The New World of Risk for Corporate Attorneys and Their Boards Post-Sarbanes-Oxley: An Assessment of Impact and a Prescription for Action

Beverley Earle

Gerald A. Madek

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The New World of Risk for Corporate Attorneys and Their Boards Post–Sarbanes-Oxley: An Assessment of Impact and a Prescription for Action

Beverley Earle† & Gerald A. Madek‡

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† Professor of Law, Bentley College and the McCallum Graduate School of Business; Fellow at the Bentley Center for Business Ethics; B.A., University of Pennsylvania; J.D., Boston University School of Law.
‡ Professor of Law, Bentley College and the McCallum Graduate School of Business; B.A., M.A., Boston College; J.D., Suffolk University Law School; and LL.M., Boston University School of Law. We wish to thank Provost Robert Galliers, Dean Margi Olson and the Enterprise Risk Management Group for the grant, which supported this research. We also wish to thank Christina A. Madek for her superb research assistance.

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INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX) imposed myriad requirements on corporate boards and corporate attorneys.1 The Act was enacted in compliance with a Congressional mandate charging the Securities and Exchange Commission (SEC) with promulgating rules to prevent fraud in public companies.2 The corporate community, already rocked by the collapse of Enron and WorldCom, struggled to comply with these complex regulatory requirements, while simultaneously dealing with the aftermath of September 11, climbing out of the recession, and negotiating the conditions of the troubled world economy.3 In a post-SOX world, corporate counsel and other separate counsel for corporate committees must navigate shoals of risk for themselves and their clients.

Section 307 of SOX empowered the SEC to set “minimum standards of professional conduct” for attorneys.4 In response, the SEC adopted 17 C.F.R. § 205 to implement section 307 of SOX in February 2003.5 Despite the initial proposals by the SEC in November 2002, which included the requirement that attorneys report suspected violations out to the SEC (the so-called “noisy withdrawal” provision),6 part 205 does not actually include those more...
controversial requirements. Instead, part 205 outlines a reporting “up the ladder provision.” This requires covered counsel to report to either the Chief Legal Officer (CLO) or, if the Board has an established Qualified Legal Compliance Committee (QLCC), to the QLCC. Part I of this Article discusses the reporting procedures of the “up the ladder” provision, which went into effect in August 2003. Part II of this Article discusses the noisy-withdrawal requirement, which was once again refloated for input in February 2003.

Part III of this Article discusses the American Bar Association’s response to the SEC changes. Part III also examines the American Bar Association’s revision of Model Rules 1.6 and 1.13 to permit lawyers to breach perceived client confidentiality obligations under certain circumstances. This section of the Article looks at how these changes would enable counsel to maintain professional standards when they were compelled to comply with SOX provisions to report “up the ladder.” Before adoption however, these changes were hotly debated. Part IV discusses how state bar associations responded in the wake of the Model Rule revisions as they decided whether to amend their rules of conduct in order for attorneys to accommodate the requirements of part 205. This Article will further discuss how there has been a lack of unanimity in this area.

Part V will then examine how the SEC has responded in kind to the various state bar challenges. The Article will next discuss, in Part VI, how corporations have operationalized SOX through the creation of qualified legal compliance committees (QLCC). Moreover, there has been a firestorm of debate surrounding the SOX regulations and Part VII will assess the controversy surrounding SOX and examines how SOX has been both criticized and welcomed by a wide range of counsel and corporations of varying size. Part VIII will open up the discussion by briefly evaluating how SOX in the United States has impacted other countries and Part VIII looks for evidence of a convergence between United States and other nations’ corporate regulation.

Moreover, domestically SOX has interesting implications on attorneys and general counsel as potential defendants in corporate criminal cases. Thus, Part IX will attempt to flesh out the interrelationship between the U.S. Sentencing Guidelines, and Corporate Compliance programs, as they related to the

8. Id.; see id. § 205.2(k) (discussing the definition of a qualified legal compliance committee).
10. See infra Part III.
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seminal case of Blakely v. Washington, in which the Supreme Court held that Washington State Sentencing Guidelines conflict with the U.S. Constitution’s Sixth Amendment right to trial by jury.

Finally, Part X will conclude the Article with recommendations to both streamline SOX as it is currently implemented and revise SOX in future legislation. Throughout this Article two questions persist: Will SOX actually deter the intended actions?; and Will the price be an acceptable one? With this Article we hope to contribute to the dialogue surrounding SOX and provide insight that will help to answer these crucial questions.

I. SOX AND THE SUBSEQUENT REGULATIONS

Enron filed for bankruptcy protection under U.S. laws on December 2, 2001. It was the largest company in the U.S. to utilize this process in what was a spectacular fall from the covers of national business magazines. Enron’s fall unleashed a flurry of study by regulatory agencies, culminating in the passage of SOX, which President Bush signed into law on July 30, 2002. The law was enacted without amendment by a vote of 423-3 in the House and 99-0 in the Senate. This history suggests that the usually lengthy deliberations which precede significant legislation did not occur and that now—some three years later—may be the appropriate time to reflect upon this hastily enacted and far-reaching legislation and subsequent regulations, which carry major ramifications for business, productivity, and competitiveness.

The SOX legislation was a dramatic response to numerous and mounting investor scandals. The goals summarized by one commentator are as follows:

13. 124 S. Ct. 2531, 2534-36, 2543 (2004). In Blakely the defendant pled guilty to kidnapping his estranged wife and the facts admitted in his plea, standing alone, supported a maximum sentence of 53 months; however, the judge imposed a 90-month sentence after finding the petitioner “acted with ‘deliberate cruelty,’ a statutorily enumerated ground for departing” from the standard range. Id. at 2535. The Washington Court of Appeals affirmed, rejecting petitioner’s argument that the sentencing procedure deprived him of his “federal constitutional right to have a jury determine beyond a reasonable doubt all [the] facts legally essential to his sentence.” Id. at 2536. Because the facts supporting the petitioner’s exceptional sentence were neither admitted by petitioner nor found by a jury, the Court held that his sentence violated his Sixth Amendment right to trial by jury. Id. at 2543.


15. JOHN BOSTELMAN, SARBANES-OXLEY DESKBOOK, Background—Twelve Months Leading up to the SOA, Vol. 1 (Practicing Law Institute 2004) (noting that some have shortened Sarbanes-Oxley to SOX and others to SOA).


17. See generally Corporate Scandals, ATLANTA J. CONST., Dec. 28, 2003, at 6Q; John Plender, Broken Trust, FIN. TIMES, Nov. 21, 2003, at 19; David Usborne, Scandals Put Wall St. Fat Cats in the
Berkeley Business Law Journal

Make management more accountable
Increase required disclosures
Strengthen the authority and obligations of corporate gatekeepers and outsiders
Remove conflicts of interest of management, auditors, gatekeepers and advisors
Regulate auditors more strongly
Strengthen the SEC
Improve guidance about accounting standards. ¹⁸

Unfortunately, the law did not take into account the cost or burden of these regulations or whether SOX was the most effective strategy to improve corporate accountability.¹⁹

While much has been written about other sections of SOX, this Article focuses on the role of attorneys. Section 307, a very brief section of the Act added by the House Senate Conference Committee to the original Senate version of the bill, stated in part that “the Commission shall issue rules, in the public interest and for the protection of investors, setting forth the minimum standards of professional conduct for attorneys appearing and practicing before the Commission.”²⁰ Section 307 specifically mandated that the attorney “report evidence of a material violation of securities law or breach of fiduciary duty or similar violation . . . to the chief legal counsel or the chief executive officer (or equivalent thereof).”²¹ This section also required some mechanism for follow-up if counsel did not detect an appropriate response.²²

When the SEC first proposed regulations to implement section 307 in November 2002, these proposed regulations were controversial because they included a “reporting out” obligation for attorneys under certain circumstances.²³ However, on January 23, 2003, after a public comment period, the SEC adopted regulations which instead required “up the ladder” reporting by attorneys rather than “reporting out.” This version of the regulations was published on February 6, 2003, and became effective on August 5, 2003.²⁴ However, the SEC allowed an additional comment period for the part of the


18. See BOSTELMAN, supra note 15.

19. See American Bar Association, Report of the American Bar Association Task Force on Corporate Responsibility (Mar. 31, 2003), available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf. Note, however, that costs as they were assessed in the report are unrealistic. For example, attorneys are listed as receiving $110 per hour but this is not a standard rate. But cf. Proposing Release, supra note 6. See generally BOSTELMAN, supra note 15, at 2-22 (discussing alternative approaches).


21. Id.

22. Id.


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original proposal that was most controversial—the noisy withdrawal provision. In addition to the reconsideration of the "noisy withdrawal" proposal, the SEC also included a new alternative proposal wherein the attorney would notify the issuer and then the issuer would be obligated to inform the SEC.

The SEC’s adopted “up the ladder” reporting requirement for attorneys mandates that when an attorney “appearing or practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation” such attorney shall “report such evidence to the issuer’s chief legal officer and its chief executive officer.” This requirement takes the language of SOX and translates this language directly into a regulation which clearly renders Congress’ intent. Regulation 205.2 resolves an issue that had troubled both U.S. and foreign attorneys by defining “appearing and practicing” before the Commission by excluding non-appearing foreign attorneys. The “up the ladder” requirement and the exclusion of non-appearing foreign attorneys demonstrate that the SEC was responsive to a number of concerns voiced through public comment when the regulations were first published in draft form. The SEC further defines evidence of a material violation to include “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.” Notwithstanding the double negative, the regulation clearly states that an attorney cannot ignore evidence or look the other way if a material violation has occurred.

As suggested earlier, the SEC regulations require an attorney not only to report material violations “up the ladder” but also to determine whether an “an appropriate response” is made by the chief legal officer (CLO). Regulation 205.2(b) defines three appropriate responses by the CLO “regarding reported evidence of a material violation.” First, the CLO might assert that there has been no material violation. Second, the CLO might report that there have been “remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has

25. February Proposed Rule and Releases, supra note 16.
26. Id. at 6335.
27. 17 C.F.R. § 205.3(b).
28. Id. § 205.2(b)(1).
29. Id. § 205.2(a)(2)(ii).
31. 17 C.F.R. § 205.2(e).
32. Id. § 205.3(b).
33. Id. § 205.2(b).
34. Id. § 205.2(b)(1).
yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence.\textsuperscript{35} Finally, the CLO might report that the issuer, through a board committee or a QLCC, has "retained or directed an attorney to review the reported evidence of a material violation and either" implement "remedial recommendations" or determine that there is a "colorable defense."\textsuperscript{36} This recognizes that attorneys are not stripped of their ability to defend their client. Attorneys are not converted to SEC moles or informants except when there is no basis for reasonable belief in a "colorable defense." Some commentators have argued that this is too big a loophole and that any attorney can make an argument of a defense in most instances.\textsuperscript{37}

If the attorney believes that the CLO has not made an appropriate response, part 205 requires the attorney to report further "up the ladder" to the audit committee, to another committee of the board, or to the board of directors.\textsuperscript{38} In fact, an attorney who believes reporting "up the ladder" will be futile may actually bypass the CLO and report directly to the audit committee, other committee, or the full board.\textsuperscript{39} On the other hand, if the corporation has previously formed a Qualified Legal Compliance Committee (QLCC), the attorney’s obligation to monitor the response to his report or report further "up the ladder" vanishes.\textsuperscript{40} The QLCC, as defined in 17 C.F.R. § 205.2(k), "[c]onsists of at least one member of the issuer’s audit committee . . . and two or more members of the issuer’s board of directors who are not employed, directly or indirectly, by the issuer and who are not[,] in the case of a registered investment company, ‘interested persons.’"\textsuperscript{41} Although the "noisy withdrawal" provision was not adopted, a QLCC has a responsibility to notify the SEC of a material violation under certain circumstances.\textsuperscript{42} However, once the attorney reports a suspected violation to the QLCC, the attorney’s obligation is finished.\textsuperscript{43} Thus, "[a]n attorney who reports evidence of a material violation to such a qualified legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer’s response to the reported evidence of a material violation."\textsuperscript{44} The QLCC, then, relieves the attorney of some of the assessment and monitoring functions he would otherwise have.\textsuperscript{45}

\textsuperscript{35} 17 C.F.R. § 205.2(b)(2).
\textsuperscript{36} Id. § 205.2(b)(3).
\textsuperscript{37} See generally Public Comments, supra note 30.
\textsuperscript{38} 17 C.F.R. § 205.3(b)(3).
\textsuperscript{39} Id. § 205.3(b)(4).
\textsuperscript{40} Id. § 205.3(c)(1).
\textsuperscript{41} Id. § 205.2(k).
\textsuperscript{42} Id. § 205.2(k)(4).
\textsuperscript{43} Id. § 205.3(c)(1).
\textsuperscript{44} Id.
\textsuperscript{45} See id.
Although attorneys are not required to report to the SEC, the regulations specify that attorneys may divulge confidences to the SEC in the following situations:

An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury . . . ;
(ii) To prevent the issuer . . . from committing perjury . . . or committing any act . . . that is likely to perpetrate a fraud . . .

To rectify the consequences of a material violation . . . that caused, or may cause, substantial injury . . . 46

In addition, regulation 205.6 attempts to insulate the liability of an attorney who decides to report out stating that "[a]n attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices." 47 More specifically, there is no private right of action against an attorney for his role in compliance or non-compliance with these regulations. 48 Furthermore, 17 C.F.R. § 205.3(b)(10) offers protections for whistleblowers who are terminated because of exercising their responsibilities under SOX. 49 However, for many attorneys, to turn on a client is a Hobson's choice, and the whistleblower's mantle offers little solace. 50

II. SEC'S PENDING PROPOSALS

A. Noisy Withdrawal and Alternative Proposals

In addition to issuing the regulations implementing section 307 discussed above, the SEC also issued two proposals for comment ending April 7, 2003. 51 The first was a reissue of the November 2002 "noisy withdrawal" proposal and the second was a so-called "alternative proposal." 52 The "noisy withdrawal" proposal called for an attorney to withdraw representation of a client and to notify the Commission when there was "no appropriate response within a reasonable time" and when "the attorney reasonably believes a material violation is ongoing or about to occur and is likely to result in substantial injury

46. Id. § 205.3(d)(2).
47. Id. § 205.6(c).
48. 17 C.F.R. § 205.7(a).
49. Id. § 205.3(b)(10).
50. See generally Public Comments, supra note 30 (including comments from attorneys expressing concern about burdens regulations place on them).
51. See February Proposed Rule and Releases, supra note 16.
52. Id. at 6326-29.
to the financial interest or property of the issuer or of investors . . . ."53 This regulation makes a distinction between an attorney "retained" by an issuer versus one "employed" by an issuer. If he believes there has been no appropriate response, an attorney "retained" by an issuer must withdraw in writing based upon "professional consideration."54 The attorney must also notify the Commission within one business day and also disaffirm any document that may be "materially false or misleading."55 However, an attorney who is "employed" by the issuer must notify the Commission but does not have to withdraw from representation.56 The CLO does need to inform any subsequent attorney (either retained or employed) that the previous attorney withdrew based upon "professional considerations." When the violation is not ongoing,57 the attorney may withdraw and may give notice but is not obligated to do so.58 In this context, there is still an obligation to notify any replacement attorney.59

As suggested earlier, however, if there is a QLCC provision, all responsibility shifts to the QLCC once the initial report of a material violation is made. Regulation 205.3(c)(1) relieves attorneys of additional responsibilities to monitor a response if the QLCC was notified. In addition, regulation 205.2(k)(4) provides that both individual members of the QLCC, as well as the committee as a whole, bear the responsibility and the authority to report to the Commission "in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take."60

In addition to the aforementioned "noisy withdrawal" proposal, the SEC also floated an "alternative" proposal which requires an attorney who finds substantial evidence of a continuing violation, and has not reported this violation to the QLCC, to notify the issuer of his withdrawal based upon "professional considerations."61 Under this proposal "the issuer shall within two business days of receipt of such written notice, report such notice and circumstances" to the SEC.62 Although this proposal also gives the attorney the option to follow-up with the Commission, such follow-up is not mandatory. However, this alternative proposal does contain an escape clause for attorneys which holds that "[a]n attorney shall not be required to take any action pursuant

53. Id. at 6326.
54. Id. at 6326-27.
55. Id.
56. Id.
57. See id. at 6324.
58. See id. at 6327.
59. Id.
60. See 17 C.F.R. § 205.2(k)(4).
61. See February Proposed Rule and Releases, supra note 16.
62. Id. at 6329.
to... this section if the attorney would be prohibited from doing so by the order or rule of any court, administrative body or other authority with jurisdiction over the attorney. An attorney shall give notice to the issuer that, but for such prohibition, he or she would have taken such action..."63

This escape clause suggests awareness that in some instances a state bar may curtail an attorney's actions. Just as the CLO has an obligation under regulation 205(d) to notify a replacement attorney that the previous attorney has withdrawn,64 the issuer also has such a notification obligation under this alternative proposal.65

B. Status of Proposals

The SEC received 253 comments on these pending proposals and posted the comments on their website.66 The commentators included individual lawyers, large law firms, bar associations, law professors, foreign counsel, individual investors and corporate counsel. In general, the comments continue to raise concerns about the impact of "noisy withdrawal" on the attorney-client relationship.67 Prior to January 23, 2003, there were 166 posted responses on the November proposals.68 However six were misfiled or duplicates. Of the remaining posts, only 21, or 13%, supported the controversial "noisy withdrawal."69 After January 23, 2003, there were a total of 86 comments where 15, or 17%, did support "noisy withdrawal" while 59, or 68% did not support "noisy withdrawal." Forty-seven (47), or 55%, did not support the alternative proposal either while 20 or 23% did support the alternative proposal. Many comments generally supported the intent of the regulations but qualified their support because of certain definitional problems. Those who supported noisy withdrawal often were law professors, investors, or the AFL-CIO.70 Lawyers engaged in representing clients, including corporations, expressed real concern about the regulations and their impact on the attorney-client relationship.71

63. Id. at 6328.
64. Id. at 6326.
65. Id. at 6328.
66. See Public Comments, supra note 30.
67. See id.
68. See id.
69. See id.
71. COMMENTS OF LATHAM & WATKINS LLP (Apr. 7, 2003), at http://www.sec.gov/rules/proposed/s74502/latham040703.htm; COMMENTS OF JONES DAY (Apr. 7,
Comments made by SEC officials underscore the SEC’s viewpoint. For example, SEC Commissioner Harvey J. Goldschmid addressed the Bar Association of New York on Nov 17, 2003. He stated, “There is a broad consensus that lawyers should play a critical gatekeeping role in large public corporations.” 72 He reiterated that a lawyer’s client is the corporation, not the particular individuals within the corporation. 73 While this may always have been true, in fact, the corporation’s CEO often hires counsel. Thus, it is not difficult to understand why counsel may have mixed loyalties, which may blur who the “client” actually is.

Reinforcing Commissioner Goldschmid’s emphasis on the role of lawyers in preventing corporate fraud, SEC General Counsel Giovanni P. Prezioso spoke before the Business Law section of the ABA Spring meeting on April 3, 2004. Prezioso began remarks with a story about a lawyer for an IPO who discovered that a controlling number of directors were felons and the company refused to disclose that in the prospectus. The lawyer allegedly told the directors that unless this was addressed he would report the matter to the SEC at 4 p.m. the following day. His phone rang 5 minutes before the appointed hour and the directors had resigned. 74 Prezioso cited this story approvingly, and emphasized that “[w]hile much of the evidence is ... anecdotal, we’re hearing that the rules are in fact strengthening lawyers’ abilities to serve their clients.” 75 Prezioso’s comments were an illustration of the positive impact that the SEC believes SOX is having on corporate accountability. Prezioso also quoted Senator John Edwards, who at a Senate hearing on Sarbanes-Oxley stated:

If you are a lawyer for a corporation, your client is the corporation and you work for the corporation[,] ... the shareholders, [and] the investors in that corporation; that is to whom you owe your responsibility and loyalty ... One of the most critical responsibilities that those lawyers have is, when they see something occurring or about to occur that violates the law ... they must act as an advocate for the shareholders, for the company itself, for the investors ... This amendment is about making sure those lawyers, in addition to accountants and executives in the company, don’t violate the law and in fact, more importantly ensure, that the law is being followed. 76

Prezioso continued and elucidated the SEC’s position on the controversial pending proposals by acknowledging that the Commission was “closely watching how lawyers are responding to the current rules ... [including] monitoring how well individual lawyers comply with the new rules, as well as

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73. Id.
75. Id.
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the extent to which the bar . . . . undertakes its own initiatives to address the concerns raised by Congress in enacting Section 307.\textsuperscript{77}

As Counsel Prezioso's comments indicate, the SEC appears to be taking a "wait and see" approach to the pending proposals. Given the overwhelmingly negative response to the January 2003 proposals, the SEC will probably not rush into a second phase of implementation at this time. When assessing the likelihood that these new regulations will keep corporate America honest, it is important to remember that while SOX imposes new obligations on attorneys, Rule 13(b)(2) of the Securities Exchange Act of 1934 had previously mandated that it was a civil and criminal violation for an officer or director of a public company or anyone else at their direction to improperly influence the company's auditors if such conduct could render the company's financial statements "materially misleading."\textsuperscript{78} Yet, these provisions did not deter the rash of corporate malfeasance, and so the latest wave of new laws and regulations were triggered.

As of this writing, the SEC has taken no action on these proposals.

III. AMERICAN BAR ASSOCIATION RESPONSE

From the legal profession's point of view, the central issue raised by the SEC's adoption of 17 C.F.R. § 205 is the potential conflict between the importance of encouraging clients to be honest with attorneys as recognized public policy\textsuperscript{79} and part 205's mandate that attorneys function as gatekeepers who, in some situations, must reveal client confidences.\textsuperscript{80} The SEC insists that imposing a monitoring duty on securities attorneys also serves an important public policy consideration—protecting investors in public companies—and as a result, protecting the health of the U.S. economy.

Although the ABA, the professional watchdog of the legal profession, does not quarrel with the goal of protecting investors, the organization has been adamant about opposing the SEC's "noisy withdrawal" proposal, which would require attorneys to report client confidences to the SEC in more broadly-circumscribed areas than state bar associations permit. The legal profession views this proposal as an attack on the essence of attorney-client privilege.\textsuperscript{81} In

\textsuperscript{77} Prezioso Remarks, supra note 74.

\textsuperscript{78} Representations and Conduct in Connection with The Preparation of Required Reports and Documents, 17 C.F.R. § 240.13(b)(2) (2003).

\textsuperscript{79} See MODEL RULES OF PROF'L CONDUCT R. 1.6 (Discussion Draft 2003) (indicating that this tends to result in upholding the law); Coffee, supra note 1 (summarizing the traditional argument that public policy should protect the confidentiality of attorney-client communications, since such protection encourages clients to be completely honest with their attorneys and thus maximizes the likelihood that the law will be obeyed and claiming that imposing gate-keeping duties on attorneys will dampen clients' willingness to communicate freely with attorneys and thus will undermine compliance with the law).

\textsuperscript{80} See 17 C.F.R. § 205 (2003) (requiring that attorneys report evidence of a "material violation" up-the-ladder in a corporation and then monitor whether corporate authorities take appropriate action).

\textsuperscript{81} See ABA Section of Corporations, Banking and Business Law, SEC Standard of Conduct for
an attempt to prevent the SEC from enacting their pending proposals, the ABA has modified its suggested Model Rules of Professional Conduct to outline what this organization views as gatekeeping requirements that do not gut the concept of attorney-client privilege.\footnote{These revised rules are essentially the same as the current SEC regulations. The revised rules require the attorney to breach client confidentiality to prevent or mitigate the effects of a financial crime. These rules also require that attorneys report perceived violations of law "up the ladder" within a company, but stop short of requiring the attorney to withdraw and report out to the SEC.} An examination of these ABA rule changes reveals an organization that is attempting to be responsive to the SEC's vision of the securities attorney's role in protecting investors, while asserting its own right to protect its internal vision of attorney loyalty to a client. This is a balancing act that requires nuance and compromise, both of which can be found in the ABA's proposed rule changes.

The ABA's response to part 205 clearly represents a loosening of traditional strictures against revealing confidential information. The changes to the Model Rules were recommended by a Task Force charged with examining the ethical principles which should govern lawyers in the post-Enron world and were approved by the ABA House of Delegates.\footnote{The August 2003 Model Rules contained additions to Rule 1.13 which require an attorney to report violations of securities law to the highest authority within an organization to prevent substantial injury to the organization. The modified rule also states that an attorney may reveal violations outside the organization if internal authorities fail to act and substantial injury is imminent.} The recommended changes involve two ABA Model Rules: Rule 1.6 and Rule 1.13. In framing these rule changes, the ABA immediately concedes some ground on attorney-client privilege. By emphasizing that lawyers have personal consciences and that moral considerations play a role in an attorney's decision to report corporate misdeeds, the ABA implies that securities attorneys have a moral duty to consider economic, social, and political factors which might adversely affect investors, rather than simply deferring to a traditional view of attorney-client privilege.\footnote{See Charles E. McCallum, Recent Changes in the Model Rules of Professional Conduct, in COUNSELOR OR ENFORCER? THE ROLE OF THE CORPORATE LAWYER POST SARBANES-OXLEY 225, at 227 (PLI Corporate Law & Practice Course, Handbook Series No. B-1394, 2003) (reporting that the ABA House of Delegates, in August 2003, approved changes to Rule 1.6 and 1.13 which were proposed by the ABA Task Force on Corporate Responsibility).} However, while giving ground, the ABA also defends its own past stewardship of attorneys' ethics by emphasizing that, prior to these revisions,
other Model Rules already required attorneys to act to protect the investor. Specifically, Model Rule 1.2(d) prohibits an attorney from assisting a client in committing a fraudulent act. In the face of a client who refuses to desist from the illegal activity, this rule requires the attorney to withdraw his representation of the client and even mandates “noisy withdrawal” in certain circumstances. Additionally, Rule 4.1 states that an attorney must not “fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.” Nevertheless, notwithstanding these original rules, the rule changes described below clearly shift the slant of the ABA Model Rules from protection of the corporate constituents with whom the attorney deals to protection of the corporation itself and its investors.

A. Model Rule 1.6

Rule 1.6 mandates that an attorney keep information which is relevant to that attorney’s representation of a client strictly confidential. This rule, as originally written, allowed breach of confidentiality only in two very specific circumstances: (1) to prevent a client from committing a crime which the lawyer felt was likely to result in death or injury, and (2) to establish a defense for the lawyer himself in a criminal or civil matter. This very narrow circumscription of the right to divulge client confidences highlights the importance of the attorney-client privilege to the legal profession and emphasizes the legal community’s public policy concerns about encouraging compliance with the law. Nevertheless, the August 2003 revision of this rule adds two more bases for legitimately divulging client confidences. In order to encourage corporate constituents to comply with laws designed to protect investors, the new rules permit the attorney to reveal client information to prevent use of his services to abet a crime which will harm the financial interests or property of another. Also, the attorney may divulge confidences to mitigate or rectify such financial harm after the fact. These additions highlight the emergence of financial crime prevention as an important part of the legal profession’s public policy consideration.

While the original rule allowed attorneys to breach confidences only to

86. See Model Rules of Prof’l Conduct R. 1.2 (1983). Rule 1.2(d) requires that a “lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent.” If necessary to avoid assisting a client commit a fraud, an attorney must withdraw and in some cases must notify third parties of his/her withdrawal and disaffirm documents.


88. See id. R. 1.6 (1983).

89. The ABA House of Delegates originally rejected any expansion of legitimate bases for revealing client confidences. See McCallum, supra note 84, at 2-3. They only approved inclusion of additional grounds for breaching confidence after the ABA Task Force on Professional Responsibility convinced delegates that the proposed changes would not gut the sanctity of the attorney-client privilege. Id.

90. See Model Rules of Prof’l Conduct R. 1.6 (amended Aug. 2003).
prevent physical harm, revised Rule 1.6 also allows an attorney to breach client confidence to prevent or mitigate financial harm and prohibits an attorney from allowing his services to be used in furtherance of such crimes. Permission to reveal confidences after a crime has been committed when the damage to be mitigated is financial and not physical represents substantial loosening of traditional strictures against revealing client confidences. This change, which circumscribes attorney-client privilege more tightly, clearly represents the ABA’s concession that securities attorneys must sometimes function as gatekeepers, responsible in part for preventing future corporate financial misconduct. These additions to Rule 1.6 were initially rejected by the ABA’s House of Delegates, likely because of this significant dilution of attorney-client privilege. However, upon the urging of the Task Force and after heated debate, the House of Delegates agreed to include prevention and mitigation of harm from financial crimes as legitimate reasons for divulging confidential information.9 However, as noted above, the ABA did not modify its rules to require attorneys to report out to the SEC in such situations, as did the originally-proposed “noisy withdrawal” proposal. By modifying its stance on attorney-client privilege to allow attorneys to take a more active role in preventing future Enrons, the ABA is outlining what it considers to be tolerable modifications to the concept of attorney-client privilege.

B. Model Rule 1.13

In revising Rule 1.13, the ABA further expands what it views as the permissible context within which attorneys may function as gatekeepers. As with Rule 1.6, however, this revision appears meant to stave off the ultimate SEC demand for “noisy withdrawal.”92 Rule 1.13 establishes that the organization, not the officers or other constituents with whom securities attorneys deal are, in fact, the clients of securities attorneys.93 Establishing this fact allows the ABA to permit securities attorneys to divulge limited information in carefully defined situations without compromising attorney-client privilege. If the organization, not the constituent, is the attorney’s client,

91. See McCallum, supra note 84 (demonstrating how Ethics 2000 Committee encouraged ABA to pass model rule changes).

92. See Proposing Release, supra note 6 (requiring attorneys to withdraw from representation, report such withdrawal to the SEC, and disaffirm relevant documents when corporate authorities fail to respond to attorney reports of violations); 17 C.F.R. § 205 (2003) (implementing final rules which do not require “noisy withdrawal”). These rules require an attorney to withdraw when corporate authorities do not respond to a report in a timely fashion but they do not require the attorney to report his/her withdrawal to the SEC or disaffirm documents. Id. Rather, the issuer must report the attorney’s withdrawal and the circumstances surrounding this withdrawal in a public filing. See id.

93. See MODEL RULES OF PROF’L CONDUCT R. 1.13 (amended Aug. 2003) (stating that “a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.”). This rule establishes that the attorney’s ultimate loyalty is to the corporate entity, not to the officers with whom the attorney is dealing. Id.
then the traditionally protected attorney loyalty is owed to the organization, not to the constituents. The recent changes to this rule eliminated wording which seemed to discourage reporting suspicions of financial crimes up the ladder. The changes elaborate possible extenuating circumstances and outline less severe options for action. In contrast, revised Rule 1.13 outlines a reporting scheme which actually requires securities attorneys to report up the ladder within a company and further allows them to report out to the SEC in specifically defined circumstances, but stops short of requiring external reporting as was required by the SEC’s originally proposed “noisy withdrawal” requirement.

In matters relating to an attorney’s representation of an organization, revised Rule 1.13 requires that the attorney shall report up the ladder as far as the highest authority within a company when an officer or other employee of the company “is engaged in action, [or] intends to act or refuses to act in a manner... [which] is a violation of a legal obligation to the organization... , and is likely to result in substantial injury to the organization... ” Another addition to this rule states that an attorney who is discharged or who withdraws because of actions taken to comply with this rule “shall proceed... to assure that the organization’s highest authority is informed of the lawyer’s discharge or withdrawal.” By emphasizing that the attorney’s ultimate loyalty is to the company, these revisions illuminate the ABA’s shift from protecting the corporate constituent to protecting the company and its stockholders. In addition, the revised rule adds wording which requires that the attorney monitor the response to his report of misdeeds. If the highest internal authority fails to act to protect the best interests of the organization, the revised rule states that the attorney “may reveal information relating to the representation” to an outside authority, even if other sections of the ABA Model Rules seem to prohibit this. Thus, the revised rules move the ABA much closer to the SEC on the gatekeeping issue. However, revised Rule 1.13 clearly leaves the final

94. See MODEL RULES OF PROF’L CONDUCT R. 1.13 (1983). Before the 2003 revision of this rule, Rule 1.13 held that an attorney who knows of a material violation which could likely cause substantial injury to the corporation “shall proceed as is reasonably necessary in the best interest of the organization.” However, the original rule then stipulated that “in determining how to proceed any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization.” By striking these words, revised Rule 1.13 shifts the focus to protecting the investor. See MODEL RULES OF PROF’L CONDUCT R. 1.13 (amended Aug. 2003).

