperative. Even abstractly, an agent cannot be imagined to be an isolated individual making contact with other people only to trade anonymously. Nor can the law of agency be imagined to be limited only to policing theft and deceit.

Rather, an agent exists only in relationship to the principal, as someone who has agreed to act for, and under the direction of, her principal. As the Restatement defines it, "[a]gency is the fiduciary relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."[74]

Moreover, in contrast to the arm's-length market relation, agency is a fiduciary relationship.[75] Agents are expected to set aside their own interests and work "solely for the benefit of the principal in all matters connected with [their] agency."[76] While a market participant is expected to bargain hard and to profit maximize at the expense of his counterparty, by contrast, an agent "who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal."[77]

If the market often seems to rely on an image of Robinson Crusoe-like individuals selling their products in an anonymous market, agency relies on more homely, communal pictures.[78] Here the metaphor becomes one of friends sharing, parents and children sacrificing for one

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[74] Restatement (Second) Agency, § 1(1) (1958).

[75] *Id.* § 13.

[76] *Id.* § 387.

[77] *Id.* § 388.

[78] DANIEL DEFOE, ROBINSON CRUSOE (Oxford University Press, Inc. 1999) (1719).

another, patriots working for the common good, or the Three Musketeers declaring "one for all and all for one." [79]

Far from anonymous, this sphere is intensely particular and intensely conscious of the differences between otherwise similar people. Relationships are all that count. The agent *must* treat different people differently. It would be grossly inappropriate for a mother to treat her child in the same manner she would treat an outsider; so too for a friend who treated a friend like a stranger, or a citizen who refused to distinguish between compatriots and aliens. In relationships, nepotism is not scandalous but required. Similarly, an agent must always distinguish between the principal for whom she is a fiduciary and selflessly works, and strangers, with whom she, or her principal, remains at market arm's-length. The market is a world of strangers ruled by disinterested justice blind to persons. Agency, in contrast, is a relationship closer to friendship in which persons are all-important. Self-interested rational maximizers have no place here.

3. Corporate Law's Mediation

Corporate law constructs the corporation as an oasis of agency in the market. In the market, employees are arm's-length contractors each pursuing their own self-interested good. Within the employment market, as contracting opposites, they and their employers are competitors, entitled (within the rules of a fair battle) to fight for themselves as hard as they are capable. But in the firm, they are agents, required to set aside their own interests to work for their principal, the firm itself. As Cardozo put it in *Meinhard v. Salmon*, copartners:

> owe to one another . . . the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market

[79] ALEXANDRE DUMAS, THE THREE MUSKETEERS (Jacques Le Clercq trans., Modern Library ed., Random House, Inc. 1999) (1844).

> place. Not honesty alone but the punctilio of an honor the most sensitive. . . . Loyalty and comradeship are not so easily abjured.[80]

The agency rules and the market rules obviously conflict, and much of the interest of corporate law concerns the problems that result from the dual role of employees as simultaneously self-interested market capitalists and altruistic, selfless agents. We sign on as employees in the world of the self-interested, impersonal, arm's-length market, but once employed, switch to the altruistic fiduciary world of agency.

But the share value maximization principle disrupts the delicate balance (or churning conflict) of corporate law. It commands managers, in their role as selfless agents, to treat all their fellow agents according to the workaday norms of self-interested arm's-length conduct in a competitive market place while simultaneously demanding that both employees and managers act selflessly. As explicated below, this is an impossible task.

4. Creating Cooperation: The Pre-conditions to Agency

In the long run, people learn to cooperate only with those who cooperate back. Only fools or romantic lovers will continue to selflessly sacrifice for someone once they realize that the object of their sacrifice will uninhibitedly take advantage of their selflessness as if they were arm's-length competitors.[81] Few people, however, fall in love with their

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[80] 249 N.Y. 458, 463-66 (1928). Although Cardozo in *Meinhard* is explicating the duties that "co-adventurers" (even the language is reminiscent of Dumas!) owe to each other, the case is an accurate, if flamboyant, description of the general duty that an agent owes to his or her principal, which is the duty that an employee owes the employer.

[81] The possibility, but fragility, of cooperation is a central theme of both game theory and evolutionary biology. *See, e.g.*, ELLIOTT SOBER & DAVID SLOAN WILSON, UNTO OTHERS: THE EVOLUTION AND PSYCHOLOGY OF UNSELFISH BEHAVIOR 173 (2003) (arguing that "social norms function largely, though not entirely, to make human groups function as adaptive

employers. Therefore, to be successful, a firm must convince its employees to work for it (rather than for themselves) by convincing them that their sacrifices will generate responses in kind. Were they to figure out that the firm sees them purely instrumentally, employees treated by the firm at arm's-length would treat it in the same way, whatever the law may say about the obligations of agents. Thus, managers who openly treat firm members like arm's-length competitors destroy the plausibility of the agency role and violate their own duty to act in the best interest of the corporation.

Managers therefore live a lie. They must attempt to convince employees that the firm will respond to employee sacrifice with cooperation of its own, as if it saw them as partners in a common enterprise bound by mutual responsibilities of agency. While doing this, managers must always remember that their own fiduciary duty to the firm requires them to be prepared to sacrifice employee interests whenever a rational calculation indicates that defection will gain the firm more than cooperation. The image of mutuality they must project to employees always remains an illusion, because the share value maximization principle requires that employees, like all firm participants other than shares, be treated as mere means to the end of profit-maximization, as tools to be exploited rather than partners in a cooperative enterprise.

Managers constructing the firm as a tool to the end of share value maximization treat the people with whom they

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units" in the biological sense). Corporate law and economic theories of the firm, of course, have long assumed in a fairly unreflective manner that the black box of the firm is the relevant unit for selection in the market. Only those firms that successfully create an internal culture conducive to survival in the market will survive. *See, e.g.*, William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 418 (1989) (summarizing the mainstream view as "contract forms with the lowest costs survive"). The argument of this article can be understood, in part, as a claim that although an internal culture of cooperation is usually advantageous for the firm's survival in a market characterized by intense competition, corporate law drives the human actors in the firm away from the psychological underpinnings of altruism.

work as means, not ends. Because they see themselves as competitors with the people with whom they are working, they learn as part of their ordinary life to break ordinary social solidarity. Learning to exploit ruthlessly is surprisingly difficult. This we learned in the first wave of the 1980s leveraged buyout boom, when a generation of managers fought bitterly in opposition to the new dispensation of abandoning ordinary social norms in order to get extraordinarily rich.[82] But cynicism can be learned, and managers subjected to the powerful incentives of the share value maximization principle do eventually learn it. Successful managers learn to project solidarity while watching, always, for the chance to defect.

This training, however, surely creates cynics, not faithful agents. As a rule, one does not learn to be a saint by daily sinning.[83] A manager whose lived experience is a pretense of selflessness (with respect to employees, customers and business partners) covering real disinterested exploitation (on behalf of shares) is unlikely to suddenly see himself as "in a position in which thought of self was to be renounced, however hard the abnegation"[84] and voluntarily hand over these hard-won gains of competitive practice to his principal. If you can properly lie to your subordinates, why not lie to your superior as well? Learning to be a rational maximizer is simply incompatible with being a faithful, selfless agent.

In the end, the cynicism of the share value maximization view must eat itself alive. The principle commands managers to abandon the ordinary ties of human solidarity: to maximize profit, they must be prepared to sacrifice their co-workers, their suppliers, and even the cities or communities in which they operate. Successful managers

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[82] *See generally*, John C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV 1, 98 (1986) (arguing that the market for corporate control forced CEOs to abrogate an implicit contract with middle managers).

[83] *Cf.* ARISTOTLE, THE NICOMACHEAN ETHICS 1103a (J.E.C. Welldon, D.D. trans., MacMillian & Co. 1912) (350 B.C.E.) (stating that habit creates character).

[84] *Meinhard*, 249 N.Y. at 468.

learn to live in a world in which there is no loyalty and all relationships are purely instrumental, lasting only so long as they remain mutually beneficial. Only the share relationship is said to be different. But there is no good explanation for why loyalty to shares should be real when loyalty to all people is illusory. The rootless, commitment-less, value-less manager is unlikely to suddenly become loyal, rooted and spiritual just because shares are at stake.

The share value maximization principle teaches managers that they are acting properly only if they treat the people around them as mere tools, to be used or discarded as needed to fulfill the firm's share value maximization ends. But if it is permissible, even required, to treat all the human participants in a firm as tools, why are shares different? Why not exploit them as well? This key route from share value maximization to Enronitis, then, is straightforwardly psychological. The profit principle is incompatible with the selfless sacrifice for shares that it demands.

B. Corporate Finance and the Specialness of Shares

The psychological difficulty of maintaining an extreme lack of commitment in every aspect of professional life except with regard to shares, of treating every corporate participant but shares as a mere tool, and of competing at arm's-length with every corporate participant but shares, is compounded by the problem that managers are also taught that shares are identical to all other corporate participants from which they are supposed to be different. Modern corporate finance theory—part of every MBA curriculum—teaches that shares, like every other firm participant, are simply fungible inputs.[85] In particular, it implicitly contradicts naive

[85] *See, e.g.*, Armen A. Alehian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AMER. ECON REV. 777 (1972) (claiming that it is a "delusion" that firms have authority over its inputs; rather, all firm decisions are made by "ordinary market contracting"); William W. Bratton, Jr., *The New Economic Theory of the Firm*, 41 STAN. L. REV. 1471, 1480 ("In a firm of bilateral contracts between free market actors, both parties possess equal power to contract someplace else.").

theories of shares as "owners" of the firm that might, were they plausible, give managers some justification for treating shares differently from other factors of production.

1. Shares as Factors of Production

Start with the *Dodge v. Ford* view that shares are different. In ordinary usage, the share-centered view of the firm is conflated with the claim that the corporation should maximize profit. Accounting conventions derive from and reinforce this view by treating benefits to shares as profit while the benefits to all other corporate participants are treated as costs (with the anomalous exception of stock option grants to employees). As the accountants portray the firm, payments to shares (i.e., dividends)—unlike payment to any other factor of production—do not reduce profits. Moreover—in stark contrast to the legal reality—accounting conventions portray shares as having the sole claim on whatever is left over after other firm claimants are paid ("shareholders' equity").

Corporate finance teaches that this picture is false in a way that resonates with the experience of any big company manager.[86] From the publicly traded firm's perspective, capital is just another factor of production. Firms need to pay to obtain raw materials, they need to pay to obtain labor, and they need to pay to obtain capital. To buy (or rent) capital, they must pay either interest or dividends. On this view, dividends are an expense and sales of shares are simply a way of raising money, to a large extent fungible with other methods of raising capital (such as retained

[86] I leave aside the problem of the former owner who takes the company public while remaining manager. It is a well-known problem that such managers are particularly apt to see the outside shareholders as, at best, arm's-length suppliers to be exploited to the maximum possible degree. For managers who built the company and formerly owned it, the public shareholders are particularly likely to look like the purely fungible suppliers of a cheap commodity I describe in the text. *See, e.g.*, James Surowiecki, *Other People's Money*, NEW YORKER, Feb. 9, 2004, at 26 (describing Hollinger CEO Conrad Black's description of his shareholders' role: "to hand over their money and keep their mouths shut").

earnings or borrowing). Part of the job of the top managers of the firm is to obtain capital in the cheapest way possible, by shifting between retained earnings, bank borrowing, bonds and equity sales according to the relative pricing of those funding sources, in pursuit of the usual goal of maximizing the returns to the firm.

This view, which is common in corporate finance circles and is likely a daily part of most CFOs' decision-making process, conflicts at the most fundamental level with the share-centered view because it treats shares as a cost like all others. Just as all other inputs to the firm should be given as little as possible, so should shares. Indeed, for a manager who is accustomed to financing the firm in the cheapest way possible, offering gifts to shares may seem like a violation of the profit maximization principle itself.

From the perspective of corporate managers and the bankers who advise them, shares are essentially a way of raising capital, largely interchangeable with other ways of raising capital such as borrowing money or retaining earnings (i.e., paying the various factors of production of the firm less than the revenues from sale of their product). On this "nexus of contracts" view of the firm, shares are merely one role among many that make up the firm.[87]

To be sure, shareholders who purchase their shares in an IPO contribute cash and some risk bearing services, accepting returns that are closely tied to the success of the company.[88] But bond buyers also contribute cash to the firm, and the value and returns of junk bonds fluctuate in close connection with the fortunes of the company. Similarly, employees, especially if they have developed company based skills or commitments not easily marketable or transferable elsewhere, if they have significant retirement savings in the

[87] *See, e.g.*, Bratton, *supra* note 81, at 417 (stating that in the "nexus of contracts" theory of the firm, "hierarchy is irrelevant"); Lynn Stout, *Bad & Not So Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002) (clearly stating the argument that shareholders do not own public corporations).

[88] Of course, the actual shareholders at any given time are likely to have purchased their shares in the secondary market and thus they may not have contributed anything at all to the company.

company's stock, if they are compensated based on company-seniority, or if they are paid in part in options or stock, also find their fortunes closely tied to the company's and bear much of its risk. Indeed, whenever labor markets are not perfectly flexible, employees are likely to be the most closely tied to the company of all: unlike either shareholders or bondholders, they cannot diversify.

The largest source of investment capital in modern large firms is retained earnings, not share or bond issuance. If the firm is able to retain earnings, by definition it must be paying its various factors of production less than it is able to sell its product for. This suggests, however, that all the factors of production have contributed to the firm's retained surplus: not only have shares foregone dividends, but employees have foregone raises, creditors have foregone higher rates, citizen-taxpayers have foregone higher taxes, and customers have foregone lower prices.

On the corporate finance view of the firm as a nexus of contracts, there is no moral or economic reason to assume that one of these factors has a stronger claim on the surplus than the others. Neither the Marxist view that all value is contributed by the employees or the obverse claim, sometimes made in shareholder circles, that the shareholders are the sole source of profits, makes much sense. The corporate product is a joint effort of all the factors of production, each one of which is likely to be a but-for cause of the company's success.

Still, common sense suggests that shares usually will have the weakest economic claim to the corporate surplus on corporate finance or nexus of contracts views. Public shareholders, after all, are perfectly fungible providers of a perfectly fungible commodity (cash) in a quite competitive market. Of all the various contributors to the final corporate product, they are the most easily replaced. It is hard to see why an arm's-length contractor would ever pay them more than the market price.

If shares are just factors of production, the share value maximization norm implodes. That norm teaches managers to treat factors of production as tools to be exploited, or at

least given no more than necessary in arm's-length negotiation. Predictably, some managers will apply precisely the same logic to the shares themselves. What is sauce for the goose is sauce for the gander. If investors have agreed to buy shares that have no legal right to a dividend, why should they get one? To give them one would be a free gift, and the maximization principle teaches managers that they should not give gifts.

2. Managerial Agency in the Corporate Finance World

At this point, the situation gets even worse. If managers have learned to be maximizers, but reject the argument that they must sacrifice themselves for the shares, for whom will they maximize? The cynic's answer must be correct: share value maximization produces cynics, and cynics work only for themselves. All bonds of loyalty and mutual respect having been broken, nothing is left for managers but to maximize their own individual wealth before their retirement (or firing) date. This is the logic of corruption well known to students of failed governments: steal as much as possible before the next group of reformers (or aspiring corruptionists) push you out to do the same. For the cynic trained in share value maximization, even the only value permitted by that norm, the only loyalty left, will soon seem just a tool. The new rule will be to maximize share value only to the extent that it is useful for personal pocket lining.

Often, of course, increasing share value will be the best way for managers to line their own pockets. It is easier to take a big piece of pie when the pie is big and growing. Similarly, often the most cynical and instrumental of managers will find that it is instrumentally useful to create a quality product or have happy employees. However, there is no necessary connection. An illusion of a quality product will often do just as well as an actual one, particularly in the short term, and similarly, illusions of profits will often do

just as well for a while.[89] In the long run, of course, illusions tend to be exposed, but chances are excellent that top managers will be gone before the fictions are apparent even to their authors.

3. The Ownership Metaphor

If shares are not different because they make a contribution to the firm that is different in kind than other factors of production, perhaps they are entitled to be the special objects of managerial concern for another reason. The traditional claim is that the shares "own" the firm and therefore are entitled to have it be run for them. Unfortunately, the reason shares need the ownership metaphor to justify their claim to the corporate surplus is precisely because, unlike owners, they lack the power to take it on their own.

The ownership metaphor, meant to differentiate shares from other corporate roles, is deeply implausible. In a public firm, shareholders own their shares. But they have few of the legal rights of owners of the firm, do not act like firm owners and do not have the normal significance of owners in the firm as a sociological entity.[90]

An owner of a fee simple absolute in real estate or the holder of title to chattel has the rights (subject to general

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[89] *See, e.g.*, Kamin v. American Express, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), in which corporate managers successfully defended their decision to characterize a transaction in a way which made the company appear more profitable although it in fact made the company's expenses rise (by increasing its tax liability). While one might imagine that a court might simply hold that the decision to pay taxes voluntarily is commendable and patriotic, in fact the court rested its decision solely on the astonishing rationale offered by management: deceiving investors was good for them.