98. See id.
99. See id. R. 1.13(c)(2) (amended Aug. 2003). The revision of this rule states that a lawyer “may... reveal information relating to the representation whether or not Rule 1.6 permits such disclosures, but only if, and to the extent, the lawyer reasonably believes necessary to prevent substantial injury to the organization.” Id.
decision about whether to report out to the attorney.\textsuperscript{100} This revised rule also emphasizes that permission to breach attorney-client privilege is still strictly limited to attorneys functioning in specific roles. For example, the new rule also adds a provision which emphasizes that reporting out is not permitted when an attorney is representing an organization to investigate or defend an alleged violation of the law.\textsuperscript{101}

By modifying Rule 1.6 and 1.13 to require that securities attorneys report up the ladder within client organizations and in certain instances report out, the ABA is accepting the SOX mandate that securities attorneys act as internal gatekeepers. These changes constitute acquiescence to the wishes of Congress and an attempt on the part of the ABA to compromise with the SEC. The ABA rules do not, however, sanction mandatory “noisy withdrawal.” That is, the changes to the Model Rules do not require an attorney to withdraw and inform the SEC although they do permit him to do so. Thus, the ABA makes significant concessions while attempting to preserve attorney independence and its own prerogative to police the legal profession. If the SEC, on the other hand, decides to adopt its pending proposal on “noisy withdrawal,” a faceoff with the ABA is likely.

The insistence on independence can be seen throughout the ABA’s revised rules. In every instance, the rules preserve the attorney’s right to make reasonable judgments. The attorney reports up only when he determines that such reporting is “reasonably necessary in the best interest of the organization.”\textsuperscript{102} Even if the attorney sees wrongdoing, the Model Rules permit him to refrain from reporting up if the attorney “reasonably believes that it is not necessary in the best interest of the organization to do so.”\textsuperscript{103} Thus, while narrowing the distance between the SEC’s vision of the attorney’s role in preventing corporate scandals and the profession’s traditional vision of its optimal role, the revised rules still insist on the attorney’s right to make reasonable decisions about an appropriate course of action based on the facts as the attorney sees them. The revised Model Rules, then, represent continued insistence on the attorney’s right to make independent decisions rather than mindlessly following mandates from an outside agency. In this regard, the rule changes attempt to hold the line against the SEC.

However, the balancing act is again made clear in the ABA’s comments on its revised rules. After emphasizing attorney independence in the rules themselves, these comments seem to warn against abuse of this independence. Specifically, in the Comment to Rule 1.13 the ABA states that “knowledge can

\textsuperscript{100} See id. R. 1.13 (amended Aug. 2003).
\textsuperscript{101} See id. R. 1.13(d) (amended Aug. 2003).
\textsuperscript{102} Id. R. 1.13(b) (amended Aug. 2003).
\textsuperscript{103} Id.
be inferred from circumstances, and a lawyer cannot ignore the obvious.\textsuperscript{104} Further, these comments spell out specifically what factors an attorney should consider when determining what action to take.\textsuperscript{105} Interestingly, these comments emphasize that, when an attorney represents a government agency, his assessment of a course of action should be qualitatively different from when he represents a private company. In the ABA’s view, when public business is involved, the balance between preserving confidentiality and preventing or rectifying wrongdoing should be tilted more heavily toward the prevention of harm to the public.\textsuperscript{106} In these comments, the ABA is clearly trying to negate the possible negative consequences of the attorney-independence stressed above, while emphasizing that attorneys have an obligation to be mindful of the public’s interest. Revised Rule 1.13 stresses an attorney’s right to make independent judgments, but, at the same time, the ABA’s interpretation of this rule spells out what a “reasonable” judgment entails, thus discouraging attorneys from hiding from the duty to act. Here, the ABA’s stress on its continuing function as a professional watchdog for lawyers implies that outside agencies need not interfere in the policing of the legal profession.

C. Criticism of ABA Action

As with all such compromises, the ABA’s revisions of its Model Rules have evoked criticism on both sides. While these changes do accept that securities attorneys should perform some gatekeeping functions, some detractors have found that these changes are not as extensive as they would like, while other critics are displeased because they have found that the revisions breach the integrity of attorney-client privilege more than they would prefer. In effect, this carefully balanced ABA response may illustrate why the ABA may not be the appropriate body to craft rules to mandate attorney’s compliance with SOX. In effect, the ABA is a private, guild-like organization whose allegiance is clearly to the legal profession.\textsuperscript{107} In effect, this reality creates a conflict of interest which perhaps compromises protection of the public interest against massive corporate fraud. To complicate this matter, each

\textsuperscript{104} \textit{Id. R. 1.13 cmt. 3 (amended Aug. 2003).}

\textsuperscript{105} See \textit{id.} The ABA’s comments state that “the lawyer should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations.” \textit{Id.}

\textsuperscript{106} See \textit{id. R. 1.13 cmt. 9 (amended Aug. 2003).} The ABA postulates that, “in a matter involving the conduct of government officials, a government lawyer may have authority... to question such conduct more extensively than that of a lawyer for a private organization in similar circumstances. Thus, when the client is a governmental organization, a different balance may be appropriate between maintaining confidentiality and assuring that the wrongful act is prevented or rectified for public business is involved.” \textit{Id.}

\textsuperscript{107} See \textit{Coffee, supra} note 1, at 1303 (arguing that the private status of the ABA means that its allegiance is to its members rather than the public, leading the organization to be less aggressive about enforcement).
individual state bar association sets its own rules of conduct which may or may not conform to the ABA’s Model Rules. While auditors and analysts are both regulated by independent organizations that are external to the profession and whose sole duty is to protect the public interest, attorneys are not regulated by any such board.\textsuperscript{108} Thus, critics point out that SEC regulation, which is arguably more objective than ABA regulation, may be more necessary in the case of attorneys than of auditors and analysts.

Critics of the ABA’s protective stance feel that securities attorney is synonymous with gatekeeper.\textsuperscript{109} Thus, a more objective body, like the SEC, might, absent political pressures, diminish the emphasis on an attorney’s independent judgment and impose more restrictive requirements on securities lawyers. These critics would argue this more objective agency would more explicitly acknowledge that standards for securities attorneys should be very different from standards for litigators because securities attorneys act in many ways like auditors, at minimum reviewing financial disclosure on which investors rely.\textsuperscript{110} These standards might, in fact, include “noisy withdrawal” and the review of attorney certification of financial results.\textsuperscript{111}

On the other hand, others within the legal profession clearly intend to protect attorney-client privilege regardless of the effect on the public interest. These critics feel that the ABA has done undesirable damage to attorney-client privilege in its attempt to protect the public interest. Thus, the President of the New York State Bar Association states that the revised Model Rules strike at “one of the ‘core values’ of the legal profession—lawyer-client confidentiality.”\textsuperscript{112} Predictably, such critics emphasize that trust is essential to the attorney-client relationship and that expanding the situations where this trust can be breached is intolerable and unnecessary. These critics also object to the attorney’s increased license to report up and out under the revised Model

\textsuperscript{108} See id. at 1303. As a result of Sarbanes-Oxley, auditors are now regulated by the Public Company Accounting Oversight Board. Securities analysts are regulated by the National Association of Securities Dealers and the New York Stock Exchange, both of which are monitored by the SEC. Id.

\textsuperscript{109} See id. at 1299. The author argues that Sommer’s definition of the securities attorney’s ethical responsibilities actually describes accurately the functions of a gatekeeper. These characteristics include “(1) independence from the client; (2) professional skepticism of the client’s representations; (3) a duty to the public investor; and (4) a duty to resign when the attorney’s integrity would otherwise be compromised.” Id.

\textsuperscript{110} See id. at 1296. Coffee believes that securities attorneys already perform some gatekeeping functions and that “the differences between attorneys and auditors are less fundamental and more marginal than opponents of the SEC’s proposed noisy withdrawal standard have recognized.” Id.

\textsuperscript{111} See id. at 1310. Coffee believes that the SEC could require attorneys to “take reasonable steps to insure the accuracy of statements made in documents that they prepare.” Such action by the SEC runs counter to the common practice in the legal profession of relying on clients’ assertions rather than making any effort to corroborate these assertions. Id.

\textsuperscript{112} See Press Release, The New York State Bar Association, Vote By American Bar Association To Turn Lawyers into ‘Snitches’ Is Not Necessary (Aug. 19, 2003), available at http://www.nysba.org [hereinafter Snitches]. New York State Bar Association President Thomas Levin stated, “The very foundation of a lawyer’s relationship with a client is based on trust. This proposal would permit lawyers to violate that trust, and is unacceptable.” Id.
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This line of criticism actually echoes in some ways the ABA’s own strategy in responding to the SEC mandate. Both emphasize that individual state bar codes already include provisions which adequately protect the public and both insist on the right of state bar associations to regulate the local practice of law. These critics also emphasize that “few states have disclosure rules as extensive as those proposed by the ABA.”

Whether the ABA or the challengers of its prerogatives are correct about the degree to which the public interest should supersede attorney-client privilege turns on how much compromise of this sacred legal tradition is actually necessary to protect the public interest.

IV. STATE BAR ASSOCIATIONS’ RESPONSE

Clearly, the revised ABA rules have provoked dissent within the legal establishment and will probably result in continuing skirmishes over states’ rights. Meanwhile, whether the SEC accepts the ABA concessions and drops its interest in “noisy withdrawal” will most probably be determined by the degree to which state bar associations conform their rules of professional conduct to the ABA’s Model Rules. Early response suggests that state bars will not rush to embrace ABA revisions. Individual state rules of professional conduct mirror the ABA’s original Model Rules which reflect more accurately the importance that state bar associations place on attorney-client privilege.

113. See id. Levin argues that the New York Bar Association’s rules are sufficient to protect the public interest and that the revised ABA Model Rules are unnecessary.

114. See id. Levin asserts that New York is not likely to adopt the ABA’s revised Model Rules. This corroborates Coffee’s view that the existence of independent state bar associations lessens the effectiveness of the ABA as a regulatory body. Id.

115. Id.

116. See Letter from the Corporations Committee Business Law Section, State Bar of California, to Giovanni P. Prezioso, Esq., General Counsel, Securities and Exchange Commission (Aug. 13, 2003), at http://www.ethicsandlawyering.com/Issues/files/CalSecletlettertoSEC.pdf [hereinafter Prezioso Letter]; INTERIM FORMAL ETHICS OPINION ON THE EFFECT OF SARBANES-OXLEY REGULATIONS ON WASHINGTON ATTORNEYS’ OBLIGATIONS UNDER RCP’S (adopted by WSBA Board of Governors on July 26, 2003), available at http://www.wsba.org [hereinafter Ethics Opinion]; Snitches, supra note 112. California attorneys object to the expansion of the area of permissible violation of client confidence, emphasizing that California rules prohibit attorneys from divulging client confidences because such a guarantee is fundamental to the successful operation of the justice system. See Prezioso Letter, supra. The California State Bar Association feels that loosening this prohibition could cause harm both to the attorney and to his client. Id. The Washington State Bar Association stresses that Washington lawyers are only permitted to reveal client confidences to prevent commission of a crime or to obey a court order. See Ethics Opinion, supra. The WSBA warns Washington attorneys not to disregard Washington state rules in an effort to comply with SEC regulations. Id. The State Bar Association of New York states that New York state rules are adequate to protect the public interest and that the ABA’s revisions in response to the SEC’s regulations will have no effect in New York. See Snitches, supra note 112. President of the Texas Bar Association, Guy Harrison, states, “historically, and in the best interest of our clients as well as the general public, lawyers have not been perceived as “certified public attorneys. Our responsibility has been to our clients, with specific rules that apply if our opinions and/or advice are known by us as being intended to be relied upon by third parties or the public in general. Our responsibility is and should continue to be to zealously represent our clients. We are not and should not be expected to be whistleblowers, corporate policeman, or graders of the accountant’s school papers.”
At the core of the states' resistance to the revised Model Rules is the fact that, while recognizing that the organization, not the constituent, may be the attorney's client, individual state bar codes nevertheless favor attorney-client confidentiality over the public interest. As mentioned above, state bar associations emphasize that local codes already contain provisions that loosen attorney-client privilege to protect the public interest. These codes often allow attorneys to disavow oral or written representations which the attorney subsequently learns to be false. In addition, these codes allow an attorney leeway, when he acquires knowledge that a crime may be committed, to report up the ladder to the highest internal authority and/or to withdraw from representation. However, while the SEC and ABA require these actions in specific situations, most local codes do not. In fact, several states specifically prohibit revelation of client confidences in such circumstances. Nor do state codes stress the importance of preventing and mitigating damage from financial misdeeds of corporate constituents, particularly when such misdeeds do not rise to the level of a crime—the traditional trigger for considering revelation of client confidences by attorneys.


117. See N.Y. STATE BAR ASSOC. LAWYER'S CODE OF PROF’L RESPONSIBILITY, Discipl. R. 5-109 (§1200.28) (2002), available at http://www.nysba.org/Content/NavigationMenu/Attorney_Resources/Lawyers_Code_of_Professional_Responsibility/LawyersCodeOfProfessionalResponsibility.pdf. While recognizing that “the lawyer is the lawyer for the organization and not for any of the constituents,” the New York State Code outlines actions an attorney may take to prevent a constituent from committing a violation which could cause substantial injury to the organization. Id. These actions include reporting internally to the highest available authority or withdrawing from representation. Id.

118. See id. Discipl. R. 4-101 (§1200.19A). This code stipulates that a lawyer may reveal “confidences or secrets to the extent implicit in withdrawing a written or oral opinion or representation previously given by the lawyer and believed by the lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud.” Id.

119. See CAL. RULES OF PROF’L CONDUCT R. 3-600 (2005), available at http://www.calbar.ca.gov/calbar/pdfs/ethics/2005_Pub_250_RPC.pdf (stipulating that an attorney “may take actions as appear to the [attorney] to be in the best lawful interest of the organization.”); N.Y. STATE BAR ASSOC. LAWYER’S CODE OF PROF’L RESPONSIBILITY, supra note 117, at EC 4-7 (insisting that “a lawyer is afforded the professional discretion to reveal the intention of a client to commit a crime and the information necessary to prevent the crime and cannot be subjected to discipline either for revealing or not revealing such intention or information”).

120. See CAL. RULES OF PROF’L CONDUCT, supra note 119, R. 3-600; Ethics Opinion, supra note 116. California holds that, even in the face of a material violation, which may cause substantial injury to the organization, “the member shall not violate his or her duty of protecting all confidential information as provided in Business and Professions Code section 6068 . . . .” Id. Washington requires that “a lawyer shall not reveal confidences or secrets relating to representation of a client unless the client consents after consultation,” except to prevent a crime or to comply with a court order. See Ethics Opinion, supra note 116.

121. See Prezioso Letter, supra note 116. Washington Rules of Professional Conduct [RPCs] do not allow disclosure of a civil violation if that violation does not rise to the level of a crime. See Ethics Opinion, supra note 116. Moreover, the State Bar of California stresses that a California attorney may report to the highest internal authority or may resign. They do not have an obligation to go public to protect the public interest. See Prezioso Letter, supra note 116.
Likewise, state codes often stress a series of responses to knowledge of criminal intent which stop short of reporting up the ladder, such as asking a client to reconsider a course of action.\textsuperscript{122} Thus, the emphasis in these codes, as in the original ABA Model Rules, appears to be on protecting the corporate constituent, rather than the corporate entity. For example, California’s rules emphasize that, even when the attorney has knowledge that a corporate constituent is about to take action which will cause substantial harm to the corporation, the attorney “shall not violate his or her duty of protecting all confidential information . . . .”\textsuperscript{123} While these rules then follow with attorney options for reporting potential misdeeds internally, they also stress that if the highest internal authority refuses to act on behalf of the corporation, the attorney may do nothing but exercise his right to resign.\textsuperscript{124} California also stipulates that an attorney must warn corporate constituents that the corporate entity, not the constituent, is the client, in situations where the constituent might otherwise reveal information which the attorney would be obliged to divulge to others.\textsuperscript{125}

In general, state rules of professional conduct do not presently recognize that the attorney has an obligation to act as a gatekeeper for the corporation even if the corporation, not the constituent, is the attorney’s actual client. These codes emphatically focus on protecting the specific corporate constituents with whom the attorney deals rather than focusing on protecting the corporation or its shareholders. In fact, state codes often emphasize that attorney-client privilege supersedes any gatekeeping function attorneys may have. California, for example, while recognizing the important role attorneys can play in upholding federal securities laws, adamantly insists that “that role does not make private attorneys an adjunct to the SEC in enforcing those laws.”\textsuperscript{126} Again, in specifically addressing attorney-client privilege when the client is a corporation, the California Rules of Professional Conduct state that “the public policy behind the attorney-client privilege requires that an artificial person be given equal opportunity with a natural person to communicate with its attorney, within the professional relationship, without fear that communication will be made public.”\textsuperscript{127} Here, the California Bar’s position fails to recognize the possibility of a conflict of interest between specific corporate constituents and corporate shareholders. Rather, the California Bar assumes that loyalty to the corporate officer with whom the attorney is in physical contact is the primary concern. This is clearly in conflict with the positions of the SEC and the more

\textsuperscript{122} See, e.g., \textit{N.Y. State Bar Assoc. Lawyer’s Code of Prof’l Responsibility Disciplinary, supra note 117, R 5-109 [§1200.28].}  
\textsuperscript{123} \textit{See Cal. Rules of Prof’l Conduct R., supra note 119, 3-600(B).}  
\textsuperscript{124} \textit{See id. R. 3-600(B), (C).}  
\textsuperscript{125} \textit{See id. R. 3-600(D).}  
\textsuperscript{126} \textit{See Prezioso Letter, supra note 116.}  
\textsuperscript{127} \textit{Id.}
reluctant ABA, who are both seeking to shift the slant from protecting corporate constituents to protecting the corporate entity itself, as well as the shareholders. In this same context, state response to the ABA’s revised Model Rules tends to stress the harm that violating attorney-client confidentiality can cause to the attorney and to the client, rather than the harm that can be caused to the shareholder or to the American economy.128

While most states have been silent about the revised ABA Model Rules, the bar associations in some major states remain more invested in their traditional vision of attorney-client confidentiality than in the mission mandated for attorneys by Sarbanes-Oxley and the SEC.129 Not surprisingly, given the discrepancy between state codes and the SEC mandate, these states are attacking part 205 and, by implication, the ABA’s revised Model Rules. Some are promising to press the issue of the SEC’s right to interfere with local ethics rules in court.130 They argue that, to the extent part 205 contradicts individual state Rules of Professional Conduct, the state rules must prevail. Further, some attorneys argue that, since part 205 allows, but does not require, reporting out, there is really no conflict between the SEC rules and state bar codes, which do not permit external disclosure. Attorneys in such states would be bound to follow state ethics rules and keep the client’s confidences, but would not, in the process, actually be violating part 205.131 Several key states claim that, because there is not yet any case law specifically upholding these particular SEC regulations, state bars are under no legal obligation to honor them, and therefore attorneys practicing in their jurisdictions may obey the SEC rules only at their peril.132 States claim the right to prosecute such violations of rules

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128. *Id.* The Prezioso letter points out that if an attorney reveals confidential information, that information may become available in a civil or criminal case, resulting in harm to the client. *Id.* Likewise, it warns that attorneys who rely on the SEC’s promise to protect whistleblowers from disciplinary proceedings may suffer harm if the SEC is found not to have the legal authority to offer that protection. *Id.*


130. See, e.g., Prezioso Letter, *supra* note 116. The California Bar Association states that “the California Bar has no power to declare a state statute unenforceable unless or until an appellate court so rules . . . the SEC’s authority to adopt these rules is untested and may be successfully challenged.” *Id.*

131. See Ethics Opinion, *supra* note 116. The Washington Bar Association states that “to the extent that the SEC Regulations authorize but do not require revelation of client confidences and secrets under certain circumstances, a Washington lawyer should not reveal such confidences and secrets unless authorized to do so under the RPCs.” *Id.* Washington attorneys emphasize here that part 205 outlines broader areas where breach of confidentiality is permissible than do the Washington RPCs. *Id.* Since part 205 does not require attorneys to breach confidences within these broader parameters, the Washington State Bar counsels Washington attorneys to adhere to the narrower circumscription of attorney-client privilege found in the Washington RPC. *Id.* The State Bar further warns that, if Washington attorneys breach confidentiality in areas not allowed by the RPCs, this will not make them immune from state disciplinary action, regardless of the “good faith” protection afforded by part 205. *Id.*

132. See Prezioso Letter, *supra* note 116; Ethics Opinion, *supra* note 116; Harrison Opinion, *supra* note 116. California asserts that the SEC’s authority to adopt regulations 205.3(d) and 205.6(c) is

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of professional conduct even though part 205 immunizes attorneys against such prosecutions of "good faith" efforts to comply with part 205.\footnote{\textsuperscript{133}}

In the absence of specific case law, dissenting states further claim that there is no evidence that Congress intended to give the SEC the power to effect such a massive intrusion into the affairs of the legal profession. These critics point out that courts have struck down other SEC regulations because there was no evidence of Congressional intent.\footnote{\textsuperscript{134}} They further note that Congressional intent is critical to determining this issue since the SEC, an administrative agency, only has the power "to adopt regulations to carry into effect the will of Congress as expressed by the statute."\footnote{\textsuperscript{135}} When examining the SOX statute, the advocates of states' rights point out that Congress empowers the SEC merely to set forth "minimum standards" for attorneys who practice before the Commission.\footnote{\textsuperscript{136}} They feel that this wording does not "invest the SEC with broad authority to permit lawyers to disclose client secrets and then immunize or otherwise protect those lawyers who do."\footnote{\textsuperscript{137}} In fact, one critic points out that "on three or four separate occasions, members of Congress specifically asked if [the bill] would require corporate lawyers to report to the SEC and were told no."\footnote{\textsuperscript{138}} To these critics, vesting the SEC with this power without a more substantial basis in the statute would in essence be undermining the legislative process to the detriment of states' rights.\footnote{\textsuperscript{139}}

\footnote{\textsuperscript{133}} See 17 C.F.R. § 205.6(c) ("An attorney who complies in good faith with the provisions of [part 205] shall not be subject to discipline... under inconsistent standards imposed by any state... where the attorney is admitted or practices."). \textit{But see} Prezioso Letter, \textit{supra} note 116; Ethics Opinion, \textit{supra} note 116.


\footnote{\textsuperscript{135}} Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129, 134 (1936) (noting example of case in which court struck down SEC's rulemaking authority); \textit{see also} Prezioso Letter, \textit{supra} note 116. The California Bar cites lack of evidence of Congressional intent as a likely basis for future challenges to part 205. \textit{Id.}

\footnote{\textsuperscript{136}} \textit{See} Sarbanes-Oxley Act, 17 C.F.R. § 307 (2002). While this section addresses the "public interest" and "protection of investors," it only authorizes establishment of "minimum standards" which does not necessarily have to be construed to mean such expansion of the right of attorneys to breach client confidentiality. \textit{Id.}

\footnote{\textsuperscript{137}} Prezioso Letter, \textit{supra} note 116.

\footnote{\textsuperscript{138}} \textit{See} Sue Reisinger, \textit{States' Rights All Over Again}, \textit{Corp. Couns.}, Nov. 2003, at 24, \textit{available} at LEXISNEXIS Library, \textit{Corp. Couns.} file. Reisinger quotes Michael O'Sullivan, who reviewed documents associated with SOX and stated that members of Congress asked several times whether this legislation would require corporate counsel to report to the SEC and attorneys were told no. \textit{Id.}

\footnote{\textsuperscript{139}} Bus. Roundtable, 905 F.2d at 413 (holding that allowing the SEC to act in a way that moves beyond Congressional intent "would circumvent the legislative process that is virtually the sole protection for state interests").
Not only do critics find a lack of evidence that Congress intended the SEC to require breaching of client confidentiality, they also claim that Congress gave no evidence of intent to preempt state laws.\textsuperscript{140} Historically, when Congress does not specifically address the preemptive effect of a new law on existing state laws, that silence is taken to evidence a lack of Congressional intent to supersede existing laws.\textsuperscript{141} However, these critics emphasize that in this case, although Congress did not mention any intent to supersede existing laws, the SEC wrote regulations which claimed this preemptive power. States' rights advocates see this as an unwarranted inflation of power by an administrative agency. Given this reality, these critics feel certain that, when challenged in courts, the SEC rules will be struck down under the mandate of the Administrative Procedure Act, which holds that a reviewing court must invalidate any agency rule which exceeds that agency's authority.\textsuperscript{142}

While this aggressive defense by some state bar associations might be dismissed as simply being prototypical resistance to change, such dismissal will likely fade as the new reality of the SOX mandate becomes part of the corporate culture, the core of these state arguments seems unlikely to lose its power to mobilize attorneys. To many attorneys, the SEC rules represent an outside attack on a central tenet of their profession and a mandate that they change their view of themselves as primarily loyal to their clients. Ceding this battle means ceding their right to self-determination and admitting the inadequacy of their self-regulation. To a number of attorneys such a concession would also signal an admission that attorneys might be at least partially culpable in the financial scandals that have recently rocked the U.S. economy.

Given this reality, attorneys may well be loathe to accede to the SEC mandate without a serious legal fight. Whether most states follow the ABA's lead and concede all but the most onerous SEC requirement—"noisy withdrawal"—may well depend on the outcome of this legal fight. Since attorneys may be forced, as the Washington position makes clear, to choose between obeying SEC part 205 or obeying local Rules of Professional Conduct, this fight may well begin when an attorney makes a choice that results in his prosecution by a state bar association.

V. SEC'S RESPONSE TO STATE CHALLENGES

The SEC has responded to these state challenges by outlining legal

\begin{itemize}
  \item \textsuperscript{140} See Prezioso Letter, supra note 116.
  \item \textsuperscript{141} See Pa. Med. Soc'y v. Marconis, 942 F.2d 842, 850 (3d Cir. 1991) (citing Cal. Fed. Sav. & Loan Assoc. v. Guerra, 479 U.S. 272, 287-88 (1997)) (stating that "when Congress remains silent regarding the preemptive effect of its legislation on state laws it knows to be in existence at the time of such legislation's passing, Congress has failed to evince the requisite clear and manifest purpose to supersede those state laws").
  \item \textsuperscript{142} 5 U.S.C. § 706 (2004).
\end{itemize}
precedents that suggest that the Commission does indeed have the authority to supersede state laws, even though specific case law on these regulations has not yet been established. Specifically, the Commission emphasizes that the Supreme Court has consistently affirmed that, when a federal agency enacts rules of conduct which conflict with existing state rules of conduct, the federal agency's rules prevail. The SEC cites Sperry v. State of Florida\textsuperscript{143} where the Court held that the regulations of the U.S. Patent Office governing who could prosecute patent applications superseded the rules of the Florida Bar.\textsuperscript{144} State critics have pointed out, however, that in this case Congressional intent was clear. Congress had expressly granted the patent office the power to make these specific regulations long before they were challenged by the Florida Bar.\textsuperscript{145} These critics believe that the facts of Sperry are in direct contrast to the lack of established Congressional intent for Sarbanes-Oxley to empower the SEC to enact far-reaching rules about attorney-client privilege. In contrast, proponents of SOX disagree, pointing out that because "Congress gave [the SEC] broad authority to set minimum standards of conduct for attorneys practicing before it," states who challenge part 205 in court will lose.\textsuperscript{146}

The SEC responds to the state bars' claims that rules which forbid such disclosure can prevail without triggering a conflict and subsequent preemption since part 205 permits, but does not require, external reporting by citing another Supreme Court Case. This case, Fidelity Federal Savings and Loan Ass'n v. de la Cuesta,\textsuperscript{147} holds that a conflict between a federal regulation and a state regulation "does not evaporate because the [federal] regulation simply permits, but does not compel" what state law prohibits.\textsuperscript{148} Here, the Court states that, if a state law removes the flexibility of choice permitted by a federal law, a conflict does exist and the federal law will prevail.\textsuperscript{149}

In response to state attacks on the SEC's grant of immunity from state

\textsuperscript{143} 373 U.S. 379 (1963).

\textsuperscript{144} See generally id. The State of Florida enjoined a non-lawyer from preparing and prosecuting patent applications before the U.S. Patent Office because, under Florida law, his action constituted the unauthorized practice of law. Id.

\textsuperscript{145} Prezioso Letter, supra note 116. The California State Bar points out three differences between Sperry and the SEC's implementing regulations for part 205. See id. First, Congress derived its power to establish a patent office directly from the U.S. Constitution, second, Congress subsequently expressly gave the Commissioner of Patents the power to determine who could act as patent agents. Id. Finally, at the time of the Sperry decision, the use of lay patent agents was routine. See id.

\textsuperscript{146} Special Report: Corporate Governance, BROWARD DAILY BUS. REV., Sept. 29 2003, at 18, available at LEXISNEXIS Library, BROWARD DAILY BUS. REV. file. Richard Painter, a law professor at the University of Illinois who defends the SEC regulations, posited that the SEC knew that only a minority of states had rules that prohibited attorneys from reporting out. Id. Painter stressed that, given this fact, the only reason the SEC would issue these rules would be for the purpose of preempting minority state rules. Id. This point does not, however, address the core issue of whether or not the SEC actually had the power to enact these rules. See id.

\textsuperscript{147} 458 U.S. 141 (1982).

\textsuperscript{148} Id. at 155.

\textsuperscript{149} See id.
prosecution to attorneys who comply with part 205, the Commission cites several other legal precedents. *Barnhart v. Walton*\(^{150}\) holds that a federal agency’s interpretation of its own regulation is afforded judicial deference.\(^{151}\) Since the issue of whether an attorney has acted in a “good faith” effort to comply with part 205 requires an interpretation of an SEC regulation, the SEC maintains that its definition of “good faith” must be accepted by states that wish to prosecute attorneys for violating state bar rules in an effort to comply with part 205.\(^{152}\) Further, the SEC warns that state attempts to define “good faith” differently from the SEC to justify prosecution of complying attorneys will fail,\(^{153}\) since *City of New York v. FCC* \(^{154}\) holds that federal agency regulations preempt any state regulation that “frustrates the purposes” of the regulation. Consequently, any prosecution of a complying attorney will be construed as an attempt to thwart the purpose of a preemptive federal regulation.\(^{155}\)

While the SEC has marshaled a convincing battery of legal precedent to bolster the legitimacy of part 205, the states have counterarguments and, as suggested above, this battle will undoubtedly be fought in the courts. Assuming that the SEC can demonstrate Congressional intent to empower the Commission to narrow the reach of attorney-client privilege, the SEC will most likely prevail in this legal battle because of the extensive precedent for federal preemption of state laws. The Commission will likely point out that the instances in which part 205 conflicts with state ethics rules will be few since this regulation only applies to instances where attorneys are practicing before the SEC. The Commission feels then that the vast majority of client confidences will not be affected by this SEC mandate. However, in reality, if states revise their local ethics rules to mirror the ABA’s revised rules, attorneys who do not practice before the SEC will also have increased latitude to reveal

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\(^{151}\) *Id.*

\(^{152}\) Letter from Giovanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission, to J. Richard Manning, President, Washington State Bar Association, and David W. Savage, President-Elect, Washington State Bar Association (July 23, 2003), *available at* http://www.sec.gov/news/speech/spch072303gpp.htm (maintaining that *Barnhart*, 535 U.S. at 217, upholds the agency’s power to define “good faith” and prohibits states from redefining this concept for their own purposes, but not addressing whether or not the SEC actually had the power to grant attorneys immunity at all) [hereinafter Manning Letter].

\(^{153}\) *Id.* (pointing out that under *City of New York v. FCC*, 486 U.S. 57, 64 (1988), the SEC’s definition of “good faith” will preempt any attempt by the states to redefine “good faith” in a way that subverts the purpose of part 205).

\(^{154}\) *City of New York v. FCC*, 486 U.S. at 64.