[90] In their seminal study, Berle & Means recognized that the public shareholders are not owners in any normal sense, but then created decades of confusion by referring to them as "owners" nonetheless. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1991). *See also* Stout, *supra* note 87 (arguing that shareholders are not owners).

legal regulation such as zoning or environmental laws) to decide to what use her property shall be put, has the right to refuse to use it in profit-maximizing ways or even to destroy it. Neither a home-owner nor a closely-held business owner has any duty to anyone to act in a way that an economist would recognize as economically rational.

In contrast, shares have none of these rights with respect to public corporations (so long as the company remains public). Our system of corporate law and securities markets has no mechanism by which a majority of shareholders could direct (or authorize) the directors to change the use of the corporation's property, place another value ahead of share value maximization or even pursue profit in a particular way.[91] Rather, shares have only the rights to a pro rata share of any distributions the corporate board chooses to make, the right to vote for that board, and the right to approve or reject certain changes in their rights proposed by the board.

Not only do shares lack the rights of individual owners, they lack even most collective rights. In practice, board members are nominated by incumbent management and usually elected without opposition. On the rare occasions where opposition appears, the rules are anything but democratic: management's candidates have full access to corporate resources while opponents are financially on their own.[92] Even if they elect a board, shares have no right to have the board act according to the wishes of the majority of the shares or shareholders. Rather, board members have a fiduciary obligation to act in the best interests of the shares as constructed by the courts without regard for the expressed desires of the shareholders, and that duty is enforceable by even a single share.[93]

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[91] *See* Greenwood, *Fictional Shareholders*, *supra* note 55.

[92] *See, e.g.*, Levin v. Metro Goldwyn Mayer, 264 F. Supp. 797 (S.D.N.Y. 1967) (upholding incumbent management's use of corporate funds to solicit proxies for its position in contested elections). Insurgents do have a right to access to (or use of) the shareholder list under Exchange Act Rule 14a-7 and state law provisions, such as N.Y.B.C.L. § 624.

[93] Any shareholder may bring a suit for breach of fiduciary duty. *See, e.g.*, DEL. CODE ANN. tit. 8 § 327 (2004).

Only if all shares act with one voice do shares have the rights of owners. Accordingly, the one serious ownership right that public shareholders have is the potential to sell their shares to a single buyer, that is, to take the company private. But since the development of the poison pill and its statutory equivalents, shares no longer have the right even to sell the company unilaterally. Prior board approval is required for sale of all the shares just as it always was for sale of the company.[94]

Far from being owners, then, in the usual course shares are just another input into the firm. As we saw above, they are largely fungible with other financing sources. It is thus hard to see why they should get something that others do not.

Owners in a capitalist society justify their rights by their function. As holders of the right to decide how property should be used, they are potentially entrepreneurial decision-makers. If there is anything that the shareholders of a public firm are not, it is that. Indeed, the closest equivalent to the entrepreneur in the public firm is the top managers themselves, who are the ones to decide what risks to take. It is a short ideological step, and an almost inevitable psychological one, for managers who act like owners to begin to view themselves as the owners in fact. Again, the strain on the share-centered agency view of the managerial role, in which managers are supposed to set aside their own interests in favor of the shares, seems impossible to sustain.

4. The Diversification Problem

Additional pressure on the share-centered view of managerial duty comes from another aspect of corporate finance. Shareholders in a modern publicly held firm typically are diversified portfolios, the interests of which are often contrary to the interests of individual firms in a competitive market. (Diversified portfolios do not benefit

[94] *See* Martin Lipton, *Pills, Polls and Professors*, 69 U. CHI. L. REV. 1037 (2002) (inventor of the poison pill describes and defends it).

when a portfolio company out-competes another portfolio company, particularly if the competition results, as it is supposed to, in collateral benefit to non-publicly traded consumers.)

Moreover, while shareholders do not own the corporation in any meaningful sense, they do have most of the usual panoply of ownership rights with respect to their shares. Shareholders, that is, actually own shares. It is shares that they buy and sell—often with considerations other than the interests of the company represented by the shares they are trading. Every shareholder who buys or sells based on a view that the market has temporarily misvalued a firm's securities is acting in a way that is not congruent with the interests of the company itself.

Shareholders do not consistently act as if they have the interests of the company at heart. Purely fungible providers of a purely fungible commodity, inputs like every other corporate participant, lacking the usual attributes of entrepreneurship or ownership including legal rights to use and control the assets, dehumanized and deracinated by the market and the legal demands of best interest analysis, the shares don't look like the company or behave as if they had its interests at heart. No wonder it is difficult for company managers to maintain the fiction that the shares are the company.

C. The Highly Paid Executive Problem

As is well known, top manager pay packages have soared in the last several decades, reaching astronomical levels previously enjoyed only by entrepreneurial owner/founders and their descendants.[95] By the logic of the share value

[95] *See, e.g.*, Piketty & Saez, *supra* note 66, at fig. 18 (showing that between 1970 and 1999, a period in which average U.S. salaries were virtually unchanged in real terms, the annual pay of the average CEO of the top 100 U.S. corporations increased from roughly $1.25 million to almost $40 million); *id.* at fig. 21 (showing that by 1998 the income share of the top .1% of American taxpaying households was almost as high as it was in the Roaring Twenties); *id.* at figs. 6-7 (showing that while in 1916

maximization model, this high pay suggests that CEOs are more important and more deserving of high pay than ever before. For when CEOs are seen as outsiders—factors of production and arm's-length market participants who are to be negotiated with according to the norms of the marketplace—there are only two possibilities: any time they do not deserve to be fired, they deserve a raise. The reasoning is slightly paradoxical but psychologically clear.

Under the share value maximization principle, managers are directed to view themselves as selfless agents acting only on behalf of the shares. In their mission to maximize share value, they should treat all employees, including themselves, as mere means to that overriding end; they, like all corporate participants, are valued not for themselves or as ends or values in themselves but merely as tools to increase share value. Perversely, the view of managers as obligated to exploit themselves can lead to an enormous over-valuation of managers.

A profit maximizing firm treating employees purely instrumentally will always seek to pay employees less than they contribute to the firm. Managers act as fiduciaries for the firm. At the same time, they are employees and tools to the end of firm profit maximization. Thus, in their fiduciary roles, managers are directed to treat themselves in their employee role as tools.

As fiduciaries, the only reason that can justify managers' decision to pay any employee (including themselves) anything at all is that the employee contributes more to the firm than the pay. So if manager-fiduciaries are doing their jobs, they are paying manager-employees less than they are contributing to the firm.

But this basic pay principle works in both directions. In a market relationship, any party to the bargain is entitled to attempt to obtain full value for their contribution. At equilibrium, indeed, the price of each firm input (including

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the top .1% received most of their income from capital, in 1998, they received 60% from wages: CEOs have overtaken the heirs of the robber barons as our economic elite).

managers) should equal its marginal contribution. So manager-employees are entitled to demand they be paid their full contribution to the firm.

Combining the two roles, it follows that either managers are not doing their jobs, or they are paid less than they contribute to the firm. Put differently, either they should be fired, or they deserve a raise. Either the CEO is contributing more to the firm than he (rarely she) is taking from it, in which case the firm is exploiting him and he is fulfilling his fiduciary obligation (in his role as an agent of the firm) but clearly is entitled to demand a raise (in his personal capacity as a free-market free agent). Or, he is not pulling his weight, he is exploiting the firm, and he is not merely presumptively incompetent and overpaid, but also dishonest—in breach of his duty as an agent and a professional. In short, he should be fired summarily. The logical conclusion is simple: if the CEO does not deserve to be fired, he deserves to be paid more.

Presumably, ordinary processes of cognitive dissonance will prevent most CEOs from concluding that they deserve to be fired; instead, they will conclude that they deserve an ever-increasing share of the corporate pie. The same processes of cognitive dissonance will lead boards to the same conclusion: if they are not making a major mistake or even breaching their own fiduciary duty, then they have chosen a CEO who is contributing more than his pay. Either he (and the board which failed by hiring and retaining him) should be removed, or he deserves the raise he is requesting.

The model here is similar to but more dramatic than the well-understood way in which the reform of having CEO salaries set by independent committees employing independent consultants led to rapid increases in CEO salaries: any board that hires a mediocre manager to run its company is surely derelict in its duty. By the logic of cognitive dissonance, it follows that a board must believe that the CEO it employs is not mediocre. Otherwise it would be obliged to fire him. But if he is not mediocre, it would be insulting to pay him a mediocre salary. Similarly, in times of transition, offering a mediocre salary to the newcomer

suggests that the board is seeking mediocrity, which would be a dereliction of duty. Accordingly, board members who wish to believe that they are acting in good faith appear to have only three choices: pay the CEO an above average salary, fire the CEO, or resign. When all boards seek to pay their CEOs above average salaries, inflation is a highly predictable result.[96]

Thus, the share value maximization model invites CEOs, acting in good faith on behalf of the firm, to see themselves as underpaid. Simultaneously, it invites directors to see themselves as required to pay above-average salaries to top managers. At the same time again, it tells CEOs, in their personal capacities, that their personal interests are, and should be, opposed to the firm's interests. They are, after all, mere factors of production that the firm should exploit. But that also means that, as contracting parties, they are entitled to exploit the firm if they can get away with it. In most firms, I imagine, the former processes are enough to make CEOs rich beyond imagination. In a few, apparently including WorldCom and Enron, the latter encourages outright theft.

D. Share Centeredness Opposed to Team Spirit

The share value maximization ethos treats all the people with whom managers have day-to-day relations as competitive opponents. On this view—given its clearest academic representation in the metaphor of the firm as a "moment in the market"—the firm is imagined to be composed of self-interested market participants whose only interest in other human beings is to use them to maximize

[96] *See, e.g.*, THE CONFERENCE BOARD, COMM'N ON PUBLIC TRUST & PRIVATE ENTERPRISE, PART I, EXECUTIVE COMPENSATION (Sept. 17, 2002) at 6, 10, *available at* http://www.conference-board.org/PDF_free/756.pdf (disapproving prior recommended practice of "benchmarking" CEO salaries due to ever rising compensation resulting from attempts to beat the average); Susan Stabile, *Viewing Executive Compensation Through a Partnership Lens*, 35 WAKE FOREST L. REV. 153, 173 (2000) (describing salary spiral resulting from independent salary consultants).

their own wealth. Perhaps it is an exaggeration to say that "in the groves of their academy, at the end of every vista, you see nothing but the gallows."[97] But certainly in these groves, there are no office romances. Not even friendships.

Contrary to this individualist ideology of mutual exploitation, firms in fact have many team-like and communitarian aspects, and, indeed, successful firms generally are quite unlike moments in the market. While this is not the place to argue the point, if the key to success were to be market-like, firms would be out-competed by real markets, which are always more market-like than the most market-like firm.[98]

Most Americans spend a good part of their waking day at work. Workplaces, therefore, are likely to be major sources of our social lives, relationship building and communities. Not all capitalist labor is alienated, notwithstanding Marx, the share value maximization principle and the best efforts of many human resources departments.[99] Many of us make

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[97] BURKE, *supra* note 72, at 113.

[98] *See* OSCAR WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM 132, 137-40 (1985) (describing failure of high-powered incentives inside firms). Enron seems to have taken the idea of firm as market to unheard of lengths, with predictably poor results. *See, e.g.*, BRYCE, *supra* note 11, at 129 (describing "rank and yank" systems' effect on transforming cooperation into competition); Toobin, *supra* note 15 (similar analysis).

[99] Marx makes a distinction between the market and the workplace that, like the arm's-length vs. agency distinction I make, emphasizes the differences between the two spheres. However, with his usual heavy handed irony, he describes the market sphere as "a very Eden of the innate rights of man. There alone rule Freedom, Equality, Property and Bentham" in order to emphasize that the rights of the market disappear in the working relationship, which he describes as unmitigated oppression, closely echoing Adam Smith's discussion of pin making. KARL MARX, CAPITAL 195-6 (Modern Library ed., 1992) (1887); ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (Modern Library ed.,1994) (1776) (describing how the division of labor that efficiently produces pins also diminishes the human capacity of the pin makers). Ultimately, both of Marx's characterizations are not illuminating with respect to the modern workplace and labor market. For my purposes, the workplace has aspects of attractive human community not seen in Marx or Smith, and the most important aspect of the market is not the "innate rights of man" but that, for good and ill, it is impersonal.

friends at work, see our fellow workers as team members engaged in a common enterprise, and identify with the common project as our own project. All this is natural, normal and usually for the best. Human beings are social animals who seem to seek out opportunities for community building.

Most often, team spirit and community are also helpful to the success of the firm. When people believe they are part of a team, they work harder, demand less in return and enjoy themselves more. Members of a team pull together for the common goal, setting aside individual egos and needs (at least outside of NBA basketball) in order to focus their cooperation in competing with the other side. Soldiers, perhaps the quintessential team members, risk their own lives to protect fellow team members (most personally, their squad members; more abstractly, their fellow countrymen). In risking their lives, they show the highest form of altruism within the team—no profit maximizer would ever be willing to give up life itself for someone else's benefit.

1. Team Competitiveness

At the same time, the internal altruism of the team is usually accompanied by intense competition with non-team members, generally seen as opponents in a zero-sum game. Soldiers and football players alike use their intra-group cooperation and altruism in order to attack the enemy, often dehumanized or devalued as those jerks on the other side of the stadium, or worse. Nationalists combine love of the nation with hatred, or at least intolerance, of non-nationals; patriots are willing to sacrifice for the good of the country, but understand that good to be in competition with the good of the neighbors. *We* pull together in order to pull ahead of *them*.

In the corporate world, team competitiveness is reflected in the war-like metaphors of salesmen and the takeover world—hostile takeovers, barbarians at the gate, white knights, scorched earth and poison pill defense—as well as the zero-sum games of market share competition and the

fundamental market rule of "exploit thy business partner" or take advantages when the opportunity offers.

2. Team Pathology

Team spirit is a good so powerful that team players with strong communities seem to live longer and healthier lives.[100] Yet it can easily become pathological: good citizenship easily moves from patriotism to nationalism to xenophobia or worse. Intra-group solidarity and mutual aid can often be accompanied by extreme disregard of larger norms or the claims and humanity of non-group members. In the corporate context, team pathology is common enough, manifesting itself in cheating and law violation. Corporate team members can become so concerned about winning for the team that they disregard external norms requiring solidarity with larger groups of people. Driven to win, corporate players begin to feel corporate solidarity justifies cheating customers, evading national taxes, regulatory schemes, or environmental laws. In short, teams play dirty.

Some observers have not discerned much team spirit at Enron itself. The "rank and yank" system of ranking all employees every six months and then firing the bottom fifteen percent led to a good deal of internal backstabbing and corruption.[101] Nevertheless, much of Enronitis, and corporate malfeasance at more typical firms, seems to relate to this pathology of competitive team spirit: outsiders don't count; rules are made to be broken; winning is all that matters. One may disregard the interests of Californians, for example, because the mission is to promote the interests of Enron.

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[100] *See, e.g.*, RICHARD WILKINSON, MIND THE GAP: HIERARCHIES, HEALTH AND HUMAN EVOLUTION 11-13 (2001) (reporting that social cohesion increases public health; increased inequality worsens health of lower status individuals while more equal societies have better health, largely because equality correlates with cohesion).

[101] *See* BRYCE, *supra* note 11, at 127-29.

3. In Praise of Teams

Human communities, the teams I referred to above, often couple extreme altruism and mutual concern within the group with a striking lack of concern or hostility to those outside the group. The two processes, altruism on the one hand and competitive hostility or arm's-length indifference on the other, seem tightly linked in our psychology. Many people have fond memories of war (or a peace movement) as a time when ordinary people came together in a common enterprise for the common good, escaping the alienating individuality of ordinary times, even though the common enterprise was little more than hostility to some other group.[102]

In the corporate context, forming the team is one of the key advantages of firms over markets. Markets price better, can incorporate more information than any plan, and have obvious and precise motivators. Firms generally blur and dull those mechanisms and incentives—for example, by unlinking pay from direct measures of productivity, quality, or demand for the individual's products.[103] Team spirit, with its solidarity and internal altruism as well as its fierce competitiveness towards outsiders, can be the tool that overcomes the inherent limitations of command and control market displacement, thereby allowing firms to out-compete spot markets.[104]

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[102] Wilkinson reports that civilian health improved in Britain during both World Wars, despite the economic shortages. WILKINSON, *supra* note 100, at 12.

[103] *See generally* WILLIAMSON, *supra* note 98; LAURENCE J. PETER & RAYMOND HULL, THE PETER PRINCIPLE (William Morrow & Co. 1969); HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) (each describing aspects of problematic internal incentive structures of firms).

[104] R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (arguing that firms appear where there are cost advantages over other alternatives); Margaret Blair & Lynn Stout, *A Team Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (discussing cost advantages of teams).

4. The Instability of Teams in the Share Value Maximization World

The importance of intra-group team spirit in corporate enterprise is no news: it is a commonplace element of managerial training. But the share value maximization principle puts a strange twist on team spirit. It teaches managers that the humans who work for the corporation are not its team but rather the opponents.

Managers who accept the commonplace idea that team spirit works and also accept that their job is to maximize share value are bound to live a double life. In order to maximize share value, they must convince their fellow employees that they are all in the game together, part of a common enterprise, and sacrificing for a common goal. But the game and the goal is to extract the most value out of the supposed team members and give it away to someone else, a fictional bystander not even present at the game. At the same time that managers are building team spirit, they are required to be looking around for opportunities to shaft their fellow team members.