\(^{155}\) Manning Letter, *supra* note 152 (warning that under *City of New York*, any attempt by a state to discipline an attorney for breaching state rules of professional conduct in a good faith attempt to comply with part 205 will be viewed as an attempt to frustrate the purpose of the SEC regulation). The Washington State Bar Association warns that Washington lawyers must obey state RPC’s rather than part 205, while the SEC asserts that any disciplinary hearing, regardless of the result, would be seen as an attempt to subvert the SEC’s grant of immunity for “good faith” efforts to comply with part 205. *Id.*

The SEC stresses its right to preempt state RPC’s. *Id.*
client confidences since the ABA Model Rules do not limit this permission to attorneys practicing before the SEC. Thus, the motivation is strong for some states to maintain the attorney-client privilege intact and to fend off outside interference with their profession. The ABA will likely exert pressure on dissenting state bar associations to forego litigation and accept the compromises contained in its revised Model Rules on the premise that such compromises are the best way to protect attorney-client privilege from the most loathsome attack—the “noisy withdrawal” requirement. As suggested earlier, the resolution of this struggle may well turn on how effective the ABA is as the arbiter of this conflict between the right of attorneys to keep client confidences and the public interest in honest corporations.

VI. ATTORNEY RESPONSE TO SOX: THE FORMATION OF THE QLCC

Like the ABA and state bar associations, corporate attorneys in the workplace have to respond to the changes wrought by SOX. Many professionals envision a sea of change for attorney behavior. One attorney noted: “In the end... amendments to the ABA ethical code could in fact change the way lawyers behave—because lawyers who don’t report wrongdoing could wind up as defendants in shareholder suits. The new language about being able to breach confidentiality... becomes ‘You really better.’”

An interview with Ben Heineman, former-GE General Counsel and now senior vice-president for law and public affairs, suggests the difficulty facing counsel after SOX by asking, “[I]s it really possible to be both an independent counsellor [sic] and a business partner, a lawyer and a member of the management team?” Although Heineman believes that attorneys can and do perform this balancing act, his description of the task at hand highlights the difficulty of so doing. In his view, general counsel should be involved in everything from creating a “culture of compliance and integrity” to engaging in public debate and fighting the current cynicism about business. Thus, counsel’s already complex job has become even more so.

156. Robert T. Markowski, SEC Rules May Bump Up Against State Ethics Rules, CHI. DAILY L. BULL., Aug. 29, 2003, at 6 (pointing out that, while the SEC rules clearly apply to lawyers who represent clients before the SEC, these rules “also apply to any attorney who has provided any advice to his or her client ‘in respect of’ federal securities laws or regulations regarding any document that the attorney ‘has notice’ will be filed with the SEC or incorporated by reference into an SEC filing.”). Many attorneys who do not consider themselves to be SEC practitioners may be surprised to find that they are now subject to the SEC’s new rules of conduct. Markowski’s point illuminates state fears that the SEC’s intrusion into the territory of client confidentiality may indeed be the top of a slippery slope. Id.


159. See id.

160. Id.
One specific area of potential difficulty for counsel under SOX involves whether or not to recommend formation of a Qualified Legal Compliance Committee (QLCC). The fact that an attorney’s obligation is to the company and not to the individual CEO or CFO who hires him complicates this decision. One attorney, at a major Boston law firm, commented that he had not recommended that any clients form a QLCC, and he would not recommend forming a QLCC unless the SEC adopted the “reporting out” procedure. He thought that most counsel would not want the extra layer “interfering” between the CEO/CLO and counsel. However, several legal scholars have expressed a different more cynical view of the QLCC decision. Professors Jill Fisch and Caroline Gentile suggest that attorneys may be tempted to further their own self-interest and recommend a QLCC despite a perceived disadvantage to the corporation.

What has been the actual practice of corporations? Have they utilized the QLCC form? Two surveys suggest that attorneys are not vigorously lobbying for the creation of QLCCs, although the surveys reveal a trend toward using audit committees as QLCCs. One survey conducted July 2003 by the American Society of Corporate Secretaries highlighted this trend. Of the respondents in this survey, 11 indicated that they had formed a QLCC, 108 indicated that they had not and 100 did not answer the question. When asked if, in the absence of a QLCC, the full board would receive reports of alleged violations, 26 responded yes, 59 responded no and 132 did not answer. On the other hand, when asked if the audit committee would receive such reports when there was no QLCC, 87 responded yes, 5 responded no and 125 gave no answer. These results, while clearly not definitive, do suggest that in the post-SOX corporate world there is no quick movement to form a separate QLCC but there is a discernible pattern of using audit committees to serve the function of QLCCs.

Another survey of 176 companies by the Corporate Counsel showed similar results. Of these respondents, 84.8% reported that they had no intention of forming a QLCC but might reconsider if the SEC adopts a “reporting out”

161. Interview with partner at Boston law firm (July 14, 2004) (on file with authors).
165. Id.
166. Id.
167. See The Corporate Counsel.net, “Reporting Up” and QLCC Survey Results (Final), at http://www.thecorporatecounsel.net/survey/july03_total.htm (last visited Mar. 15, 2005).
Of the 15.2% who reported that they had formed a QLCC, 14% said that the audit committee functioned as the QLCC, while 1.2% said that the governance/nominating committee was their QLCC. Again, this survey suggests that attorneys are not putting great weight behind suggestions to begin forming QLCCs. However, as suggested above, these surveys were not exhaustive and certainly many of the large companies have gone ahead and established QLCCs. In fact, the corporate charters of many large companies include QLCCs. Thus, at least some large corporations appear to see a benefit in establishing a QLCC.

168. Id.
169. Id.
Johnson Controls:

**Authority/Responsibility**
The Committee shall have the authority and responsibility to do the following:

- Inform the issuer’s CLO and CEO of any report of evidence of a material violation.
- Determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:
  - Notify the audit committee or the full board of directors;
  - Initiate an investigation, which may be conducted either by the CLO or by outside attorneys; and
  - Retain such additional expert personnel as the committee deems necessary; and
- At the conclusion of any such investigation, to:
  - Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and
  - Inform the CLO, CEO, and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted.
- Acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement its recommendations.

**Procedures**
1. Notify the public and employees of the availability of the QLCC for reporting on the Corporation’s website and Hotline.
2. Assure QLCC reports are segregated and confidentially reported directly to the Chair of the Audit Committee.
3. Assure that the report is entered into a log of such reports and all records are maintained until the matter is resolved by the QLCC.

*Effective July 2003*

As with advising formation of QLCCs, law firms have not totally changed the way they do business in other areas post-SOX. For example, the SEC reported that when Speigel, Inc. withheld adverse financials, its counsel, law firm Kirkland & Ellis advised the company that it would be breaking the law.

However the firm did not withdraw and did not notify the SEC. Will SOX change the way attorneys perceive their obligations? Commentator Mike France noted:

[M]any of the highly paid corporate attorneys in America all but ignore the spirit of tax, corporate, and securities law. Instead, they are often linguistic Houdinis who specialize in hypertechnical arguments as to why their client’s rat poison meets the five-part test for being apple pie. Many corporate law firms have a “business ethos that does not appeal to a larger sense of right and wrong but instead defines itself solely in terms of technical compliance.”

France further explains:

This legal climate is making it a lot harder than it should be to throw executives in jail. And that, in turn, is forcing lawmakers to try to prevent future wrongdoing by devising increasingly detailed regulations governing how businesspeople, auditors, lawyers, and analysts should behave. Witness the Sarbanes-Oxley Act, a bureaucratic nightmare that is spawning a whole new industry in compliance software. Rather than force hundreds of managers to cut through red tape, it would make a lot more sense to put the few genuinely bad apples behind bars. But to do that the lawyers are going to have to be held more accountable for the advice they give.

Clearly, the need to maintain the balance between conforming to SEC regulations and effectively representing people who hire counsel makes this a difficult time to be corporate counsel. Although well-paid, attorneys face many dilemmas. Mark Belnick, recently acquitted counsel of Tyco, argued successfully that he believed he was doing nothing wrong and that his bonus was not “hush money” for his silence about Tyco CEO L. Dennis Koszlovski’s misdeeds. However, the fact that he had to make this argument at all underscores the new accountability and increased exposure for counsel. This elevated responsibility results from the fact that corporate counsel now operates within the federalization of responsibility. Evidence from the news suggests

172. Paul Rice & Peter White, Should They Whistle While They Work, LEGAL TIMES, Jan. 26, 2004, at 60 (suggesting that attorneys consult a shareholder board, not the SEC, when counsel has problems correcting wrongdoing).

173. Mike France, Close the Lawyer Loophole, BUS. WK., Feb. 2, 2004, at 70 [hereinafter Lawyer Loophole] (quoting law professor William H. Widen); see also Mike France, Can Law Profs Consult—And Keep Their Distance?, BUS. WK., Feb. 2, 2004, at 71 [hereinafter Law Profs]. France notes that some ethics experts are also willing to be employed to help assist in defense of law firms. Professors John Coffee, Geoffrey Hazard, Jr., and Charles Wolfram have reportedly assisted Vinson & Elkins in their handling of Enron legal matters.


175. Compare Former Tyco Attorney Acquitted, L.A. TIMES, July 16, 2004, at C3, with Kris Hundley, Enron’s Survivors Anticipate CEO’s Fate, ST. PETERSBURG TIMES, Feb. 19, 2004, at 1A (quoting Jeffrey Skilling’s lawyer and Enron’s former COO Bruce Hiler: “If a COO can’t rely on the dozens of experts who review and recommend transactions, then no COO should go to work tomorrow, because they may find themselves indicted.”). See also Mary Flood, The Fall of Enron, HOUS. CHRON., Feb. 17, 2004, at A1; Mike France, Art, Science, Crapshoot, BUS. WK., Mar. 29 2004, at 86, 88 (quoting Professor Alan Dershowitz: “The first rule of committing a crime in America is always [do so] with someone more important than you—so you have somebody to turn in. If you are Mr. or Mrs. Big then you have nobody you can offer.”).

176. See France, Law Profs, supra note 173.

177. But cf. Coffee, supra note 1 (commenting that “this essay by no means advocates the
that some counsel have responded to this responsibility.\textsuperscript{178} Sidley Austin reportedly withdrew from representing a corporation and reserved the right to report to the SEC.\textsuperscript{179} This is a clear difference from typical pre-SOX behavior. For example, prior to SOX, Vinson and Elkins apparently had no difficulty defending Enron's accounting behavior and even enlisted distinguished professional ethicists to support their position and to try to dissuade the courts from proceeding against them as well.\textsuperscript{180} However, in spite of some evidence of change, we should not expect SOX alone to dramatically alter the way counsel perceives his obligations.

Yet, in cases where counsel accepts the responsibility mandated by SOX, the corporate attorney can play a significant role both in preventing and identifying misconduct as well as in preventing harm to the corporation which ultimately affects the shareholders. For example, counsel's conduct reportedly persuaded the federal prosecutors not to indict HealthSouth along with its CEO Richard Scrushy.\textsuperscript{181} Similarly prosecutors opted not to indict Merrill Lynch because of actions of its counsel.\textsuperscript{182} However, the number of corporate attorneys who actually choose to accept this responsibility to curb corporate fraud remains to be seen.

\textbf{VII. ASSESSMENT OF SOX}

While everyone agrees that investor confidence was severely shaken by the recent scandals and needs to be restored, the verdict is out on whether SOX is the means to achieve that goal. SOX has no doubt changed the corporate landscape of management. The law firm Foley & Lardner recently published a survey called, "The Cost of Being Public in the Era of Sarbanes Oxley."\textsuperscript{183} It concluded that for companies with under $1 billion dollars in revenue the costs of sustaining as a public company increased 130\% through fiscal year 2003. Furthermore, these were not merely one-time costs; rather, the survey showed that these costs appear to be continuing and may even be increasing. This is particularly true of director compensation. The survey also noted that the
problem was not only escalating costs but also the unpredictability of the costs which include lost productivity as well.\(^{184}\)

In addition to cost, the survey found that 67\% of respondents found the governance and disclosure reforms for public companies too strict, which represented an increase of 12\% over the 55\% who so responded in 2003.\(^{185}\) The focus of much of the concern was section 404, or the certifications required by the CEO.\(^{186}\) As a result of these concerns, 21\% of respondents (up from 13\%) were considering going private and 13\% were considering selling or merging the company.\(^{187}\) These concerns may ultimately have a widespread effect on which companies choose to go public. Recent figures seem to confirm this turning away from the IPO process. In 1999 and 2000 the average annual sales of a company with an IPO was $15 million; in contrast, between 2002 and 2004 the average was $164 million.\(^{188}\) While it is difficult to lay the reason for this change at the feet of SOX, it is clear that SOX and its progeny constitute one of the factors. The fact that post-SOX regulations are partly to blame for the move away from public companies is borne out by the results of another survey, which found that “59\% viewed overregulation as a significant risk . . . to the growth of their companies—far more than viewed global terrorism . . . as posing major risks.”\(^{189}\) Also, the costs of these compliance efforts weigh heavily on the small company.\(^{190}\) Brent Longnecker, president of Longnecker & Associates, a Houston Consulting Firm, verified that this is a significant problem for small companies: “Any company under $100 million in revenues has to be asking itself whether it’s worth it to stay public.”\(^{191}\) The SEC seems to

\(^{184}\) Id.

\(^{185}\) Id.

\(^{186}\) Id.

\(^{187}\) Id.; see Emily Thornton, A Little Privacy, Please, BUS. WK., May 24, 2004, at 74. See generally Sarbanes-Oxley: Time To Step Up, BUS. WK., July 19, 2004, at 100 (noting that “CEOs say that the cost of compliance is onerous. Yet it is hard to see much impact. Earnings are at record levels, and many companies have billions in cash. Moreover, implementing Sarbanes-Oxley is mostly a one-time cost. Once the compliance structures are in place, annual costs should fall.” Also noting that only 5\% of 500 big corporations surveyed are in compliance with the required financial controls.).

\(^{188}\) See Thornton, supra note 187.


\(^{190}\) See id. (quoting Michael Dell of Dell Computer: “For big, established companies that already do the right thing, it is no big thing.” But he also passed along a song being circulated on the Internet about a supposed chief executive who has nightmares about being led away in handcuffs. “I really miss the good old days, when I told my board what to do,” he sings. “Now my audit committee is slapping me silly. Got the Sarbanes-Oxley blues.”) (internal quotations omitted); but see Anne Field, Some Private Companies Embrace Tougher Rules, N.Y. TIMES, July 15, 2004, at C6 (providing that some small companies are trying to incorporate SOX changes in governance to help the company be more profitable by incorporating outside directors who have new perspectives and can help grow the business and also help them get ready to be acquired).

\(^{191}\) Melinda Ligos, When Going Public May Not Be Worth It, N.Y. TIMES, June 3, 2004, at C7 (telling the story of a company that went public in 2001 with 35 employees and $10 million in revenue and later determined that it would cost $400 thousand to comply with SOX. “The decision to return to private status ‘became a no-brainer,’ Mr. Huzenlaub said. ‘We were pouring all of our resources into...
have heard these complaints and has established a committee to examine the effects of SOX on smaller companies in December 2004.\textsuperscript{192}

The CEO of the New York Stock Exchange, John Thain, expresses the same reservations about SOX despite his agreement with the objective of improving investor confidence.\textsuperscript{193} He notes several persistent issues associated with SOX: (1) the costs of compliance a significant increase over operational costs pre-SOX;\textsuperscript{194} (2) the decline in the listing of foreign companies on the exchange as a result of the foreign companies reluctance to pay additional amounts to comply with SOX;\textsuperscript{195} and (3) the increase in anti-business litigation and class-action lawsuits. Thain implies that SOX could accelerate these trend.\textsuperscript{196} He stresses the importance of balance in these reforms:

[W]e do not want America’s most promising and successful companies to start pulling back from our capital markets. We need to find a better way. In matters of governance and regulation we should be guided by an equivalent of the Hippocratic Oath, “Do no harm.” We need to strike a balance between the costs of increased time and resources devoted to compliance, and the incremental benefits they will produce in terms of transparency and governance. We at the NYSE would be willing to bring together a representative sample of listed companies to discuss these rules and the cost-benefit of the new requirements. Let the principles of Sarbanes-Oxley remain intact, but at a price that makes sense to the economy.\textsuperscript{197}

In addition to concerns about costs and over-regulation, another previously-noted concern is the effect of these regulations on the attorney-client privilege post-SOX. As discussed earlier, post-SOX requirements include the request by SEC investigators for a limited waiver of attorney client privilege during investigations.\textsuperscript{198} While such a waiver has not been unequivocally required at compliance instead of trying to grow the business . . . [and it] no longer made sense for us to be public.”). The author also references a Grant Thornton International study showing 120 companies announcing plans of going private versus 92 in the same period before SOX. \textit{Id.; see also} Thornton, supra note 187, \textit{cf} John Thain, \textit{Sarbanes-Oxley: Is The Price Too High?}, \textit{WALL ST. J.}, May 27, 2004, at A20 (discussing the high price of SOX, particularly on European companies); Phyllis Pritch, \textit{Blowing the Whistle: Sarbanes-Oxley Requires That Companies Treat Internal Complaints}, \textit{WALL ST. J.}, June 21, 2004 at R6 (discussing how SOX has made it easier for employees to complain, thus illustrating another cost of compliance).


\textsuperscript{193} Thain, supra note 191.

\textsuperscript{194} \textit{Id.}

\textsuperscript{195} \textit{Compare id.}, with Paul Volcker & Arthur Levitt, Jr., \textit{In Defense of Sarbanes-Oxley}, \textit{WALL ST. J.}, June 14, 2004 (estimating that he has seen no impact on foreign company listing and referring to the Foley & Lardner survey previously, stating how a number of public companies are considering going private).

\textsuperscript{196} Thain, supra note 191. \textit{But see} Volcker & Levitt, supra note 195 (discussing a cost benefit analysis of SOX and comparing the costs with investor losses stating, “we must not forget that the U.S. markets are the best in the world because they are the best regulated”).

\textsuperscript{197} \textit{See} Thain, supra note 191; \textit{see also} Norris, supra note 189.

\textsuperscript{198} Burns, supra note 3 (providing General Counsel Logan Robinson’s discussion on not adopting the reporting-out procedure because when you use a limited waiver when turning something over to the SEC, this could then be used by third-parties against you); \textit{see also} Bob Sherwood, \textit{How Safe Is It to Confide in Your Lawyer?}, \textit{FIN. TIMES}, Oct. 27, 2003, at 12. Richard Fleck, a British corporate partner
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this point, the regulations create a climate where counsel may be pressured to waive privilege. Such pressure would create a very difficult predicament for the corporate attorney.

However, not all experts are so negative about SOX. For example, John Coffee of Columbia University argues persuasively that attorneys can be gatekeepers. He argues that the SEC should go further and require attorney certification that any material is not “misleading.” He states, “[I]n this light such a negative certification requirement would simply mandate for the 1934 Act periodic filings what is already done by the private insurers in the primary market for 1933 Act disclosure documents.” Coffee suggests a second certification is advisable stating that the attorney “believed adequate disclosure had been made.” Coffee dismisses state bar associations as neither effective nor comprehensive in regulating and policing attorney conduct and heartily welcomes SOX as a step in the right direction.

Similarly, Paul Volcker, the former Federal Reserve Chairman, defends SOX as well. He dismisses the cost of regulation argument by suggesting that companies have been remiss in not having adequate controls in the first place. He notes how many companies have had to correct their financials in recent years. Volcker also emphasizes the benefits of regulation:

Countries are emulating our reforms—from the new combined Code in the U.K. to Germany’s new Kodex of best practices—and as a result, we are strengthening the global economy, not being defeated by it . . . While there are direct money costs involved in compliance, we believe that an investment in good corporate governance, professional integrity and transparency will pay dividends in the form of investor confidence, more efficient markets, and more market participation for years to come.

It is early in the history of SOX to assess its impact. However, if the goal is to maintain markets in which investors are fully confident that the financial statements are accurate and reliable, then making explicit what has always been an attorney’s implicit obligation is an important step. What is more difficult to

pointed to “US investigators’ offers of leniency if corporations waive their right to attorney-client privilege and hand over confidential material when they are under suspicion.” Id. Fleck also states that “many believe that [waiving attorney-client privilege] offers the companies ‘Hobson’s Choice’—they can either waive their right or be pilloried for failing to cooperate.” Id. But see Burns, supra note 3 (giving examples where many individuals were more positive about the impact of SOX).

199. Coffee, supra note 1.
200. Id.
201. Id. at 1313.
202. Id. at 1314.
203. Id. at 1316. Coffee states that despite the shortcomings of the “guild-like regulation by state bar associations” something short of the “federalization of . . . ethics” is necessary. Id. He concludes with a quotation: “To paraphrase Clemenceau, professions are too important to be left to the professionals.” Id. It is ironic that Coffee has taken this aggressive stance and yet also has been hired to defend such professionals.
204. Volcker & Levitt, supra note 195 (commenting on possibility that European companies might not want to be listed in U.S. as turning out not to be true). But see Thain, supra note 191.
205. See Volcker & Levitt, supra note 195; see also Sherwood, supra note 198.
assess is the impact of the burden of regulation on development and growth. Surely sclerotic government regulation hampers business growth. SOX does not obviously fall into that category but, if it deters public offerings, or deters foreign companies from listing on the New York Stock Exchange, SOX may damage the U.S. economy in the long run.

VIII. INTERNATIONAL DIMENSIONS

It is not surprising in the globalized interdependent business world of today that changes in the United States might reverberate in Europe and Asia. As one writer for the Financial Times noted:

In an apparent attempt to head off stricter SEC regulation, the American Bar Association in August relaxed its ethics rules to allow, rather than require, lawyers to blow the whistle on clients if they discover corporate misdeeds.... Richard Fleck, corporate partner at Herbert Smith, the London based law firm... points to US investigators’ offers of leniency if corporations waive their right to attorney-client privilege and hand over confidential material when they are under suspicion.... The winds of change have blown across the Atlantic too... and the U.K. government has made it clear... that the need to tackle terrorism and organised crime must override legal privilege in some circumstances.

Thus, the discussion in the United States described in earlier portions of this Article continues internationally as legal privilege, once considered sacrosanct, is being eroded on both sides of the Atlantic in the name of necessity. In essence, this erosion of attorney-client privilege signals a shift from rigid adherence to the principle of privilege in safeguarding individual rights to an emphasis instead on safeguarding societal rights.

However, not surprisingly, there are differences between the U.S. and the European approach to the issues of poor corporate governance and resulting loss to the shareholders. The U.S. response to the problem was the passage of SOX and the subsequent regulations. Interestingly, Tony Tassell of the Financial Times explained that, outside the U.S., SOX is “widely derided as a hurried, overly-legalistic response to the unfolding corporate scandals.” In fact, the U.S. approach is in direct contrast to the European approach to the problem which is described as a “‘soft law’ model—requiring companies to comply or to explain with an evolving set of principles of best practice rather than laying down inflexible, limiting legislation.” Twenty-three European-Union countries plus Turkey and Switzerland have enacted such corporate

206. See Sherwood, supra note 198.
208. See id.; see also Bosses Behind Bars, ECONOMIST, June 12, 2004, at 59 (“Outside America, short custodial sentences remain the norm. The typical sentence for fraud in England is four years, and almost never more than ten.... In Germany, the maximum sentence for serious fraud is ten years, though most people get less.”).
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governance codes in the past few years. For example, in July 2002 Italy adopted il Codice di Autodisciplina delle societa' quotate rivistato, the Italian corporate governance code. Similarly, Germany passed the Corporate Governance Kodex in February 2002, which was amended in May 2003; Sweden adopted the Swedish Code of Corporate Governance in December 2004; and also in December 2004, Belgium published a corporate governance code.

Many of these Codes were modeled or inspired by the Organisation for Economic Co-Operation and Development (OECD) Principles of Corporate Governance first adopted in 1999 and updated in 2004. The Principles are non-binding and, as the authors say in the Preamble, "their purpose is to serve as a reference point." There are six principles in the framework, which primarily stress transparency, disclosure and absence of conflict of interest. Although it would be easy to be cynical about the impact of purely advisory principles, it is useful to remember the history of the OECD's work on anti-bribery and the important role it has played through its enactment of the Convention in Combating Bribery of Foreign Public Official in International Business Transactions. The Agreement effectively criminalized bribery of public officials in international business transactions, thereby encouraging international economic cooperation and demonstrating the OECD's efficacy in international business affairs.

The European Union considered how Europe as a whole should respond to the passage of SOX, as well as Europe's own corporate scandals. On May 21, 2003 the European Commission issued a report entitled "Communication from the Commission to the Council and the European Parliament (Modernising Company Law and Enhancing Corporate Governance in the European Union -

209. European Corporate Governance Institute, Index of Codes, available at http://www.ecgi.org/codes/all_codes.htm (last visited Mar. 17, 2005); see also Tassell, supra note 207.
216. See id.
A Plan to Move Forward). In this report, the Commission concluded that:
There is little indication that the development of a European corporate governance code as an additional layer between principles developed at the international level and codes adopted at national level would offer significant added value. In that respect, the Commission notes that corporate governance is now at the forefront of the activities of the OECD, which recently decided to revise its corporate governance principles of 1999 with the aim of adopting a modernised version of these principles in 2004.

A self-regulatory market approach, based solely on non-binding recommendations, is clearly not always sufficient to guarantee the adoption of sound corporate governance practices. Only in the presence of a certain number of made-to-measure rules, markets are able to play their disciplining role in an efficient way. In view of the growing integration of European capital markets, respect to a few essential rules and adequate coordination of corporate governance codes should be ensured.

At present, the European Commission is moving ahead with a number of proposals to increase disclosure through the annual report, strengthen shareholders’ rights and modernize the board of directors. Progress has been agonizingly slow. The European Union has chosen to use the nonbinding recommendation format rather than regulation or directive. This means simply that the European Commission recommends that member states take the suggestion and craft it into national law. On October 6, 2004, two recommendations were enacted. The first addressed independent directors as well as disclosure requirements. The second recommendation on the same day sets out guidelines on directors’ pay, disclosure, and shareholder approval. The Commission also proposed a directive on company law to simplify the formation, maintenance, and alteration of companies’ capital.


219. Id. at 12.

220. Id. at 12-26.


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the Commission’s release stated:

Stakeholders find some aspects of the current legal capital regime under the Second Company Law Directive too inflexible and costly. To remedy this, the new proposal would enable Member States, under certain conditions, to eliminate specific financial reporting requirements and to facilitate specific changes in share ownership. It would also bring into line across the EU the basic element of legal procedures for creditors when capital is reduced.225

The choice of the Directive means that while a member country has a defined period of time to implement its own law, it is mandatory and the EU could bring enforcement proceedings if the country fails to do so. The EU also instituted a European Corporate Governance forum which had its first meeting in January 2005.226 Its purpose is “to encourage the coordination and convergence of national codes....”227 Additionally, the EU called for applications for an Advisory Committee on Company Law and Corporate Governance that will offer “technical advice on implementation of the 2003 Company Law and Corporate Governance Action Plan.”228 However, all of these measures are dramatically different from the U.S. approach under SOX and the SEC regulations. It remains to be seen whether the E.U. sticks with this less intrusive tact and whether individual countries opt to exceed what is suggested.

Separate countries have also independently enacted other laws, which may have initially been motivated by an attempt to address terrorism but have other applications as well, just as RICO was initially adopted in the United States as a tool against organized crime but was then subsequently used against business people.229 For example, a new law in the U.K., the Proceeds of Crime Act, will require “lawyers, as well as accountants and those providing financial services—to report to authorities whenever they find, suspect, or even ought to suspect that a client is engaged in money-laundering.”230 The implications of


225. Id.


227. Id.


this new law are staggering. One commentator noted:

Divorce lawyers were left reeling by a judgment this month from Dame Elizabeth Butler-Sloss, Britain's most senior family judge, that the Act requires them to report even the smallest tax evasion—such as paying tradesmen or nannies in cash. Divorce solicitors leapt on the "ludicrous" implications of turning them into tax spies, warning that divorces could be complicated if a spouse threatened to reveal tax evasions to force a higher settlement.\footnote{231}

This British law no doubt chills the attorney-client relationship. One commentator tried to capture the extent of concern noting "a Spanish bullfighter buying a house in England might do well to avoid a British solicitor."\footnote{232}

It is not surprising that the legal developments in the U.S. are reverberating around the world. Corporate scandals have not been confined to the United States. Countries realize that without investor confidence in the markets, capital will flow elsewhere and so while there is not rapid convergence of law, there are developments suggesting that countries may be watching the U.S. and the results closely. Regardless of whether the laws converge, issuers of securities in the United States will have to comply with SOX even if they are based in Europe. Thus there may be standardization of practice even without convergence of national laws. However, at least one commentator has predicted that "change is coming" to the Continent in terms of regulation.\footnote{233} Efforts to monitor these developments have already commenced. The European Corporate Governance Institute and the American Law Institute convened the first of a series of conferences July 2004 in Brussels, which brought together Harvey Goldschmid, SEC Commissioner; Alexander Schaub, Director General of the EU Internal Market; Mario Draghi, managing director of Goldman Sachs International; and leading professors from the U.S. and the E.U. to discuss corporate governance and related issues.\footnote{234} Whether the legalistic approach taken by the U.S. or the principle-based approach favored by Europe is more effective in terms of costs and results will not be known for at least several years.

IX. INTERRELATIONSHIP BETWEEN SENTENCING GUIDELINES, COMPLIANCE PROGRAMS, AND SOX

In Sentencing Reform Act of 1984, Congress directed the U.S. Sentencing

\footnote{231. Sherwood, supra note 198.}
\footnote{232. Id. (discussing the concerns of Paul Marshall, a British commercial attorney, with respect to the expansion of attorney reporting requirements and the effect such requirements might have on attorney-client privilege).}
\footnote{233. Floyd Norris, Corporate Rules in Europe Have Been Flexible, But Change Is Coming, WALL ST. J., Apr. 8, 2005, at C1.}
\footnote{234. European Corporate Governance Institute, at http://www.eegi.org/tcgd (citing the establishment of the Transatlantic Corporate Governance Dialogue, which was created to bring together high-ranking, world leaders to discuss corporate governance).}
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Commission, an independent commission in the judicial branch, to put forth sentencing guidelines for use in federal sentencing proceedings.\(^{235}\) In 1987 the first sentencing guidelines were promulgated by the Commission and in 1991, after the creation of organizational sentencing guidelines, the guidelines went into effect.\(^{236}\) The Sentencing Commission, in 1995, attempted to revise the guidelines to the extent that they affect cocaine offense sentences, but Congress was not amenable to such changes. In an effort to further restrict judicial discretion in sentencing, Congress subsequently passed the PROTECT Act in 2003, which contains the Feeney Amendment. The Feeney Amendment attempts to limit the extent to which federal judges may depart downward from the sentencing guidelines.\(^{237}\)

The Federal Sentencing Guidelines have spawned an entirely new “compliance industry” for American companies. Before SOX, many corporations already had “Compliance Programs” in place to both monitor compliance with the law and provide a mechanism to report wrongdoing to authorities. These compliance programs were not only instituted because of ethics concerns, but also because if corporations have Compliance Programs, under the Federal Sentencing Guidelines the existence of such programs reduces both criminal fines and sentences.\(^{238}\) Further, companies realized that, if they had an “Ethics Officer” to monitor compliance, it could reduce their liability should irregularity be uncovered. As a result, the Ethics Officer Association formed and now boasts over 900 members.\(^{239}\) After SOX, the necessity for these programs became more imperative since SOX expands the ways in which corporate officers and attorneys can incur liability and thus be subject to these Sentencing Guidelines.

In the post-SOX world, the Sentencing Guidelines have created great disparities that seem patently unfair. Corporate employees who find themselves guilty of violating any of the myriad regulations implementing SOX may find themselves victimized by these disparities. For example, a principal architect of


\(^{237}\) See Borges, supra note 236; Laurie P. Cohen & Gary Fields, Legal Quagmire: High Court Ruling Unleashes Chaos Over Sentencing, WALL ST. J., July, 14, 2004, at A1. See generally United States Sentencing Commission, at www.ussc.gov (last visited Mar. 17, 2005). Not all judges follow the Sentencing Guidelines. For example, the CFO of Health South received a 6-month house arrest sentence rather than the 5-year term recommended by prosecutors. See Bosses Behind Bars, supra note 208 (“[T]he Commission keeps a record of those judges who depart downwards, prompting fears that Congress, which must endorse all federal judicial nominations, may block the promotion of judges who do not toe the government’s line.”).


\(^{239}\) See generally Ethics Officer Association, at http://www.eoa.org/AboutEOA.asp.
a corporate fraud who pleads guilty may receive a 5-year sentence but an underling who believes he is innocent, but who is convicted, may receive a 20-year term based upon the financial loss to the shareholders. An example of this scenario can be seen in the widely publicized trial of Jamie Olis, a midlevel executive, who received a 24-year prison sentence. His sentence was quintupled because of the $100 million loss of the corporation.

Complicating the picture, the Supreme Court ruled on May 1, 2004, in Blakely v. Washington, that judges, in sentencing defendants, cannot use information not heard by the jury or admitted by the defendant during trial, thereby invalidating Washington State's sentencing guidelines. This ruling has now raised questions about the validity of the similar Federal Sentencing Guidelines. Several judges subsequently ruled that Blakely applies to federal courts, thus undermining Federal Sentencing Guidelines. However on August 2, 2004, the Supreme Court, signaling the necessity of addressing this issue, agreed to review two lower court decisions, Booker and Fanfan, on October 4, 2004, the opening day of the term. These cases raised issues about judges increasing penalties under the Sentencing Guidelines and whether that rendered the entire sentencing schema unconstitutional in violation of the Sixth

240. Adam Liptak, Sentencing Decision's Reach is Far and Wide, N.Y. TIMES, June 27, 2004, at 16; see Bosses Behind Bars, supra note 208.

241. See Bosses Behind Bars, supra note 208 (discussing the fact that even though Olis did not directly financially gain for his part in the scheme in which he was convicted of participating, because the total loss was $100 million Mr. Olis's sentence quintupled to 24 years).

242. 124 S. Ct. 2531 (2004); see also Peter Grant, Adelphia Sentences Look Thorny: Defense Hopes to Exploit Recent High Court Ruling; Mistrial for Michael Rigas, WALL ST. J., July 12, 2004, at A3. This article discusses the impact of the Blakely case on Rigas's sentencing, determining that Rigas should get minimal jail time but: In the Adelphia case, the statutory maximum term is five years for conspiracy, 10 years for securities fraud and up to 30 years for bank fraud, meaning John and Timothy Rigas, each convicted of 23 counts of conspiracy and fraud, would still get long prison sentences, despite the Blakely decision.

Id.

In United States v. Croxford, 324 F. Supp. 2d 1255 (D. Utah 2004), Federal District Court Judge Paul Casell ruled that, as in Blakely, sentencing guidelines are “unconstitutional.” See Laurie P. Cohen & Gary Fields, Judge Rejects Federal Rules on Sentencing, WALL ST. J., July 1, 2004, at B1 (noting, however, that Congress can solve the problem by enacting a higher maximum ceiling and by doing so, it would be within judges’ discretion to give the maximum, thereby ensuring that judges would not exceed maximum sentencing guidelines as they must now); see also Bosses Behind Bars, supra note 208 and accompanying text. See generally Cohen & Fields, supra note 237.


Amendment right to trial by jury.245

The Supreme Court announced both decisions on January 12, 2005. In Freddie Booker's case, the judge had imposed a 30-year sentence rather than a 21-year sentence when he found additional facts that Booker had 566 more grams of cocaine than was presented to the jury.246 The Seventh Circuit found that the sentence violated the Sixth Amendment in concert with the holding in Blakely.247 The Supreme Court affirmed and remanded.248 Fanfan was charged with "conspiracy to distribute and to possess with intent to distribute at least 500 grams of cocaine."249 His sentence would have been 78 months.250 The judge conducted a hearing and found additional evidence that Fanfan was an "organizer" and that he had cocaine powder as well as 261.6 grams of crack.251 These additional findings could have moved the sentence to "fifteen or sixteen years instead of the five or six years authorized by the jury verdict."252 However, the judge refused to enhance the sentence.253 The government appealed and also filed a writ of certiorari before judgment. The Supreme Court found that the "Sixth Amendment is violated by the imposition of an enhanced sentence under the United States Sentencing Guidelines based on the sentencing judge's determination of a fact [other than a prior conviction] that was not found by the jury or admitted by the defendant."254

Justice Breyer wrote the opinion of the court on the issue of whether the the Sentencing Guidelines are mandatory. He stated:

...finding the provision of the federal sentencing statute that makes the Guidelines mandatory, 18 U.S.C.A. § 3553(b)(1) (Supp. 2004) incompatible with today's constitutional holding, we conclude that this provision must be severed and excised. ... So modified, the Federal Sentencing Act...makes the Guidelines effectively advisory. It requires a sentencing court to consider Guideline ranges...but it permits the court to tailor the sentence in light of other statutory concerns as well..."255

The Supreme Court vacated and remanded the decision from the lower court regarding Fanfan's case.256 Thus, Fanfan could be sentenced in light of the trilogy of Booker, Fanfan, and Blakely. These rulings will have great impact as defendants like Jamie Olis appeal their sentences.

247. See Booker I, supra note 244.
248. See Booker II, supra note 246.
249. Booker II, 125 S. Ct. at 747.
250. Id.
251. Id.
252. Id.
253. Id.
254. Id. at 757.
255. Id.
256. Id. at 769.
In a development parallel to the *Blakely* firestorm, in April 2004 the U.S. Sentencing Commission made “standards for compliance and ethics programs more stringent.” On May 1, 2004 these more stringent standards, which directly impact corporate violators of SOX-related regulations, were submitted to Congress and in November 2004, without Congressional disapproval, they became effective.\(^{257}\) Many believe that the Sentencing Guidelines, which were already tough, in conjunction with these more stringent standards, are now patently unfair.\(^{258}\)

In the revised Guidelines, the Commission stipulated that under certain circumstances, a company may need to waive attorney-client privilege in order to lower its culpability score and receive favorable treatment for cooperation, such as a penalty fine reduction. Thus, these Guidelines exacerbate the pressures on attorneys to waive attorney-client privilege for the supposed benefit of the client.\(^{259}\) Although the revisions explicitly state that waiver is not a prerequisite for lowering an organization’s culpability score, the government’s emphasis on the need to self-report makes the pressure to waive privilege implicit. In fact, the revised guidelines state that there may be instances in which “waiver is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.”\(^{260}\) When the government declares something to be necessary, failure to do so may land you in the situation in which Jamie Olis found himself-facing over 20 years.

Now that the Supreme Court has declared mandatory Sentencing Guidelines unconstitutional, some of the threat of punishment under SOX regulations may be diminished. If first offenders do not face the specter of quintuple punishment based on financial loss to the company, but instead, failure to comply triggers probation for a first offender, then executives and attorneys may be less concerned about the operation of SOX.

**X. RECOMMENDATIONS AND CONCLUSION**

SOX represents the U.S. Congress’ efforts to make companies and those who operate them more accountable to society. Many argue the costs of SOX are minimal compared to the costs of not doing something to insure the validity of financial reporting. Paul Hodgson, of Corporate Library, was quoted as


\(^{258}\) See *Bosses Behind Bars*, supra note 208 (“Frank Bowman of Indiana University, whose ideas helped shape those guidelines, now says they are arguably ‘too tough.’”) (also noting the problem that 97% of all criminal convictions come from plea bargains and the Sentencing Guidelines increase the pressure to plea).


\(^{260}\) USSG, *supra* note 11.
stating, “Ask the stockholders of Enron if they’d rather pay the total expenses to the company for implementing Sarbanes-Oxley or if they’d rather have lost their life savings. . . . I think they’d rather pay that amount of money to keep it honest.”

Yet, the scheme is one of regulation and layers of reporting and certification.

The ramifications of SOX are innumerable. It could be dubbed the “Attorneys’ Full Employment Act” because its impact may lead to diverse constituencies within the company seeking separate counsel. This multiplication of attorneys and additional layers of counsel belies the fundamental question—how does counsel manage the nuanced and complicated roles of both advisor and enforcer? Failure to negotiate these roles may lead to personal liability for the attorney as well. Los Angeles District Attorney Steve Cooley, has create a special unit devoted to pursuing lawyers. This sends a message to all about the perils of interpretation of the attorney’s responsibility to “zealously represent ‘the client’” within the bounds of the law.

There are a number of actions the SEC could take that would further the goals of SOX and improve its efficacy. First, to make the existing regulations more user-friendly, the SEC should “clean up” the existing language in the SEC regulations implementing SOX. SOX was supposed to use simple language, as did Senator Edwards, but the SEC language is anything but simple. For example, the definition of material violation contains two negatives which makes analysis unnecessarily muddled.

Second, to make these regulations more effective, the SEC should close the major loophole in the existing regulations and separate the obligation to report “up the ladder” from the colorable defense argument.

Additionally, the SEC should not make the regulations regarding implementation any more stringent before a comprehensive examination of the effect of the current regulations has been completed. At a minimum, the SEC should not implement the “noisy withdrawal” provision at this time. Rather, the business world and the government should examine the data regarding the costs to firms of complying with SOX after a year or two. Based on the results of that examination, the SEC should decide whether or not it is economically feasible to continue with the SOX regulatory scheme as it is currently administered.

In conjunction with the above examination, a separate inquiry should be conducted to determine the effect of SOX on the overall U.S. economy. For example, an inquiry should be conducted into how SOX has affected the number and size of companies who choose to go public. The SEC should use

262. France, Lawyer Loophole, supra note 173.
263. 17 C.F.R. § 205.2(e) (2005); see Koniak Letter, supra note 70 and accompanying text.
264. See Koniak letter, supra note 70 and accompanying text.
the results of this investigation, in addition to the results of the investigation into the cost of SOX to firms, to thoroughly analyze the reasonableness of their current regulatory scheme.

Finally, the gap between theory and practice must be closed. While the ECGI’s call for a joint U.S.-Europe conference is useful, such a forum will not effectively focus on the specific effects of SOX regulations on the U.S. legal and business community. Thus, an exclusive U.S. symposium should be convened. This symposium should pull together academics, who seem to enthusiastically support SOX and its progeny, with practitioners who are currently trudging through its implementation. The symposium should consider the very specific day-to-day effects on practitioners, particularly attorneys, who have to work under the current regulations. The SEC should also consider the results of this discussion when evaluating the effectiveness of their current regulations.

SOX has been in effect for three years now; the implementing regulations have been in effect for two years. Clearly, as this Article shows, there are already enough significant issues with the implementation of this law to mandate an examination of its effects on the economy, public companies, and individual practitioners. Both Congress and the SEC must responsibly monitor the results of their actions to date before moving forward with new regulations. Such is their duty to the American public whose national and personal economies are intimately entwined with the effects of SOX and its accompanying regulations.
Dequity

The Blurring of Debt and Equity in Securitized Real Estate Financing

Georgette Chapman Poindexter†

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† David B. Ford Professor of Real Estate, Wharton School University of Pennsylvania, Professor of Law, University of Pennsylvania Law School. I am grateful for great suggestions made by many insightful colleagues at a colloquium presented at the University of Pennsylvania Law School and at the Wharton Real Estate Department research symposium. Specifically I want to thank Peter Linneman, Chris Mayer, Todd Sinai, and Rick Jones for their guidance and Catherine Hamberger and Pam Loughman for research assistance. Thanks to the Zell Lurie Real Estate Center, the Real Estate Research Institute, and the Rodney L. White Center for Financial Research for financial support in the preparation of this paper. Errors, omissions and egregious misstatements, of course, remain my own.
Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing

Dequity

The Blurring of Debt and Equity in Securitized Real Estate Financing

Georgette Chapman Poindexter

Synopsis: This paper explores the legal differentiation of equity and debt in subordinate real estate financing. Various financing vehicles that occupy a gray space between true debt and true equity have replaced traditional asset secured debt lending. This paper investigates the legal rights and responsibilities of parties functioning in the gray area. The goal of this examination is to identify potential conflicts and unforeseen consequences of investments possessing attributes of both equity and debt in the event of default.

There was a time in the not so distant past when a real estate borrower and lender entered into a financing transaction whereby, in exchange for a nonrecourse loan of upwards to 90% of the value of the asset, the borrower would grant the lender a first lien mortgage on the real property. The legal rights and obligations between borrower and lender were uncontroversial and quite straightforward. If the borrower failed to pay, the lender was limited to a single (yet powerful) course of action: foreclosure.

Fast-forward to today’s real estate market. Lenders and borrowers are no longer working in an insular decision making mode. Unlike more traditional corporate finance, where the firm makes shifting internal decisions as to debt/equity ratio in its capitalization, real estate firms have a more static debt ceiling imposed by external forces. Securitization of commercial real estate loans in the Commercial Mortgage Backed Securities (“CMBS”) market imposes a market discipline that generally caps Loan to Value (LTV) ratios of first lien debt no higher than 65% (remaining 35% as borrower equity).\(^1\) In other words, required borrower equity has increased by 25%. I will refer to this funding hole as the “gap equity.” Borrowers with a seemingly insatiable taste for leverage will seek to plug this gap with additional third party financing.

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The most straightforward choice would be to finance this gap equity through obtaining a second loan on the property. A subordinate lien on the asset would secure this second loan. However, the rating agencies in CMBS transactions frown on what would traditionally be denominated a "hard second," leaving borrowers and other capital investors to fashion new forms of capital infusion. These alternative forms of capitalization have attributes of both debt and equity, hence the moniker "dequity."²

But what exactly does a holder of these dequity obligations possess? As we walk the middle road between true first lien debt and pure borrower equity, the legal rights and obligations of the parties blur. This paper will highlight some of the more common methods of financing gap equity to illustrate why this new financing has attributes of both equity and debt and how this melding affects the legal relationship between owner and investor.

By innovating around the twin prohibitions on over leveraging and subordinate debt, the market offers a smorgasbord of alternatives to finance gap equity. Due to pressure from the rating agencies, firms and investors create hybrid investment vehicles while trying carefully to denominate these investments as more "equity-like" and less "debt-like."

The open question is what happens upon default? Could a court recharacterize the dequity investment granting (or limiting) rights of the parties? Further-

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more, can contractually agreed upon ordering of creditors (through such documents such as intercreditor agreements) withstand the pressure of recharacterization?

Contract theory will be the analytic engine propelling this discussion. Specifically, this paper will compare the effect of discrete contracts (debt-like instruments) and relationship contracts (equity-like instruments) on the rights and obligations of subordinate lenders financing the gap equity. Naturally while the loan is in good standing, the legal effect of the type of financing of gap equity is close to inconsequential (although there certainly may be economic differences). As long as everyone is getting paid, all parties are happy. The differences matter only in the event of default. While the rights of the holder of a true second mortgage are well traveled and the rights of the holder of equity are well known, the rights of those who fall somewhere between debt and equity, the dequity holders, are subject to a certain amount of conjecture.

For background to the analysis, Section One of this paper will first introduce the CMBS market and its influence over commercial mortgage finance. Then, in light of the financing changes in today’s real estate finance market, several alternatives to straight debt/straight equity will be analyzed in Section Two. To a varying degree, these alternatives have attributes of both equity and debt. The third section examines how and when debt and equity are differentiated. Both economic and accounting differences are discussed, but the emphasis will fall on how and why legal distinctions are made between equity and debt. Finally, Section Four turns to the potential shifting of economic and legal strategies if an investment is recharacterized. The goal of this paper is to heighten awareness of potential issues in default when real estate capitalization incorporates not only equity and debt but also intermediate and combination vehicles.

I. OVERVIEW OF THE CMBS MARKET

In the aftermath of the real estate recession of the late 1980s an infusion of “Wall Street” money began to flow into “Main Street” real estate.3 Real estate financing shifted away from whole loans (retail or “Main Street” loans) to the sale of securities backed by the income stream produced by loans (“Wall Street”).4 Currently, these Wall Street securities represent a $347.9 billion market commanding almost a 20% share of all commercial real estate financ-

4. For a complete history of the origins of the CMBS market, see Georgette C. Poindexter, Subordinated Rolling Equity, Analyzing Real Estate Loan Defaults in the Era of Securitization, 50 Emory L.J. 519 (2001).
Even this 20% figure is somewhat misleading. Although only 1/5 of the present market may be securitized, the policies, practices and limitations of the CMBS market bleed into the entire commercial market because many lenders underwrite with an eye towards potential resale of the loans onto the secondary market. Therefore, the practices of the CMBS market have far reaching, percussive effects throughout the entire real estate industry.

The process of securitizing commercial mortgages requires amassing a pool of loans that produce an income stream. Investment banks sell security instruments that are funded through the income received from the monthly payment of principal and interest on the underlying loans. The quality of this income stream naturally determines the character of the securities that can be sold.

Rating agencies, such as Moody's, Standard & Poor's or Fitch, play an integral role in any CMBS transaction. These agencies classify the securities by assessing the quality of the underlying income stream. In their analysis, the agencies focus on two key factors: the probability of default and the severity of loss. In other words, they ask what is the likelihood that an investor will not be paid on time (due to interruptions in the underlying cash flow) and, if there is a loss, what percent of the pool will be impacted?

In sizing and tranching the pool, one of the most important determinants employed by the rating agencies is the loan to value ratio. The amount of leverage placed on the asset must be capped low enough to withstand a drop in market value. Otherwise the lender may suffer losses after foreclosure due to the non-recourse nature of the loan. Although 80-90% LTV commercial loans were commonplace prior to the real estate depression of the early 1990s, more conservative underwriting practices have led to a 65% limit on LTV. In other words, the loan can be no more than 65% of the value of the asset. In the event of foreclosure this allows the property value to drop 35% without the lender sustaining a loss.

Loan to value ratios, however includes all debt encumbering the asset. With this in mind, rating agencies drill down into the transaction to analyze subordinate financing. At the inception of the CMBS market, rating agencies essentially prohibited traditional subordinate financing because second mortgages

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6. The size of the commercial real estate finance market is $1.693 trillion. Id.
8. For a complete explanation of the process, see Poindexter, supra note 4, at 535-41.
10. Horowitz & Morrow, Mezzanine Financing. REAL ESTATE FINANCING DOCUMENTATION: STRATEGIES FOR CHANGING TIMES, SK006 ALI-ABA 961, 963-64. See also Baron, supra note 9, at 84-85. Using residential securitization as an example, the author points out that during the Texas real estate depression in the 1980s (when LTV ratios often hovered around 90%), 3% of loans with a 60% LTV, 25% of loans with a 90% LTV, and all loans with 100% LTV defaulted.
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have the ability to impact the value of the asset. However, as the market has matured,\textsuperscript{11} rating agencies have acknowledged that the method (as opposed to the mere existence) of subordinate financing defines the important issue.\textsuperscript{12} Therefore they have presented the parameters of the impact of several types of subordinate financing. For example, if we assume that the Aaa component of the offering is 40% LTV (with a 65/25 Senior/Subordinate split) the Aaa tranche will be reduced by 1.5% to 5%, depending on the type of subordinate financing. As an example, this is how Moody’s would interpret different forms of subordinate financing:\textsuperscript{13}

<table>
<thead>
<tr>
<th>Form of Subordinate Debt</th>
<th>Reduction from Aaa tranche</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Equity</td>
<td>1.5-2.5</td>
</tr>
<tr>
<td>Mezzanine Debt</td>
<td>1.5-2.5</td>
</tr>
<tr>
<td>A/B Notes</td>
<td>3.0-4.0</td>
</tr>
<tr>
<td>Second Mortgage</td>
<td>4.0-5.0</td>
</tr>
</tbody>
</table>

Thus, the pricing of the senior debt is a function of the rights of the holders of subordinate financing. As the rights of subordinate investors to demand payment is curtailed, the value of the first lien is increased. To maximize the value of their loan to the mortgage pool (and therefore reduce the cost of their financing since reductions from the Aaa tranche increase the cost of borrowing), the real estate firm seeking financing should limit the “debt-like” attributes of the subordinate investment just up to the point of satisfying the tranching requirements of the rating agencies.

II. BRIDGING THE GAP BETWEEN DEBT AND EQUITY

In response to the CMBS market’s hard line on leverage ratios, real estate finance has moved beyond straight debt/straight equity into an era of more creative gap-bridging finance. This gap equity can be funded through several different vehicles ranging from more “equity-like” to more “debt-like.” Common financing responses include: issuance of preferred equity in the borrower, mezzanine loans, A/B loans and “soft seconds” in the form of subordinated mortgages. Concomitant with such creativity, though, comes the loss of a bright line to delineate rights and obligations of the parties. Before discussing how

\textsuperscript{11} Current estimates on the size of the mezzanine market range from $65,000,000,000 to $135,000,000,000. Kathleen Fitzpatrick, \textit{Mezz Debt is a Magnet for Borrowers and Lenders}, NAT’L REAL EST. INVESTOR 1 (2003).

\textsuperscript{12} For a detailed and descriptive explanation of how rating agencies view the default impact of these several forms of gap financing, see Levidy & Philipp, \textit{supra} note 1.

\textsuperscript{13} \textit{Id.} By way of explanation this means that if the loans in the pool had second mortgages the Aaa tranche would be reduced by 4-5%. From an economic perspective the more of the pool pushed into the higher rated tranches (which have a lower yield), the better for the issuer.
these intermediate investments impact the relationship between the firm and the investor a brief explanation of each vehicle is in order beginning with the most "equity-like" and ending with the most "debt-like".\textsuperscript{14}

\textbf{A. Preferred equity}

Preferred equity is when a financing source makes a capital contribution to mortgage borrower in exchange for an equity share in the borrower. This equity is preferred in right of payment over the common equity in borrower. Holders of the preferred equity are entitled to preferred distribution of the borrower's excess cash flow until equity is repaid plus agreed upon return on preferred equity. This form of investment steps away from true equity in that holders obtain a debt-like attribute of payment preference over all other types of equity (although, of course, the holders of the "common equity" may have preferred distribution rights as among themselves as a class).

\textbf{B. Mezzanine debt}

A mezzanine loan is a loan to the equity holders of a mortgage borrower secured by a pledge of equity interests in the mortgage borrower.\textsuperscript{15} This is a relatively large and robust market ranging from $65B to $135B.\textsuperscript{16} Obligors on the note are the equity holders of the borrower—not the mortgage borrower. The mezzanine lender has the ability to foreclose on the equity in the borrower in the event of a default, and would assume ownership and control of mortgage borrower and effective control of the mortgaged property (subject to liens and encumbrances).

This scenario presents a somewhat confounding mixture of equity and debt attributes. Nominally debt, it differs from true mortgage debt because it is debt not of the asset's owner, but rather that of the asset's equity holders. It is more akin to convertible debt in the corporate world, but the exercise point is default; i.e., the strike price is zero.\textsuperscript{17} Even this analogy, though, falls short because it reverses normal economic incentives. In convertible debt the holder generally


16. Fitzpatrick, supra note 11.

17. An alternative analogy would be that the equity owners have effectively sold their firm to the mezzanine lender but hold a call option to buy the firm back with a strike price equal to principal + interest on the loan.
exercises the conversion option to take advantage of the arbitrage advantage between the conversion price and the prevailing stock price. Here conversion theoretically would occur upon the diminution in value of the firm (and, by extension, of the firm’s equity value).

C. A/B loans

The A/B structure is a variation on the standard participation loan in that it represents a senior and junior co-lending arrangement within a first mortgage loan. The fundamental shift here is that whereas mezzanine debt is secured by the equity in the borrower purchasing the underlying real estate, the B piece in an A/B structure is secured by the real estate itself. There is single note and single mortgage but the ownership of loan is divided into two interests, an A and a B. The A note is securitized in a CMBS transaction and the B note is usually sold to a third party and held outside the CMBS transaction.

The distinction between this structure and a more standard participation scenario is that there is payment priority and loss allocation. In standard participation all payments are pari passu. Likewise, in most A/B transactions, the note holders are paid pro rata before a default. However, in an A/B transaction, payments are senior subordinated in event of default, meaning that there is sequential pay first to A then to B. Likewise, losses incurred are allocated from bottom up, starting with B’s interest. This technique moves us closer to debt-like attributes, especially before default. After default, however, the B note holder (who previously has waived its rights in bankruptcy) is in a weaker position than an ordinary second lien holder because of an intercreditor agreement that (among other requirements) forces the B holder to “stand still” in the event of default.

D. “Soft Second” Subordinated debt

A subordinated mortgage is a loan secured by lien on property that is subordinate in priority to the first mortgage lien. Generally, though, rating agencies

18. See Herwig J. Schlunk, Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?, 80 Tex. L. Rev. 859, 884 (2002) (“Economically, convertible debt is like equity when equity performs well (because the debt will be converted) but is like debt when equity performs badly (and the conversion feature is not exercised).”). Interestingly, in contrast to convertible debt, convertible preferred stock is one shade closer to equity in that it possesses precisely the attribute that emerges when the mezzanine “debt” is foreclosed upon: right to corporate governance. In fact, venture capitalists prefer convertible preferred stock to convertible debt precisely because it confers upon them this right to participate in firm governance. See Deborah A. DeMott, Agency and the Unincorporated Firm, 54 Wash. & Lee L. Rev. 595, 607 (1997).

19. This structure has been even further modified to include A/B/C notes where the C piece is unrated. For further explanation, see Chambers & Vrchotha, supra note 14, at 1.

20. See Choe & Somerville, supra note 14. Generally there is one long term (7-10 years) issued by a large institutional lender which is then split internally. The “A” piece is sold into a CMBS pool. The “B” piece is either held by the issuer or sold separately.
prohibit second liens behind a securitized first, as it is contrary to the bankruptcy's fundamental goal of remoteness. To ameliorate (but not eliminate) this prohibition the second lender will sign a "stand still" agreement making it a "soft second." In the standstill agreement, the second lender agrees not to interfere with the foreclosure on the first and may waive rights in bankruptcy. Obviously, this is the closest to "straight debt" of all the alternatives presented.

E. The Equity – Debt Continuum

As with other types of corporate finance, these alternatives exist on a continuum between equity and senior debt. As the techniques become more specialized, characterizing a deal as more "equity-like" versus more "debt-like" may involve drawing seemingly arbitrary lines. Perhaps the randomness of the labeling is a reflection of the motivation for choosing a particular vehicle to finance the gap. The tool chosen to finance the gap equity is largely outside the power of the borrower and is not driven by borrower concerns. Rather, it is driven by the rating agencies in securitized transactions.

Since rating agencies disdain naked subordinate debt, borrowers and lenders go to great lengths to disguise gap financing as anything other than subordinate debt. Therefore, in CMBS transactions, characterization of an investment as closer to debt or closer to equity has significant pricing and economic repercussions. The next step, then, is to fine tune the categorization of the possible methods of gap financing according to the criteria that matters most to the rating agencies: the relationship of the investor to the firm/senior debt in the event of default. In conjunction with this analysis we should include the perspective of the investor as well as expectations of the firm.

III. DEBT/EQUITY DICHOTOMY

Even after describing the various methods of creating hybrid investment vehicles, the underlying question remains: why do rating agencies treat investment vehicles differently? It is more than a cosmetic or naming issue. The fundamental concern is that the less the investment looks like debt, the less likely it is to impact on default risk and the less likely it is to impair the value of the underlying real estate collateral.

To explore the dichotomy the rating agencies are attempting to draw, we can look to several disciplines where such distinctions have been crafted, including economics and accounting. Such characterization questions usually come to a head in the context of tax and bankruptcy, so the legal analysis un-

21. The variety and volume of debt/equity hybrids has likewise proliferated in corporate debt. See Haskins, supra note 2, at 526.
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dertaken in these fields is instructive. In this way we can gather insight as to when (or even whether) such meticulous attention to gradations of characteriza-
tion matters.

A. Economics

As this paper is focused on the effects of attempts of legal ordering upon default, a full exposition of the economics of firm capitalization and debt/equity decision-making is beyond the scope of this article. However, the legal envi-
ronment does not exist in a vacuum; it works within the framework of the eco-
nomic decisions undertaken in firm capitalization. As such, a basic discussion of capitalization is in order.

From the Modigliani and Miller perspective, capital structure should not af-
fect firm value.\(^23\) In fact, most analyses of secured debt start from the observa-
tion that, in a perfect market, a firm's capital structure cannot add value,\(^24\) but this view neglects the effect of double taxation of corporate income.\(^25\) However, if we leave aside the tax, the decision to finance through secured debt might be viewed as an economic choice designed to reflect a desired outcome of legal ordering upon default.

In fact, the economics literature supports this view. Of course the financial reasons to go beyond straight debt are multifaceted. They include innovation, risk reallocation, and management entrenchment.\(^26\) However, target debt levels will be influenced by the probability of financial distress of the firm. Compa-
nies with higher operating risk should be expected to use less debt.\(^27\) Compa-
nies who have riskier profiles are less likely to take on contractual obligations of debt. In fact, one study showed that bankruptcy risk was a determining factor in whether a company issues debt or equity.\(^28\) The higher the risk, the more


\(^{24}\) For more discussion and citations on this point, see Claire A. Hill, Is Secured Debt Efficient?, 80 TEX. L. REV. 1117, 1120 (2002).

\(^{25}\) Modigliani and Miller likewise acknowledged the effect of corporate income tax on firm capitalization by showing that if a corporate income tax is in effect firm should use entirely debt since this allows corporate taxes to be avoided. Franco Modigliani & Merton H. Miller, Corporate Income Taxes and the Cost of Capital: A Correction, 53 AM. ECON. REV. 433, 433-43 (1963); Franklin Allen, The Changing Nature of Debt and Equity: A Financial Perspective, in ARE THE DIFFERENCES BETWEEN EQUITY AND DEBT DISAPPEARING? 12-38 (Richard W. Kopcke & Eric S. Rosengren eds., 1989). As federal income tax law changes to eliminate (or at least decrease) the taxation on corporate dividends this argument becomes less salient.

\(^{26}\) See Allen, supra note 25, at 14-15.


\(^{28}\) Id. at 142. Of course an alternate explanation for debt avoidance is that the higher risk translates into more expensive debt. Furthermore the advantages of leverage may be less salient because the riski-
ness of the venture demands a higher return and you do not need as much leverage to achieve a desired expected return on equity.
likely the company was to issue equity.\textsuperscript{29} Therefore, there is support for the assertion that contractual obligations (or lack thereof) are a determinative factor in choosing between equity and debt.\textsuperscript{30} At default these obligations will be tested.

\textbf{B. Accounting}

Accounting rules have begun to change to reflect a desire for transparency.\textsuperscript{31} As the initial stage of part of a larger Financial Accounting Standards Board project, FASB 150 requires reclassification of financial instruments with characteristics of both equity and debt. Financial instruments previously treated as part of shareholders' or mezzanine equity will now be treated as liabilities. Returns on investment will be treated as interest expense rather than dividends.\textsuperscript{32}

There are several instruments affected by FASB 150, including mandatory redeemable shares (not including stock that may be redeemed at the issuer's option) and freestanding repurchase obligations (including put options and forward contracts that obligate the firm to purchase its own shares).\textsuperscript{33} Most relevant to the present analysis is that other freestanding contracts are covered under FASB 150. Instruments such as equity kickers and warrants are included, as they are obligations of the firm to repay investment with its own shares in amounts unrelated or inversely related to share price.\textsuperscript{34} This will impact mezzanine loans that are secured by pledges of equity.

\textsuperscript{29} The natural extension of this argument is that structuring of capitalization can affect the probability of default. In other words, marginal firms that take on more debt may have a higher probability of default because of the absolute obligation to repay at a specified time as contrasted with equity with a more discretionary repayment obligation.

\textsuperscript{30} We can even take this argument one step further to bring in the effect of the number of debt creditors. The ability to renegotiate debt after default can be linked to the number of creditors with claims against the firm. The optimal debt structure should be that which balances the effect of both the number of creditors in addition to a debt/equity trade off. See Patrick Bolton & David Scharfstein, \textit{Optimal Debt Structure and Number of Creditors}, 104 J. POL. ECON. 1 (1996).

\textsuperscript{31} For example, in January of 2004 FASB issued a draft of \textit{Qualifying Special-Purpose Entities and Isolation of Transferred Assets}, which would amend FASB Statement No. 140, \textit{Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities}. The purpose of the proposal is to provide specific guidance on accounting procedures for transfers of financial assets from a company to an off-balance sheet structure known as a qualifying special-purpose entity (QSPE). The guidance would alter the accounting for QSPEs as follows: The proposal prohibits an entity from being a QSPE if a company that transfers assets to the entity enters into a commitment (such as a financial guarantee, liquidity commitment or total return swap) to provide additional cash or other assets to fulfill the QSPE's obligations to its beneficial interest holders. Also, if an entity can reissue beneficial interests, the proposal would prohibit that entity from being a QSPE if any party involved with the entity has certain risks or combinations of risks and decision-making abilities. Additionally, the proposal prohibits an entity from being a QSPE if it holds equity instruments, such as shares or partnership interests. Last, the proposal clarifies certain of the requirements in Statement 140 related to legally isolating assets and surrendering control of assets.