The key advantage of team spirit for rational managers is that team players are not rational maximizers. Team members give towards the common goal without expecting precise compensation for every act. They are motivated not by self-interest but by community feeling—positive towards fellow community members and negative towards outsiders. But this very altruism opens them to exploitation by a supposed team member who is really an opponent. When someone is giving their all, they are particularly open to being taken all the way.

Managers, then, are caught in a double game. The share value maximization principle tells them that their real team is the shares. They are meant to compete with everyone else in order to win one for the shares. To serve their true masters, they must convince their fellow employees, customers and suppliers that they are all on the same team; that is, that they are engaged in a common enterprise for a common goal. Or, in other words, they must show that they, as managers, are not serving their true masters. Then, they

must betray the team. Surely only the most extreme of cynics can succeed in this role.

But a manager who has learned to betray those he or she works with every day, pretending to be their teammate while constantly seeking opportunities to exploit their communal good feeling, is a manager who has learned to be dishonest, a dissembler, a traitor to his small community, and a breaker of trust. Why, having betrayed his trust to the team that he works with every day, should he remain loyal to a fictional shareholder that doesn't even exist except as a legal abstraction or an investment portfolio?

The share value maximization scheme teaches managers to betray the people with whom they have relationships in order to serve their ultimate master. It should be no surprise that some learn this lesson well enough to betray the master as well. Double agents, in the end, work only for themselves.

In short, share value maximization teaches that the real team is the shares and their servants are the managers; but enterprise success depends on creating a team composed of employees and often customers and suppliers as well. The two team notions are incompatible. The latter requires mutual concern and trust. The former constructs members of the firm as opponents, to be treated somewhere between arm's-length according to the norms of the market, in which mutual concern is absent, and active competitive hostility, in a zero-sum game in which every gain for one side is a loss for the other. The one requires trust; the other bars it.

Enronitis is a predictable pathological result. The team breaks down into a one-on-one competition of every man to himself and the devil take the hindmost.[105] All that remains of the team spirit is the disregard of rules, the desire to win

[105] Some commentators have argued that large gaps between CEO and ordinary employee salaries harm corporate spirit and therefore productivity. *See, e.g.*, Jay Lorsch, *CEO Pay*, 70 HARV. BUS. REV. 132 (1992) (large pay gaps highlight intra-group competition and weaken claims that all employees are on the same team).

at all costs, and the depersonalization of opponents, now understood as everyone.

V. POLICING SHARE-CENTEREDNESS: THE REFORMS

Many of the proposed post-Enron reforms are steps in the right direction, although taken as a whole they seem unlikely to solve the problem. A few, however, may well accentuate the pathology, much as the independent compensation committee and tax-law insistence that salaries over $1 million be performance-based worsened the problem of overpaid executives.[106]

A. Disclosure

First, improved disclosure is a good thing, if not necessarily for the reasons usually given.

The prices of publicly traded stocks are related to the profits of the underlying corporation, but as anyone who followed the market on its way up and down in the last few years is aware, the connection can be very loose. Stock markets often price shares based on expected earnings (or on expected price gains resulting from expectations of expected earnings), placing greater weight on trends and patterns than on the current absolute numbers and increasing or decreasing stock prices disproportionately for changes in trends.[107] This provides cynical managers a great incentive to massage the numbers or even lie. A few well-timed

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[106] I.R.C. § 162(m) (2004). *See also* Stabile, *supra* note 30 (discussing excessive compensation); Ryan Miske, *Note: Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1680 (2004) (describing failed history of tax-code provisions as intended maximums became de facto minimums and tax-favored "performance based" pay became authorization for enormous stock-option grants); Susan Stabile, *Is There a Role for the Law in Policing Executive Compensation*, 72 ST. JOHN'S L. REV. 81 (1998) (policy analysis of relevant tax code provisions).

[107] *See generally*, ROBERT SHILLER, IRRATIONAL EXUBERANCE (2000) (describing excess volatility of stock markets, including trend chasing behavior).

disclosures can cause a terrific price increase (or avoid a decrease) and allow top managers, who are nearly always near the end of their employment, to cash out before the truth emerges.[108]

Moreover, even managers who have not succumbed to ultimate cynicism may convince themselves that they are doing their jobs by managing reported earnings. The share value maximization ideology perversely suggests that corporations ought to manage their disclosures in the way that maximizes market valuation of their securities, rather than in the way that most accurately reflects their underlying condition. If the goal is to increase the value of shares, and any means will do, why not deceive shareholders for their own good? (Of course, deception cannot be to the good of actual shareholders as a group, but it can effectively increase share price for some period of time, and the latter may be the more salient effect even to managers still trying to act as good-faith agents.[109])

Much market behavior seems to be the result of this perverse incentive. Because the market is quite sensitive to changes in disclosure, companies find that they can affect stock price as much by manipulating disclosure as by the more difficult task of out-competing their competition. If reported earnings can be increased or reported debt decreased by changes in financing or reporting or strategic acquisitions, the share value maximization ideology suggests that managers ought to do so, even if there is no real economic justification for the action.

The basic problem is managing the company according to the whims and prejudices of the stock market; reforming accounting rules or forcing CEOs to swear that they have not lied will not change that. However, accounting anomalies make a bad problem worse. If companies can create reported earnings by "round trip" trades, they will waste social resources and distort their reported earnings by making

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[108] *See, e.g., supra* notes 17, 18, 23 and 26.

[109] *See* Kamin v. American Express, 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976).

those trades. If executive stock options have no effect on the company's reported financials, they will be used more. If accounting for merger rules allow the combined company to have higher reported earnings than did the parts of which it was made, companies will combine even when no efficiencies result.

The reforms, of course, will create new and sometimes odd market incentives. If stock options are reported as an expense at the time of issuance based on their Black-Scholes value, and companies then correct the accounting when they are actually cashed in, the effect may be to smooth earnings oddly. When stock prices are down, options will expire unused, and the company will be able to report "earnings" resulting from reversing the too-high estimate of the cost of the options. Marking to market periodically would lessen the jumps in earnings but not change the effect of generating "earnings" for no reason other than stock price drops.

Overall, surely honesty is better than deception. The fierce resistance to disclosing options suggests that executives, at least, believe that the market responds to the reported bottom line numbers rather than the underlying reality or even the total information publicly available (which these disclosure reforms will not change), and it seems most likely that they are right.[110]

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[110] *See, e.g.*, Melone, *supra* note 31 (describing FASB attempts to mandate disclosure of stock based compensation as an expense and the accompanying political opposition). The current FASB rule, Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation (Oct. 1995), *available at* http://www.fasb.org/pdf/fas123.pdf, requires disclosure (in a footnote) of the Black-Scholes value of option granted, but does not require expensing. Thus, analysts have available all of the information necessary to recalculate profits with options expensed. Nonetheless, both sides appear to believe—contrary to the strictures of an efficient market—that expensing (or not) matters. Kevin Murphy, in contrast, has argued that both compensation committees and executives constantly value options at considerably less than their market value as predicted by the Black-Scholes formula. *See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 857-68 (2002). If Murphy is correct, the gap between private and public value would be another reason for executives to resist disclosure.

Moreover, the end-stages of Enronitis involve deliberate deception and outright fabrication. Reforms that seek to increase the independence of auditors, demand stronger audit committees, require rotation of audit partners, separate auditors from consultants, and the like, seem quite likely to catch more fraud and perhaps even limit some of the semi-bad faith game-playing. Increasing nominal criminal penalties seems less likely to have any effect. These reforms do not, however, change the underlying incentives to cheat, so we should expect that as we close up some obvious routes, clever cynics will find others.

More disclosure than is currently on the table might help even more. For example, apparently some public companies report one set of earnings to the SEC for public disclosure, showing high profits, and another different set of books to the Internal Revenue Service, showing low profits, for tax reasons, which the IRS does not make fully public.[111] Under this system, managers serving the share value maximization norm predictably will stretch accounting conventions as far as possible in both fora, with only the good faith of managers and the limited resources of the governmental agencies standing in the way of powerful incentives to outright fraud. Private market incentives to exaggerate are limited only by governmental enforcement.

Reversing the rule would reverse the incentives and produce better results. If the IRS revealed the numbers submitted to it, or if the SEC ruled that double bookkeeping is prima facie evidence of a fraud on the marketplace, companies might have some reason to seek a single set of numbers that accurately represented the economic functioning of the firm. Even if that is too optimistic, at a minimum managers would seek to present a single set of profit numbers defensible in both fora. Instead of pushing to the limits of the law, companies might seek to live by the spirit of at least one of the two systems.

Finally, disclosure is important well beyond the narrow conceptions of securities law. Markets often prevent profit-

[111] *See* Johnston, *supra* note 32.

maximizing companies from acting in socially valuable ways even when consumers would be willing to pay private fees for public goods.[112] Thus, companies might well be able to charge higher prices for products with lower associated pollution or fewer social externalities. Not all consumers free ride all the time. But consumers are unlikely to decide voluntarily to contribute towards maintaining the commons if they cannot even tell if the higher price is associated with greater social responsibility. Companies required to disclose the pollution associated with a product on its label, or to explain the testing they have done or not done, or to detail the externalities associated with their processes, or to state the wages they pay in their factories abroad, might well find that the consumer markets would reward efforts to behave in more socially acceptable ways, especially if a securities-like private right of action gave companies and consumers some assurance that false disclosures stand a good chance of being quickly and punitively disclosed.

In short, corporate disclosure and transparency is important well beyond the stock market. Corporations are part of our collective governance structure. As citizens, we must know what they are up to if we are to intelligently evaluate how to control them—both externally through regulation and internally through corporate law and market processes. The stock market, consumer markets, and the general political process depend on full disclosure.[113]

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[112] *See* Coffee, *supra* note 56.

[113] For this reason, as well as the reasons discussed in Greenwood, *Essential Speech*, *supra* note 38, current doctrine regarding corporate constitutional rights is backwards. Corporations should no more be constitutionally protected from public view than should other governmental agencies. Rather than possessing a Fourth Amendment constitutional right against unreasonable searches and seizures that can be used to foil governmental regulation, corporations should be subject to a sunshine principle along the lines of the Freedom of Information Act. *Compare*, *e.g.*, Gulf, Colo. & S.F. Ry. v. Ellis, 165 U.S. 150, 154 (1897) (granting corporation 4th Amendment rights against searches and seizures on the (clearly incorrect) ground that this is equivalent to protecting the rights of citizens whose interest the corporation purports to serve) *with* Wheeling Steel Corp. v. Glander, 337 U.S. 562, 576-81, 579 (1949) (Douglas, J., dissenting) *and* Connecticut Gen. Life Ins. Co. v.

B. Independent Directors

There has been a good deal of discussion of continuing and accentuating the reforms of the last decade, primarily by increasing the number of independent directors (marginally tightening the definition of independence to exclude some former employees, contractual beneficiaries of the company or relatives who might be considered independent today) and by increasing the number of consultants used by audit, hiring and compensation committees.[114]

The model outlined in this essay suggests that these reforms are unlikely to work as expected. If independent directors and their consultants view themselves as working for the shares or fictional shareholders, they will simply increase the perversities of the share value maximization model. By demanding that managers conform to the model, they will accentuate its incoherence. Managers will be driven to exploit their corporate team members even more, thus leading former team members to see themselves instead as free agents. Top managers attempting selfless selfishness will sink into self-interested cynicism. Corporations attempting to maximize share value will still find that often the easiest way to do that is to show Wall Street what it wants to see, regardless of whether it is what otherwise would make business sense. Top managers will, after a brief slowdown during the current scandals, continue to increase their share of the take, as the ineluctable logic of Lake Wobegon drives consultants and independent directors to conclude that they must pay above-average employees above-average salaries, and the agency principle requires that they convince themselves that their overpaid executives are contributing ever more to the firm as they take more from it.

The reality is that most independent directors are not particularly independent, and that seems unlikely to change.

Johnson, 303 U.S. 77, 83-90 (1938) (Black, J., dissenting) (both rejecting view that corporations should be entitled to constitutional protection against the citizenry or government).

[114] *See supra* text accompanying note 48.

For good reason, consultants and incumbent managers alike are likely to look for other CEOs.[115] No one else, after all, is likely to have the expertise to police managers. But CEOs sitting on each other's boards are unlikely to criticize their peers too stringently. In any event, even if they had the inclination, directors rarely have the time or information necessary for serious review of company managers (and this problem is likely to be even worse for directors who are not themselves senior managers elsewhere). Thus, directors, nominally independent or not, are not likely to stand in the way of any but the most egregious managerial abuses.

The point of this essay is that truly independent directors, if they are or view themselves as answerable to the portfolios or fictional shares, will just make the problems worse. Enronitis ends in betrayal of the shares, but it begins in share-centeredness itself. Increasing share-centeredness will not cure this disease.

VI. RECONCEPTUALIZING CORPORATE LAW: MAKING SPACE FOR CITIZENS

A more effective reform program must begin by recognizing the perversity of the share value maximization model and offering an alternative ideology of corporate governance. But it cannot end there. The selfish share may be a legally constructed fiction, but the law and our stock market have given it enormous market power to enforce its fictionalized, constructed will. Directors and managers have only limited ability to unilaterally reject the demands of the share value centered model before the market, as currently regulated, will oust them. Moreover, the easiest reforms—shifting power from the market to managers or boards they effectively dominate—are more likely to empower the truly cynical among managers, the solo players who have lost all social constraints, than they are to create a more desirable

[115] *See, e.g.*, Lucian Arye Bebchuck et. al, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 771 (2002) (discussing social ties of directors to CEOs and likelihood of common interests); JAY WILLIAM LORSCH, PAWNS OR POTENTATES (1989) (discussing board room composition).

corporate ethos. If we free managers from shares, the most likely immediate result is that they will steal more freely.

A. Corporation as Polis: An Alternative Ideology of Corporate Governance

For a start, we need an alternative metaphor to the corporation as its shares, and a different explanation of the purpose and reality of public corporations. Hobbes proposed to end his war of all against all by characterizing the state as a corporation.[116] I propose to reverse the process, and recharacterize the corporation as a polis, a community of all its human affiliates, not the shares.

The advantages of the metaphor of the corporation as a quasi-municipality or quasi-state go well beyond the probability that it would induce law faculties to seek political theorists or moral philosophers rather than law-&-economists to staff their corporate law curriculum.

1. Polis to Politicians

Principally, the polis metaphor, like earlier "managerialist" understandings of the public corporation, emphasizes the common enterprise of the various corporate participants. Corporate managers instead of conceiving of themselves as selfless, unsituated rational maximizers could rather see themselves as statesmen, promoting the common good of all corporate participants, and, in our multiple-sovereigned system, as participants in the American governance system required to promote the good of all citizens.

On this model, it is clear that the corporate team extends well beyond the shares. It would, therefore, offer a rationale

[116] THOMAS HOBBES, LEVIATHAN 106-18 (Edwin Curley ed., Hackett Publishing Co., Inc. 1994) (1660) (describing commonwealth as "artificial . . . covenant"); THOMAS HOBBES, ELEMENTS OF THE LAW 167 (J.C.A. Gaskin ed., Oxford University Press 1994) (1640) (analogizing body politic to corporation). *Cf.* BURKE, *supra* note 72 ("Nations themselves are such corporations").

for acting for the good of corporate participants as ends in themselves, rather than doing so simply because treating them in an apparently good way is the best way to extract more out of them. But given the vague limits to "corporate stakeholders" in a firm that, understood as a nexus of contracts and externalities, lacks determinate or firm boundaries, the polis metaphor offers a rationale for managers to consider the public good generally, even beyond the narrower interests of corporate participants.

This broader conception of the managerial/director role is not an unmitigated good. Statesmanship is difficult. Many aspirants to the title have been cynical charlatans or self-interested deluders (even self-deluders). No doubt many managers will be able to explain to their own satisfaction why the common good requires precisely their private good. Moreover, the public good is often controversial, and there is no reason whatsoever to think that unelected corporate managers, or directors nominally elected on a "one share, one vote" basis, will reflect in their views the divisions of the citizenry as a whole. Managerialism is a poor substitute for democracy. Still, unlike the reigning share-centered ideology, working for the good of all corporate participants does not require managers to take inconsistent positions, play cynical double games, or deliberately lull people into trusting them when they know they will be required to take advantage of whatever trust they achieve.

2. The Struggle Over Surplus

The corporation as polis also emphasizes the open-endedness of the struggle over corporate surplus. In this way, it is quite different from the older managerial views, which often seemed to conceal the possibility of conflicts within the corporation under a veneer of professionalism. The polis metaphor is meant to emphasize that there is no "scientific," neutral, or professional objective solution to the problem faced by managers. The issues are value laden, not professional: what kind of society we wish to be or how to mediate our conflicting values, not efficient administration.

Share-centered models define profit as what is left over after all corporate factors other than shares have been paid, and insist that all those corporate factors be paid as little as possible. The corporation as polis matches economic reality more closely. In the polis model, corporations can out-compete markets only when the combined contributions of all the corporate factors of production (including labor as well as investment capital, whether in the form of debt, equity or retained earnings) produce more in cooperation than they would in market competition. That excess is the corporate surplus, and it is available to be given to any factor of production, none of which has an a priori exclusive claim to it.