\textsuperscript{32} Financial Accounting Standards Board, Summary of Statement 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (May 2003).

\textsuperscript{33} \textit{Id.}

\textsuperscript{34} \textit{Id.}
The changes in treatment of certain instruments grow from a post-Enron environment of investment transparency. Labels are discarded in favor of revealing the underlying substance of the transaction. Instruments denominated as equity must now be accounted for as debt, because they constitute obligations of the firm to repay an investor, even though repayment may take the form of issuer stock. This emphasis on the nature of the obligation of the firm to repay (notwithstanding the method—stock not cash) falls right in line with the legal dichotomy of debt versus equity that also looks to the nature of the obligation to repay the investment.

C. Legal

Significant legal distinctions between equity and debt arise in two relevant areas of law: tax and bankruptcy. A common thread, though, runs between the two bodies of law. In both practices, the characterization turns on an analysis of what obligations the firm owes to the investor and what rights the investor possesses if those obligations are not met.

1. Taxation

Often when discussing tax differences between equity and debt, analysis focuses on the economic impacts and decisions of the firm, rather than the legal relationship between the investor and the firm. For the purposes of the present analysis, the focus must shift to the legal distinction courts draw between equity and debt, leaving aside the economic impact of these distinctions. This is not to imply that the tax distinctions are inconsequential. Presently, corporate earnings are double taxed when distributed as dividends but not double taxed when distributed as interest and principal on debt capital. As such, characterization as equity or debt has a tremendous impact on the economic functioning of the firm.

The importance of the tax law for our purposes is the underlying legal reasoning of why debt is treating differently than equity. Tax courts look to corporate governance rights and contractual obligation of repayment to differentiate debt from equity. How the courts deal with the blurring of the debt/equity dichotomy in tax cases and characterization of capital contribution and may inform later discussion as to how far an investment can stray from traditional

35. Hariton, supra note 22, at 499-500. However, if the entity is structured as a partnership (rather than a corporation) this tax effect is not present. There are other more subtle differences that depend on partnership/corporation difference. For example, partners can increase the outside basis in their partnership if they bear the ultimate risk of loss for the partnership's liabilities (e.g., through guarantee of debt). See Richard Winston, Shareholder Guarantees of S Corporation Debt: Matching the Tax Consequences with Economic Reality, 81 Va. L. Rev. 223, 239 (1995). Such a discussion strays from the core of this paper.

The concepts and still retain equity or debt core values. The tax courts do not give bright line guidance but they do endeavor to characterize instruments to reflect their economic reality rather than their nominal title.

The classification of contributions to an entity as "debt" or "equity" for tax purposes can be a complex matter, particularly where a close corporation and its shareholders are involved. The general distinction between debt and equity is formulated as follows: shareholders place their money 'at the risk of the business' while lenders seek a more reliable return. When an investment bears a substantial risk of the business enterprise, it is more likely equity than debt.

While there is less than total agreement as to the applicable legal criteria to distinguish debt from equity for tax purposes, there is uniformity amongst

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37. For example, convertible debt is treated as pure debt by the Internal Revenue Service until conversion at which point it becomes pure equity. As one commentator noted, quoting a leading treatise: "In effect, until conversion, debt genes are treated as dominant and equity genes are treated as recessive." Haskins, supra note 2, at 533 (citing BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAX OF CORPORATIONS AND SHAREHOLDERS 4.60-.62 (6th ed. 1994)). The issue for later discussion is how recessive must the equity gene be before contractual obligation to pay is impaired.

38. For discussion, see Haskins, supra note 2, at 540. For a different perspective, see Herwig J. Schlunk, Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?, 80 TEX. L. REV. 859, 859 (2002) ("The tax law frequently taxes economically similar items in very different ways... corporate equity is taxed in one way and corporate debt in another.").

39. Once the contribution has been properly classified, determination of the appropriate tax treatment for an entity distribution is a fairly routine matter. The entity may deduct interest paid on indebtedness, but not dividend distributions. Returns on equity are taxable income to the recipient, while nonrecognition is the rule for returns of principle. I.R.C. §§ 163(a), 316.

40. More specifically,

[T]he 'risk of the business' formulation has provided a shorthand description that courts have repeatedly invoked. Contributors of capital undertake the risk because of the potential return, in the form of profits and enhanced value, on their underlying investment. Lenders, on the other hand, undertake a degree of risk because of the expectancy of timely repayment with interest. Because a lender unrelated to the corporation stands to earn only a fixed amount of interest, he is usually unwilling to bear a substantial risk of corporate failure or to commit his funds for a prolonged period. A person ordinarily would not advance funds likely to be repaid only if the venture is successful without demanding the potential enhanced return associated with an equity investment.

Slappey Drive Indus. Park v. United States, 561 F.2d 572, 581 (5th Cir. 1977).

41. Id.

42. The Fifth Circuit, for example, considers the following issues: (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement. See e.g., In re Receivership Estate of Indian Motorcycle Mfg., 2003 WL 21380547 (D. Mass. 2003); Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972); Montclair, Inc. v. Comm'r, 318 F.2d 38 (5th Cir. 1963).

The Eighth Circuit, like the Fifth Circuit, considers whether the corporation is grossly undercapitalized; whether the maturity date of the loan is fixed and whether the shareholder/lender participates in management. However, the Eighth Circuit implements a broader approach and also considers: (1) whether the shareholder loan (and similar loans by other shareholders) is made directly proportionate to equity holdings; (2) whether repayment of the shareholder loan is dependent on the corporation's profitability; (3) whether the shareholder loan was subordinate to other debt; (4) whether arms length bargain-
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courts of varying jurisdictions in their respect for substance over form.\textsuperscript{43} All tax courts evaluate the relationship between the entity and the contributor according to an objective test of economic reality to determine the nature of the contribution.\textsuperscript{44}

In tax law, most classification controversies involve government challenges to taxpayers who seek debt treatment for instruments with both debt and equity characteristics. In these cases, the fundamental inquiry is whether an outside lender would have made a loan in the same form and on the same terms as the one in question.\textsuperscript{45} Factors that weigh in favor of a debtor-creditor relationship include: the regular payments of principal and interest by the recipient; the right of the contributor to compel full repayment of the advance; the ownership of sufficient assets from which the recipient can repay the advance; a fixed maturity date; the adequate capitalization of the recipient, and the ability of the recipient to obtain loans on similar terms from outside lending institutions.\textsuperscript{46} In identity of interest cases, that is, when an individual both contributes capital and lends funds to an entity, additional factors come into play. The advances are more likely to be characterized as equity if the advances are made in direct proportion to its ownership interest\textsuperscript{47} or if the contributor participates in management of the entity.\textsuperscript{48}

Risk also plays a key role in the debt-equity determination. For example, a tax court is more likely to classify an advance as equity where the advance is subject to subordination because the risk of delinquency on the repayment of the advance increases.\textsuperscript{49} The use of advanced funds to finance start-up costs
and initial operations, and the contingency of principal and interest payments upon earnings are additional factors that increase the risk of investment and, accordingly, weigh towards treatment of an advance as equity.\textsuperscript{50} The sufficiency of the debt-equity ratio, requirements for collateral or other security and a consistent history of payments of principal and interest are factors that decrease the risk of investment and, therefore, weigh towards treatment of an advance as bone fide debt.\textsuperscript{51}

For tax characterization purposes, the courts have not fixed a single determinative factor to ascertain whether an advance is a capital contribution or bone fide debt. Rather, they employ a more holistic approach. The task of the court is to evaluate, not merely tally, the applicable criteria.\textsuperscript{52} Several factors, though, are consistently scrutinized such as whether there is adequate capitalization, whether the contributor has the right to enforce payment of principal and interest, whether arms’ length bargaining would have produced a loan under similar terms and conditions; and whether the contributor participates in management as a result of the contribution. This fundamental analysis is instructive for our purposes for it highlights critical differences between equity and debt. Such differentiation will guide later analysis and help explain why differing funding sources have different rights in the event of default.

2. Bankruptcy

As in tax, bankruptcy treatment of equity versus debt likewise directly impacts the legal relationship between firm and investor. The bankruptcy code distinguishes between secured claims and equity.\textsuperscript{53} Obviously, secured debt is in a more advantageous position with regard to payment from the bankrupt estate. But the distinctions are finer than this broad brush statement. As the Bankruptcy Code recognizes the validity of subordination agreements, subordinated debt is classified separately from non-subordinated debt. Furthermore, distinctions between equity classes are recognized and preferred stock will be dealt with as a separate class from common stock.\textsuperscript{54}

Clearly the bankruptcy courts are adept at dealing with classifications of either debt or equity. Where it becomes difficult is classifying a claim that has attributes of both debt and equity. In other words, slicing a box of debt or eq-

\textsuperscript{50} William J. Rands, \textit{The Closely Held Corporation: Its Capital Structure and the Federal Tax Laws}, 90 W. VA. L. REV. 1009 (1988); \textit{see also} Haffenreffer Brewing Co. v. C.I.R., 116 F.2d 465, 468 (1st Cir. 1940) ("Perhaps the most significant fact is the lack of a fixed maturity date at which time the holder can demand payment whether or not there are net earnings.").


\textsuperscript{52} John Kelly, Co. v. Comm’r, 326 U.S. 521, 530 (1946); Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969).


\textsuperscript{54} For more discussion, see Normandin, \textit{supra} note 2, at 59.
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Dequity securities into separate claim categories is not particularly difficult. But what of the super-preferred equity that looks amazingly similar to the super-subordinated (but nonetheless nominally secured) debt? Should these claims be lumped into one box? For guidance the courts will fall back on the firm governance principals that will be examined more depth later in this paper.\(^{55}\)

There is significant cross-over between bankruptcy and tax jurisprudence regarding the distinctions between debt and equity. Like tax courts, bankruptcy courts that confront this issue may employ equitable concepts and, if the economic substance warrants, reclassify an investment as equity or debt.\(^{56}\) The bankruptcy code grants bankruptcy courts considerable discretion with respect to the treatment of an investment as debt or equity. First, bankruptcy courts may reprioritize any claim or interest as per any other claim or interest pursuant to their general equitable powers. Second, these courts also may reprioritize claims of creditors pursuant to the doctrine of equitable subordination.

a. Recharacterization: The Exercise of General Equitable Power

Recharacterization is the method that bankruptcy courts use to reclassify investments, exercising their general equitable powers pursuant to Section 105 to disregard the form of a transaction and classify claims asserted against a debtor as equity or interests asserted against a debtor as debt.\(^{57}\) The majority of courts construe this section of the code as permitting the courts to reorder the priorities of any type of claim to any other type of claim as necessary to produce an equitable result.\(^{58}\)

In recharacterization cases, the court will reclassify debt as equity if (i) the parties intended an instrument labeled "debt" to have the advantages and disadvantages of equity and (ii) the treatment of the instrument as debt would significantly disadvantage genuine creditors.\(^{59}\) The courts frequently utilize recharacterization in cases where shareholders have substituted debt for adequate

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55. For an exhaustive treatment of the view of bankruptcy courts, see Peter V. Pantaleo and Barry W. Ridings, Reorganization Value, 51 BUS. LAW. 419 (1998).

56. See, e.g., Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001) (applying the Roth Steel factors to determine whether transaction was properly classified as a loan); In re Hillsborough Holdings Corp., 176 B.R. 223 (M.D. Fla. 1994) (finding an intercompany payable exhibited characteristics of debt and was, therefore, a bona fide loan, despite also exhibiting some indicia of an equity investment.). For a detailed discussion of the application of the Roth Steel factors in bankruptcy cases, see Jo Ann J. Brighton, Capital Contribution or a Loan?, 21 AM. BANKR. INST. J. 1, 42-45 (2002).

57. 11 U.S.C. § 105(a) (2000) (empowering bankruptcy judges with the authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]"); but see In re Pacific Express, Inc., 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (arguing that since there is no specific provision in the Code that authorizes recharacterization, bankruptcy courts have no authority to do so); In re Pine Tree Partners, Ltd., 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988) (arguing same).

58. As discussed infra, under the doctrine of equitable subordination, a loan may not ordinarily be subordinated to interests; this, however, is the de facto result in recharacterization cases.

b. Equitable Subordination

The second method that bankruptcy courts may use to reclassify an investment is through the doctrine of equitable subordination. Although its application produces similar results, equitable subordination is a concept distinguishable from recharacterization. Equitable subordination penalizes egregious conduct of a nominally superior claim holder who directs the firm in such a way that causes harm to inferior claim holders. Designed to protect against abuses by company insiders, equitable subordination allows a court to subordinate claims of insiders to claims asserted by bondholders, trade creditors, or other stockholders. For bankruptcy purposes, both priority claims and secured claims can be subordinated to the claims of general unsecured creditors. The courts use the doctrine of equitable subordination sparingly, as it is a remedial measure.

Section 510(c), the cornerstone of the doctrine of equitable subordination, allows bankruptcy courts to subordinate the claim of an overreaching creditor to the claims of other creditors. The threat of equitable subordination of claims produces extreme reluctance amongst debt holders to take an active management role in distressed firms. In cases of multiple funding, subordination agreements ordinarily grant the senior debtholder a superior right to collection of indebtedness vis-à-vis junior creditors. That is, junior debtholders receive no distribution until the senior debtholder receives payment in full and, frequently, any distributions received by a junior holder must be surrendered to the senior creditor until its claim is satisfied. As a general rule, subordination agree-

60. Brighton, supra note 56, at 2.
62. A minority of courts freely interchange the two doctrines. See, e.g., In re Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977); In re Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991). However, the majority distinguish equitable subordination and recharacterization based upon the restrictive language of Section 510(c), which does not authorize the recasting of a claim as an interest. See, e.g., In re Hyperion Enterprises, Inc., 158 B.R. 555 (D.R.I. 1993); United States v. Colorado Invesco, 902 F. Supp. 1339, 1342 (D. Colo. 1995) ("[T]he first determination must be whether the loan transaction was a contribution to capital or a loan.").
63. Typically, a lender will not be classified as a controlling or insider shareholder (and hence will not be open to equitable subordination) under certain circumstances, such as where the contract under question flows from an arm's length relationship; the firm was adequately capitalized and the terms of the contract do not result in injury to creditors or confer an unfair advantage on the claimant. Brighton, supra note 56, at 44-45.
64. See id. at 44 (discussing Section 510(c) of the Bankruptcy Code); see, e.g., In re Cumberland Farms Inc., 181 B.R. 678 (Bankr. D. Mass. 1995) (noting that the doctrine is not a penal measure and therefore ought not be utilized to take assets), aff'd in part, modified in part, and rev'd in part by Hascotes v. Cumberland Farms, Inc., 216 B.R. 690 (D. Mass. 1997) (holding a creditor is justly entitled to upon liquidation of the debtor's assets and award those assets to others without right or claim to them).
66. The amounts recovered by senior claimholders through these provisions, referred to as "double
ments are enforceable in bankruptcy according to their terms and to the same extent as they would be under non-bankruptcy law.\(^67\) Bankruptcy courts, however, have the discretion to classify lenders as insiders in cases where the lender exercises overwhelming domination and control over a debtor.\(^68\)

For equitable subordination to apply, three elements must be satisfied: (1) the party to be subordinated has engaged in inequitable conduct; (2) that conduct has injured other creditors or given the party against whom subordination is sought an unfair advantage; and (3) subordination of the claim is consistent with the purposes of the Bankruptcy Code.\(^69\) The definition of "inequitable conduct" is narrow, and courts limit application of the doctrine of equitable subordination to cases of fraud, illegality, breach of fiduciary duty and undercapitalization.\(^70\) Courts normally subordinate claims only to the degree necessary to offset the unfair advantage or harm caused by the inequitable conduct.\(^71\)

Thus, recharacterization and the attendant exercise of general equitable powers have distinct advantages over the doctrine of equitable subordination for a bankruptcy court. In recharacterization cases, a supposed "loan" never qualifies as a claim and, therefore, the stiffer requirements of equitable subordination need not be met. Additionally, the court can invoke its general equitable powers to mold the relief granted to comport with the equities of the particular case. In the evaluation of a convertible bond, for example, a bankruptcy court might treat the actual bond issue as debt, but extract the conversion rights from the bond and treat them as independent options.\(^72\) It is because of its flexibility that recharacterization is a more powerful tool than equitable subordination.

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\(^{67}\) See 11 U.S.C. § 510(a).

\(^{68}\) See Brighton, supra note 56, at 45. Brighton summarizes the relevant factors as follows: (1) stock ownership, (2) interference with the operations of the debtor's borrowers, (3) participation in management decisions, (4) orders as to which creditors the debtor will pay, (5) placement of lender employees as directors or officers of the debtor, (6) hiring and firing of debtor personnel, (7) participation in shareholder meetings, (8) participation in director meetings, (9) participation in management meetings, and (10) arm's length transactions with debtor.


\(^{70}\) In re Eufaula Indus. Auth., 266 B.R. 483 (B.A.P. 10th Cir. 2001). On occasion, courts have applied the equitable subordination doctrine in noninsider cases; however, the degree of wrongful conduct must be tantamount to fraud, overreaching or spoliation, or involving moral turpitude. In re 80 Nassau Assocs., 169 B.R. 832 (Bankr. S.D.N.Y. 1994); In re Castletons, Inc., 990 F.2d 551 (10th Cir. 1993); In re Dry Wall Supply, Inc., 111 B.R. 933, 938 (D. Colo. 1990).

\(^{71}\) See In re Mobil Steel, 563 F.2d 692, 699 (5th Cir. 1977) (noting that in cases of egregious conduct, claimants may seek disallowance of a claim in full).

This very flexibility, however, is a double-edged word for creditors. On the one hand, a creditor, through its course of dealings with the borrower, unwittingly risks subjecting its claim to subordination or recharacterization. On the other hand, an opportunity may arise where a creditor may increase its bankruptcy distribution by forcing another creditor into a junior position.\textsuperscript{73}

Having explored the treatment of equity and debt through three different lenses, we return to the initial question of why delineations are carved between debt and equity. There is a common thread of distinction that runs through these three disparate areas of economics, accounting and law. In each case the demarcation of equity versus debt turns on the relationship between the investor and the firm. The rigidity (or, conversely, fluidity) of obligations and rights between the investor and the firm will inform the differentiation between equity and debt. As such, the next issue will be whether the rating agencies in CMBS transactions are asking the right questions in order to distinguish investment vehicles and hence permit accurate market pricing and economic transparency.

IV. GREAT EXPECTATIONS

Rating agencies, and hence borrowers and lenders, react differently to various methods of gap financing. In this section we examine the underlying theoretical differentiation between equity and debt as explained by the relationship between the firm and the investor. Equity and debt clearly have legal situational differences (e.g. tax and bankruptcy). The inquiry, then, should be how the theoretical bases for these distinctions correlate with how rating agencies differentiate between gap financing vehicles. Contract theory will be the tool of dissection with the goal of parsing out the relationship between firm and investor and crafting a model of categorization.

There are two avenues of inquiry, joined by contract theory, for analyzing an investor/firm relationship. The first is to look at the right to participate in the governance of the firm. The other is to examine the right to demand repayment of investment. Both avenues, however, will be determined by the nature of the obligation that runs between the investor and the firm.

A. Firm Governance

The historical distinction in firm governance has been discussed previously by the author.\textsuperscript{74} Although equity holders are paid at the discretion of the firm


\textsuperscript{74} See Poindexter, supra note 4, at 555 and footnotes.
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(no right to demand repayment) they are given responsibility for firm governance. On the other hand, debt holders are promised a fixed rate of return but have no say in firm governance.\textsuperscript{75}

In terms of firm governance the holders of equity make the decisions while the holders of debt are relegated to the sidelines. Traditional debt holders can take no part in the management of the firm, and the firm owes them no explanation for their actions. The seminal case of RJR Nabisco\textsuperscript{76} made the relationship clear:

\textit{[A] bond represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties. Before such a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist.}\textsuperscript{77}

In essence this goes back to the classical distinction between debt and equity: the debt holder is insulated from risk of the firm but does not get to share in the reward of the firm.\textsuperscript{78} As such the debt holder has no voice in the management of the firm.\textsuperscript{79}

The legal basis for this distinction evolves from contract theory: While the underlying duty of the firm to its equity holders is fiduciary, the duty to its creditors is contractual.\textsuperscript{80}

Although there have been attempts at creating some sort of duty toward creditors these challenges were generally unsuccessful.\textsuperscript{81} To determine whether an investment is debt or equity, we should ask whether the duty of the firm to the investors is fiduciary or contractual. A fiduciary duty is a caretaker responsibility that gives rise to a cause of action if firm managers undertake activities that cause harm to the investors.\textsuperscript{82} It is a duty of care that keeps opportunism in

\textsuperscript{75} Allen, supra note 25, at 12.
\textsuperscript{78} As one commentator has noted: "The real question, then, is not how many debt characteristics does the instrument possess, but rather to what extent does the instrument insulate the investor from the risks and rewards of the issuer's business." Hariton, supra note 22, at 522.
\textsuperscript{79} Of course there is the opportunity to use "exit" threats as a method of influencing firm behavior. This is especially true if structured as a call feature. See George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 CAL. L. REV. 1073, 1080 (1995) (arguing that "... debt is a potent and flexible governance instrument and that [lenders] are effective governance players.").
\textsuperscript{80} See Normandin, supra note 2, at 49-50.
\textsuperscript{81} See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173, 182 (Del. 1986); Simons v. Cogan, 542 A.2d 785, 788 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988); but see Robert Scott, Discussion of The Changing Nature of Debt and Equity: A Legal Perspective, in ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? 76 (Richard W. Kopcke & Eric S. Rosen- gren eds., 1989) (discussing when legal disputes have centered on whether the relational obligations of good faith and best efforts should be applied to debt contracts).
In contrast, a cause of action for breach of a contractual duty will only occur if a payment is missed. The greater the right of the investor to participate in the management of the firm, the more equity-like the investment. By extension, the more isolated from management the investor remains, the more debt-like the investment.

This difference can be analyzed along the lines of relational versus discrete contracts. Equity relationships are relational, as they are typically non-standardized contracts evidencing an ongoing relationship between the parties, and are based upon a discretionary relationship. Debt relationships, on the other hand, are discrete contracts—more standardized and less idiosyncratic. Debt relationships are rules driven, and represent a transactional relationship. These distinctions allow us to segregate investment vehicles and categorize them not according to their economic cloak, but rather according to their relationship with the firm. Therefore, the analysis of a specific vehicle requires investigation as to the right to participate in firm decisions.

B. Contractual obligation

Another way of differentiating between equity and debt is the contractual right to demand return on investment. As stated before, an equity holder’s return on her investment is contingent on the success of the firm, whereas a debt holder can demand no more (but is entitled to no less) than the contractually agreed upon return. Debt traditionally has been defined as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payments regardless of the debtor’s income or lack thereof.” Courts explain the conceptual difference between lenders and equity holders by contrasting shareholders who place their money at the risk of the business while lenders seek a more reliable return. In other words, a loan is made upon the reasonable assumption that it will be repaid no matter whether the business venture is successful or not, while capital is put to the risk of the business. The debt contract may be judged according to the standard of good

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86. Id. at 10-11.
87. See Scott, supra note 81, at 75-76; see also David Campbell, Breach and Penalty as Contractual Norm and Contractual Anomie, 2001 Wis. L. REV. 681, 692 (2001).
88. Gilbert, 248 F.2d at 402.
89. Slappey Drive, 561 F.2d at 581; see also, Midland Distrib. v. United States, 481 F.2d 730, 733 (5th Cir. 1973). The seminal case making this dichotomy, United States v. Title Guarantee & Trust Co, put the case most eloquently: "The essential difference between a stockholder and a creditor is that the stockholder’s intention is to embark upon the corporate adventure, taking the risks of loss attendant upon
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faith and fair dealing but remains relatively static as the conditions of the firm may change.90

We return to relational versus discrete contracts. The ongoing relationship of sharing capital appreciation (or risking loss) categorizes an investment as equity-like. The transactional relationship of set payment at defined intervals categorizes an investment as debt-like. In fact it is this feature that rating agencies focus on in reviewing gap financing. The greater the right to demand payment the more frowned upon by the rating agencies.

C. When does this all matter?

Putting this all in the context of default on the debt in a CMBS transaction crystallizes the importance of the debt/equity distinction. In fact, the legal cases tend to be most concerned about rights of investors in the event of default.91

Default is the correct point for analysis, because it merges fundamental questions of firm decision making with payment rights of investors holding obligations of inferior priority. In essence, I am advocating a consideration of a default-rule paradigm in event of borrower default. Default in this context embodies both of the commonly used legal interpretations of default: non-excused contractual breach and utilization of community accepted norms (rules) to order unspecified contractual rights.92 As will be fully elaborated, the goal here is to recognize both the wealth maximization arguments as well as the information forcing aspects93 of implementing rules that minimize ambiguity of investor status in the event of borrower breach.

Default also sweeps in all of the intercreditor issues of the transaction. Intercreditor agreements are drafted at the inception of the transaction to contractually order the rights of various investors of the firm. The pressure to recharacterize a particular investment to alter these rights potentially occurs when another class of investors has suffered or is about to suffer a loss. For example, defaults that trigger cash sweeps (hyper-amortization) and/or the exercise of equity kickers negatively impact other investors. At this point the ordering agreed to in the intercreditor agreement will be tested against the debt/equity

90. Good faith and fair dealing should not be used to "shoehorn" new rights into the debt contract. See Normandin, supra note 2, at 54.


92. There is certainly a vast body of literature interpreting the default rule paradigm. See, e.g., Charles Goetz & Robert Scott, Liquidated Damages, Penalties and the Just Compensation Principal, 77 COLUM. L. REV. 554 (1977); Alan Schwartz, The Default Rule Paradigm and the Limits of Contract Law, 3 S. CAL. INTERDISC. L.J. 389 (1993).

93. These are two common justifications for the default rule paradigm. See Robert E. Scott, Rethinking the Default Rule Project, 6 VA. J. 84 (2003). For other applications of the default rule paradigm, see Schwartz, supra note 92.
recharacterization algorithm.

Let's hypothesize a firm with a $65 mortgage lien against its only asset, which has a value of $100. Suppose there is also a $25 third party investment of unspecified categorization and $10 owner equity remaining. Upon default of the $65 debt, the holders of the $25 investment can travel various paths depending on the nature of their investment. In formulating a default rule of priority the dequity holders' rights/responsibilities will vary according to (1) their legal rights of participation in governance (equity-like rights) and (2) their ability to jeopardize the payment priority of the senior debt (debt-like rights).

The rating agencies are most concerned about impairment of the payment priority of the senior debt. But they need to widen and refocus their attention. They should view the nature of the $25 gap financing not only from the perspective of whether the dequity investor has the right to demand payment from the borrower to the detriment of the first lien, but also whether the dequity investor can exercise managerial discretion that would adversely impact the senior debt. By focusing primarily on limiting "debt-like" attributes, the possibility arises that unforeseen recharacterization of equity-like attributes can likewise impair the position of the senior lien (e.g. managerial rights that will spring into action when the mezzanine lender steps into the shoes of the borrower in the event of default on the mezzanine loan). The move away from hard second liens secured by the real estate asset to more amorphous dequity investment introduces the obfuscation of investor rights and limitations.

This is only part of the equation, though. The gap financing is like a pressure cooker. Upon default it can explode into the first lien piece. This is the focus of the rating agencies. There exists another, equally important, economic consequence. The dequity can also blow into borrower equity and impact the rights of other creditors of the borrower. Hence, risk of recharacterization can affect more than just the first lien holder.

Therefore, the debt/equity examination needs to take a further analytical step. The exercise of the rights of dequity holders will potentially impact a wide range of other transaction participants. It is imperative that these other participants be aware of and acquiesce to (through transparent pricing) the rights of the dequity holders. However, as shown above, the courts will exalt substance over form in recharacterizing a particular investment (and hence reordering rights). To satisfy informational equilibrium and economic transparency, the nature of the investment (relational vs. discrete, rights of governance and rights to demand payment) must survive judicial scrutiny and emerge without recharacterization. As shown through examples in tax and bankruptcy, this is not a

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simple prediction to make.

Market application illustrates this point. When the gap equity was financed through a hard second mortgage, the rights and responsibilities of the parties were relatively well defined and unambiguous. Now that the gap equity is financed through hybrid investment, the ambiguity of recharacterization should be reflected in pricing of the dequity. When purchasing the $25 capital stake, the investor gave up some debt rights (no “hard seconds”) in exchange for some equity-like rights in the firm.\textsuperscript{95} Equity is a higher risk investment than debt. However, the risk/return makeup in the shift from debt to equity may not be a true representation of the risk/returns of the enterprise.\textsuperscript{96} What is not priced in this structure is the volatility and ambiguity produced by the threat of recharacterization along with the concomitant costs of litigation, etc.

This shift can be diagrammed like this:

\textsuperscript{95} For example, in a mezzanine loan, second lien on real property is replaced by a pledge of equity in the borrower. From another angle it matters who owns these equity rights. This is a further ambiguity faced by the first lien holder. As stated above rating agencies take the purchaser of the second lien into consideration.

\textsuperscript{96} See Polito, supra note 36, at 303 (“Yet, by examining all facts and circumstances to determine how risky is risky enough to be equity, existing law sets no real standard for how much of the risk-and-return of the corporate enterprise a security must bear to be treated as equity.”) Another way to look at this problem is how bankruptcy courts value firms in reorganizations. Some commentators, such as Pantaleo and Ridings, have called the bankruptcy courts’ focus on P/E multiples misplaced when the firm has significant leverage. Although debt generally is cheaper than equity, it can make an equity investment more risky:

The increased risk also increases the cost of equity capital and, therefore, decreases a firm’s P/E multiple—precisely the opposite of what some courts have concluded. A higher valuation is appropriate was not because debt increases P/E multiples, but because P/E multiples reflect only equity value. Thus, if the comparable firms being valued are capitalized with debt as well as equity, measuring reorganization value by reference only to the P/E multiple of those firms ignores the value in those firms that is reflected in the market value of their debt. Therefore, while debt tends to depress a firm’s P/E multiple, its market value contributes to the overall value of a firm. Thus, it needs to be factored into a valuation by using a broader multiple than a P/E multiple if the valuation is to be accurate. Determining value by using only P/E multiples in a case where a target and its comparables have different leverage fails to take this into account.

Pantaleo & Ridings, supra note 55, at 439.
In this chart the thick line represents a one to one trade off between a relational contract (equity) and a discrete contract (debt). The thin line represents the disparate value between the two investments. In essence the difference corresponds to the option value of whether the investment will be recharacterized. The difference is attributable to the ambiguity created by the chance that a more debt-like discrete contract will be transformed into a more equity like relational contract by the courts upon default. The value of the option should be reflected in the price of the investment.

To a certain extent, the ambiguity of the US bankruptcy system is reflected in the pricing of the CMBS securities insofar as the ability to impair the first lien is concerned. To illustrate this phenomenon we can compare two legal environments that present more chance for recharacterization (United States) and less chance for recharacterization (Canada). Much like United States bankruptcy law, Canadian bankruptcy law has a reorganization component, and a secured creditor cannot systematically veto a debtor's attempt at reorganization. As compared to U.S. proceedings however, Canadian restructuring proceedings are more business negotiation oriented and less litigation oriented. In fact, the proceedings closely resemble mandatory alternative dispute resolution. "As a result," one study reports, "Canadian insolvency proceedings are materially shorter, less expensive and less litigious than U.S. proceedings".97

Rating agencies perceive Canadian bankruptcy laws as significantly more supportive of creditors rights that those of the United States. They analyze that

Canadian borrowing culture is superior because: (1) Canadian default rates are consistently lower than comparable U.S. default rates; (2) Canadian bankruptcy law is more creditor-friendly than comparable U.S. laws; and (3) the collateral associated with a Canadian mortgage can be acted upon quickly. Accordingly, the agencies permitted lower subordination levels on Canadian pools than for comparable pools in the United States.98

However for complete economic transparency in the CMBS market, models of debt/equity characterization should be expanded beyond the question of impact upon the payment priority on the first lien. The nature of the dequity investment should be broadened to include both relevant legal indications: governance and right to demand payment. In financing the gap equity, the second lender gave up a portion of the security of a hard second on the property. In exchange, this "lender" received equity that may not be equivalent in value because it does not include the cost of the ambiguity created by the possibility of recharacterization.