On this understanding of corporate surplus, the surplus is called profit if it is retained by the corporation or paid out to shares. If it is paid out to bondholders, it is called attractive interest rates; if it is paid out to employees, it is called decent working conditions, good benefits, competitive wages/salary or hard-earned executive stock options; if it is paid out to consumers, it is called every day low pricing; to the government, taxes; to suppliers, high prices; to stockholders of other companies, investment bankers and lawyers, acquisition costs; to architects and builders, a landmark headquarters; to the eco-system, ecological responsibility. Like the apocryphal Aleut languages with thirty-five words for snow, we have many words for corporate surplus. For political and economic purposes, however, the distinctions are not as important as the commonality. This is money that is available for someone to take and no one "owns" it until the struggle to allocate it has concluded.

3. Politics, Not Administration

Third, the political metaphor emphasizes the political nature of the decisions that must be made. Corporations are not only about increasing share value. They are also about creating jobs for employees and suppliers, and those jobs consist not only of paychecks but also of quality of life and quality of work issues: relationships, individual

empowerment, self-improvement and education, health and safety, hours that allow for families, movement and stability in our various communities, support in sickness and old age and for dependents. Corporations also exist to beautify our cities, to provide products for consumers, to support charities, to enhance and not merely destroy our environment.

The share-centered view tells managers that these concerns are illegitimate except when they are illusions. Thus, on the share-centered view, corporate charity is improper unless it is really advertising designed to increase share returns rather than to accomplish a charitable purpose.[117] Working conditions, wages and retirement benefits are just costs to the corporation, justifiable only if they induce workers to work harder or stick around longer and that in turn increases returns to shares. Even abiding by the law is defensible mainly because it is instrumentally useful in maximizing profit. As Friedman famously put it, "the business of business is business."[118] All other values must be imposed forcibly on business by enforceable regulation.

In contrast, on the polis view, the inhuman and uncivil claims of selfish shares can easily be rejected inside the firm. Improving working conditions is a good thing because it is a good thing, not because it is a subterfuge to extract more out of employees. Managers who cause their corporations to contribute to social needs are fulfilling their roles as trustees for major accumulations of social wealth, not stealing from shares. To be sure, firms can do none of these things unless they generate enough income to cover the expenses, but

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[117] *See, e.g.*, A. P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953) (upholding charitable contribution on ground that it is really self-interested).

[118] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept 13, 1970, at 32 ("There is only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game").

there is a difference between a constraint and a goal.[119] The share-centered vision has the world backwards. Far from all of us existing to make shares worth more, the only reason a decent capitalist society allows some shareholders to become indecently rich is because the market is a critical part of improving working conditions and fulfilling social needs. Those are not the means, they are the ends; it is not us who are the tools but the shares.

B. The Democratic Deficit in Corporate Governance

Finally, the view of corporation as polis places front and center the democratic deficit of our current corporate governance system. Externally, corporate governance law largely comes from Delaware. It is not even formally approved by the citizens whom it governs, few of whom vote in Delaware. Internally, corporations are governed by managers who are answerable to boards elected, formally at least, by shares on a basis of dollar proportionality. This is, in political terms, a "herrendemocracy" in which the "herren"—the elite group that adopts democratic norms among its own members while exploiting non-voting inhabitants—are not even people but dollars.[120]

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[119] Indeed, sometimes working to make the world better can also redound to private profit. Bruce D. Butterfield, *Test by Fire: The Story of Malden Mills*, BOSTON GLOBE, Sept. 8, 1996, at A1 (recounting that after 1995 fire, Malden Mills decided to retain all employees during rebuilding). Although Malden Mills stated that its decision was not based on profit-maximization calculations, it appears to have redounded to the benefit of the company, as sales of its Polartec soared and the unionized plant was strike-free. One shouldn't over emphasize this point: Malden Mills has since filed for bankruptcy. *See* Marianne Jennings, *Smart Money*, WASH. POST, Aug. 25, 2002, at B7 (interview with CEO and owner Aaron Feuerstein in which he denies that bankruptcy was related to fire and aftermath). Curiously, even though Malden Mills is closely held, at least one business ethicist claimed that Feuerstein's decision to retain his employees was unethical because it violated the profit maximization principle (and without offering any evidence that in fact the costs to the firm did exceed the benefits). *Id.*

[120] I have discussed the varieties of democratic governance at greater length in Greenwood, *Beyond the Counter-Majoritarian Difficulty*, *supra*

Managers who are expected to manage on behalf of the entire corporation and possibly the public at large, not just its shares, ought to be answerable to the entire corporation and the public at large, not just its shares.

Bringing the public at large into the corporate governance system may be the easier part. First, it requires ending the bizarre choice of law regime under which managers (with share approval) get to choose the corporate law that will govern them. Instead, we should have a genuinely federalist system, in which different states govern corporations under their jurisdiction in substantially different ways—and no state purports to govern corporations that exist primarily outside its borders. Corporations should be governed by the law of the states in which they operate; if the laws appear to cause conflicting regulation, trans-jurisdictional (i.e., national or multi-national) corporations should create legally separate subsidiaries to hold assets in different states, as European corporations have long done.

Second, corporate boards should include board members whose portfolio is specifically to represent the public and to promote the interest of the public at large—understood as citizens rather than shareholders, consumers or employees—and who are selected, directly or indirectly, by the public or its representatives.

Third, the fiduciary duty of board members should be clarified to be a duty to the corporation as a whole, understood to include all the people whom it affects, and not (as in the more extreme versions of the share-centered ideology) as a mere duty to shares or fictional shareholders.

In order for this broader duty to function as something more than a defense to shareholders' derivative actions, it must be enforceable by someone other than representatives of the shares—perhaps a public official, if staffing can be found, or perhaps private attorneys general. The courts, no

note 59; Daniel J.H. Greenwood, *Akhnai*, 1997 UTAH L. REV. 309 (1997), *available at* http://www.law.utah.edu/greenwood/pdf/Akhnai.pdf; Daniel J.H. Greenwood, *Beyond Dworkin's Dominions: Investments, Memberships, The Tree of Life and the Abortion Question*, 72 TEXAS L. REV. 559 (1994), *available at* http://www.law.utah.edu/greenwood/pdf/Dworkin.pdf.

doubt, will continue to emphasize good faith, procedural safeguards and lack of direct personal conflicts of interest, permitting boards great discretion under the business judgment rule. Given the current leniency of judicial review of board action, I do not think that the more amorphous duties of a trustee for the corporation as polis would generate radically different judicially imposed limitations on firm behavior. Rather, its advantage is that it seems likely to put a significantly different cast on the deliberations of directors attempting to act in good faith, without much affecting those who are not.

Finally, corporate intervention into the general political debate ought to be restricted. As I have argued elsewhere, corporations, particularly when they are governed in accordance with the share value maximization model, are not legitimate participants in democratic debate.[121] At a minimum, direct corporate intervention into campaigns should be restricted well beyond historical norms or the limits of current Supreme Court doctrine.[122] More broadly, we need to find effective ways of limiting corporate lobbying or placing it under the control of all the citizens concerned, not merely managers and their purported beneficiaries the fictional shareholders.

Indeed, the image of corporations as polis emphasizes that in general corporations ought to be seen as on the state side of the great liberal divide between state and society. We need to be protected from them far more than they need protection from our collective will. Current constitutional law, which for over a century has granted corporations the rights of citizens against governmental agencies, is precisely backwards. Instead, citizens ought to have rights against these government-like entities. And we should be as unrestrained in using other governmental entities to regulate them as we are in using state law to regulate

[121] *See generally*, Greenwood, *Essential Speech*, *supra* note 38.

[122] *See* Adam Winkler, *The Corporation in Election Law*, 32 LOY. L.A. L. REV. 1243 (1999) (describing election law's treatment of corporations).

municipal corporations or federal law to regulate administrative agencies.[123]

Representing more defined corporate constituencies inside the firm is a more difficult problem and I have only preliminary thoughts on it. The model of the corporation I have used, like the nexus of contracts model from which it borrows, tends to blur the edges of the corporation: this firm is anything but firm. Are consumers, or suppliers, or municipal hosts, members of the corporate team or not? For purposes of corporate governance, and in light of the unexpected results likely from radical changes, I am inclined to take the conservative position that such people, although undoubtedly dependent on the firm and necessary for its success, probably should be classified as members of the public at large and represented as discussed above.

In contrast, employees who spend significant parts of their waking lives working for and at the corporation must have some form of representation in the corporate governance structure if the team or polis concept is to be anything other than yet another cynical tool to delude marks into thinking they are being befriended rather than taken for another ride. For all its problems, democracy remains a far superior alternative to autocracy, kleptocracy or Enronitis. In 1776 we rejected Parliament's claim to virtually represent the American colonies. The claims of public corporations to represent the public—or even the corporate team—while granting the vote only to shares are even weaker.

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[123] *See generally*, Greenwood, *Fictional Shareholders*, *supra* note 55 (arguing, inter alia, that corporations are not citizens that require protection from the state but rather state-like entities from which citizens need to be protected); Adolf A. Berle, Jr., *Constitutional Limitations on Corporate Activity—Protections of Personal Rights from Invasion Through Economic Power*, 100 U. PA. L. REV. 933, 942-53 (1952) (arguing that the state action doctrine does or should not apply to corporations: "The emerging principle appears to be that the corporation, itself a creation of the state, is as subject to constitutional limitations which limit action as is the state itself").

THE REFRIGERATED REAL ESTATE BOOM: WHO IS REALLY PAYING THE PRICE OF SLOTTING?

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I. INTRODUCTION

In November of 2003, the Federal Trade Commission ("FTC") released a staff study titled "Slotting Allowances in the Retail Grocery Industry: Selected Case Studies in Five Product Categories."[1] The result of recent efforts by the legislature to scrutinize the secretive world of retailing slotting fees, the report sought to provide the ongoing debate with much-needed empirical data. Having failed in an attempt to use the Government Accountability Office ("GAO")[2] to investigate these practices in September of 2000, the U.S. Senate Committee on Small Business & Entrepreneurship requested that the FTC take the helm, authorizing the Commission to spend up to $900,000 on its inquiry.[3] The FTC's study was narrow in scope. The Commission sent a voluntary access letter to nine retailers in an attempt to obtain "data, documents, and interrogatory responses on slotting allowances and other retailer practices for five product categories."[4] This Note examines how much light the resulting data sheds on the practice of slotting and suggests that such studies alone will not resolve the issues surrounding the practice of slotting. Regulators and legislators alike must first develop a common language with

[1] Press Release, FTC, FTC Releases Grocery Industry Slotting Allowance Report (Nov. 14, 2003), *available at* http://www.ftc.gov/opa/2003/11/slottingallowance.htm.

[2] Formerly the General Accounting Office; *see* GAO Human Capital Reform Act of 2004, Pub. L. No. 108-271, 118 Stat. 811 (2004).

[3] S. REP. NO. 106-404 (2001), *available at* http://thomas.loc.gov/cgi-bin/cpquery/?&db_id=cp106&r_n=sr404.106&sel=TOC_558383&.

[4] FTC, SLOTTING ALLOWANCES IN THE RETAIL GROCERY INDUSTRY: SELECTED CASE STUDIES IN FIVE PRODUCT CATEGORIES, at ii (2003) [hereinafter FTC 2003 STUDY], *available at* http://www.ftc.gov/os/2003/11/slottingallowancerpt031114.pdf (The five product categories consisted of fresh bread, hot dogs, ice cream and frozen novelties, shelf-stable pasta, and shelf-stable salad dressing).

which to approach the problem and address possible limitations on traditional conceptions of the retailing industry.

A. The Practice of Slotting

For several decades, the grocery industry has used a system of negotiated upfront payments to extract discounts from suppliers seeking access to store shelves. While the terms of these payments vary, the most basic of these agreements involves a fixed-dollar purchase of the right to a reasonable trial period for the manufacturer's new product. This charge is called a "slotting allowance" or "slotting fee."[5] Other permutations of the standard slotting fee include arrangements that guarantee a specific location on the shelf, that require manufacturers to pay for an existing product to stay on the shelf, and that exclude competitive products from a particular retailing outlet altogether. As the size and frequency of these fees have continued to increase in recent years,[6] they have generated considerable debate in the business world, in the media, and in the legislature.

In their most innocent form, slotting fees address one of the more difficult aspects of the retailing business—new product introductions. The typical supermarket carries about 30,000 items on its shelves, which must be chosen from over 100,000 available products.[7] While existing products have a track record that a grocery store can use to make purchasing decisions, new products and their manufacturers are frequently unproven. These new products fail on the retailing shelves at rates estimated to be as high

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[5] FTC, REPORT ON THE FEDERAL TRADE COMMISSION WORKSHOP ON SLOTTING ALLOWANCES AND OTHER MARKETING PRACTICES IN THE GROCERY INDUSTRY, at 1 (2001) [hereinafter FTC 2001 REPORT], *available at* http://www.ftc.gov/os/2001/02/slottingallowancesreportfinal.pdf.

[6] *Id.* at 11.

[7] *Competitiveness in Agriculture and Food Marketing: Hearing Before the House Comm. on the Judiciary*, 106th Cong. (Oct. 20, 1999) (statement of Willard K. Tom, Deputy Director, Bureau of Competition, FTC), 1999 WL 27595793 [hereinafter Tom Statement].

as eighty percent.[8] Failure rates at these levels present two clear problems to the retailer seeking to maximize profits on very narrow margins. First, given limited shelf space, each product a retailer chooses to carry displaces another potentially profitable product, resulting in an obvious opportunity cost for each unsuccessful product added to the shelves. Second, the retailer often must invest a considerable amount of money into getting a new product into its inventory systems and onto the shelves before the first bar code is ever scanned at the checkout counter. As a result, large groceries and other retailers have used slotting fees to protect their bottom lines and to force manufacturers to internalize some of the costs of new items.

Even though these new products often fail, manufacturers appear to be making an increasing number of new product introductions. There is a good deal of disagreement over how many new products come out each year. While some estimate as many as 20,000 introductions each year, others report that the actual number is usually between 1,100 and 1,200.[9] This discrepancy likely stems in part from the difficulty of drawing a line between a new product and an old product that has been slightly modified. Regardless of the actual number, manufacturers have clearly been introducing "new and improved" merchandise at a quickening pace and retailers have allegedly resorted to slotting fees to combat the merchandise onslaught.

Slotting fees have gained their greatest notoriety in grocery and drug stores. However, computer software, compact disc, book, and apparel retailers have all added

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[8] *Competitiveness in Agriculture and Food Marketing: Hearing Before the House Comm. on the Judiciary*, 106th Cong. (Oct. 20, 1999) (statement of Timothy M. Hammonds, President and CEO, Food Marketing Institute), 1999 WL 27595799 [hereinafter Hammonds Statement].

[9] *Slotting: Fair for Small Business & Consumers?: Hearing Before the Senate Comm. on Small Bus.*, 106th Cong. (Sept. 14, 1999) (statement of the Grocery Manufacturers of America, presented by Jeffrey Schmidt, Counsel, Grocery Manufacturers Of America), 1999 WL 27594410 [hereinafter Schmidt Statement].

slotting allowances to their repertoire of business tactics.[10] Some even suggest the fees have found their way into the emerging Internet retailing sector.[11] In the grocery industry alone, slotting fees reportedly amount to $9.5 billion in annual promotional expenditures.[12] Moreover, these fees now account for roughly half of a grocery store's profitability.[13] The answer to the slotting question will ultimately determine where in the distribution chain these dollars will reside. Accordingly, as the practice has expanded and the number of stakeholders has increased, the call for investigation has grown louder.

B. Small Business Backlash and Legislative Inquiry

The debate on slotting has intensified dramatically in recent years. In 2000, the Senate Small Business Committee held a hearing on the slotting fees charged by food retailers in exchange for a guarantee of shelf space and "put supermarkets on notice that they were determined to step up scrutiny of the industry."[14] Also in 2000, the Independent Bakers Association, the Tortilla Industry Association, and the National Association of Chewing Gum Manufacturers asked for the issuance and enforcement of guidelines to govern the practice of charging slotting fees.[15] However, despite multiple hearings and several FTC inquiries into the

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[10] *Slotting: Fair for Small Business & Consumers?: Hearing Before the Senate Comm. on Small Bus.*, 106th Cong. (Sept. 14, 1999) (statement of Gregory T. Gundlach, Associate Professor of Marketing, University of Notre Dame), 1999 WL 713691 [hereinafter Gundlach Statement].

[11] *Id.*

[12] Robert J. Aalberts & L. Lynn Judd, *Slotting in the Retail Grocery Business: Does it Violate the Public Policy Goal of Protecting Businesses against Price Discrimination?*, 40 DEPAUL L. REV. 397, 397 (1991).

[13] Evan Lee, Notes and Comments, *Supermarket Slotting Fees (Allowances): Are They Legal Under Sections 2(c) and 2(d) of the Robinson-Patman Act?*, 22 WHITTIER L. REV. 577, 578 (2000).

[14] Jerry Guidera, *Supermarkets Face Scrutiny Over Fees*, WALL ST. J., Sept. 15, 2000, at B6.