This further inquiry and assessment, though, must go beyond the perspective of the rating agencies. Holders of these dequity investments should look more closely at how their legal obligations shift upon default and whether this shift is reflected in the price of investment. A nominally debt like investment that gives holders corporate governance rights in exchange for forsaking the ability to unilaterally demand repayment upon default would be more attractive to the rating agencies and therefore lower the cost of financing the first mortgage loan. However, there is an additional consideration: whether the purchase price reflects the ambiguity created within this investment that it could or would be recharacterized as equity.

Let's go back to our $25 of gap equity that must be financed. We assume that as a straight debt investment (a "hard second") it would be priced at $25, as it possessed the right to demand repayment (i.e. foreclosure). Now let's strip off elements of debt (e.g. adding a stand still agreement) and add elements of equity (e.g. right to participate and vote in certain management decisions). The move from a discrete contract to a relational contract is not a one for one straight line trade-off. As more equity-like attributes are added there is a non-linear progression due to the increasing ambiguity of recharacterization.99 Therefore, the $25 former debt investment is no longer worth $25 but rather some price less.

Parties can attempt to attenuate this ambiguity through the use of intercredi-

99. The value of the investment can be interpreted as a function of the probability of repayment. Assume a hypothetical investment of $100. If the probability of repayment is 100% then the price paid should be $100. If the probability of repayment is 0% the price should be zero. The ambiguity of recharacterization produces a risk aversion where if the probability of recharacterization from debt to equity (eliminating right to demand payment) is 50% an investor would not pay $50 but, rather some price less $50 to compensate for the ambiguity.
tor agreements. Here we are not only talking about agreements between the senior lien holder and the dequity investor. Rather, there should also be a recognition by the dequity investor that to recoup some of the value lost through ambiguity of threat of recharacterization they should strive to maintain priority over other investment classes even though such priority may be lost vis-à-vis the first lien holder.

Additionally, these intercreditor agreements perform another function. In essence they are a form of credit support for the senior debt. The intercreditor agreements give comfort to dequity investors who then agree to invest in something that is less than debt but presumably more than equity. If, through recharacterization, these agreements are not enforced in accordance with their terms the dequity suffers a loss in value. Subordinate real estate investors will (should) begin to demand more at the inception of the transaction possibly affecting the price of the first lien debt.

In constructing the default rule of interpretation of rights upon default we therefore must incorporate both right to demand payment and right to participate in firm governance. The ambiguity risk, i.e. the risk of recharacterization, turns on the courts' interpretation of these two factors. The goal in instituting a default rule of interpretation is to illuminate this possible ambiguity and allow for transparent pricing not only of the senior debt but also of the subordinate dequity. Legal review of intermediate investment vehicles should begin to include not just the ability of the dequity holder to jeopardize payment priority of the first lien, but also whether payment demands and management rights will possibly recharacterize the dequity investment. In economic terms the value of the dequity investment is a probability function where \( p \) is the chance of recharacterization.\(^{100}\)

V. CONCLUSION: DELINEATING THE DICHOTOMY IN THE FUTURE

As real estate finance employs more and more sophisticated tools the debt/equity distinction will become even more difficult. Characterization as debt or equity has implications in today's real estate market beyond the traditional legal boundaries of tax and bankruptcy. Therefore, mechanisms must be designed to effectuate a more accurate representation of the nature of the investment. A first step would be to include in the analysis the notion that equity like relational contracts are not perfect substitutes for debt like discrete contracts. Then the markets may present a truer reflection of the price of hybrid gap financing.

Furthermore, we need to expand our thinking about the effect of hybrid fi-

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100. The probability of recharacterization will be a function of right to participate in firm governance and right to demand payment. Algebraically, it would be expressed as \( V = 1 \times p(\text{recharacterization}) \). \( p(\text{recharacterization}) = f(\text{right to participate in firm management, right to demand payment}) \). \( V \) is value and \( I \) is investment price.
nancing beyond the scope of first lien financing. The effect of recharacterization from debt to equity in the event of default likewise restructures the relationship between the holder of the gap financing and other creditors and investors of the borrower. Real estate firms will have a clearer picture of their investment structure by undertaking a 180 degree examination of firm capitalization utilizing the analysis tools of right to demand repayment and right to participate in corporate governance.
Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention

Sharon Hannes†

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Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention

Sharon Hannes

ABSTRACT

This Article develops a theory that sheds light on recent evidence that shows that high-quality issuers antitakeover adopt defenses during an IPO, and keys this behavior to the existing literature on private benefits of control. The Article then analyzes the decision of the pre-IPO owners concerning takeover defenses. Their decision is shown to be influenced by the quality of the venture that goes public. High quality in firms that go public often means an abundance of growth and business opportunities, rather than sizeable existing assets. In such ventures, managers are unlikely to consume many harmful control benefits. Nevertheless, managers derive a great deal of non-monetary control benefits from their stint in the promising entity. Consequently, takeover defenses help the pre-IPO owners to preserve their non-monetary control benefits without causing too much harm to the value of the enterprise.

This Article also shows that even if we take as given the conventional assumption that antitakeover defenses are harmful to shareholders, the inimical influence of takeover defenses is hard to trace since the issuers that adopt them are those whose antitakeover charter provisions' influence is the least harmful. Finding a matching sample for the adopting issuers, as some have tried before, may therefore be an impossible task. This Article thus considers possible extensions that result from complications of asymmetric information, and concludes with the perils of federal intervention.

I. INTRODUCTION

In a previous article, I argued that the inconclusive evidence about the influence of takeover defenses on the value of the firm can be explained by an equilibrium argument. The essence of the argument was that takeover defenses provide the target firm with some benefits, but also divert takeover activity to unshielded firms, and thus the market ultimately reaches a state in which takeover defenses are benign to the public shareholders. Here, I will take the

conventional assumption that takeover provisions are actually harmful to the public shareholders, and propose a different theory that can shed light on the concurrent empirical findings. Subsequently, the two theories will be merged to explain how equilibrium of the type presented in the previous Article can be derived, even if adoption of takeover defenses is indeed harmful for the firm’s market value.

The vivid contemporaneous empirical literature on takeover defenses at the IPO stage may be summarized by four points. First, takeover defenses and harsh takeover defenses are not adopted by all IPO firms. Second, it is hard to identify any characteristics that differentiate adopting and non-adopting firms. Third, takeover defenses arguably seem to hurt shareholder value. Takeover defenses are used in circumstances in which they are most needed to shield managers’ positions, while least needed to create shareholder value. While I have previously argued that this finding is questionable, here, I will take this assumption as given. Finally, and surprisingly enough, the adopting firms seem to be the most promising firms in terms of profitability and business opportunities.

As will be elaborated below, the first three clusters of empirical findings seem to suit the predictions of the theory that attributes takeover defenses to incidents of high private benefits of control. This Article argues that even the fourth empirical finding about the quality of the adopting issuers, which seemingly contradicts the predictions of the above-mentioned theory, may comfortably fit into the picture once some plausible assumptions are introduced. Additional complications that arise from asymmetric information may fit these empirical findings as well.

Private benefits that flow from the control of a public firm may derive decisions regarding ownership structures. Once ownership is dispersed among

2. See Frank Easterbrook & Daniel Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981) (arguing that it is socially optimal that the target’s management remain passive in takeover event); John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 CAL. L. REV. 1301, 1327 (2001) (“[A]cademics have generally opposed defenses, and practitioner-commentators have generally supported them.”). But see Jennifer Arlen & Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 U. PA. L. REV. 577 (2003) (arguing that a ban on legal antitakeover defenses would only yield harsher transactional defenses that are unregulable); Marcel Kahan & Edward B. Rock, Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment, 152 U. PA. L. REV. 473 (2003) (arguing that takeover defenses provide managers with leverage that benefits the shareholders from an ex ante point of view).


5. See Lucian A. Bebchuk, A Rent-Protection Theory of Corporate Ownership and Control (Nat’l
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a wide group of shareholders unaffiliated with the manager-controller, a third-party bidder may approach the shareholders directly and acquire control without the approval of the incumbent manager. In such a transaction, which does not involve the current manager, the bidder may wrest the private benefits of control from the hands of the incumbent manager without any compensation to the incumbent. This incentive for the bidder to grab control benefits without directly paying for them may cause the founder of the firm to maintain a control block in the first place. Hence, the larger the private benefits of control become, the higher the likelihood that founders will sustain a lock on control when going public.

Concentrating a high fraction of the personal wealth in a control block, however, may be too expensive a measure for the founder. Therefore, where benefits of control are still substantial, the founder may partially shield her private benefits of control by adopting takeover defenses. For this theory to be interesting and shed light on the fact that only a fraction of the firms adopt defenses, one must assume that these defenses have adverse effects on shareholder value. Otherwise, if defenses were beneficial to shareholders, all firms would have adopted them. However, if antitakeover defenses harm the value of the firm from the perspective of the public shareholders, then the founder will adopt defenses before going public only if the harm caused to shareholders is less than the preservation of private benefits that such an act

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6. To be precise, a concentrated ownership structure will be chosen by the entrepreneur even if shareholders value more a dispersed ownership structure if the net private benefits of control (less the costs of a takeover bid) are higher than half the loss to shareholders from the concentrated ownership structure. Or explicitly (assuming for simplicity that all managers are of equal qualities and not cash constrained):

\[ B_{cs} - C > 0.5(Y_{ncs} - Y_{cs}), \]

where \( B_{cs} \) is the private benefits net of the private costs, \( C \) is the cost of the bid, and \( Y_{ncs} \) and \( Y_{cs} \) are the values of the firm to the shareholders under a dispersed ownership structure and a concentrated ownership structure, respectively. The intuition is that a bidder must purchase at least half of the company to gain control and would therefore need to pay at least half of the shareholders the value of their dispersed ownership holdings and some administrative costs. The bidder would have incentives to take control in such a manner (and the entrepreneur would react in deciding on a concentrated ownership structure) only if her concentrated ownership of half of the shares that she purchases plus her net private benefits in that situation are higher than the total costs of the bid that were mentioned above.

7. At least two direct costs result from the controller decision to maintain a large fraction of the firm stock. First, under the conventional assumption that an individual controller is risk averse, the inability to diversify the investment of her personal wealth and easily liquefy it is very costly to the controller. See Anat Admati et al., Large Shareholders Activism, Risk Sharing, and Financial Market Equilibrium, 102 J. POL. ECON. 1097 (1994); Patrick Bolton & Ernst-Ludwig von Thadden, Liquidity and Control: A Dynamic Theory of Corporate Ownership Structure, 154 J. INST'L & THEORETICAL ECON. 167, 177-211 (1998). Secondly, a high fraction of the shares in the hands of the controller reduces the public float of the securities and in turn their liquidity. In the absence of a highly liquid market for the firm stock, the reliability of the share value as an informative signal declines and the value of the firm is discounted accordingly. See Bengt Holmstrom & Jean Tirole, Market Liquidity and Performance Monitoring, 101 J. POL. ECON. 678 (1993).
achieves.8 

Following this logic, the adoption of defenses must leave inimical traces on the value of a firm that goes public with defenses. The value of the firm's stock on the exchange is the value for the public shareholders and does not include the private control benefits that accrue to the manager-controller. Hence, a decision to adopt defenses that is based on the need to preserve those private benefits at the expense of the firm's shareholders would end up in lower valuations for the adopting firms.9 

The empirical evidence, however, supposedly contradicts this prediction. High-quality underwriters tend to serve the issuers that choose to adopt defenses.10 Since high-quality underwriters are conventionally assumed to back firms that create the highest value for shareholders, it seems unlikely that adopting firms suffer from relative lower valuations.11 Nevertheless, this Article argues that the existence of high private benefits may still explain the behavior of the adopting firms. The same argument would explain why adopting issuers are the more profitable ones in the years prior to the IPO.12 

The empirical puzzle can be solved once we recognize that high-quality firms tend to systematically produce higher private benefits of control, without these higher benefits aggravating shareholders' losses from the adoption of defenses. This is especially true if quality is measured and defined by the scale of the business and growth opportunities of an issuer. Consequently, issuers of better quality will more often be the ones to adopt takeover defenses. In turn, comparing the valuations of the adopting firms with the non-adopting firms is a biased measure for the effects of defense adoption. The supposedly matching sample for the group of adopting firms is an inferior sample to start with, and possible lower valuations may expose this inherent characteristic and carry no probative value regarding the impact of the defenses. Put differently, if high


9. Measuring Tobin Q of the adopting and non-adopting firms may identify these relatively low valuations of the adopting firms. Tobin Q is the ratio of the firm's market value to its book value and therefore a measure of shareholder value (that is, how large are the business opportunities that the firm is likely to develop after controlling for the value of its assets).

10. Additional empirical findings show that adopting firms have superior performance before going public. Specifically, adopting firms are significantly older with significantly higher operating income in the year before the IPO, and fewer liabilities and fewer years of negative operating income before the IPO. They are also less likely to be in a developmental stage. See Field, supra note 3. Such findings, however, cannot help in uncovering the effects of the adoption of defenses. Moreover, direct evidence regarding the relative performance of adopting firms after going public is not reported.


12. See Field, supra note 3, at 21.
quality spurs adoption of defenses in the first place, the inherent high valuations of the adopting group may hide the harm that defenses cause to shareholder value.

To understand why high quality may lead to higher control benefits without causing harsher damage to shareholders, we must examine the specific properties of the private benefits of control. An entrepreneur who maintains control over the enterprise subsequent to the IPO endures many forms of private benefits of control that the public shareholders cannot share. Some of those forms are often wasteful and inimical to the corporate entity. Benefits flowing to the controller from self-dealing, insider trading in securities, perks consumption, investment in “pet projects,” or unjustified expansion are all members of such a group of detrimental private benefits practices.13 In countries with effective legal regimes, there are indications that although these types of harmful activities indeed exist, their scope is limited.14

Other forms of private benefits of control may be mere transfers of value from the public shareholders to the controllers, which do not entail any direct waste, such as excessive salaries.15 Finally, there are types of private benefits that the enterprise’s controller accumulates without any direct effect on the firm’s value. Such benefits are mostly non-pecuniary benefits that attach to the prestigious stint, including self-satisfaction from being the one in control of the enterprise and accordingly, the respect and esteem inflicted by society.16 Political power and reputation also play an important role in this equation. The effectiveness of the legal regime that surrounds the corporation does not bind these types of private benefits, and whoever believes that managers are driven not only by monetary compensation and perks, but also by prestige, satisfaction and authority considerations would not underestimate these types of private benefits.


Interestingly, the quality and value of the underlying issuer does not influence the size of the harmful and beneficial types of private benefits in a similar way. Generally, this Article argues that higher firm value usually leads to higher beneficial private benefits, but not necessarily to higher consumption of harmful control benefits, at least once some level of firm quality is achieved. This is especially true when the high value of the issuer is the result of its superior business and growth opportunities, and not necessarily the result of the value of its existing assets.

As for the beneficial control benefits, typically an entrepreneur will place high value on a secured controller position in a potentially successful enterprise, but will not cherish as much the equivalent stint in a less promising entity. Becoming the manager of the next Microsoft must be worth more for the entrepreneur than being a manager of an ordinary firm, even when the pecuniary benefits are left out of the equation. Therefore, by and large, it seems sound to assume that beneficial private benefits rise with the quality of the underlying venture that is going public.

As will be elaborated extensively below, this link between beneficial control benefits and firm quality does not systematically carry on to the consumption of harmful control benefits. Under an effective legal regime, the ability of the manager-controller to abuse her power at the expense of the public shareholders is limited. Surely, opportunities to benefit from a possible abuse may increase with firm value, but the legal regime, along with other mechanisms, does not allow all possible opportunities to be consumed. Specifically, as will be discussed momentarily, the presence of valuable business opportunities prevents the managers of the firm from consuming some types of private benefits that are most detrimental to shareholders. Hence, beyond some threshold of quality, the larger scope of potential opportunities would not translate into higher consumption of harmful private benefits.

Although each class of harmful private benefits should be analyzed separately, we can use the consumption of managerial perks as an example. While a low-quality firm cannot provide its managers with enough means to consume expensive perks, the perks consumed by a mediocre firm’s manager may be similar to those consumed by a manager of an excellent firm. Social norms and potential adjudication may deter managers from consuming additional perks, even if her firm can easily afford them. Similarly, high firm value that is the result of high growth and business opportunities naturally brings the enterprise to exhaust all its resources and prevents the managers from spending the existing cash flows according to their whims.

There are thus good reasons to believe that beneficial private benefits increase corresponding with firm quality, while the consumption of harmful control benefits is not systematically linked to firm quality. Hence, if shareholders mainly fear that takeover defenses protect the consumption of
harmful control benefits, then beyond some threshold of quality, the IPO valuation discount for adoption of takeover defenses need not be greater for higher-quality entities.\footnote{17}

Consequently, the upside of adopting defenses is greater for superior entities, while the downside (namely the IPO valuation discount for their adoption) is by and large equal to that of their less successful peers. It therefore follows that high-quality firms would more often be the ones to choose to adopt defenses.\footnote{18} To be sure, other firms with idiosyncratic reasons to have high control benefits, such as family businesses, may choose to adopt defenses as well, but high quality is a systematic factor in the decision to adopt defenses.\footnote{19}

Altogether, the above story fine-tunes the predictions of the private benefits of control theory in regards to adoption of takeover defenses at the IPO. The recent empirical findings seem to fit these modified predictions with no contradiction. Adoption of defenses is not homogeneous among all firms, just as the dispersion of private benefits among firms is not homogeneous. Salient different characteristics of adopting firms are hard to trace, but there is some concrete evidence that the adopting firms are of higher quality.\footnote{20} Finally, although defenses were found to decrease shareholders’ average premiums in takeover events, the adopting firms were often served by high-quality underwriters that are assumed to be the best agents of shareholders value. This odd finding is explicable once we recognize that high-quality firms tend to furnish more control benefits without this elevated benefit level causing additional harm to shareholders. The superior performance of the adopting firms may therefore cover any trace of the harmful effects that takeover defenses have on the value of the adopting issuer to the public shareholders.

Additional predictions may result from asymmetric information. First, if entrepreneurs hold private information concerning the quality of the managerial team, the issuers with high-quality managers may signal their superiority by refraining from adopting defenses.\footnote{21} This signal can be persuasive since a better manager who runs her firm properly should fear less from a hostile takeover. Second, and counterintuitively, if the entrepreneurs possess private information regarding the quality of the venture and not in regards to the quality of the managerial team, then high-quality issuers may signal their

\footnote{17. Additional reasons for a valuation discount due to adoption of takeover defenses are explored below. Specifically, the Article discusses possible inimical \textit{ex post} effects and mismanagement \textit{ex ante} effects. See infra Part III.}

\footnote{18. See Field, \textit{supra} note 3, at 20.}

\footnote{19. See Bebchuk, \textit{supra} note 5.}

\footnote{20. See Field, \textit{supra} note 3, at 27.}

superior type by adopting defenses. As discussed above, high-quality ventures provide their controllers with additional beneficial private benefits of control without causing further harm to the shareholders. Hence, high-quality ventures may adopt wasteful defense measures to help the market reveal their superiority, while the low-quality issuers would find it too expensive to mimic this behavior.

The remainder of the Article continues as follows. Part II briefly describes the emergence of takeover defenses, how they work, and their proliferation in the 1980s. Part III presents the main argument that high-quality firms should systematically adopt more defenses than their inferior peers. Part IV explains how the theory in this Article can shed light on the seemingly contradictory empirical findings, and suggests testable predictions for the theory. Part V merges the firm's heterogeneity theory developed in this Article with the equilibrium argument. In Part VI, the attention is turned towards cases of asymmetric information. Two signaling arguments à la Spence, 1973, are raised, which suggest that adoption (or rejection) of defenses are costly signals sent by superior types to help the market ascertain their identity. This Part delineates the requisite background conditions for each of the signaling arguments to hold. Empirical evidence and predictions for the signaling arguments are also mentioned. Finally, Part VII summarizes and discusses the normative implication of the descriptive arguments that were raised earlier. It demonstrates that one should be very cautious before proposing a federal intervention of any sort in the private order of takeover decisions.

II. TAKEOVER DEFENSES

A. Hostile Takeovers and the Development of Incumbents' Powers to Impede Bids

Unsolicited Control Transactions, otherwise known as hostile takeovers, became prevalent in the 1980s. The unique and defining feature of a hostile takeover is that the board of directors of the acquired firm condemns the offered transaction. Notwithstanding, the bidder who wants to gain control appeals to the shareholders of the corporate target to overcome the managerial disapproval.

22. This was by no means the first wave of unsolicited control transactions and the "market for corporate control" was famously described much earlier in the seminal work of Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110 (1965); Bernard S. Black, The First International Merger Wave (and the Fifth and Last U.S. Wave), 54 U. MIAMI L. REV. 799 (2000) (extensively describing the different merger waves including the enormous hostile wave of the 1980s).


24. The merger wave of the 1980s was so fierce that an unbelievable thirty percent of the Fortune 500 companies were subject to takeover bids during that time. See Gerald Davis & Suzanne Stout, 272
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By law, directors are elected or dismissed from office by the vote mechanism at a firm at certain times or events. When a bidder, however, successfully purchases a majority of the targets' shares, it is only a matter of time until she uses the vote mechanism to replace the reluctant directors with her proponents. Therefore, the ability to buy the shareholders' stakes in a market transaction, usually by way of a tender offer, left the vote mechanism unemployed in early 1980s takeovers. 

Innovative legal devices and landmark court decisions, however, allowed exploitation of such legal devices and altered the takeover battlefield. Shareholders' rights plans, notoriously known as poison pills, were designed by lawyers to impede hostile market transactions. Under the terms of such plans, a purchase of a significant fraction of the target stock without its directors' approval triggers special rights for incumbent shareholders. As a result, the value of the hostile purchase is severely diluted up to the point in which the purchase is rendered self-defeating. Moreover, since shareholders' right plans are distributed as dividends in kind, directors need not receive shareholders' approval to employ the harsh measures, making their adoption easy for managers. This eventually marked the end of the pure market transaction as a possible mean to accomplish a hostile takeover.

Nevertheless, the adoption of poison pills and subsequent court approval could not halt the vibrant market for unsolicited control transactions. Simply put, poison pills do not temper the vote or proxy mechanisms of the firms.

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26. The tender offer mechanism was invented in the 1950s, and since then has become the major tool of acquiring shares in control transactions. See DOUGLAS AUSTIN & JAY FISHMAN, CORPORATIONS IN CONFLICT 7-23 (1970) (describing the mechanism and the background for its development).


29. Notwithstanding the potential clash between the will of the shareholders and that of their firms' directors, the seminal Delaware court decision in Moran and following cases legitimized the adoption of poison pills. For some time, commentators debated whether boards' decisions to reject control transactions, sheltered by poison pills, were about to be carefully scrutinized by the courts. See Ronald Gilson & Reinier Kraakman, Delaware Intermediate Standard for Defense Tactics: Is There Substance to Proportionality Review?, 44 BUS. LAW. 247 (1989); Marcel Kahan, Paramount or Paradox: The Delaware Supreme Courts Takeover Jurisprudence, 19 J. CORP. L. 583 (1994). Soon, it became clear that in most cases, boards are granted with a very broad mandate to reject acquisition offers.

30. Ronald Gilson, Unocal Fifteen Years Later (and What We Can Do About It), 26 DEL. J. CORP. L. 491 (2001) (explaining the development in the market for corporate control as a reaction to the adoption of the poison pill and Delaware's jurisprudence).

31. Scattered shareholders usually do not show up for a vote, but rather mail in their proxies that
Therefore, and notwithstanding the existence of a poison pill, bidders can still solicit the shareholders’ votes in order to replace the incumbent board of directors with pro-bidder directors. In turn, the newly elected directors are to dismantle the poison pill and allow the bidder to purchase the stock, thanks to the fact that “poison pills can be removed by a board of directors as easily as they can be installed.”\(^{32}\) Thus, the vote process may circumvent the effect of poison pills unaccompanied by further mechanisms.\(^{33}\)

By all means, poison pills made hostile takeovers more expensive, but the out-of-pocket expenses of shareholders’ solicitation do not amount to a real obstacle for many hostile takeovers.\(^{34}\) The real costs that poison pills entail are the costs of delay.\(^{35}\) Market climates change rapidly and therefore deals are more valuable when they may be finalized quickly. Moreover, the takeover activity engages the bidders’ managers, creating significant opportunity costs. Finally, the longer it takes to complete the deal, the more competition the bidder should expect. As a result, if replacing the board takes much longer than a pure tender offer, then the effect of poison pills becomes much more salient.

Surprisingly, this is not the case. Or, to be precise, this need not be the case. If, for example, a majority of the shareholders can nominate directors by way of written consent in lieu of a meeting, and if incumbent directors may be dismissed from office immediately and without cause, then soliciting such a procedure does not consume much more time than a pure takeover via tender offer.\(^ {36}\) Moreover, and maybe even more surprising, this is precisely the default standard that the Delaware law applies, according to which a proxy fight may carry their decisions. Hence, the vote process is more accurately termed the proxy process.

32. See Coates, supra note 25, at 852.

33. Interestingly, the vote mechanism that was designed in the first place to allow control changes assumes its lead role in the poison pill era. In reality, however, when the bidder solicits the shareholders’ votes to circumvent a poison pill, she must also create a credible commitment to purchase the stock upon capturing the board. The commitment is required to assure the shareholders that the bidder does not pursue her own agenda at the expense of the shareholders after she prevails in the vote. Moreover, the committed purchase price serves as a signal to the shareholders with which they can evaluate the quality of the bid. See Lucian Bebchuk & Oliver Hart, Takeover Bids, Proxy Fights and Corporate Voting (John M. Olin Ctr. For Law, Econ., & Bus., Harvard L. Sch., Discussion Paper No. 336, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=290584. The market mechanism to allow for such commitment is a contingent tender offer that is held in conjunction with the proxy fight for the board. See J. Harold Mulherin & Annette B. Poulsen, Proxy Contests and Corporate Change: Implications for Shareholders Wealth, 47 J. FIN. ECON. 279, 286 (1998).


36. Instead of the 20-day minimal period for tender offers imposed by the William Act, it takes about 45-60 days for the solicitation and for the Securities and Exchange Commission to pre-clear the proxy statement. This minimal delay is the result of the Federal Proxy Solicitation rules. For the Williams Act requirements, see 15 U.S.C. § 78m(d)-(e), 78m(d)-(f) (2000). For the delays imposed by S.E.C. involvement, see Coates, supra note 25, at 853.
be concluded in 45 days.\textsuperscript{37} Hence, a poison pill alone does not leave the managers of a defending target with much time to save their sinking ship.\textsuperscript{38}

Various measures, however, can cause delay and thus magnify the strength of the poison pill. To implement such delays beyond the legal default arrangement, firms normally must receive shareholder approval, in contrast to poison pills that may be adopted by the board of directors.\textsuperscript{39}

On top of these antitakeover charter provisions ("ATPs") that cause delay, owners can choose to prevent hostile takeovers altogether by maintaining a controlling stake after the IPO or using dual-class stock structures.\textsuperscript{40} The analysis of such harsh measures, however, lies beyond this Article's ambit.\textsuperscript{41}

By and large, ATPs that cause delay and impede the proxy mechanism of the firm may be divided into ATPs that inhibit shareholders' opportunities to express their opinions and ATPs that narrow shareholders' means to wrest control from the incumbent board of directors. ATPs that limit shareholders' opportunities to voice their opinion are provisions that prevent the shareholders from using a written consent procedure in lieu of a meeting, provisions that foreclose shareholders' rights to summon a special shareholders meeting, and provisions for staggered boards. ATPs that narrow shareholders' means to wrest control from the incumbent board of directors include provisions that limit shareholders rights' to dismiss directors or expand the board, leaving open only the opportunity to replace directors that have served their full term. Each of these ATPs are briefly discussed below.

\textit{1. Written consent in lieu of a meeting}

The most rapid and easiest way for shareholders to voice their opinion and replace the board of directors is the written consent process. Consequently, even if the target firm is shielded by a poison pill, it may be captured within a minimal period of 45 days imposed by the federal proxy regulation.\textsuperscript{42} A charter provision that forecloses shareholders ability to act by written consent impedes

\textsuperscript{37} Since Delaware General Corporation Law allows action by written consent and removal of directors without cause as a default matter, it imposes no more delays over the minimal 45 days that the federal proxy regulation imposes. See Del. Code Ann. tit. 8, §§ 141, 228 (1999).

\textsuperscript{38} Therefore, it is not surprising that by itself a poison pill does not hinder much of the likelihood of being taken over. See Robert Comment & G. William Schwert, \textit{Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures}, 39 J. Fin. Econ. 3, 4 (1995).

\textsuperscript{39} Alternatively, ATPs may be installed by in the initial charter of the firm or while ownership is concentrated before the initial public offering, when the tension between managers and shareholders is nonexistent.


\textsuperscript{41} For a relevant discussion, see Hannes, supra note 1, at 1961.

\textsuperscript{42} Assuming that shareholders possess the right to dismiss directors without cause or manipulate the size of the board.
this rapid avenue for shareholder action.

2. **Special Shareholder Meetings**

A special shareholder meeting is a meeting scheduled in addition to the annual shareholder meeting, which can facilitate rapid replacement of the management even in the absence of a written consent procedure. Shareholders may use the firm bylaws to set a procedure for a special shareholder meeting. One, however, can often find charter provisions that preclude or limit the right to call for a special shareholder meeting. Once the charter explicitly impedes shareholders' right to summon a special meeting, the bylaws, and in turn, the shareholders, lose control over the issue.

This ATP that prevents special meetings postpones the opportunity of shareholders to express their opinion until the general annual meeting. With a right to summon a special meeting, proxy solicitation can be accomplished within 60 to 90 days, but without it, shareholders have to wait for the regular annual meeting of the firm. The board is authorized to schedule annual meetings and the period between two "annual" meetings could be stretched to as much as 360 to 540 days, depending on the state of incorporation. This, undoubtedly, is a substantial delay.

3. **The staggered board provision**

The most potent ATP, the charter provision that forms a staggered board, is to be blamed for delays beyond the shareholders' annual meeting. According to the Delaware Code, all members of the board must stand for election annually. However, a charter provision may form a staggered ("classified") board, in which merely a third is being replaced every year. Thus, to gain control over a company with a staggered board, one must win at

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43. Another technique is to make a supermajority bylaw requirement regarding special shareholders meetings within the bylaws so that shareholders would not be able to change it.

44. See Coates, *supra* note 2, at 1403, tbl. B-5, for the maximum days between annual meetings in the 50 different states.


47. For background, criticism and statistics regarding staggered boards, see Alesandra Monaco, *Corporate Governance Service 1999 Background Report C: Classified Boards*, INVESTOR RESPONSIBILITY RESEARCH CENTER (1999).


49. There is a possibility to form a two-tiered staggered board instead of a three-tiered board. However, in practice such a structure does not provide managers with the benefits of a three-tiered staggered board and therefore is rarely if ever seen.
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least two consecutive proxy fights, which may take up to two years, and in some cases even three years. In an upsurge from the early 1980s, today, over 60% of all public companies have board of directors that are not fully replaced every year. Undoubtedly, this is a very lethal and frequently used ATP.

4. Provisions that limit shareholders rights to dismiss directors or expand the board

Assuming that shareholders have the opportunity to express their opinion, it does not automatically follow that they can easily alter the power structure in the boardroom. To accomplish a takeover, it is necessary for the bidder’s proponents to occupy a majority of the board seats. Such a majority could be achieved by replacing directors who have served their full terms, removing and replacing directors while they serve in office, or expanding the board and packing it with a majority of new directors. Well-structured ATPs, however, may prevent shareholders from removing directors before their terms are due. ATPs may also prevent the shareholders from circumventing the limitation on directors’ removal by expanding the board and electing a majority of new directors.

B. The Proliferation of ATPs in Seasoned Firms During the 1980s and Their Adoption Trends in IPO-Stage Firms

Since poison pills do not promise much delay without ATPs that hinder the availability of the proxy mechanism, it is of no surprise that the proliferation of poison pills was tightly followed by ATP adoption. As discussed earlier, however, while poison pills are solely under managerial discretion, ATPs that impede the proxy process require shareholder approval to be implemented. Notwithstanding, the empirical data clearly indicate that shareholders did not stand in the managers’ way in the late 1980s when many public corporations adopted such ATPs.

The fact that seasoned firms adopted ATPs did not convince many scholars that such adoption is efficient. Moreover, in the 1990s, the ease of ATP

50. If the firm opts for cumulative voting and the managers have considerable influence on a small fraction of the firm’s votes, staggered boards may delay takeover for three years.
51. See Monaco, supra note 47.
52. For the proliferation of ATPs in the population of seasoned firms in the second half of the 1980s, see Morris G. Danielson & Jonathan Karpoff, On the Uses of Corporate Governance Provisions, 4 J. CORP. FIN. 347 (1998). Other sources report similar findings. For example, the usage of staggered boards rose from about 20% in the early 1980s to beyond 60% nowadays. See Wayne H. Mikkelson & M. Megan Partch, Managers’ Voting Rights and Corporate Control, 25 J. FIN. ECON. 263, 267 (1989) for the evidence regarding the 1980s and Monaco (1999), supra note 47, for additional data.
adoption was all but gone. The growth in power and activity of institutional shareholders practically precluded managers’ ability to implement ATPs in seasoned firms. Surprisingly enough, although institutional investors block proposals to add ATPs, they do not pressure IPO-stage firms to defer ATP implementation. Were institutional investors to despise ATPs in IPO-stage firms as much as they despise them in mature firms, underwriters would advise issuers to abjure ATPs, which they apparently do not do. The trend of adoption of takeover defenses in the IPO stage by a large fraction of the issuers in the market, and the reluctance of investors to allow changes of this status in the midstream is explained below, first, in a setting with complete information, and then in a more complicated asymmetric information framework.

III. THE RELATIVE ADVANTAGE OF HIGH-QUALITY FIRMS IN ADOPTING DEFENSES AS A REFINEMENT TO THE PRIVATE BENEFITS OF CONTROL THEORY

The private benefits of control theory suggests that high control benefits may lead to the adoption of takeover defenses by entrepreneurs even if, as conventionally assumed, these measures are harmful for the public shareholders. To exemplify, imagine a firm that is worth one hundred for the shareholder without ATPs and additionally provides its managers with non-monetary private benefits of twenty that cannot be shared with the public shareholders. However, without ATPs, the chances of a takeover that would oust the entrepreneur is 50%, and therefore the entrepreneur values the option of taking the firm public without defenses at 110 (or 100 + 50%*20). Alternatively, with ATPs, the private benefits would remain the same, but the firm’s inherent value declines to ninety-five because managers may reject value-enhancing mergers.

For simplicity’s sake, let us further assume that the probability of a takeover with defenses is zero. Consequently, the entrepreneur would value the company with ATPs at 115 (or 95 + 20), and prefer to take the company public with takeover shields (115 > 110). Note that the value of the firm with ATPs in this case is lower than the comparable value without ATPs, both in the eyes of


54. “ATPs are . . . opposed by institutional investors. Institutional investors sponsored shareholder proposals seeking elimination of ATPs and adopted shareholder voting protocols under which they will automatically vote against the adoption of a charter amendment containing an ATP.” See Daines & Klausner, supra note 3, at 84.


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the public shareholders (95 < 100) and social welfare (95 + 20 < 100 +20). Nonetheless, the entrepreneur preferred to install ATPs to protect her private consumption of control benefits, which is endangered by the prospects of a hostile takeover.

In the next Part of the Article, I will discuss the empirical evidence, which is usually interpreted as indicating that ATPs are harmful for the public shareholders. If one believes in the validity of the evidence, then the control benefits explanation seems appealing.

To sum up, two main factors determine whether entrepreneurs would decide to implement takeover defenses according to the control benefits argument: the private benefits that defenses secure versus their effect on the value of the venture for the public shareholders. Possible harmful effects on the public shareholders must be taken into consideration since they lead to a discount in the value of the shares that the entrepreneur wishes to sell. Put differently, defenses are adopted only if they secure control benefits to a larger extent than the negative effect they may have on the public shareholders.

The overwhelming belief among scholars that ATPs are harmful to shareholders has strong foundations, at least from an ex ante point of view. Simply put, and in terms of incentives, the threat of hostile takeovers, which takeover defenses undermine, restrains managers. If managers do not run their firm properly, shirk on the job, engage in harmful self-dealing, pursue empire building, or invest in pet projects, the value of their firm in the marketplace will decline. In turn, hostile bidders will have an opportunity to buy such a company for a low price and reap the benefits of improving it or alternatively achieve a payoff by tearing the company apart. From this standpoint, any use of a takeover impediment is harmful and increases managerial agency costs. More defenses lead merely to more managerial misbehavior and may undermine more successful business combinations.

57. This calculation is under the simplifying assumption that the bidder shall also exert private benefits of 20.

58. Conventionally, the effects of takeover defenses are divided between ex ante effects (effects on the incentives of the managerial team to run the firm for the benefits of their principals—the shareholders), and ex post effects (influence on the average premium paid to the shareholders in takeover events). In this context, it is assumed that defenses raise the premiums paid once a takeover event materializes, but on the other hand, reduces the frequency of bids.

59. Note that the literature also points out good reasons for shareholders to allow takeover defenses from an ex ante point of view. If securities markets are inefficient and do not reflect a precise valuation of the firm, opportunistic bids may appear. Granting managers discretionary power to defer such bids may prevent the managers from under-investing or over-investing in the first place to evade these opportunistic bids. See Jeremy C. Stein, Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior, 104 Q.J. ECON. 655 (1989); Lucian A. Bebchuk & Lars A. Stole, Do Short-Term Objectives Lead to Under- or Overinvestment in Long Term Projects, 48 J. FIN. 719 (1993).

60. See Jensen & Meckling, supra note 8.

61. Many more restraining market forces and internal mechanisms help in reducing managerial agency cost. However, they all leave a huge gap for takeover to fill. See, e.g., Michael C. Jensen, The
Additional costs of takeover defenses may also be revealed once a takeover bid is launched. Backed by a takeover defense, a manager can refuse to accept takeover bids and thus foreclose shareholders' ability to collect the fruits of the takeover premiums. This premium loss has two components. First, mismanagement that occurred due to managerial pursuit of her private benefits or incompetence may lead to poor performance. A bidder that can undo the effects of such ill performance would reap the improvement benefits and is therefore able to pay a large premium. If managers defer such a bid, shareholders would not enjoy the premiums and would continue suffering from the mismanagement discount. Second, some bidders may improve the value of the firm, even if the firm is perfectly run by the incumbent managers, due to possible synergies for example. Once again, the bidder is able to offer a premium, and if managers decline the bid, shareholders would lose the possible value of improvement.

As pointed out earlier, the entrepreneur may implement defenses where they are privately optimal even if they are harmful for the shareholders and society. To be precise, to reach the possible conclusion that ATPs are inefficient to society and not only harmful to shareholders, we must also


62. Note though, that there are at least three identified reasons indicating that shareholders may benefit from having antitakeover defenses from a bargaining standpoint (ex post gains from defense adoption). First, bids may be designed in a coercive way and antitakeover mechanisms allow managers to block them. See Lucian Bebchuk, The Pressure to Tender: An Analysis and a Proposed Remedy, 12 DEL. J. CORP. L. 911, 917-931 (1987); Lucian Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 HARV. L. REV. 1693 (1985). Second, managers can use ATPs to negotiate a better price from the bidder or procrastinate the bid until a better offer comes along from a third party. See Gilson, supra note 53; Elazar Berkovitch & Naveen Khanna, How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeovers, 45 J. FIN. 137 (1990); Rene M. Stulz, Managerial Discretion and Optimal Financing Policies, 26 J. FIN. ECOn. 3 (1990); Harry DeAngelo & Edward M. Rice, Antitakeover Charter Amendments and Shareholders’ Wealth, 11 J. FIN. ECOn. 329 (1983); Kahan & Rock, supra note 2. Third, since markets are not fully efficient, at least not in the strong form, market prices may not always reflect real values, allowing bidders to trick shareholders by offering them too low of a price that appears promising. See Stein, supra note 59; Jeremy C. Stein, Takeover Threats and Managerial Myopia, 96 J. POL. ECOn. 61 (1988). Under this view, managers backed by ATPs may therefore save shareholders from their ignorance in deterring such opportunistic bids.

Shareholders, however, may hope for a better price (a higher takeover premium) when they choose to implement ATPs. The downside is that managers may use defenses to entrench themselves. Instead of keeping the interests of the shareholders in mind, the agents may prefer to maximize their own benefits and hang on to their jobs. Consequently, managers defer many takeover bids that shareholders should fancy. Ultimately, shareholders must balance between the higher premiums that ATPs may furnish and the decrease in takeover frequency that ATPs bring about.

63. In the partition of the welfare function that this section refers to, the third player is the potential bidder. Intuitively and figuratively speaking, since the potential bidder does not sit at the table at the IPO stage, she cannot take part in arranging the efficient solution. This is the essence of the efficiency problem that may result from a social viewpoint.

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consider the welfare effects on the managerial team.\textsuperscript{64} These concerns are, of course, also essential for the decision-making entrepreneur. Although not every entrepreneur would care about the future private benefits of the managerial team of her firm,\textsuperscript{65} an entrepreneur that reckons she will stay in office and run the firm surely takes these effects into account.\textsuperscript{66}

While takeover defenses are not necessarily socially inefficient, even if they harm shareholders, some forms of private benefits that takeover defenses nourish are plausibly inefficient. The private benefits that managers earn from shirking on the job, consuming luxurious and wasteful perks, adopting pet projects, or pursuing unjustified expansion seem to be very modest in comparison to the harm they cause to the firm.\textsuperscript{67} These managerial private benefits, which takeover defenses secure and that are the direct cause of the costs firms endure, will therefore be further termed the \textit{harmful private benefits}. Note that this definition does not cover all managerial private utility gathered from managerial consumption of inefficient benefits, but only the fraction of such utility that would vanish if ATPs were not installed.\textsuperscript{68}

Aside from these harmful private benefits, one must also account for another type of private utility that ATPs secure. A manager typically derives psychological benefits from her top position at the firm.\textsuperscript{69} Such non-pecuniary benefits that attach to the stint include self-satisfaction from being in control and the respect accorded by society. Political power and social stance are also byproducts of firms’ control, leading in turn to both monetary and non-monetary benefits for the managerial team. Plausibly, prestige and power are no less important than direct monetary compensation and perks consumption, and therefore the psychological benefits should not be overlooked.

The consumption of such private benefits that cannot be shared with the shareholders does not generally harm the firm in any way. Nevertheless, they are keyed to the stint and if the manager loses control over the firm, say in a takeover event, she will immediately forego these private benefits. Hence,

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\item \textsuperscript{64} For a related discussion, see Harold Demsetz, \textit{The Structure of Ownership and the Theory of the Firm}, 26 J.L. & ECON. 375 (1983).
\item \textsuperscript{65} While the entrepreneur can theoretically negotiate a lower salary with a manager who prefers takeover defenses and hence cares about the welfare of the management team, I doubt that such frictionless bargaining is realistic. See Reinier Kraakman et al., \textit{When Are Shareholder Suits in Shareholder Interests?}, 82 GEO. L. J. 1733 (1994).
\item \textsuperscript{66} Because we are interested in the entrepreneur decision in the IPO I neglect to account for externalities on other firm constituents, such as the firm’s employees, suppliers, consumers and hosting communities, who should definitely be included in the social welfare function.
\item \textsuperscript{67} See Bebchuk et al., \textit{supra} note 40 (discussing the waste involved).
\item \textsuperscript{68} The term “vanish” should be seen from the manager’s viewpoint. The manager may lose her ability to consume private benefits where she is not protected by ATPs for two reasons. First, the higher exposure to hostile takeovers may deter the manager from consuming some of the benefits. Second, because of the greater chance that a takeover will materialize, the manager endures a greater chances of losing her ability to consume even the private benefits she chooses to consume.
\item \textsuperscript{69} See Daines & Klausner, \textit{supra} note 3.
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because ATPs reduce the chances for a takeover, they also help the manager secure her ability to consume the private benefits of the psychological type. These benign private benefits that ATPs preserve will be hereinafter termed the beneficial private benefits, in contrast to the harmful private benefits that are inimical to shareholders.\(^7\) Once again, note that this definition does not cover the entire scope of benign utility that managers derive but only the fraction preserved by ATPs.

Interestingly, the way that takeover defenses secure beneficial private benefits is somewhat different than the way in which they nourish the harmful private benefits. By reducing the frequency of takeovers, firms with ATPs promise their managers better chances of keeping their beneficial private benefits from being severed in a control transfer. This is true for the harmful type of private benefits as well, but ATPs not only secure harmful private benefits but also encourage their consumption. The consumption of harmful private benefits reduces the value of the firm and invites hostile raiders to prey on a cheap target. Once a manager is partially protected from the takeover market by ATPs, she can afford to consume more inimical private benefits without being fully disciplined by the market for corporate control. Put differently, ATPs not only preserve harmful private benefits, but also provide incentives for managers to enlarge their scope.

A. Private Benefits of Control and Firms' Quality

Another difference between the consumption of harmful private benefits and their beneficial counterparts lies in their correlation to the value and quality of the firm, especially when the excess value is the result of an abundance of business and growth opportunities. A successful venture provides its manager with much higher beneficial private benefits than a mediocre firm. A venture that would turn into the next Microsoft undoubtedly promises its entrepreneurs much more prestige, political power, and satisfaction than any less successful venture. The correlation between the quality and value of the venture and the consumption of harmful private benefits, however, is not so clear.

True, a company that performs well may offer its managers more opportunities to waste shareholders' wealth, especially if the successful firm also produces a hefty stream of cash flow. There are two reasons, however, to believe that managers of better enterprises would not consume higher harmful private benefits, at least once a certain threshold of firm quality is achieved. First, an effective legal regime backed by fine-tuned social norms binds the ability of managers to consume private benefits at the expense of the

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70. As in the definition of harmful private benefits, the definition of beneficial private benefits does not include all the psychological benefits that the manager consumes, but only the fraction of such benefits that ATPs secure.

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shareholders. Therefore, while a poor company cannot offer its manager much slack, managers' consumption of perks and misbehavior in mediocre and high-end firms do not significantly differ.

This reasoning fits well with some forms of private benefits that are potentially detrimental for the shareholders, such as self-dealing, insider trading, and expropriation of corporate business opportunities. In an inefficient legal regime, a valuable firm may provide its controllers tremendous opportunities for such theft. However, once the legal regime is able to reduce this inimical behavior to a moderate level, high corporate value does not easily lead to soaring wealth transfers to the controllers.

The efficacy of the legal regime, though, has its limits. For instance, it seems almost impossible for any court system to intervene in cases in which managers are pursuing their own agenda without receiving any feasible material benefit in return. Specifically, managers often pursue empire-building objectives, such as extending the firm's sales and size instead of net revenue, which is the shareholders' main concern. Once the legal regime is capable of reducing direct wealth transfers, these second-degree problems turn out to be a main source of concern for shareholders. This leads us to the second mechanism that can limit the consumption of harmful control benefits in high-quality firms.

Superior entities sometimes provide managers with more opportunities to consume harmful private benefits, but they may also provide their managers with fewer reasons or incentives to consume harmful private benefits. While the managers of less successful entities may waste their time on inefficient empire building and diversification of their firms, the managers of successful enterprises can concentrate on justified expansion of their enterprises. Hence, these managers may satisfy their hunger for growth and expansion without causing any harm to the shareholders. Moreover, flourishing investment opportunities may consume all available cash flows that managers of inferior

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71. See La Porta et al., Corporate Ownership Around the World, supra note 14; La Porta et al., Law and Finance, supra note 14; La Porta et al., Legal Determinants of External Finance, supra note 14; Johnson et al., Tunneling, supra note 14; La Porta et al., Investor Protection and Corporate Governance, supra note 14.

72. Russia in the post-communist era serves as a notorious example of such occurrences. See Bernard Black, Russian Privatization and Corporate Governance: What Went Wrong?, 52 STAN. L. REV. 1731 (2000).

73. Recent empirical work provides evidence on the agency cost explanation for corporate diversification. The level of diversification is negatively related to managerial equity ownership and to the equity ownership of outside block-holders. Additionally, decreases in diversification are associated with external corporate control threats, financial distress, and management turnover. These findings suggest that agency problems are responsible for firms maintaining value-reducing diversification strategies and that the recent trend towards increased corporate focus is attributable to market disciplinary forces. See David J. Denis et al., Agency Problems, Equity Ownership, and Corporate Diversification, 52 J. FIN. 135 (1997).
entities may elect to misuse.\textsuperscript{74}

This logic does not carry out to the entire population of IPO-stage firms that can justifiably be termed "high quality," but only to those that are especially valuable due to their high growth opportunities. High-quality ventures that already exhausted their development stage may arrive at the IPO with an ample stream of cash flow and lack of business opportunities. Obviously, this type of successful firm cannot be trusted to restrain its managers by its own business structure. In fact, such firms seem most prone to destroying shareholder value by managerial pursuit of empire building and waste of free cash flows.\textsuperscript{75} Nevertheless, valuable firms that reach the IPO stage are typically valuable due to their promising growth opportunities, in contrast to enterprises that already exhausted such opportunities. The reason is because successful entities that already materialized their business model need not normally engage in an IPO in the first place. Raising funds from the public equity markets is very expensive and firms that enjoy an internal source of financing usually avoid outside financing.\textsuperscript{76} Therefore, by and large, the most valuable firms that reach the IPO stage are the ones that are least prone to engage in harmful empire building and other forms of managerial misbehavior.

\textbf{B. High-Quality Firms and Takeover Defense Adoption}

The above discussion leads us to the conclusion that takeover defenses should not necessarily result in a higher market discount for firms of higher quality, at least beyond some threshold of firm quality. As explained above, this conclusion is especially robust where quality and value are derived from high growth and business opportunities. The market discount that is linked to ATP adoption is the market penalty for a securities design that encourages managerial misbehavior. However, since managers of high-quality firms should not be assumed to misbehave more than their less successful peers, the market discount should not fluctuate much with firm quality. Some indirect factors may render this conclusion false. For one, managers of more valuable firms may misbehave less often, but their misbehavior may distract them from running their firms properly, and this distraction is more harmful when there is

\textsuperscript{74} See Jensen, \textit{Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers}, supra note 13.


\textsuperscript{76} Outside financing is expensive because equity and risky debt are information sensitive. Therefore the buyers account for the possibility that they are abused by the corporate insiders who possess superior information and accordingly discount the value of the offered securities. As a result firms prefer to use internal finance or risk-free debt before they sell additional securities to the public markets. These preferences are known as the pecking order theory. See Stewart C. Myers, \textit{The Capital Structure Puzzle}, 39 J. Fin. 575 (1984); Stewart C. Myers & Nicholas S. Majluf, \textit{Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have}, 13 J. Fin. Econ. 187 (1984).
more value to destroy.\textsuperscript{77}

Additionally, if shareholders are troubled by managerial incompetence, the reduction in chances of managerial replacement once takeover defenses are in place may skew the "equal discount" conclusion. Put simply, incompetent managers may cause greater harm when they are in charge of a more valuable firm. Nevertheless, if shareholders are primarily concerned with the direct effects of managers' pursuit of private benefits, but otherwise trust the competence and performance of their managerial team, then the discount for takeover defenses should not be higher for better firms.

Furthermore, if the market discount for defense adoption is indeed not higher for firms of higher quality, they are more prone to be the ones to adopt defenses. The reason is that high-quality firms systematically promise their managers higher beneficial control benefits, even though they do not offer additional harmful control benefits. Due to the fact that the private benefits of control theory assumes that issuers adopt defenses where defenses secure more control benefits than hurt the share value, one should find high-quality firms adopting defenses more often.

As we shall see in the next Part, our conclusions are consistent with current empirical evidence. Defenses appear in industry sections where we often find control transfers, which are therefore the industries in which managers must fear the loss of their control benefits the most.\textsuperscript{78} Hence, the adoption of defenses fits the general predictions of the private benefits of control theory.

Adding the conjecture that firm quality contributes to control benefits without necessarily increasing the deadweight loss to shareholders may explain three additional findings. First, the adopting firms have superior performance before the IPO stage.\textsuperscript{79} Second, superior underwriters serve the adopting issuers, which suggest that these issuers carry superior value to shareholder even after adopting the defenses.\textsuperscript{80} Finally, the proposition concerning the relatively high quality of the adopting firms may still hold, even if the hypotheses that better firms that adopt defenses should not suffer from sharper valuation declines is somewhat exaggerated. High-quality issuers will opt for defenses as long as they gain from the upside of private benefits preservation more than the sharper valuation declines that they would consequently sustain.

In Part VI, which discusses a scenario of asymmetric information, we shall see that the group of adopting firms may actually be wider than the one

\textsuperscript{77} Scharfstein for instance models managers' agency costs as shirking (assuming disutility of effort). Shirking is likely to become more harmful with an increase in a firm's underlying quality. However, it is arguable if shirking is a salient problem among senior management in the United States. See David S. Scharfstein, The Disciplinary Role of Takeovers, 55 REV. ECON. STUD. 185 (1988).

\textsuperscript{78} See Daines & Klausner, supra note 3, at 98.

\textsuperscript{79} See Field, supra note 3, at 20.

\textsuperscript{80} See id. at 27.
contemplated so far. In such a scenario, it will be argued that some firms may adopt defenses even when such behavior is privately wasteful for the entrepreneurs. Put differently, some firms would adopt defenses even if the private benefits that defenses secure to their pre-IPO owners is lower than the value discount that such defenses instigate. The reason is that in the IPO stage, the entrepreneur of a better venture has an incentive to stand out and reveal its quality to the market by adopting harmful ATPs.

IV. Empirical Evidence and Predictions

Four recent empirical articles examined the adoption trends of takeover shields among IPO-stage firms. These articles provide some evidence that takeover defenses do not serve the interest of the public shareholders but rather that of the managerial team. As we will see momentarily, defenses reduce the premium paid to shareholders in takeover events and do not often appear in circumstances where they can enhance shareholder value. This highlights the possible role of the theory that attributes defenses to entrepreneurs' desire to protect their control benefits when going public where such benefits are large.

Following this logic, all firms would have opted for defenses if those were not costly to adopt since, all things equal, controllers would always prefer to retain control. Because defenses harm shareholders, however, they cannot be freely adopted, and all empirical studies indeed found that only a fraction of the firms adopts defenses. Since shareholders discount the issuer value for any harm they sustain from an antitakeover provision, it seems that only entrepreneurs that feel extremely vulnerable due to high control benefits are the ones that decide to adopt defenses.

While so far the control benefits story seems to fit the empirical picture, the direct evidence for high private benefits of the adopting firms are quite disappointing. Some other findings seem puzzling as well and allegedly inexplicable by the control benefits hypothesis. Adopting firms are relatively more valuable and mature ventures and are often served by high-quality underwriters. The main findings of the empirical literature are briefly summarized below. It is shown that the theory developed in this Article can shed light on every apparent contradiction in the empirical findings. Therefore,

81. See Coates, supra note 2; Daines & Klausner, supra note 3; Field, supra note 3; Field & Karpoff, supra note 3.
82. These findings are therefore aligned with the arguments of the classic literature. See Bebchuk, supra note 23.
83. See Coates, supra note 2 (reporting divergent behavior); Daines & Klausner, supra note 3, at 110 (reporting that only 50% of their sample adopted harsh defenses); Field & Karpoff, supra note 3, at 1884 (reporting that 53% of the sample had at least one takeover defense).
84. See Daines & Klausner, supra note 3, at 106-10 (reporting that they could neither refute nor support the private benefits hypothesis).
85. A summary of larger scope may be found in Part III.A of Hannes, supra note 1, at 1946-52.
it is argued that the empirical findings, taken as they are, fit the modified predictions of the control benefits theory put forward by this Article.

The first study was conducted by Daines and Klausner, who performed a comprehensive investigation of 310 IPOs that took place in the period between 1994 and 1997. They intentionally over-sampled IPO corporations with venture capital or LBO experts' backing. Daines & Klausner justifiably assumed that the pre-IPO managers cannot abuse these corporations, nor do they use ATPs by mistake.

Daines and Klausner's most salient finding is that IPO firms greatly diverge in their ATPs practices. Half of the sample adopted harsh ATPs, mostly staggered boards, and another 18% adopted milder ATPs, such as a prohibition on written consent procedures. The remainder refrained from any ATPs.

Then, Daines and Klausner found that defenses are less common in industries with low activity of mergers and acquisitions ("M&A"). In these low M&A activity industries, shareholders are most in need for takeover defenses to enhance bargaining power, since competition to buy the firms is unlikely to emerge. The fact that defenses are more common in high M&A activity industries points to the conclusion that defenses serve managers' needs rather than those of the shareholders. Quite disappointingly, while this result suggests that control benefits are the driving force behind ATP adoption in the IPO stage, direct evidence for high private benefits in the adopting firms were not

86. See Daines & Klausner, supra note 3, at 92.

Moreover, venture capital firms liquidate their holding within a short period, as they must distribute profits to their investors. Thus, the venture capital presence promises that the ownership is soon to be dispersed, which in turn makes the market for corporate control most relevant for the firms they invest in.

88. See Daines & Klausner, supra note 3, at 96.
89. As I have argued in the second section of this Article, this explanation is inaccurate. First, the authors assumed that the more M&A activity in the industry, the less ATPs are needed because competition will drive the prices up notwithstanding defenses. However, one could make the opposite argument by claiming that where potential competition is present, ATPs are most valuable to drive up the price because delaying a takeover bid allows for the competition to emerge. A recent empirical work indeed suggests that management opposition can improve the bid price in a takeover event only if it ultimately leads to a competition for the target firm. See Craig E. Lefanowicz & John R. Robinson, Multiple Bids, Management Opposition, and the Market for Corporate Control, 35 FIN. REV. 109 (2000).

Secondly, expected M&A levels rather than concurrent M&A levels should be analyzed, especially since merger waves tend to swipe through industries and then disappear in a rather short time frame. Finally, and most importantly, for high M&A activity to render ATPs vestigial one must assume that targets have a common value to all bidders. However, since it is more plausible that targets have different private values to different bidders, ATPs may become more important when there are more potential bidders available, since it is worthwhile to attract only the bidders with the highest valuation for the target.
found. The authors, however, did not relate private benefits to the quality of the underlying issuers, as this Article suggests.

Daines and Klausner suggest a few possible explanations to their surprising empirical findings.⁹⁰ Their most elaborate explanation undermines the well-established understanding that the IPO market accurately prices different corporate governance schemes.⁹¹ Specifically, they argue that the market underestimates or ignores the harsh consequences of ATPs. But Daines & Klausner themselves seem to reject this explanation and say: "This interpretation, however, is also problematic... if ATPs are not fully priced, why don't more firms adopt strong ATPs?... Assuming that management would generally favor ATPs, all things being equal, the fact that strong ATPs are not universally adopted implies that there is some constraint on their adoption."⁹²

Interestingly, this Article's argument can shed light on the elusive constraint. ATPs may be harmful for shareholders, but it is nevertheless adopted by issuers with high control benefits and in instances where such benefits are at stake, as in the case of high M&A activity in the industry. High quality, defined by high growth and business opportunities, can serve as a good proxy for high control benefits for this matter. Daines and Klausner looked for other measures of private benefits,⁹³ but good proxies for private benefits may be hard to find. Therefore it is hardly surprising that they did not find any substantial evidence.

Field and Karpoff conducted a second study of ATPs at the IPO stage. They investigated 1019 firms that went public from 1988 to 1992.⁹⁴ This is the earliest sample that was investigated. Similar to the other empirical studies, they found that 53% of the firms in the sample had at least one takeover defense, while the rest refrained from ATP adoption.⁹⁵

Field and Karpoff's more innovative result found that IPO firms with managers who are not tightly monitored by non-managerial pre-IPO investors and whose interests diverge from that of non-managerial pre-IPO investors deploy more defenses.⁹⁶ Even if we accept the validity of this finding, however, its conclusion might be false.⁹⁷ Managers that are least monitored may be the

⁹¹ See Jensen & Meckling, supra note 8.
⁹² See Daines & Klausner, supra note 3, at 113.
⁹³ See id. at 106-10.
⁹⁴ See Field & Karpoff, supra note 3, at 1859.
⁹⁵ See id. at 1865.
⁹⁶ “Among IPO firms, the likelihood of a takeover defense is positively related to managers' compensation, board size, and whether the CEO is also board chairman, and negatively related to managers' shareholdings.” Id. at 1884.
⁹⁷ Some of the findings by Daines & Klausner, however, raise doubts as to whether Field & Karpoff's finding is robust. First, in Daines & Klausner's sample and entirely contrasting Field & Karpoff's findings, higher levels of ownership by managers increase ATPs severity. See Daines &
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most powerful managers that also enjoy the highest degree of private benefits. Hence, it might be the control benefits consideration and not the lack of monitoring that brought them to adopt defenses.

Field & Karpoff conducted a third analysis that is important to our framework. They followed the firms in their sample for five years after their IPO to contemplate ATPs’ impact on takeover activity and takeover premiums. Five years may be too short a period to draw final conclusions, but evidently a large fraction of the firms (168 firms or 16.5% of the sample) was acquired during this period.

While following the firms, the authors assessed the influence of takeover defenses on takeover frequency and takeover premiums. First, they found that ATPs indeed deter bids. The five-year takeover probability is 16.6% for unshielded firms, and 11.3% for firms with at least one defense. Second, Karpoff and Field do not find that ATPs raise the takeover premium, which means that shareholders are not compensated for the decrease in takeover frequency that ATPs bring about. This finding reinforces the notion in the literature that ATPs are harmful for shareholders but are nevertheless sometimes adopted. While this finding is also aligned with the control benefits hypothesis, Karpoff and Field too were able to show only slight direct evidence for high control benefits among the adopting issuers.

While direct evidence for the existence of high levels of private benefits of control among the firms that adopt defenses can hardly be obtained, a related previous work by Field shows that better issuers are the ones that opt for defenses. The argument of this Article is therefore consistent with reality. In

Klausner, supra note 3, at 101. Field & Karpoff themselves do not find significant results in all regressions, as evident in the results of their sensitivity tests. See Field & Karpoff, supra note 3, at 1872. This means that managers with incentives that are more aligned with shareholders may adopt more defenses.

Second, and more important, Daines & Klausner investigated a large control sample of IPO firms with venture capital and LBO professional investors. See Daines & Klausner, supra note 3, at 92. Those firms did not have fewer defenses, which makes the argument that rigorous monitoring limits defenses sound a bit awkward. Moreover, unlike the other empirical studies that concentrate on the gravity of defenses, Karpoff & Field concentrate on the number of defenses. As explained earlier, some defenses are mighty while others do not hold much water. Further, some defenses must work in concert to achieve their full (or any) impact. Therefore, because Field & Karpoff report the impact of adopting “at least one defense” of any type, they should hope for no better than very crude results.

98. Out of the 163 sample firms that were acquired, sufficient data exist for 148 firms only. See Field & Karpoff, supra note 3, at 1873-77.

99. I have earlier raised doubts regarding the validity of this point. See Hannes, supra note 1, at 1946-52.

100. Aligned with the control benefits theory, they find that firms with takeover defenses usually overpay their management. However, high managerial compensation is also naturally related with the firms’ quality and size. Therefore, even this finding does not add to the main argument of this Article that one should look for high benefits of control among the high quality ventures and consequently also more takeover defenses. See Field & Karpoff, supra note 3, at 1884.

101. See id.
particular, Field finds that ATP adoption is significantly more common among firms that use higher-quality underwriters,\(^\text{102}\) and the relevancy of this finding will be discussed momentarily.\(^\text{103}\) Additionally, adoption of defenses is more common in firms with fewer liabilities, higher operating income in the year before the IPO, and fewer years of negative operating income in their record.\(^\text{104}\) These salient findings directly reinforce the stance of this Article, that high quality is systematically linked to adoption of takeover defenses.

According to the argument of this Article, the key aspect of "quality" that raises private benefits without aggravating agency problems is superior business opportunities. It is therefore best to test for this by direct measures of business opportunities, such as Tobin Q or industry adjusted P/E ratios. Since this test was never reported in the empirical literature, however, it is plausible that high business opportunities were partially translated into higher profits (relative to those with less business opportunities) already at the stage where the firms go public. As mentioned earlier, this prediction is consistent with Field’s findings.