[15] Edward C. LaRose & Patrick J. Poff, *Slotting Allowances and the Emerging Antitrust Debate*, 74 FLA. B. J. 42, 44 (Nov. 2000).

practice, no formal guidelines have been issued. Instead, efforts to date have focused on increasing the information available to policy makers. While antitrust regulators acknowledge their role in protecting the consumer from the adverse effects of the accumulation of market power by demonstrating interest in the slotting controversy, this interest has been tempered by the desire to avoid unnecessary intervention in the free market.[16]

II. TREATMENT OF SLOTTING

A. The Pro-Competitive Case for Slotting

Scholars and industry lobbyists who argue that slotting fees should remain largely unregulated contend that the fees serve pro-competitive and pro-consumer functions. These proponents theorize that the payment of slotting fees can increase the efficiency of the new product introduction process by more fairly allocating the associated costs and risks and providing initial intelligence about the potential profitability of new goods. In this way, the payments not only provide the consumer with cheaper retail prices, but also a greater variety of available products.

1. A Necessary Response to the Never-Ending Stream of New Products

A new product can burden a retailer with significant expense before ever hitting the shelf. Activities such as rearranging products in the warehouse system, modifying the layout of the store shelves, and integrating the product into the inventory and accounting programs create numerous costs for retailers.[17] In addition, retailers must either mark down the products which are being replaced or remove them

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[16] *See Antitrust, Business Rights and Competition: Hearing on Antitrust Enforcement Before the Senate Comm. on the Judiciary*, 106th Cong. (Mar. 22, 2000) (statement of Robert Pitofsky, Chairman, FTC), 2000 WL 310085.

[17] FTC 2003 STUDY, *supra* note 4, at iv.

from the shelves entirely.[18] If every product selected by a retailer had an initially identifiable revenue stream, the retailer could pick and choose accordingly to maximize returns from each square foot of shelving with little worry of losing these up-front costs. However, since failure rates can be as high as eighty percent,[19] proponents argue that slotting fees serve an important purpose by reducing the potential losses born by retailers and thereby encouraging greater experimentation with unproven products.[20] According to this theory, without slotting, retailers operating on thin margins would be forced to limit variety and consumer choice by dealing only with known manufacturers and product lines. Furthermore, by sharing the up-front cost with the manufacturer, the retailer has essentially lowered its cost structure and thus has more room to compete on price across its product line with other retailers.[21] In this manner, the retailer has the ability to pass the benefits of the slotting fee on to the consumer.

2. Market Intelligence and Efficient Allocation of Shelf Space

Advocates of slotting fees also claim that the fees help retailers to allocate shelf space efficiently because the willingness of a manufacturer to pay the fees can serve as an indication of the likelihood of success for a new product line.[22] Given the sheer quantity of new products, retailers rely on slotting fees to get a more accurate sense of the manufacturer's view of the product's potential. The one-time payments provide informal access to any private information the manufacturer might have gained through research or

[18] *Id.*

[19] *See* Tom Statement, *supra* note 7.

[20] Hammonds Statement, *supra* note 8.

[21] Lee, *supra* note 13, at 585.

[22] *Id.*

test marketing.[23] Equipped with this information, retailers can stock their limited shelf space more profitably.[24]

Supporters of the fees also argue that despite some conceded hardships on smaller manufacturers, well-conceived products for which there is sufficient consumer demand will make it to the shelf regardless of the slotting fees charged.[25] They attribute the vocal resistance to slotting fees to the understandable bitterness of those who have lost a competitive battle on the shelves.[26] Moreover, retailers point out that they have taken active steps to mitigate some of the concerns of smaller manufacturers. For example, some retailers have established special programs that waive slotting fees in order to encourage the growth of local or minority-owned businesses.[27]

B. The Case Against Slotting

1. Damage to the Consumer

When manufacturers and others argue against the practice of charging slotting fees, they must take great care to put their complaints in a form which carries weight with the protectors of the competitive market place. Without ultimate injury to competition and consequent cognizable harm to the consumer, courts and regulators have been hesitant to intervene in the free market system. In particular, the antitrust inquiry will often terminate when actions are not perceived to raise consumer prices.[28] As a

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[23] FTC 2001 REPORT, *supra* note 5, at 13.

[24] Mike France, *Are Corporate Predators on the Loose?: Small Businesses Argue That the Microsoft Case is Symptomatic of a Broader Problem*, BUS. WK., Feb. 23, 1998, at 126 (comments of Gene Gabrowski, spokesperson for Grocery Manufacturers of America, discussing slotting fees).

[25] Hammonds Statement, *supra* note 8.

[26] *Id.*

[27] *Id.*

[28] William H. Borghesani et al., *Food for Thought: The Emergence of Power Buyers and its Challenge to Competition Analysis*, 4 STAN. J.L. BUS. & FIN. 39, 81(1999).

result, opponents of the practice focus primarily on how these fees negatively affect the interests of consumers. They articulate three principal adverse impacts on the buying population: higher prices, a decrease in product variety and innovation, and less access to information.[29]

a. Higher Prices

Opponents argue that slotting fees are up-front profits which reduce the incentive for retailers to compete through pricing.[30] If slotting fees exceed the potential gains from negotiating a better price, then manufacturers can avoid lowering the retail price to the levels that would exist in a purely competitive market situation. To the extent that slotting fees allow manufacturers to charge higher prices for their products, consumers end up paying more for their goods.[31] While it may be reasonable for a merchant to impose fees to compensate for the costs of allocating space to a new product, many fear that slotting fees go beyond the costs incurred by the retailer and that the excess is often paid by the consumer.[32] This argument seems to accept the possibility of slotting fees being used in a pro-competitive manner, but questions whether retailers meaningfully limit their use of the fees in practice given the current structure of the industry. Others point out that the tremendous conflict that these fees have created in the distribution chain has introduced new costs and wasteful disruptions which have hindered efficiency and burdened consumers.[33]

b. Less Variety and Innovation

Opponents of slotting further contend that the practice limits variety, innovation, and ultimately consumer choice. The magnitude and up-front nature of the fees can

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[29] Gundlach Statement, *supra* note 10.

[30] Lee, *supra* note 13, at 586.

[31] FTC 2001 REPORT, *supra* note 5, at 27.

[32] Schmidt Statement, *supra* note 9.

[33] Gundlach Statement, *supra* note 10.

substantially limit the ability of some manufacturers to gain the access to the distribution channels that their products need to compete, a problem that is particularly troublesome for smaller suppliers.[34] The result is a narrowing of consumer options in the marketplace. Sometimes the appearance of choice on the store shelf can itself be illusory given the influence of these slotting arrangements.[35]

Proponents of the payments respond that a large number of products are simply "me too" items with little additional value.[36] They argue that given the commodity-like nature of many grocery products, regulators should focus on the price effect of these practices, rather than on non-price factors. However, variety may have significant inherent value worthy in its own right of antitrust consideration.[37] When one considers the growing influence these fees have outside of the grocery context, variety may have even greater relevance to the debate. Slotting may also reduce the incentive of large manufacturers to innovate across their product lines.[38] The presence of this formidable barrier to entry for potential competitors may allow products to retain their shelf space on a basis other than true merit.

c. Less Information is Made Available

Opponents also believe that since manufacturers often pay these slotting fees with funds earmarked for consumer-

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[34] *Id.*

[35] *See* El Aguila Food Prod. Inc. v. Gruma Corp., 301 F. Supp. 2d 612 (S.D. Tex. 2003) (suit brought by tortilla makers against a competitor for alleged slotting fees). A news article about the case reported that shoppers might see five to six different brands on supermarket shelves, but all of the brands actually belonged to one company, the defendant. Thus, the defendant was able to take the entire shelf while providing the appearance of choice to the consumer. Marla Dickerson, *Tortilla Makers Try Not to Get Flattened: Small Companies Face Off with Giant Rival Over Market Share*, L.A. TIMES, Oct. 28, 2003, at C1.

[36] FTC 2001 REPORT, *supra* note 5, at 5.

[37] Thomas B. Leary, *The Significance of Variety in Antitrust Analysis*, 68 ANTITRUST L.J. 1007 (2001).

[38] Aalberts & Judd, *supra* note 12, at 401.

directed marketing and other promotional expenditures, they now spend less on programs to inform the consumer.[39] One manufacturing representative speaking on the condition of anonymity (so as not to upset his chief customers) explained that in paying these fees manufacturers were taking "the eye off the consumer" by spending less on advertising and couponing, strategies that often get the consumer into the stores in the first place.[40]

2. Damage to Smaller Manufacturers

Consumers may not be the only ones hurt by slotting. Some commentators believe that large manufacturers have encouraged the proliferation of slotting fees in order to manipulate the cost of shelf space and reduce the access of smaller competitors. While the manufacturers of some brand name products such as Tide or Miracle Whip largely avoid paying any slotting fees, other large and cash-rich manufacturers seem to embrace the practice.[41] Opponents of slotting fees argue that these manufacturers understand the role the fees play in keeping out smaller rivals.[42] It has been estimated that it costs approximately $16.8 million to introduce a small product line of four items in all supermarkets across the country.[43] The upfront nature of the payment only exacerbates the precarious position of any new entrant to a market. The lack of cooperation on the part of most large manufacturers in providing data on slotting

[39] Gundlach Statement, *supra* note 10.

[40] Caroline E. Mayer, *Supermarket Space Race: The Controversial Costs of Putting Products on the Shelves*, WASH. POST, Apr. 26, 1989, at E1.

[41] Aalberts & Judd, *supra* note 12, at 398.

[42] "They make offers of such high numbers that others can't match them. It's a way to control the shelves and force the small firms out of the market." Mayer, *supra* note 40 (quoting Allan Kaufman, Executive Director of Sales and Marketing of Ben & Jerry's Homemade Ice Cream Co.).

[43] FTC 2001 Report, *supra* note 5, at 4.

certainly raises suspicion of their complicity in the practice.[44] At the same time, retailers often defend slotting by highlighting the cooperation of manufacturers.[45]

In response to these criticisms, supporters of slotting point out that while the practice may exclude small manufacturers from selling their products through large retailers, they are nonetheless able to make their products available through other distribution methods such as coffee and juice bars, specialty food shops, the Internet, and mail order.[46] Success in these formats will generate the consumer demand required to reach the supermarket shelves. However, opponents of slotting caution that the implications of such a bifurcated distribution structure are not necessarily economically advantageous.[47]

3. Damage to Smaller Retailers

Opponents argue that smaller retailers also lose out in the slotting equation. They contend that while retailers of considerable size are able to extract these fees from manufacturers, "mom and pop" operations are unable to command the same treatment.[48] Manufacturers can therefore focus their slotting dollars on retailers offering broad market access and can forgo the independent stores if they attempt to extract similar fees.[49] Without the cushion provided by the slotting fees, these stores are at a competitive price disadvantage against their larger adversaries.[50] In this manner, chains are able to use their size to tighten their grip

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[44] The FTC was unable to get the large retailers and suppliers to participate significantly in a public workshop on slotting in 2000. *Id.* at 26.

[45] Aalberts & Judd, *supra* note 12, at 398.

[46] Hammonds Statement, *supra* note 8.

[47] Borghesani et al., *supra* note 28, at 81-82.

[48] Gundlach Statement, *supra* note 10.

[49] Aalberts & Judd, *supra* note 12, at 401.

[50] *Id.*

on the overall retailing market,[51] and the cycle of slotting continues.

4. Alternatives to Slotting

Even if one concedes a need to help retailers efficiently manage new product introductions, opponents of slotting fees point out that there are other available tools.[52] Test marketing can help to alleviate some of the risk in chain-wide product rollouts, and to determine winners and losers before the products hit the mainstream shelves.[53] Unfortunately, the sheer number of new products hitting the shelves each year limits the usefulness of this method as a stand alone solution. Failure fees can also help retailers hedge risk.[54] However, some protest that retailers are left overexposed if a company is out of business at the time the retailers call to collect.[55] One should also consider how the knowledge that a cash payment will follow the failure of a product might alter the behavior and incentives of a retailer.[56] One of the more compelling alternatives to slotting is a fee charged per unit. This would theoretically help small manufacturers circumvent the barrier to entry created by large lump sum cash payments,[57] and could guarantee a transfer payment more in line with the costs of the new product. Such an arrangement would make it easier and less risky for the small manufacturer which need no longer worry that it paid a large sum for an uncertain stay on the

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[51] *Id.*

[52] The FTC has acknowledged that even if slotting fees are shown to be beneficial, if there is anticompetitive harm the analysis will ask if the benefits are achievable through less restrictive means. FTC 2001 REPORT, *supra* note 5, at 6.

[53] *Id.* at 16.

[54] *Id.* at 17.

[55] "Manufacturers, particularly the smaller manufacturers, are almost never around to buy back inventory that will not move." Hammonds Statement, *supra* note 8.

[56] FTC 2001 REPORT, *supra* note 5, at 18.

[57] *Id.* at 17.

shelves.[58] Interestingly, companies like Wal-Mart and Kroger have found profitable ways to do business without using slotting fees.[59]

5. Buyer Power

Furthermore, anti-slotting factions attack the fundamental assumption of a purely competitive retailing market critical to the position of allowance proponents. The competitive state of the retailing market directly impacts not only the amount being charged for slotting, but, more importantly, the amount of savings being passed along to consumers. "If the retail market is competitive—a very important precondition—the discount is likely to be passed through to consumers and competition will not ordinarily be harmed."[60] In the real world, opponents argue, there are many signs that this precondition doesn't hold. When a *Supermarket Business Magazine* survey asked the question, "What is the going slotting allowance that your company charges," the response it received was, "Whatever the traffic will bear."[61] The economics of the grocery industry make the additive effect of the fees on the bottom line quite transparent. Taking the typical margins of a supermarket, "a $40,000 slotting fee is equal to the profit of $4 million of sales."[62] Opponents believe that retailing chains have begun to consider shelf space as real estate for the use of which they charge manufacturers.[63]

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[58] Some say as little as six weeks. *See* Mayer, *supra* note 40.

[59] *See Competitiveness in Agriculture and Food Marketing: Hearing Before the House Comm. on the Judiciary*, 106th Cong. (Oct. 20, 1999) (statement of Nicholas Pyle, Vice President of Legislative Affairs, Independent Bankers Association) [hereinafter Pyle Statement], *available at* http://www.house.gov/judiciary/pyle1020.htm.

[60] Tom Statement, *supra* note 7.

[61] *Slotting: Fair for Small Business & Consumers?: Hearing Before the Senate Comm. on Small Bus.*, 106th Cong. (Sept. 14, 1999) (statement of Kenneth Partch, Editor-at-Large, *Supermarket Business Magazine*), 1999 WL 27594409 [hereinafter Partch Statement].

[62] Mayer, *supra* note 40.

[63] Partch Statement, *supra* note 61.

The "merger mania" of the past few decades may have made the assumption of perfect competition particularly vulnerable. Though the retailing industry has traditionally been viewed as highly competitive with very low barriers to entry, this notion has started to change. Mergers reported under the Hart-Scott-Rodino Act have increased dramatically from 1,529 in 1991 to 4,679 in 1998.[64] While in 1996 the top five U.S. grocery retailers accounted for approximately twenty percent of the overall market, by 1999 their share had jumped to a whopping sixty percent with the top twenty grocery chains holding seventy-eight percent.[65] When the FTC investigated a potential merger between Staples and Office Depot, it discovered that non-superstore retailers did not exercise a significant competitive restraint on the chains, since they constituted a market unto themselves.[66] Consumer prices were higher in markets with two chains than in those with three, regardless of what other outlets remained.[67] Even the presence of Wal-Mart in a market had no effect on this trend.[68]

Curtin has noted that a key European decision rejecting a proposed merger of two Finnish supermarkets acknowledged the competitive dangers of increasing combinations in retailing.[69] Determining that the merger would have created a level of concentration potentially harmful to consumers, the decision also voiced concern over the considerable pressure the combined entity could exert on manufacturers. High levels of concentration might create "gatekeeper" retailers with the power to determine both the extent and price of a producer's access to the marketplace.[70] Opponents

[64] Tom Statement, *supra* note 7.

[65] LaRose & Poff, *supra* note 15, at 43.

[66] Tom Statement, *supra* note 7.

[67] *Id.*

[68] *Id.*

[69] *See* John J. Curtin et al., *The EC's Rejection of the Kesko/Tuko Merger: Leading the Way to the Application of a "Gatekeeper" Analysis of Retailer Market Power Under U.S. Antitrust Laws*, 40 B.C. L. REV. 537, 541 (1999).

[70] *Id.* at 539.

of slotting fees in the United States claim this behavior has manifested itself in the actions of our own retailing giants.[71]

C. The Legal Challenge to Slotting

Currently, there are no laws which specifically govern retailer slotting. While the Robinson-Patman Act,[72] Sherman Act,[73] Clayton Act,[74] and FTC Act[75] have all been invoked as possible tools to confront any excessive fees, these usual suspects of competition law have not provided an effective framework for slotting opponents. In particular, the Robinson-Patman Act has been singled out as "a poor remedy."[76] In 1995, Robert Skitol urged Congress to amend the Robinson-Patman Act, arguing that the Act "does not appear to have inhibited pervasive and markedly anticompetitive exercises of monopsony power by dominant retailers, one of the fundamental objectives of this legislation at its inception. This is an objective of continuing importance to our economy today and tomorrow . . . ."[77] Unfortunately, given the uncertain outcome of a legal challenge, the expense of litigation, and the potential distribution dislocation, few cases have thus far been brought by the manufacturing industry. One unreported case in the 1990s did address the question of slotting, and acknowledged the possibility of a claim under the Robinson-Patman Act.

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[71] "...chains began to look at themselves as gatekeepers, or toll collectors, who owned the retail estate, and were going to charge the manufacturers for its use..." Partch Statement, *supra* note 61.

[72] 15 U.S.C. § 13 et seq. (2000).

[73] 15 U.S.C. § 1 (2000).

[74] 15 U.S.C. § 12 et seq. (2000).

[75] 15 U.S.C. § 45 (2000).

[76] Barbara O. Bruckmann, *Articles: Discounts, Discriminations, and Exclusive Dealing: Issues under the Robinson-Patman Act*, 68 ANTITRUST L.J. 253, 292 (2000).

[77] *Hearings on Global and Innovation-Based Competition Before the Fed. Trade Comm'n,* 1910 (Nov. 8, 1995) (remarks of Robert A. Skitol, Drinker, Biddle & Reath), *available at* http://www.ftc.gov/opp/global/gc110895.pdf.

1. *Atlantic Coast Vess Beverages*

In *Atlantic Coast Vess Beverages, Inc. v. Farm Fresh, Inc.*, the Federal District Court in Richmond, Virginia, had the opportunity to address a slotting scenario.[78] In the spring of 1989, Vess paid a $10,000 slotting fee to Farm Fresh to guarantee Farm Fresh shelf space for Vess' soft drink products.[79] In September of 1990, Royal Crown, a competitor of Vess, approached Farm Fresh to retail its soft drink product, Diet Rite.[80] As discussions between Farm Fresh and Royal Crown progressed, Farm Fresh halted its relationship with Vess.[81] Royal Crown paid its own slotting fee (of the same amount paid by Vess), and, at the request of Fresh Farm, agreed to purchase and remove Farm Fresh's remaining stock of Vess beverages.[82] Vess commenced an action alleging that Farm Fresh's decision to stop retailing Vess beverages violated section 2(c) of the Robinson-Patman Act.[83] Vess also alleged that Farm Fresh's decision was influenced by an unfair discriminatory payment, also in violation of section 2(c) of the Act.[84]

Vess urged the court to adopt a broad reading of section 2(c), in order to capture all forms of disguised payments made between a buyer and seller that are not based on services rendered.[85] As opponents of slotting practices have also argued, Vess claimed that slotting fees amounted to nothing more than a gratuity with no legitimate economic value.[86] Interestingly, the court allowed Vess' claim to survive a summary judgment motion,[87] despite

[78] Atl. Coast Vess Beverages, Inc. v. Farm Fresh, Inc., Civ. Action No. 3:93CV284, 1993 U.S. Dist. LEXIS 21405 (E.D. Va. Oct. 8, 1993).

[79] *Id.* at *3.

[80] *Id.* at *4.

[81] *Id.*

[82] *Id.*

[83] *Id.* at *5.

[84] *Id.*

[85] *Id.* at *8.

[86] *Id.* at *12.

[87] *Id.* at *22.

acknowledging that the slotting fees were not technically a "brokerage" by name within the meaning of Section 2(c).[88] The parties settled, however, before any fact findings were made or a final judgment was rendered.

Not all courts have thought it wise to move in this direction. In *Zeller Corp. v. Federal-Mogul Corp.*, the Sixth Circuit refused to expand the scope of Robinson-Patman as had been contemplated in *Vess* and ruled that Section 2(c) did not apply to a signing bonus for which no service was rendered.[89] The court so ruled despite admitting that the bill was passed "with the express purpose of preventing sellers from having to yield to the economic pressures of large buyers by granting unfair price preferences."[90] Courts might be concerned that these types of claims introduce significant turmoil into the marketplace and ultimately could cost the consumer more than the practice of slotting itself.

2. *El Aguila Food Products*

In addition to these interpretive difficulties in sustaining a slotting claim, the recent decision in *El Aguila Food Products Inc. v. Gruma Corporation* has further highlighted the challenges of bringing a slotting suit. In *El Aguila*, plaintiffs sued a national brand leader in the tortilla market alleging violations of Sections 1 and 2 of the Sherman Act and discriminatory practices in violation of the Robinson-Patman Act.[91] The plaintiffs argued that Gruma made "up-front" exclusionary payments to retailers for the purposes of managing and controlling retail placement through a financial incentive program.[92] The plaintiffs further claimed

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[88] "While the slotting fee is perhaps not brokerage by name, it may be brokerage in fact under the authority of *Southgate*." *Id.* at *16.

[89] Zeller Corp. v. Federal-Mogul Corp., 1999-1 Trade Cas. (CCH) ¶ 72,522, 1999 U.S. App. LEXIS 6345, at *8 (6th Cir. 1999).

[90] *Id.* at *7.

[91] El Aguila Food Products Inc. et al. v. Gruma Corp. et al., 301 F. Supp. 2d 612, 616 (S.D. Tex. 2003).

[92] *Id.* at 615.

that Gruma's conduct "affected the quantity, quality, variety, choice and price that consumers pay for tortillas."[93]

Gruma defended its practices with many of the arguments put forth by pro-slotters: there are no significant barriers to entry in the tortilla market,[94] competition for limited shelf space is accordingly intense,[95] and these programs reduce the prices paid by retailers.[96] The court ultimately granted summary judgment and a directed verdict for the defendants, struck down the testimony of the plaintiff's expert witness and showed just how high the current hurdles are for those attacking these arrangements.

In essence, the court viewed the payments as business as usual in the complex world of buyer-supplier negotiations. In the court's eyes, the agreements were not only a "part of the mix in the competition arena between competing products,"[97] but they were also an "acceptable and desirable means to acquire market share."[98] As such, the payments were not seen as per se unlawful.[99] While the plaintiffs' expert witness outlined an anti-competitive theory, the court found his opinion was based "on wholly insufficient data."[100]

Unfortunately for plaintiffs, given the complexity of the marketplace it will be extremely expensive, if not impossible, to isolate the point at which these payments traditionally regarded as lawful become illegal. Importantly, the court relies on traditional assumptions that the retailing market ensures that these fees result "in discounts that are passed on to the consumer."[101] The court also stressed that the

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[93] *Id.* at 616.

[94] *Id.* at 617.

[95] *Id.* at 616.

[96] *Id.*

[97] *Id.* at 620.

[98] *Id.* at 629.

[99] *Id.* at 621.

[100] *Id.* at 624. Interestingly, the court points out that the expert testimony relied solely on the 2003 FTC Study, *supra* note 4.

[101] *Id.* at 629.

presence of private label brands mitigated some of their competitive concerns.[102]

However, the difficulty for the small manufacturer does not end there. Interestingly, the court found that the conduct could not be exclusionary as a matter of law because some of the plaintiffs engaged in similar practices,[103] and at the same time posited that manufacturers who refused to negotiate for shelf space with retailers suffer a "self-inflicted wound."[104] Such findings clearly put manufacturers in a difficult strategic position in deciding how best to find their way onto the store shelves.

D. The 2003 FTC Study

The 2003 FTC Study attempted to provide some data with which to examine the slotting controversy. However, given the limited scope of the study, the authors emphasize the need to use appropriate caution in considering its results.[105] The FTC sent out nine surveys to retailers and received various degrees of responses from seven.[106] The study also incorporated the interview responses of eight suppliers—six manufacturers and two food brokers representing manufacturers of products in the study's categories.[107] While the authors warn against drawing significant conclusions from the results, a good deal can be learned about slotting by examining the answers that were given by various survey groups across different product categories.

The study makes it clear that retailers and suppliers have different perspectives as to the frequency and negotiability of

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[102] *Id.*

[103] *Id.*

[104] *Id.* at 621.

[105] FTC 2003 STUDY, *supra* note 4, at iii ("The Study is based on a small sample of detailed case studies and may not be representative of all retailers in the United States. Care must be taken to avoid over-extrapolation of its results. At most, the study's results are suggestive, not probative").

[106] *Id.* at iii.

[107] *Id.*

slotting allowances.[108] Retailers view them as the flexible result of a negotiation process which incorporates many promotional, cost, and risk factors.[109] Suppliers, on the other hand, see a rigid environment when it comes to slotting,[110] with the amount of the required payment "known by vendors in advance of discussions."[111] Data from retailers further suggest inconsistency in the occurrence of slotting for new products in the same product category, with some suppliers making the payments and others refraining.[112] This result highlights the arbitrariness at the heart of many opponents' complaints, but could still cut in both competitive directions. These two dramatically different pictures provide only one easy conclusion—the answer to the slotting debate will only be found through more access to data.

The survey suggests that when most new products are introduced, retailers and suppliers negotiate over the amount of slotting allowances as part of a larger conversation.[113] If a retailer accepts a new product onto its shelves, the product is usually given a trial period of four to six months, but in most cases there is no contractual commitment to a specific length of time.[114] The retailers indicated that slotting allowances are used to help defray the costs and the risk associated with new product introductions.[115] This is a principal justification used in the defense of slotting which, if accurate, would support the pro-competitive case. However, the authors of the study go on to admit that "other information provided by the retailers

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[108] *Id.* at 58.

[109] *Id.*

[110] Six of eight suppliers stated slotting occurred eighty to ninety percent of the time. *Id.*

[111] *Id.*

[112] *Id.* at v.

[113] This conversation spans advertising allowances, introductory allowances per unit, marketing funds, and other special funds such as those used for in-store displays, couponing, and customer savings cards. *Id.* at iii.

[114] *Id.*

[115] *Id.* at iv.

in the study raises questions as to whether cost recoupment is the sole reason for slotting allowances."[116]

The new product risk rationale for slotting finds additional support in the data on refrigerated and frozen goods, which are more expensive for the retailer to introduce. The study correspondingly found a higher level of slotting in the hot dog and ice cream categories.[117] Again, the FTC authors point out that while this does support a risk-sharing theory of slotting, it does not rule out any of the other theories.[118] The data on direct-to-store-delivery items also reinforce a cost/risk sharing aspect to the fees. Direct-to-store products impose fewer of the warehousing and distributional expenses on the retailer and are accordingly charged smaller and less frequent slotting fees.[119] In addition, the retailers report that they consider many of these items, such as breads, less risky for them.[120]

All of these data could be used to construct the pro-competitive theory for slotting. However, none of the data rules out the possibility of excessive use of these fees, which many claim is the true heart of the issue. The FTC admits that the various theoretical models on slotting are not "mutually exclusive."[121] In fact, one retailer in the study explained that it requests slotting allowances "to remain on a competitively level playing field with the other retailers that require slotting."[122] It might therefore be foolish to think that one theory alone can account for the tremendous variation observed in the retailing world.

III. SUGGESTIONS FOR THE FUTURE

To date, many questions about the competitive role of slotting fees in the market remain unresolved and the

[116] *Id.*
[117] *Id.* at v.
[118] *Id.* at 63.
[119] *Id.* at iv.
[120] *Id.* at 16.
[121] *Id.* at vi.
[122] *Id.* at 9-10.

practice continues to become more prevalent. Without the necessary data to prove their case, opponents have been unable to convince regulators to alter the status quo. Regulators have themselves examined the practice and have yet to reach any conclusions. The 2003 FTC study reiterated the need for additional examination of the issue while remaining hesitant to suggest any specific action or intervention.[123] To move forward and find a satisfactory answer, investigators must overcome several hurdles. First, they must find a way to get better information. Second, they must develop a common language with which to analyze the information. Finally, they must retest many of the assumptions under which they have previously patrolled the retailing landscape.

A. Mandate Record Keeping and Better Disclosure of the Fees

The poor record keeping of the retailing industry has been a major hurdle in the effort to learn more about the practice of slotting. The FTC study found that retailers lack any "complete, historical electronic records" of slotting allowances.[124] Only one of the seven retailer respondents had an electronic system to record the fees and only two more recorded slotting fees separately on their deal sheets.[125] Retailers claim they do not need to maintain detailed records of slotting fees for regular business purposes.[126] Often, retailers lump the slotting fee allowances into a general line item recognizing other promotional allowances, focusing not specifically on the slotting fees themselves, but on the aggregate amount of cost reductions which negotiations with the manufacturer have produced.[127] As a result, studies such as the one performed by the FTC will continually understate

[123] FTC 2001 REPORT, *supra* note 5, at 67.

[124] FTC 2003 STUDY, *supra* note 4, at vi.

[125] *Id.* at 7.

[126] *Id.* at vi.

[127] *Id.* at 65.

the occurrence and magnitude of slotting even with full cooperation from retailers.[128] Although supermarkets have invested a great deal to modernize their inventory management systems and squeeze out every incremental penny of margin, they have not put a fraction of this effort into recording the results of slotting negotiations with their suppliers. While any effort to impose disclosure and record keeping requirements has the drawback of additional costs, this is one industry which seems well positioned to comply.

The retailers stress that there has not been a need to keep track of specific figures.[129] While plausible, the importance which the retailers attach to these fees in curbing the costs of new product introductions seems to warrant more attention on their part to tracking and recording the terms of each deal. While buyers and suppliers negotiate deals according to specific sets of circumstances, a data set collected across a broad spectrum of transactions should nonetheless provide a significant amount of market intelligence for retailers. In an industry like the grocery business where slotting accounts for an estimated one half of profits, one would expect at least a minimum level of care to be taken to document and analyze each transaction.

Because the negotiations often take place behind closed doors and involve numerous promotional considerations which are difficult to separate, any effort to understand the impact of these fees will be hindered without a firm grasp of the numbers involved. Poor record keeping, however, is just one informational challenge which must be overcome. Even on the rare occasion when the retailing industry does participate in slotting discussions with regulators, the companies, citing competitive concerns, refuse to provide specific details on slotting.[130] The futility of the effort has led one legislator spearheading the investigation to analogize

[128] *Id.* at 8.

[129] *Id.* at vi.

[130] FTC 2001 REPORT, *supra* note 5, at 3.

the secrecy involved in the practice to a "blockbuster whodunit."[131]

Manufacturers have not been eager to fill in the blanks either. Most of the manufacturers participating in a workshop set up by the FTC to discuss the issue of slotting allowance were smaller firms, despite the fact that larger manufacturers had also been invited.[132] While not conclusive by any stretch, the absence of large manufacturers does provide some support for those who argue that such manufacturers have supported and intensified the practice of slotting as a means of excluding competition. Even small manufacturers have been hesitant to come forward given the possibility of retailer retaliation. Given the prevalence and significance of slotting fees for the manufacturer, it is interesting that the FTC receives few complaints concerning such fees, one every three months on average.[133]

In 2001, the Financial Accounting Standards Board decided to change the way manufacturers recorded slotting fees in an attempt to make them more transparent.[134] Many manufacturers had adopted the practice of treating the fees as a marketing expense without deducting the fees when they reported their top line revenue figures. By including the expenses with numerous other marketing costs, the manufacturers had helped protect the secrecy of the slotting expenses and boosted their growth results. As of the first quarter of 2002, companies were asked to deduct the slotting fees from their revenues. More accurate disclosure throughout the process will provide regulators and legislators with the information they have been thus far unable to obtain. Importantly, even if regulators and legislators continue to resist intervention, additional

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[131] *Retailers Stonewall Slotting Investigators, Feds Turn up Heat*, CANDY BUS. (Nov./Dec. 2000), (quoting Christopher S. Bond), *available at http:/ /* www.retailmerchandising.net/cbus/archives/1200/ news.asp.

[132] FTC 2001 REPORT, *supra* note 5, at 3.

[133] Tom Statement, *supra* note 7.

[134] Greg Winter, *Audit Shift Set on Fees to Put Goods in Stores*, N.Y. TIMES, May 15, 2001, at C4.

transparency may provide the information which plaintiffs like El Aguila need to make their case in the courtroom. In addition, mandated disclosure might better ensure the payments serve the pro-competitive purpose of risk sharing by making sure all parties comprehend the going rate of shelf space.

B. The Value of Product Variety

Regulators must also examine the importance of variety in the antitrust equation. Thomas Leary has recently argued that variety alone may have significant value which deserves antitrust consideration in its own right.[135] Recent decisions, such as in *LePage's, Inc. v. 3M*, could demonstrate that such notions about consumer welfare may be coming into judicial favor.[136] In *LePage's*, a predatory pricing case involving the packaged bundling of several product lines, the Third Circuit recognized that despite the lower overall costs the 3M plan provided, its actual effect was to drive a smaller competitor from the shelves.[137] Turning its back on the *Brooke Group* line of Sherman Act cases, the court found antitrust injury despite the absence of a negative, near-term price effect for the consumer. This is illustrative of a new way of thinking about protecting smaller market participants and defending consumer choice. Future studies should account for the possible importance of variety on the store shelf.

C. The Definition of a New Product

Proponents of slotting are quick to point out that the proliferation of new products seems to contradict the arguments that slotting discourages innovation and new product introductions.[138] However, one must first analyze the make-up of new products to examine where and why these new products are coming to market. If a large percentage of

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[135] Leary, *supra* note 37, *passim*.

[136] LePage's, Inc. v. 3M, 324 F.3d 141 (3d Cir. 2003).

[137] *Id.* at 155.

[138] *See* Hammonds Statement, *supra* note 8.

these "new" products are minor cosmetic changes or "new and improved" versions of existing lines, then this would weaken the retort dramatically. In fact, the quantity of new products being thrown at the retailer could be an attempt by large manufacturers to continue to bid up these slotting allowances to maintain their anti-competitive effect as a barrier to entry. The increasing frequency and size of slotting at a time when both information collection and analysis have improved seem to hint that there may be something more to the story.

The recent FTC study highlighted the need for a more developed approach in analyzing these new product introductions. Differentiating items along a well-defined scale of novelty would allow for an apples to apples comparison of risk and cost. Not only would this help regulators dig deeper into the seemingly arbitrary nature of slotting suggested by the FTC study, it would also help monitor innovation, the introduction of "new and improved" products by the dominant manufacturers, and the real risk of failure which the retailers confront. Importantly, regulators could then better identify the point at which pro-competitive uses of slotting became anti-competitive.

D. Retailer Intelligence

Proponents of slotting argue that the fees serve a signaling function of a product's ultimate success. This justification, however, runs into trouble as the information disparity between manufacturer and retailer changes. While a manufacturer would logically be willing to pay more in slotting allowances for a product in which it had more faith, the value of that information to a retailer may not be as large as proponents of the practice argue. The modern retailer, equipped with barcode scanning and real-time data analysis capabilities, should be in a much better position to make predictions as to the ultimate success or failure of a new product. The retailer occupies a position closer to the consumer and has access to firsthand data on how the consumer makes purchasing decisions. Furthermore, the

retailer ultimately has the ability to place a product in the location capable of maximizing its potential revenues. While the corroborative effect of a manufacturer putting dollars behind a product in this fashion is certainly informative, it seems that unless the product in question is revolutionary, the retailer has a real opportunity to exploit its informational advantage to help its own bottom line.[139] Increasing the size of the retailer would only magnify the power of its data.

E. Power Buyers and the Role of Self-Branded Products

Borghesani points out that antitrust legislation and enforcement have traditionally focused on the ability of manufacturers to control prices or competitive entry into a market.[140] Unfortunately, this methodology does not appear to contemplate the emergence of power-buyers.[141] Importantly, European regulators have taken notice of the possibility of the anti-competitive effects of these buyers acting as gatekeepers for the manufacturer's products.[142] While U.S. authorities may not consider this a current threat, the possibility of buyer power necessitates a greater role in their analysis of the slotting equation.

Both Borghesani and Curtin also call for the antitrust establishment to account for the impact of retailer-branded products in the marketplace. The retailer's dual role as both a customer and competitor in the marketplace could create additional avenues for the enhanced exercise of market power.[143] Not only do these retailers have access to consumer information and the promotional strategies of the

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[139] Several speakers at the FTC workshop brought attention to these potential informational advantages at the retailer level. FTC 2001 REPORT, *supra* note 5, at 16.

[140] Borghesani et al., *supra* note 28, at 81.

[141] *Id.*

[142] Curtin et al., *supra* note 69, at 539.

[143] *Id.* at 540.

manufacturers, they also may be able to price with an advantage: the absence of slotting fees.[144]

Private-label brands account for slightly less than fifteen percent of total dollar sales in U.S. supermarkets and are the dominant brands in about twenty percent of more than 350 product categories that most stores carry.[145] These private-label products are guaranteed full distribution and advantageous shelf placement.[146] Furthermore, these derivative products might push out the secondary names which drive competition through innovation, resulting in markets which only have one research and development based manufacturer.[147]

These forces at work in the market do not act in a vacuum. Power buyers are selling self-branded products and competing with the small manufacturer who once would have been secondary suppliers. At the same time, the direct purchasing power of large retailers makes wholesalers and distributors less efficient and indirectly raises the cost structure of the smaller retailer.[148] Yet, decisions like *El Aguila* do not seem to account for this new reality. The *El Aguila* court continues to take solace in self-branded products as a guarantor of competition and takes for granted that the discounts represented by slotting would be passed along to consumers. To address the concerns of slotting opponents and commentators like Borghesani and Curtin, further study must be done to examine how these self-branded products might combine in a cumulative fashion with slotting and a power-buyer dynamic to decrease the variety of products on the shelves, hamper innovation, and ultimately weaken the competitive marketplace.

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[144] Borghesani et al., *supra* note 28, at 61.

[145] Curtin et al., *supra* note 69, at 568.

[146] Borghesani et al., *supra* note 28, at 60.

[147] *Id.* at 62.

[148] *Id.* at 52.

IV. CONCLUSION

The slotting controversy is far from being settled. Recent investigations by the FTC have proved inconclusive. The complexity of slotting requires greater precision and more data. To get closer to a satisfactory answer, regulators must not only better define the terms of debate but they must also analyze the question within a vision of retailing which acknowledges the many forces at play. The retailing world of the twenty-first century has changed dramatically. Suppliers no longer appear to have a chokehold on competition and the corresponding market power. In sharp contrast, retailers have consolidated their market shares, improved their intelligence capabilities, and now compete with their own self-branded products. Attempts to move forward without first establishing a new framework of analysis will likely leave all concerned parties with an empty stomach.

REPUTATIONAL PENALTIES FOR CORPORATIONS AND THE FEDERAL SENTENCING GUIDELINES

Dennis J. Recca*

I. INTRODUCTION

Corporations that commit crimes are subject to a variety of penalties. First, in many cases, a corporation is subject to civil penalties.[1] An injured party may sue a corporation for damages, which may be in the form of either compensatory damages, intended to compensate the injured party for its loss, or punitive damages, which are intended to punish the corporation and act as a deterrent.[2] Second, a corporation that commits an offense can generally expect to suffer reputational, or "marketplace" losses.[3] That is, consumers may be less likely to do business with offending corporations, either because they have been harmed by the corporation in the past, causing them to be wary, or because of a general desire among consumers not to transact business with an offending corporation based on ethical reasons or a desire to

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[1] *See* Mark A. Cohen, *Empirical Trends in Corporate Crime and Punishment*, 3 FED. SENT. REP. 121, 122 (1990).

[2] *See* BMW of N. Am. v. Gore, 517 U.S. 559, 568 (1996).

[3] *See* Cohen, *supra* note 1, at 123.

avoid a stigma attached to the corporation.[4] This reaction by consumers may result in the loss of corporate revenue and profits. Finally, a corporation, as a legal person, is subject to the criminal law.[5] Although certain criminal penalties, such as incarceration, are not applicable to corporate defendants, corporations are subject to criminal fines, probation, and other criminal sanctions.[6] In recent years, Congress has greatly expanded the breadth of criminal offenses of which a corporation may be convicted, as well as the penalties attaching thereto.[7] These disparate sanctions must be coordinated to arrive at the appropriate penalty if the socially optimal level of deterrence is to occur.[8]

In the federal system, the form of criminal sanction and the precise amount of a fine, if any, that will be imposed on a corporation are determined by application of Chapter Eight of the Federal Sentencing Guidelines ("the Guidelines").[9] Despite the presence of substantial civil and market-based sanctions in many cases, the Guidelines do not account for these additional penalties in determining an appropriate criminal sanction, aside from a brief policy statement that suggests that sentencing judges may, in their discretion, choose a fine, within a mandated range, that reflects "any collateral consequences of conviction, including civil obligations."[10] Substantial empirical evidence demonstrates

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[4] *See* Stephen A. Saltzburg, *The Control of Criminal Conduct in Organizations*, 71 B.U. L. REV. 421, 431 (1991).

[5] *See* U.S. DEPARTMENT OF JUSTICE MEMORANDUM REGARDING FEDERAL PROSECUTION OF CORPORATIONS, *available at* http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html.

[6] *See* Shayne Kennedy, Note, *Probation and the Failure to Optimally Deter Corporate Misconduct*, 71 S. CAL. L. REV. 1075, 1079-83 (1998).

[7] *See* Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L.Q. 95, 95-96 (2004).

[8] *See* Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741, 756 (1993).

[9] *See* Kennedy, *supra* note 6, at 1077.

[10] *See* U.S. SENTENCING COMM'N, FEDERAL SENTENCING GUIDELINES MANUAL [hereinafter SENTENCING GUIDELINES], § 8C2.8(a)(3) (2003).

that civil and market-based sanctions are not only significant but, in many cases, may be greater than the criminal sanction imposed on a corporation.[11] The upshot of this is that a system of corporate sentencing guidelines that ignores civil and market-based sanctions in determining the criminal penalty will often fail to produce the socially optimal sanction, which will result in social costs of over-deterrence and under-deterrence.

This Note focuses particularly on the effects of reputational, or market-based, penalties on corporations. In Part II, I provide a brief background on how the Guidelines operate to sentence corporate defendants. In Part III, I address the issue of the optimal penalty. In Part IV, I consider the problems of over-deterrence and under-deterrence, and the social costs of failing to apply the optimal penalty. In Part V, I discuss the reasons why corporations suffer market-based penalties for their crimes, and I explore a number of factors that affect their magnitude in specific cases. Finally, in Part VI, I suggest possible ways in which the Guidelines may be amended to account for these reputational effects.

II. BACKGROUND: CORPORATE SENTENCING UNDER THE GUIDELINES

Pursuant to the powers granted to it under the Sentencing Reform Act of 1984, the Federal Sentencing Commission, after concluding that criminal sanctions for corporations were too low, drafted Chapter Eight of the Guidelines.[12] This chapter deals with the sentencing of organizational defendants, and its primary target is the publicly-held corporation.[13] Since Congress did not act to

[11] *See* Cohen, *supra* note 1, at 123.

[12] *See* Cindy R. Alexander et al., *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 42 J.L. & ECON. 393, 395 (1999).

[13] *See* Michael K. Block, *Guest Editor's Observations*, 3 FED. SENT. REP. 115 (1990).

reject it, Chapter Eight became effective on November 1, 1991.[14] Chapter Eight contemplates fines as the primary form of sanction for corporate defendants, but also provides for other penalties, including probation.[15]

Under the Guidelines, the determination of the corporate fine begins with a minimum fine, which corresponds to the statutory offense for which the corporation was convicted. The "base fine" is then determined by taking the greatest of (1) this minimum fine, (2) the pecuniary gain to the organization, or (3) the pecuniary loss caused by the organization.[16] A "culpability score" is then determined based on factors that are intended to reflect the organization's overall level of culpability.[17] The base fine is then multiplied by a multiplier corresponding to the culpability score.[18] The result is a range of fines.[19] It is then within the sentencing judge's discretion to impose the precise fine he feels is appropriate within the mandated range. Section 8C2.8 includes a policy statement listing appropriate factors to be considered by a judge in setting a fine within the applicable range. One factor listed is "any collateral consequences of conviction, including civil obligations arising from the organization's conduct."[20]

Finally, a sentencing judge has the authority to depart from the fine range and impose a fine that he feels is appropriate if "there exists an aggravating or mitigating circumstance of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission in formulating the guidelines that should result in a sentence different from that described."[21] Section 8C4 of the

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[14] *See* Jed S. Rakoff, *The Corporation as Policeman: At What Price?*, 207 N.Y.L.J. No. 6, at 3 (Jan. 9, 1992).

[15] *See* SENTENCING GUIDELINES, *supra* note 10, at § 8.

[16] *See id.* at § 8C2.4.

[17] *See id.* at § 8C2.5.

[18] *See id.*

[19] *See id.* at § 8C2.6.

[20] *See id.* at § 8C2.8(3).

[21] 18 U.S.C. § 3553(b)(1) (2000).

Guidelines lists a number of factors that, according to the Commission, may serve as legitimate grounds for departure in the corporate context. This list is, however, not exhaustive, and does not preclude judges from departing in other cases in which the judge believes that a factor is not adequately taken into consideration by the Guidelines.

III. THE OPTIMAL PENALTY

Setting an optimal penalty for a given offense is a complicated task. Sanctions must be set at a level that induces the offender to internalize the total costs of his crimes.[22] A potential offender, acting rationally, will compare the private gain which is expected to flow from the offense with the private loss that is expected to occur if the offender is caught, multiplied by the chances of being caught.[23] The expected private loss in the corporate context includes civil and criminal sanctions and decreased profits resulting from reputational effects. If commission of the offense yields an expected net gain ex ante, the rational offender will commit the crime, while in the case of an expected net loss, the would-be criminal will be deterred. This leads to the natural result that, ceteris paribus, increased sanctions will lead to fewer crimes being committed, as fewer opportunities for net gains from commission of the crime will exist, and conversely, decreased sanctions will lead to an increased rate of commission.

In order to induce the rational offender to internalize the total social costs of crime, the expected private loss to the criminal from committing the offense must be made equal to

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[22] *See* Bruce H. Kobayashi, *Antitrust, Agency, and Amnesty: An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against Corporations*, 69 GEO. WASH. L. REV. 715, 731 (2001).

[23] *See* ANDREW ADSWORTH, PRINCIPLED SENTENCING: READINGS ON THEORY AND POLICY, at 45-46 (Andrew von Hirsch & Andrew Ashworth eds., 2d ed. 1998).

the expected loss to society.[24] If a crime is certain to be detected, the optimal penalty will equal the harm caused by the offense.[25] Decreased probabilities of detection must be compensated by proportional increases in the total sanction.[26]

Under this scheme, the rational criminal will be induced to internalize the costs of his crime. If the expected gain from commission is less than the expected total harm to society (measured by the expected private sanction), the crime will not be committed, whereas if the expected gain to the criminal is greater than the estimated total harm, the crime will be committed. This is exactly the result that should be desired. That is, socially detrimental conduct will be avoided, while socially beneficial conduct will not be discouraged. However, if the total penalty imposed on a corporation is not equal to the optimal penalty, problems of over-deterrence and under-deterrence occur.[27]

IV. OVER-DETERRENCE AND UNDER-DETERRENCE

Between over-deterrence and under-deterrence, the problem of under-deterrence is more obvious. That is, if penalties are set too low, corporations will not fully internalize the costs of their crimes. This will result in social losses, as too many crimes will be committed, or more precisely, some crimes with a net social loss will not be deterred.

The problem of over-deterrence is less obvious. In fact, the casual observer might remark that all crime is socially detrimental—is the goal of the criminal law not to eliminate *all* crime? This ignores several important considerations,

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[24] *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 709-10 (1997).

[25] This is not exactly true. To be precise, the costs of enforcement must also be considered. *See* Kennedy, *supra* note 6, at 1086.

[26] *See* Kobayashi, *supra* note 22, at 732.

[27] *See* Parker, *supra* note 8, at 757-58.

including the possibility of socially beneficial crime, as well as the possibility that socially efficient *legal* behavior will be deterred because individuals (or corporate managers) fear that their conduct will be misinterpreted by the legal system as illegal conduct. Especially relevant in the corporate context is the possibility that excess costs will be expended to internally detect and prevent potentially criminal conduct.

Over-deterrence occurs when socially beneficial behavior is deterred. This occurs when the total benefits of the deterred crime would have been greater than its costs.[28] By way of illustration, let us consider the following hypothetical involving fines for illegal parking. Parking regulations and the mechanisms that enforce them are intended to induce vehicle operators to internalize the costs of parking. If the social costs of parking in front of a fire hydrant were, say, $50,[29] but there were no laws prohibiting this activity (or the laws were not enforced), a driver who wished to park in front of a hydrant could choose to free ride on the public by not considering the social costs of his actions. If the use of the space were worth, say, $10 to him, he would choose to park in front of the hydrant, even though this would result in a net social loss of $40 (his $10 private gain minus the $50 public loss). In order to prevent this loss, the city might enact an ordinance prohibiting parking in front of fire hydrants. If the chances of being discovered and ticketed were estimated at, say, fifty percent, the optimal fine would be $100. Returning to our example, the estimated cost to the driver of violating the ordinance would now be $50. His private gain being $10, he would be faced with a net loss of $40 and would therefore choose not to park illegally. The $40 net social loss would be avoided. Notice that in this case, the driver's personal loss is equal to the net social loss. This is not a coincidence, but the result of an optimal penalty.

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[28] *See* Kobayashi, *supra* note 22, at 732.

[29] This figure might be calculated by the estimated increase in damage that a fire could be expected to cause due to the hindrance multiplied by the probability of a fire occurring within a given time.

Now suppose that the city council, in an attempt to raise revenues, increases the fine for the same violation to $500. And now suppose our driver has a more valuable use for the parking space, making it now worth $100 to him.[30] Under this scenario, the driver would choose not to park illegally (his expected personal gain is $100, but his expected personal loss is $250). However, his decision to avoid the possible sanction is socially inefficient because an opportunity to achieve a net social gain of $50 (our driver's $100 personal gain minus the $50 public loss) was eliminated. If the fine had remained at the socially optimal level, the driver would have chosen to park, and the social gain would have been achieved.[31]

The above hypothetical demonstrates one form of the social costs of over-deterrence by inappropriately high sanctions. However, in this situation, further costs will result from the impreciseness of the legal system. Since the legal system is not always correct in distinguishing legal from illegal behavior, a corporation might refrain from socially efficient *legal* behavior because of the possibility of legal error. Although this problem is always present in human institutions, it will be unnecessarily exacerbated if sanctions are increased beyond their appropriate levels, causing further losses in efficiency.

In the corporate context, additional losses in efficiency will occur due to agency costs. Corporations themselves, unlike individuals, cannot commit criminal acts because they cannot possess the requisite mens rea.[32] Instead, corporate criminal liability is based on vicarious liability for the acts of its officers and employees under the doctrine of respondeat

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[30] The other elements of our hypothetical remain constant, including the social costs of parking in front of a hydrant and the probability of detection.

[31] In this hypothetical, we ignore for simplicity any indirect social gains from parking ticket revenues. To tighten the logic, we might assume that the revenues in both cases were just sufficient to fund enforcement.

[32] *See* Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 320 (1996).

superior.[33] Therefore, a corporation may be criminally liable if it fails to control the actions of its employees. The potential costs of criminal liability for corporations are therefore a form of agency costs. Faced with these potential costs, a corporation will spend money on programs that are designed to prevent employees from committing acts for which the corporation may be held criminally liable and to detect the commission of such acts, which may entitle the corporation to a reduction in penalties.[34] In fact, since the corporation itself cannot commit a crime, the intent of the criminal law is to provide incentives to corporations to take such steps to prevent its agents from committing crimes. If sanctions are set at a level higher than the social costs of the crime, corporations will be induced to spend excessive amounts to monitor their employees and prevent crimes.[35] These monetary costs will result in increased prices for consumers, as the increased costs of doing business will be passed on to them.[36] Additionally, these costs will put domestic firms at a comparative disadvantage vis-à-vis foreign competitors not subject to American criminal law. Finally, by raising the cost of doing business in the United States, excessive criminal sanctions will discourage foreign investment.

The determination of appropriate criminal penalties is therefore a very important task. If the penalties are set too low, excessive corporate crime and its attendant ills will result. If penalties are set too high, social costs will result, which in the corporate context are exacerbated by agency costs. Determining the optimal corporate sanction is a complicated task involving economic and empirical analysis. However, in setting the level of fines, there is no evidence that the Sentencing Commission considered the potential

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[33] *See* Kobayashi, *supra* note 22, at 735.

[34] *See* John C. Coffee, *"Carrot and Stick" Sentencing: Structuring Incentives for Organizational Defendants*, 3 FED. SENT. REP. 126 (1990).

[35] *See* Kobayashi, *supra* note 22, at 735-36.

[36] *See* Kennedy, *supra* note 6, at 1087.

penalties or undertook any such analysis. In fact, reputational penalties are not even mentioned in the Guidelines. Instead, the Commission based its fine schedule on the fines imposed by judges in pre-Guidelines cases, when judges had virtually complete discretion in setting fines.[37] Even if it could be shown that the pre-Guidelines judges were, by and large, aware of the effects of reputational penalties and considered them in their assessments of the appropriate fines, the Commission had very little data on which to base its calculations. At the time Chapter Eight of the Guidelines was being drafted, there were only about 300 corporate convictions each year in federal courts.[38] The fact that the Commission based its fines on such scant evidence is striking.

Furthermore, the Commission, in drafting Chapter Eight, was acting largely under the presumption that corporate sanctions were too low.[39] Empirical evidence has shown that criminal fines imposed on corporations have been substantially higher under the Guidelines than they had been previously.[40] There is no reason to believe that the Commission in any way considered reputational sanctions when they determined that criminal sanctions should be increased.

V. MARKET-BASED PENALTIES

A substantial body of empirical evidence supports the proposition that corporations incur significant decline in reputation when news of impropriety is announced. Sam Peltzman found that publicly traded corporations suffered significant losses in goodwill after news of FTC investigations into false and misleading advertising practices

[37] *See* Cohen, *supra* note 1, at 121.

[38] *Id.*

[39] *See* Alexander et al., *supra* note 12, at 395.

[40] *Id.* at 416.

was released.[41] Another study found that losses in shareholder wealth resulting from news of product recalls went beyond the direct costs of the recall.[42] Mark Mitchell found that the pharmaceutical company Johnson & Johnson incurred substantial losses in goodwill following disclosure that their Tylenol medication had been tampered with in the 1980s.[43] Mitchell and Michael Maloney found that commercial airlines suffered significant losses in shareholder wealth resulting from decreased goodwill following crashes involving pilot error.[44] Finally, Karpoff and Lott found substantial losses in shareholder wealth following revelations of corporate fraud.[45]

One explanation for the reputational losses experienced by corporations in these contexts is the loss of the ability of a corporation to charge a premium for quality. Consumers hold expectations about product quality, and when these expectations are not met, a reputational penalty is incurred.[46] Another potential cause of reputational penalties is a stigma effect caused when consumers choose not to do business with a corporation that has committed some violation, either on ethical grounds or to avoid a social stigma that attaches to the corporation.[47] These two explanations for market-based reputational penalties

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[41] *See* Sam Peltzman, *The Effects of FTC Advertising Regulation*, 24 J.L. & ECON. 403 (1981).

[42] *See* Gregg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. POL. ECON. 512 (1985).

[43] *See* Mark L. Mitchell, *The Impact of External Parties on Brand-Name Capital: The 1982 Tylenol Poisonings and Subsequent Cases*, 27 ECON. INQUIRY 601 (1989).

[44] *See* Mark L. Mitchell & Michael T. Maloney, *Crisis in the Cockpit? The Role of Market Forces in Promoting Air Travel Safety*, 32 J.L. & ECON. 329 (1989).

[45] *See* Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757, 796 (1993).

[46] *See* Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J.L. & ECON. 489, 493 (1999).

[47] *See* Saltzburg, *supra* note 4, at 431.

suggest that we distinguish between offenses based on the identity of the injured party. Thus, offenses may be classified as either related-party or third-party offenses.[48]

Related-party offenses are those in which a party to the transaction in question has been directly harmed. These offenses include consumer fraud in its various forms, fraudulent overcharging, payment of bribes, receipt of kickbacks, and fraudulent bidding, such as where a contractor makes misrepresentations in order to win a contract.[49] In all these cases, the corporate misconduct results directly in harm to the injured party who is a party to the transaction.

A second category of corporate crimes involves conduct that injures third parties. Environmental offenses, for example, do not harm related parties, but instead cause damage to a public good. Other examples of third-party offenses include various regulatory offenses, such as a bank that fails to report large cash transactions in violation of federal law, or an exporter of goods that disobeys an embargo, compromising national foreign policy.[50] These offenses do not directly injure another party to the transaction, but instead cause a more indirect harm that is dispersed throughout some segment of the public, or the society as a whole. Because the harms caused by third party offenses are indirect and dispersed, it is unlikely that a corporation that commits such an offense would suffer a loss to its quality premium. In other words, a third party offense is unlikely to affect an individual consumer's perceptions about the quality of the corporation's product or service. However, this does not mean that the firm will escape all reputational losses. Consumers may be less likely to conduct business with an offending corporation because of ethical

[48] *See* Alexander, *supra* note 46, at 497-500.

[49] *Id.* at 498.

[50] *Id.* at 500.

considerations or a stigma that may attach to the guilty firm.[51]

A statistical analysis by Cindy Alexander demonstrates that the disparate impact of reputational penalties on corporations depends on the identity of the injured party. Alexander examines the impact of criminal convictions on seventy-eight public corporations occurring between 1984 and 1990.[52] Alexander found that the corporations suffered substantial reputational penalties, measured by losses in shareholder wealth, after being convicted. Consistent with the theory of market-based penalties, she also found that corporations convicted of crimes involving related parties experienced significantly larger shareholder losses than those convicted of crimes involving third parties.[53] These results persist even after controlling for the magnitude of the fine imposed.[54] The effect was most acute among smaller firms.[55]

The magnitude of reputational losses is also likely to be affected by certain characteristics of a firm's customers. In the normal case of atomistic consumers,[56] no individual consumer can significantly influence the reputational penalty borne by a corporation. Reputational losses will therefore only be experienced if it is in the narrow self-interest of a significant number of consumers to terminate their relationship with the supplier.[57] This will depend on both the availability of information in the market and the ability of consumers to share this information. For example, if an instance of corporate misconduct receives widespread coverage in the national news media, a greater reputational

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[51] *See* Saltzburg, *supra* note 4, at 431.

[52] Alexander, *supra* note 46, at 497-98.

[53] *Id.* at 504-05.

[54] *Id.*

[55] *Id.* at 520-21.

[56] These considerations are not present in the case of non-atomistic consumers.

[57] *See* Alexander, *supra* note 46, at 494.

penalty can be expected because more consumers will be aware of the misconduct and may act upon it. On the other hand, if the event is not widely publicized, consumers will be less likely to be aware of the misconduct, and the reputational effects will be attenuated.

Similarly, the ability of consumers to communicate with each other will affect the reputational losses incurred by a corporation, at least in the case of minimal publicity.[58] This ability depends on several factors, including how widely dispersed consumers are. If a corporation operates a small store which draws the majority of its customers from a single community, it is likely that consumers will be able to communicate relatively cheaply. In this case, many customers may even know each other, and word-of-mouth can be expected to operate efficiently to inform consumers of misconduct. The operator of a large retail chain operating over a wide area may be expected to suffer a smaller reputational penalty, as customers will be more dispersed and information will not flow as readily. This will be especially true if the misconduct involves only one location. A company that operates a mail-order catalogue may expect an even smaller reputational penalty, as customers will tend to be even more dispersed, and customers will be unlikely to encounter each other. A company that sells its wares on the Internet may be in a similar situation, but the ability of its customers to identify each other and communicate relatively costlessly over the Internet will mitigate, if not eliminate, the effects of geographic dispersion. More generally, the impact of the Internet in substantially decreasing costs of communication may lead to greater overall reputational penalties for corporations, whether or not they transact business on the Web.

[58] If the event is well-publicized, a large number of consumers would likely become aware of the misconduct through the media, and the ability of consumers to communicate with each other would therefore be of reduced (and perhaps eliminated) importance.

Despite the strong evidence that corporations bear substantial market-based sanctions for crime, the presence of these penalties was apparently not considered by the Sentencing Commission in formulating its scheme for corporate sentencing, as no mention of reputational penalties appears in the elaborate model that determines the criminal sanction. Of course, it is possible that the Commission recognized the existence of these sanctions and tailored the fine amounts sub silentio by mandating lesser fines than would have been appropriate given no reputational penalties. However, given the significant variation in the magnitude of reputational losses depending on the nature of the crime, the identity of the injured parties, and the nature of the firm's customers, the failure to account for these variations in setting criminal sanctions will necessarily result in either over-deterrence or under-deterrence.

VI. POTENTIAL SOLUTIONS

Although the Federal Sentencing Guidelines do not explicitly account for the presence of reputational penalties, sentencing judges can and should take these effects into consideration in determining the appropriate corporate sanction. In this way, individual judges may take significant steps toward optimal corporate sanctions under the current system. This is possible because the Guidelines include built-in safeguards that could perhaps make such an approach workable. The first, and less dramatic, is the ability of the sentencing judge to set a fine within a range determined by the Guidelines.[59] A judge might therefore take into account the reputational factors in determining where *within* the range the fine should be set. In fact, the Guidelines suggest such an approach in Section 8C2.8, a policy statement listing appropriate factors to be considered by a judge in setting a fine within the applicable range. One factor listed is "any collateral consequences of conviction,

[59] SENTENCING GUIDELINES, *supra* note 10, at § 8C2.7.

including civil obligations arising from the organization's conduct."[60] The language "including civil obligations" does not limit the scope of this consideration to such, and this section could therefore be interpreted as applying also to reputational losses as "collateral consequences of conviction."

The other, more dramatic, safeguard built in to the Guidelines to assure that appropriate sanctions are imposed is the ability of a sentencing judge to depart from the Guidelines-mandated range under certain circumstances. The requirement for a departure is "that there exists an aggravating or mitigating circumstance of a kind, or to a degree, not adequately taken into consideration by the Sentencing Commission in formulating the guidelines that should result in a sentence different from that described."[61] Section 8C4 of the Guidelines lists a number of factors that may not have been adequately taken into consideration and therefore may constitute appropriate grounds for departure. Although the list does not explicitly mention reputational penalties, it is not exhaustive. It is therefore possible that a sentencing judge, acting under the current formulation of the Guidelines, may depart based on reputational considerations.

Despite the limited ability of judges to factor in reputational penalties under the current system, the Sentencing Commission should do more to account for the effects of these penalties within the Guidelines. Efforts to incorporate reputational penalties into the Guidelines may come in two forms. First, the Sentencing Commission may attempt to control for the presence of reputational penalties ex ante by adjusting the fine scheme to take these factors into consideration within the Guidelines. On the other hand, the Sentencing Commission may provide additional mechanisms to enable the courts to control for market-based penalties by performing ad hoc analyses in individual cases.

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[60] *Id.* at § 8C2.8(3).

[61] 18 U.S.C. § 3553(b) (2000).

In order to account for reputational penalties, the Sentencing Commission might amend the Guidelines to account for reputational effects in its scheme for determining the corporate fine. This could be achieved in a number of ways, but in any case, it would probably resemble a point system similar to that used throughout the Guidelines. Points might be added to or subtracted directly from the offense level based on reputational factors designed to predict the reputational penalty. Alternatively, points might be added to or subtracted from the culpability score, which affects the fine multiplier. Factors that would likely be accounted for are the size of the corporation, the nature of the offense, the identity of the injured party (whether a related party or third party), whether customers are atomistic or non-atomistic, the degree of dispersal of the corporation's customers, the ability of customers to communicate, the level of media coverage that the case has drawn, and the current state of the company's reputation.

These factors are numerous and complex, and there is a significant degree of interplay between them. Furthermore, case-specific factors that would be nearly impossible to account for may render the calculus futile. For example, in the normal case of a crime involving the injury of a third party, such as a criminal violation of environmental regulations, we would expect the reputational penalty to be relatively low. On the other hand, consider the case of a company convicted of such a violation that is a manufacturer of consumer solar panels whose customers are primarily committed environmentalists. In this case, we would expect the market-based sanction to be high; at least higher than would normally be expected for an environmental violation involving unrelated injured parties. It is hard to imagine how the Guidelines could account for such factors ex ante, as they are likely to be numerous and unpredictable.

An ex ante approach to the consideration of reputational effects within the Guidelines, combined with the judicial discretion to set a fine within a range and to depart in extraordinary circumstances, may achieve a satisfactory

result in the determination of appropriate sanctions as well as provide for extraordinary cases. It would certainly be preferred to the current system, which does not account for reputational losses. However, such a system would still be imprecise, and would involve a significant amount of crude estimation and guesswork both on the part of the Sentencing Commission and the judge. A better system would therefore provide for a method of estimating the reputational losses that a convicted corporation may be expected to suffer in a particular case and applying this estimation to the final sanction imposed by the court.

Toward this end, the Sentencing Commission might provide for a hearing within the sentencing phase of the trial. The purpose of this hearing would be to provide a reasonable estimate of the reputational losses that the convicted corporation can be expected to suffer as a result of the conviction. This ad hoc approach would have the advantage of being able to take into consideration all possible factors affecting the magnitude of the reputational loss, including extraordinary factors that cannot be contemplated ex ante (such as the solar panel example), and apply them to the unique considerations of the individual case. Experts from both sides could be called to testify to the amount of the expected reputational loss, and the judge would then weigh the testimony to determine the best estimate.

This method of calculating the expected reputational penalty would resemble the provisions in the Guidelines for determining the "pecuniary gain to the organization from the offense" and "the pecuniary loss from the offense caused by the organization."[62] Similar to the provision that the court may forego these calculations if they would "unduly prolong or complicate the sentencing process,"[63] the revised Guidelines might provide that in cases where the reputational sanction would likely be negligible or where the

[62] SENTENCING GUIDELINES, *supra* note 10, at § 8C2.4(a).

[63] *Id.* at § 8C2.4(c).

costs of the process would likely outweigh the reputational losses, the estimation hearing would not be required, and the court may substitute a rough estimate.

VII. CONCLUSION

The reputational penalties suffered by corporations convicted of crimes and the civil remedies available to injured parties present issues for corporate criminal sentencing. In order to avoid the social costs of over-deterrence and under-deterrence, these independent sanctions must be coordinated in determining the socially optimal penalty. However, the Federal Sentencing Guidelines, as they currently stand, fail to sufficiently account for these factors.

The evidence presented in this Note suggests that failure to achieve the optimal sanction results in social costs, which are exacerbated in the corporate context due to agency costs. Reputational losses incurred by corporations that are convicted of crimes may in some cases be substantial. The nature of the crime, the identity of the injured party, the extent of media coverage, and characteristics of the corporation's consumers, inter alia, account for differences in the magnitude of the market-based penalty a convicted corporation can be expected to experience. This suggests that the Guidelines should account for these factors in formulating an appropriate sentencing scheme. Nevertheless, the difficulties of estimating the effects of these factors ex ante and the many potentially unforeseeable factors that may affect the calculus in an individual case warrant an ad hoc approach. Although judges operating under the current formulation of the Guidelines may take significant steps toward the optimal sanction by considering the probable reputational losses in selecting a specific fine from within the Guidelines-mandated range and in deciding whether or not to depart from the range, the Sentencing Commission should nevertheless take affirmative steps to remedy this problem.