It is also highly plausible that the finding about the quality of underwriters of issuers that adopt defenses also indicates that the adopting issuers are of higher quality. Surely, each and every issuer would like to be served by the best underwriters. The best underwriter provides the market with the best signals about the private information of the issuer, helps the issuer develop its business plan, and provides the issuer with the underwriter’s network of business connections.\(^\text{105}\) The fact that the underwriters’ main task is to gap the information asymmetry between the market and the issuer does not mean, however, that only firms with private information that is hard to verify appreciate the services of the best underwriters. The reason is that the market needs the signal that the firm was scrutinized and that there is no adverse private information that is not reflected in the price.\(^\text{106}\) The best underwriters provide the best signal of this sort and consequently reduce the uncertainty discount that would otherwise follow.

Therefore, and since all or most firms are interested in the services of the best underwriters, those underwriters can pick and choose the best issuers to work for. Presumably, this argument is consistent with the commonsensical notion that in order to get the services of Goldman Sachs, Merrill Lynch or

\(^{102}\) See id. at 21.


\(^{104}\) See Field, supra note 3, at 21.

\(^{105}\) A summary of the literature regarding underwriters’ ability to signal issuers’ private information to the market exists in Randolph P. Beatty & Ivo Welch, Issuer Expenses and Legal Liability in Initial Public Offerings, 39 J.L. & ECON. 545 (1996).

\(^{106}\) I assume here that the market cannot verify if the issuer possesses any relevant private information.

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Morgan Stanley, one must be an excellent firm. The conclusion of this discussion is that our result regarding the quality of the issuer that adopts defenses is consistent with Field’s finding about the quality of the underwriters of such issuer. This leads us to another empirical study, conducted by Coates, which raises similar findings.

Coates investigated two samples of IPO firms. The main data set includes 320 IPOs from 1991 to 1992, accompanied by a smaller control sample for 1998. His basic findings follow that of Daines & Klausner and Field & Karpoff. There is a high variance in defensive practices among firms that go public. Although the trend of ATP adoption among IPO issuers seems to increase through time, even in the 1998 sample, there are still many firms that do not adopt defenses, and a high proportion of firms that do not adopt harsh defenses.

Coates reinforces Fields’ finding concerning the quality of the underwriters which is central to the argument of this chapter: “underwriters have an apparent effect on defense adoption, but contrary to the general... hypotheses, companies advised by higher-quality underwriters are more likely to adopt defenses, not less.”

Finally, Coates’ innovative maneuver is to measure the impact of the legal market on ATP adoption. He finds that ATPs are more common among corporations that hire specific law firms rather than others. Coates therefore argues that lawyers’ preferences rather than clients’ needs determine whether a firm goes public with or without defenses. The divergence in the skills and attitudes toward defenses in the legal world drives the divergence in ATPs practices of firms in the IPO stage.

Coates’ finding concerning the legal market also fits the predictions of this Article. Just as better firms are associated with specific underwriters, they also employ certain lawyers. However, unlike investment banking firms, law firms are not clearly indexed for quality. Therefore, it is hard to verify if issuers that use “better” law firms systematically adopt more takeover defenses. Furthermore, it seems that underwriters screen their clients more rigorously than lawyers, which leads to relatively tighter links between the quality of the issuer and the quality of its underwriters. Nevertheless, if indeed lawyers that serve better issuers advocate defenses, it might simply be, as this Article argues, that defenses fit those high-quality firms better. Put differently and opposing Coates’ conjecture, defenses may be employed by better lawyers

107. This means that good underwriters are very different from good doctors. Good doctors work for the patients with the gravest problems and not for the ones that are most famous. Good underwriters, though, are required by all issuers and hence do not serve the clients with the gravest private information “problems,” but rather the most successful clients (actually, some excellent doctors that have sufficient demand from the gravest patients indeed take the patients that are most successful and famous).

108. See Coates, supra note 2, at 1367.
because of the nature of their clients and not because they have different views than other lawyers about the qualities of takeover defenses.

It is therefore hard to differentiate, at least in the short run, between the predictions of Coates’ theory and the predictions developed in this Article regarding firms’ quality. However, Coates suggests that a learning process occurs. The rising numbers of firms that adopt defenses in the IPO stage may imply that many lawyers mimic the behavior of the best lawyers that were the first to identify the importance of defenses at the IPO stage. According to Coates’ theory, this trend should only increase. The empirical predictions of the theory of this Article, however, are different. If a learning process occurs, then it is a mistaken process. Lawyers of mediocre firms should not mimic the behavior of the lawyers of the best firms, as antitakover practices do not fit all clients. It is therefore predicted that the trend of increased ATP adoption will overturn at some point in the future.

Moreover, some evidence regarding mature firms seems inexplicable by Coates’ theory, but still makes sense from the point of view of this Article. Since the beginning of the 1990s, institutional investors actively opposed most mangers’ proposals to add takeover defenses. For Coates theory to hold, we must assume that this massive opposition movement of highly sophisticated players in the capital markets is irrational, since it opposes the adoption of measures that are healthy for the owners of the firms. The theory of this Article and the private benefits theory at large, however, can explain this finding more persuasively. Some issuers elect to adopt defenses in the IPO stage for the welfare of their controllers. Since the costs of these measures are priced in the IPO, investors are not harmed by the adoption of defenses. Nonetheless, investors justifiably oppose the midstream adoption of defenses since there is no pricing mechanism to compensate them for the loss associated with the adoption of defenses.

V. CONSOLIDATING TWO THEORIES OF ANTITAKEOVER PRACTICES OF IPO-STAGE FIRMS

A different theoretical perspective, which I pursued in a different article, explains that even similar issuers may diverge in their antitakeover decisions. Simply put, there is a point of equilibrium where the market becomes loaded with ATPs and from there on issuers would not choose to adopt defenses. The relative possible advantages of takeover defenses fade away as more firms adopt defenses. In brief, the reason is that non-shielded firms enjoy more attention the more their peers become shielded, as they are relatively cheaper


110. See Hannes, supra note 1.
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and easier to acquire. With more and more firms adopting defenses, there is a point where the advantages of being shielded match the mounting benefits of remaining unshielded. Therefore, the market is composed of both shielded and unshielded issuers.

This concept of equilibrium can also accommodate heterogeneity among issuers and different levels of control benefits. Interestingly, the modified equilibrium concept will be one in which the market value of the issuers that adopt defenses is hurt, but the pre-IPO owners are nevertheless indifferent between adopting and rejecting defenses at the IPO.

To understand how the equilibrium argument can accommodate a reality with multiple types of issuers, I will frame the equilibrium argument in a novel concept of demand for unprotected firms. For simplicity, I will concentrate on the premium effect of ATPs, and put aside the main argument of this Article that the quality of the issuers should be regarded as a proxy for private benefits. The private control benefits argument will subsequently be presented as a theory of supply of unprotected firms.

The classic literature approach to takeover defenses could be phrased as a theory of demand for unshielded firms, which is indifferent to the fraction of shielded firms in the population. The reason is that the classic literature does not acknowledge the equilibrium argument, which states that shielded firms divert takeover activity to unshielded firms. Hence, the expected premium that an unshielded target can hope for is fixed and does not fluctuate with the fraction of firms in the market that adopt defenses. In the same spirit, the equilibrium argument or the takeover diversion argument can be termed as a theory of a declining demand function for unshielded firms. The price, that is, the expected premium that an unshielded firm can hope for, is dependent on the fraction of shielded firms in the population. The existence of shielded firms raises both the likelihood of a takeover event and the actual premium paid in such event for an unshielded target. Conversely, the more unshielded firms there are, the lower the price that each of them can hope for. Put differently, being unshielded is a product with similar characteristics to many other products. The more products there are available in the market, the lower the price paid for each. The downward sloping demand curve for unshielded firms is delineated in Figure 1 below.

On the other hand, the private control benefits theory can be rephrased as a supply theory for unshielded firms. A pre-IPO owner will agree to take her firm public without defenses only when the total utility she gains without defenses tops the utility gained by defenses. This utility is therefore the "price" the owner requires to "produce" an unshielded target and hence this consideration can be termed a supply theory of takeover defenses. The assumption of the theory is that there are multiple types of issuers and hence multiple supply
curves. Three such supply curves are delineated in Figure 1. The curves are horizontal because the theory assumes that the costs of going public without shields are unrelated to the fraction of unprotected issuers in the market.\footnote{Some simple versions of the equilibrium argument of my previous article also yield such horizontal supply curves. See Hannes, supra note 1, at 1967-68.}

Now we can see that instead of the single equilibrium in which ATPs are benign, we can have multiple equilibria, and there is no requirement that in any of them the public shareholders will be indifferent to ATP adoption. For clarification, we must note that there might be a pure strategy equilibrium in which all firms would reject or adopt defenses. For instance, if the demand would top all existing supply curves, then all issuers will remain unshielded since the price offered for an unshielded firm can satisfy even issuers with the most considerable private benefits consideration. Conversely, if the demand function lies below all supply curves, all issuers would opt for shields since the price for unshielded targets cannot compensate for the costs of remaining unshielded.

Let us now observe the three equilibria delineated in Figure 1. The highest supply curve stands for the types of issuers with the highest private benefits. For these issuers, adopting takeover defenses can protect much utility and hence they require a lot to reject shields. This high requirement can be fulfilled with a relatively low fraction of unshielded firms in the market, where the price paid for each unshielded target is relatively high. The intermediate supply curve represents issuers with less private benefits and hence their pre-IPO owners are less reluctant to adopt shields. Finally, let us assume that the lowest supply

\begin{figure}[h]
\centering
\includegraphics[width=0.8\textwidth]{figure1.png}
\caption{Equilibria with Heterogeneity}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=0.8\textwidth]{figure2.png}
\caption{Fraction of Unshielded Firms}
\end{figure}
curve represents issuers with no considerations of private benefits for their pre-IPO owners. The reason that such issuers still demand some positive value to supply an unshielded target must therefore lie in another explanation, such as the increased leverage that ATPs provide targets in negotiations to sell the firm.

Since the demand curve is decreasing with the fraction of unprotected firms, each higher level of private benefits brings about an equilibrium that has fewer unshielded firms. As long as there is an intersection between the curves, however, there will always be a mixture of shielded and unshielded firms for each type of issuer. The predictions of the private benefits theory that more private benefits lead to more protected issuers are thus reinforced but still modified. Moreover, the elasticity of the demand curve is the fundamental element in judging which theory is more important in predicting ATP behavior. The more elastic the demand curve is, the more important the private benefits theory becomes.\footnote{This simply means that there is not a lot of takeover diversion going on.} Conversely, if the demand curve was very steep, even sizable changes in private benefits would not significantly change the fraction of unshielded issuers for each type of firm.

This supply and demand framework can also be helpful to create a complex testable prediction of the equilibrium theory. Using data on ATP usage in industry sections with different private benefits levels, one may be able to delineate the slope of the demand curve. Put differently, the data on the supply side may serve to measure the demand.

Finally, we should understand why the notion of equilibrium does not necessarily mean that shareholders would be indifferent to ATP adoption in the IPO stage. In Figure 1, indifference of the public shareholders is achieved only in the lowest equilibrium. Since we assumed that this curve represents firms with no private benefits considerations, the interests of the pre-IPO owners is aligned with maximizing the market value of their ventures. Simply put, they have no other utility consideration than the price they can receive for their firms in the marketplace. Hence, in equilibrium, ATPs cannot be harmful or beneficial from the perspective of the public shareholders. The two other supply curves, however, represent the considerations of entrepreneurs with private benefits concerns.

The point of equilibrium is a point where the entrepreneur is indifferent between ATP adoption and rejection but has more to consider than the mere market value of the firm that goes public. Specifically, she has to consider the loss of private benefits that is keyed to an unshielded position. Hence, and since we assumed earlier that ATPs are harmful to the public shareholders, the result is that in equilibrium, ATPs hurt the market value of the firm, although the entrepreneur is indifferent to the ATP question. In a previous article, I have...
argued that reality tends to persuade that the equilibrium is more of the type of the lowest equilibrium in Figure 1, where ATPs are benign to the market value of the firm.  

There is some evidence, however, that ATPs are harmful for the shareholders, and as we just saw, accepting such evidence does not contradict the equilibrium concept of the earlier article.

VI. ADOPTION OR REJECTION OF TAKEOVER DEFENSES AS A SIGNAL SENT BY SUPERIOR ISSUERS

So far, the has analysis concentrated on a scenario of complete information in which the value of the issuers is common knowledge in the market. The decision to adopt takeover defenses by high-quality issuers therefore does not provide the market with any additional information regarding the type of the issuer. In the following Part, the assumption of complete information is relaxed and adoption or rejection of defenses is viewed as a signal that bridges over the gap caused by the inability of the market to directly observe the quality of the issuer.

A. The Problem of Asymmetric Information

A classic argument explains that entrepreneurs commit to maintaining a large portion of the firm equity after the initial public offering to signal their belief in the quality of their enterprise. This expensive measure is required in order to overcome the market’s asymmetric information problem in determining the quality of the underlying venture. Informational asymmetries, as will be elaborated below, can also explain the adoption of takeover defenses at the IPO stage or conversely and under a different set of assumptions, refraining from such adoption, even where these decisions are costly for the entrepreneur. Using these expensive measures may help the market sort out high-value issuers from their low-value peers.

An entrepreneur that intends to take her venture public naturally possesses information that is not transparent to the market. The extensive disclosure requirements of the federal regulation, as well as the wishes of high end ventures to reveal their type, cannot entirely overcome the information gap. The close acquaintance of the entrepreneur with the specific properties of her venture translates into private knowledge that can hardly be credibly conveyed to the market. Ironically, this asymmetry of information poses a threat to owners of superior entities. Since the market cannot fully distinguish between

113. See Hannes, supra note 1, at 1964.
115. This measure is expensive for the risk-averse individual who, other things equal, would rather diversify the investment of her fortune to minimize risks.
issuers of different qualities, it must attach an average valuation to them.

In the extreme, when the average valuation does not top the payoff that a superior entity owner can achieve without going public, she will defer the decision to offer securities to the public. Consequently, public markets would become thin and would be composed of merely the inferior issuers that fully deserve low valuations.\textsuperscript{117} It is therefore the task of superior entities to break the vicious circle and prove that they are worthy of higher valuations by separating themselves from the other firms. Although the private information that they hold cannot be directly verified by the market, and hence cannot be directly conveyed to the market, the mission is not doomed to failure.

Interestingly, usage or rejection of takeover defenses may signal the issuer’s type to the market. The first possible signaling phenomenon may drive entrepreneurs of high value firms to refrain from defense adoption even if such defenses were optimal for them under complete information. This may happen if the asymmetric information is in regards to the quality of the managerial team. Better managers may run their firms in a way that would result in maximal share price in the secondary securities market and hence provide fewer opportunities for a hostile takeover. These lower takeover opportunities translate into lower risk of losing their control benefits for the better managers. Consequently, better managers may refrain from defense adoption in order to persuade the market that they are the high-quality types, while their low-quality peers would find such exposure too risky. The higher IPO valuation that this signaling mechanism could promise firms with better managerial teams may compensate for the loss in private benefits that would presumably follow.

A second signaling phenomenon may counter-intuitively drive high-value firms to adopt takeover defenses even where they are privately wasteful for the entrepreneur. This may be the result of an information asymmetry regarding the quality of the underlying venture and its business opportunities. This Part first concentrates on such possible outcomes since they are close to the argument about the influence of quality on defense adoption.\textsuperscript{118} Similar to the results in Part III, high-quality issuers will eventually adopt defenses, but the group of adopting firms will be larger than assumed before. Consequently, under a different set of assumptions, the opposite signaling scenario will be discussed, and the result would be that firms with better managers may refrain from using defenses.

\textsuperscript{117} George A. Akerlof, \textit{The Market for “Lemons”: Qualitative Uncertainty and the Market Mechanism}, 84 Q.J. ECON. 488 (1970). Akerlof formalizes a familiar story about the market of “lemon” cars. Since the buyers of used cars can hardly detect a car with serious defects, they must discount the value of all cars due to the possibility of buying a lemon. In turn, this could discourage the owners of the better cars from selling them in the open market. In the extreme the market could collapse and only lemon cars would be available for sale.

\textsuperscript{118} See supra Part III.
B. Adoption of ATPs as Signals Sent by Firms with Superior Business Opportunities

The notion that inefficient ATPs result from asymmetry of information at the IPO stage is indeed tempting. To simply argue that market professionals cannot comprehend the harsh effects of such means, however, may be overreaching. Furthermore, such a straightforward argument cannot untangle the mystery of heterogeneity of ATP adoption practices at the IPO stage. Put differently, it does not help us understand why some issuers adopt defenses while others reject them.

The signaling argument suggests a refined understanding of the nature of the information asymmetry that ATPs entail. Similar to the private benefits of control theory, this framework can clarify why some firms eventually adopt ATPs at the IPO stage, while the rest of the firms refrain from such restricting strategies. The advocated approach assumes, as before, that the harsh effects of ATPs are by and large transparent to the market. Therefore, entrepreneurs that taint their firm's charter with an ATP sustain market penalties, as the value of the shares they wish to sell at the public offering are being appropriately discounted to account for the costly provisions.

While the market penalty for ATP usage is unavoidable since takeover defenses are easily verifiable, not everything is transparent to the market. Specifically, there is a gap between the entrepreneur's knowledge in regards to the quality of her venture and the information which is available to the market. Coincidentally, and as was extensively discussed earlier, the scope of private benefits of control is plausibly also tied to the quality of the underlying venture. Recall our previous conclusion that the upside of ATPs may be relatively much higher for superior entities. This conclusion remains intact even under the new assumption that the private benefits that defenses secure cannot compensate even the superior types for the market discount that ATPs brings about. Simply put, even if takeover defenses inflict a net private loss to all issuers, the loss is smaller for firms of higher quality.

Interestingly, the signaling argument reckons that the market cannot directly observe the quality of the issuing venture, but can easily notice the decision of the entrepreneur to adopt or reject takeover defenses at the IPO stage. Along with a few more requisite conditions, to be contemplated below, this reality may lead high-quality enterprises to adopt inefficient ATPs, while low-quality ones would defer such adoption. Once again, the key assumption is that quality should be measured by the size of the business opportunities of the firm, and such high-quality does not aggravate the loss in market value that ATPs bring about. As will be exemplified momentarily, ATPs are costly to install, but may nevertheless be required to sort high-quality ventures from poor

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119. See supra Part III.B.

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ones, thanks to the fact that the sacrifice is less painful for high-quality entities. Put differently, entrepreneurs of low-quality ventures may choose not to mimic the restricting behavior of the high-quality types since they cannot secure as much private benefits from ATP adoption as their more successful peers.

Altogether, the above story delineates an intriguing equilibrium. Better firms tend to adopt inefficient antitakeover charter provisions, and as a result, may receive lower valuations than their inferior peers, but the pre-IPO owners of the superior issuers are still better off. On the one hand, the lower valuations that ATPs bring about discourage low-quality firms from imitating the restricting behavior, thus providing the market with a way to sort high-quality firms from poor ones. On the other hand, the larger scope of private benefits that ATPs guarantee better firms, along with the exposure of their superior nature to the market, compensates the high-quality ventures for the costly ATP adoption. Thus, it may justify the adoption of the inefficient charter provisions by the high-quality firms in the first place, and provide an additional rational for the enigmatic divergence in ATP practices among IPO-stage firms.

1. A Simple Numerical Example

Assume that there are two types of ventures in the market, a high-quality venture and a low-quality venture, with valuations of 1100 and 900, respectively. There is an abundance of low-quality types in the population and only few high-quality ones. The entrepreneurs of both types of ventures wish to sell their entire holdings to the public market. The market, however, cannot distinguish between the two types of ventures and will therefore value each at the average valuation, which is close to 900. Each entrepreneur also faces the decision whether or not to install an antitakeover mechanism in the corporate charter prior to the IPO. Assume that such mechanism is widely recognized by the investment community as inefficient and therefore its adoption depresses the value of the relevant enterprise by a fixed penalty of 300.120

Since the entrepreneur of either type intends to stay around and manage her venture after selling the stock to the public, she can earn some private benefits by shielding her position from takeovers. Since higher firm quality brings about higher psychological control benefits, we assume that the control benefits secured by defenses are equal to 10% of the value of the firm, or 110 for the high-end type and 90 for the low-end type.

Since the market penalty for ATP usage (300) is much higher than the private benefits that ATPs secure for both types of ventures (90 and 110), it is

120. Also assume that the ability to consume harmful private benefits is bounded, so that superior ventures do not suffer from harmful absorption of private benefits more than lower-quality ventures. See the discussion above, supra Part III.A.
obvious that with complete information no firm would adopt defenses. Because the market, however, cannot tell the high-quality type apart from the low-quality type, the high-quality type would adopt defenses to distinguish itself from its inferior peers. At the same time, it will not be worthwhile for any inferior type to mimic the behavior of the superior type.

Let us first verify that the superior type would rather opt for defenses than receive an average valuation without defenses. If the superior type refrains from any action, it will receive about 900 for its stock, which is the average valuation in a market with many inferior types. However, if it adopts defenses and the market believes that it is therefore the superior type, it can hope to receive 800, which is the true value of the superior type (1100) minus the market penalty for adopting defenses (300). To this calculation, the entrepreneur of the superior type should add her 10% secured private benefits which amount to 110. Altogether, she is better off adopting defenses than receiving the low valuation without defenses:

\[
1100 - 300 + 110 > 900
\]

This does not end our inquiry, as we should still understand why the market should credibly believe that only the superior types would opt for defenses. The reason for that is simply that no inferior type would rationally adopt defenses, even if such an act were to grant it with the valuation of the superior type. For example, let us contemplate the decision-making process of the entrepreneur of the inferior type. If the market believes that every adopting enterprise is superior, it will grant it a valuation of 800 (1100 minus a penalty of 300). To that, the entrepreneur of the inferior type should add 10% of the real valuation of her venture to account for the private benefits that she gains from ATP adoption. But all this adds up to merely 890 and she would rather remain exposed as the inferior type and reject all defenses:

\[
900 > 1100 - 300 + 10\% * 900
\]

Hence, no inferior issuer would rationally adopt defenses to mimic the behavior of the superior type. Consequently, and as shown above, the superior type would do better by adopting defenses and revealing its type to the market. Adopting defenses may thus be expensive but still worthwhile to some.

2. A Generalized Signaling Argument

One of the routes high-quality types can choose to help the market distinguish them from poor quality types is sending the market an expensive signal that only they can afford. If the inherent characteristics of high-quality types also make some possible act less expensive for those types to embark on, as this Article argues, this act may serve as the proper signal. Although such a

121. See Spence, Job Market Signaling, supra note 21; SPENCE, MARKET SIGNALING, supra note 21.
signal seems wasteful, it may be necessary to dispatch it in order to be sorted out as a high-end type.

Two of the assumptions that were adopted in the earlier discussion about the complete information scenario are also necessary in this case. First, in line with the literature’s overwhelming conclusion, takeover defenses must be expensive for the entrepreneur to install. The conventional assumption is the combination of the prevailing belief that ATPs are harmful to shareholders, along with the common understanding that the issuer absorbs any inefficiency that she sets in the firm structure at the IPO stage.

As was earlier discussed, even if takeover defenses are expensive to install, they may be worthwhile for the entrepreneur to implement if the private benefits they preserve are higher than the value they destroy. The signaling argument, however, deals with a group of firms that even after accounting for private benefits would rather not adopt defenses. Put differently, the signaling argument assumes that defenses are not merely harmful to shareholders, but also privately counter-productive for the entrepreneur to implement.

The second assumption is taken from our conclusion in the earlier discussion that better issuers may gain more (or in this context suffer less) from defense adoption. In short, the reason is that as long as the market discount, along with the harmful private benefits that produce it, is more or less fixed for every entity beyond a certain quality, it is always true that ATPs secure higher beneficial private benefits for better firms. Better firms systematically bring their managers more prestige, respect, and satisfaction. Or from another angle, if the market discount is not contingent on the quality or valuation of the company but beneficial private benefits are increasing with the firm quality, then takeover defenses are less costly for better ventures.

Based on the above discussion, it will further be assumed that the costs of ATP adoption for the entrepreneur decline with the firm’s quality. Note,

122. See supra Part III.A.
123. See, e.g., Schwartz, supra note 53.
124. This point was clearly stated by Harris and Raviv: Jensen and Meckling (1976), among others, emphasize that the entrepreneur or founder bears the agency costs when the firm goes public, because investors anticipate conflict of interest with management and value the securities issued accordingly. Therefore the entrepreneur maximizes his wealth by designing securities (including voting rights) that induce him to deviate as little as possible from total-value-maximizing resistance behavior.
Milton Harris & Artur Raviv, The Design of Securities, 24 J. FIN. ECON. 255 (1989); see also Jensen & Meckling, supra note 8; EASTERBROOK & FISCHEL, supra note 8, at 4-7.
125. See supra notes 72-76 and accompanying text.
126. One should actually distinguish among three groups of firms. In firms of the highest quality, private benefits preservation tops any harm that shareholders may sustain from defenses and hence even under perfect information these firms will opt for ATPs. Conversely, in the lowest quality firms the private benefits which defenses may secure fall far short of the benefits they secure. Hence, no firm in this inferior class may ever adopt defenses. Finally, for intermediate-quality firms, defenses cause more harm than the private benefits they secure, but may still act as a signal for quality within this class.
however, that takeover defenses do not pose a binary choice for firms but rather a continuum of defense alternatives, each with different shielding strength. Consequently, the assumption should be modified to assume that the marginal cost of each additional level of defense adoption is higher for inferior issuers.

This assumption is delineated in Figure 2. The Y-axis represents the market value of the venture, or the payoff that the pre-IPO owners receive when going public from the public shareholders without accounting for the private benefits which defenses secure. The X-axis represents the level or strength of defenses that the venture adopts. The two curves, I(H) and I(L), are the indifference curves for the high-quality issuer and for the low-quality issuer, respectively. The indifference characteristic of the curves is the result of their design to capture all the combinations of takeover defenses and market valuations that leave the entrepreneur indifferent. Following our second assumption, ATPs provide better issuers with higher private benefits than secured for the less successful entities. Therefore, both entrepreneurs have downward-facing indifference curves, indicating that they enjoy more private benefits the more defenses they adopt, and hence a lower market valuation would leave them indifferent to such adoption. The indifference curve of the high-quality type, I(H), however, is steeper than the one of its low-quality peer, I(L), indicating that defenses secure more benefits to better firms. Put differently, the better type would settle for relatively higher market penalties for defense adoption.

For a given increase in takeover defenses, we can easily see that in order to

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127. See supra Part II.A.
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remain indifferent to different combinations of market values and defense levels, the inferior type can forgo marginally lower market values than the superior type. Of course, the indifference curve for each type of firm depicted in Figure 2 is only one of the infinite possible indifference curves that can be drawn. Parallel indifference curves that promise each issuer better utility lie above the two indifference curves in Figure 2, and parallel indifference curves that provide less utility lie beneath them.

Now, let us contemplate the decision-making process for each of the ventures. As a starting point, Figure 3 examines the case of perfect information, where the market can accurately price each issuer. Since the market attaches the proper value to each venture, both ventures will certainly choose to refrain from defense adoption. In Figure 3 the one indifference curve I(i) can represent either type of venture, together with a shadow indifference curve with lower utility for the same venture type (the dotted curve), whether we assume it is an inferior or a superior issuer. The final curve is the value that the market is willing to pay for the issuer in question. The decision not to adopt defenses is represented by the intersection of the indifference curve and the market valuation line. The intersection occurs at a point with no takeover defenses. Hence, and notwithstanding the type of the venture, opting for higher levels of defenses would only lead to lower utility, exemplified by the intersection between the horizontal valuation line and the dotted utility curve. The intersection with the dotted curve is clearly inferior, as the dotted curve is parallel to the indifference curve, I(i), and lies beneath it. This follows our assumption that the preservation of private benefits that defenses bring about falls short of the harm caused to the public shareholders, and in turn, to the market value of the issuer. Therefore, the lower market value that is attached to defenses by the market cannot leave the entrepreneur indifferent to the decision to adopt defenses.

Put differently, when valuations are transparent, ventures cannot reach a higher indifference curve than the one that appears in Figure 3 by adopting takeover defenses because defenses are not only wasteful, but also convey no information when the market is fully informed about the value of the issuers.
When the market cannot directly observe the value of each venture, the picture is different. If the superior type remains unshielded, it will have to forgo its superior valuation and receive an average valuation together with the inferior type. By adopting a high level of takeover defenses, though, it can differentiate itself from the poor type, taking advantage of its relatively lower costs of defense adoption.

If the value of the superior type and the inferior type, without defenses, is denoted by $V_H$ and $V_L$, respectively, and if ATPs bring about a market penalty of $Q(D)$ which is a function increasing with the level of defenses, but also secure private benefits of $d(V_i, D)$ which is an increasing function of the firm's quality and the level of defenses adopted, then the inferior type will not adopt defenses as long as:

$$V_L > V_H - Q(D) + d(V_L, D).$$

At the same time, the superior type will opt for defenses to evade the consequences of the market belief that issuers that do not adopt defenses are inferior:

$$V_H - Q(D) + d(V_H, D) > V_L.$$

The adequate level of takeover defenses that the superior type would adopt to reach such separation lies just to the right of point $D'$ in Figure 4.\(^{129}\)

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128. This is accompanied by the market belief that whoever adopts defenses is a superior type.

129. To reach such a separating equilibrium we must also add the proper market beliefs "off the equilibrium path" that all issuers that adopt defense levels that are higher than $D'$ cannot be inferior. However, while other beliefs may also be consistent with a perfect Bayesian equilibrium definition they are illogical as $D > D'$ is a dominant strategy for inferior types. Pay attention, though, that we did not rule out possible perfect Bayesian pooling equilibria (or hybrid equilibria). But see In-Koo Cho & David
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**Separating Equilibrium**

In Figure 4, the value that the market attaches to both types of issuers for any level of defenses is depicted by two parallel and downward sloping curves. They are parallel to reflect our simplifying assumption that the market penalty for each level of defense adoption, Q(D), is fixed for both types of issuers. The market value curve for superior issuers is of course above the market value for the low-value curve to reflect their difference in quality in the eyes of the market. I chose to delineate an indifference curve for the low-value type that starts from the point of maximal market value for a type, which is identified by the market as inferior (which as we found earlier is the point of no defenses). The level of defenses at the intersection between this indifference curve for the poor-quality type, I(L), and the market value curve for the superior type is denoted by D'. Finally, I have delineated through the same point of intersection an indifference curve for the high-quality type, I(H).

We can see that the inferior type is indifferent between receiving the "low" accurate valuation while rejecting all defenses and receiving the high valuation while adopting a level of defenses of D'. Furthermore, if the level of defenses slightly tops D', the inferior type should not adopt defenses at all even if this behavior exposes it as the inferior type. Graphically, we can therefore observe in Figure 4 that every intersection between the superior valuation line and a level of defenses, which is higher than D', lies below the depicted indifference curve of the inferior type. Hence, it is logical for the market to believe that anyone adopting the defenses level of D' or higher cannot be the inferior type.

This complementary market belief that any issuer not adopting defenses is of poor quality makes the separating equilibrium stable because the superior

type is definitely better off adopting a level of defenses of D' and thus evading the lower valuation of the inferior type. Note, however, that the superior type would choose, if possible, a level of defenses that is as close to D' as possible because any higher level of takeover defenses is both costly and excessive.

The conclusion is that even if we adopt the restricting assumptions that takeover defenses are wasteful for both the shareholders and the entrepreneurs, there may be a justification for some ventures to adopt defenses in the IPO context.

Before I continue to discuss the second possible signaling scenario, it seems that a few words are in order regarding the relationship between the private benefits of control theory and the theory of signaling by usage of takeover defenses. According to the private benefits of control theory, takeover defenses may be beneficial for entrepreneurs to adopt since they secure control benefits. The downside of defenses is not ignored—takeover defenses harm shareholders and therefore reduce the valuation of the firm at the IPO. However, where the preservation of private benefits is worth more than the reduction in share price that ATPs bring about, the entrepreneurs would choose to adopt defenses.

The signaling argument discusses a different situation, a situation in which defenses are adopted even if they are privately wasteful for the entrepreneur to adopt because they reduce the firm value by more than the private benefits they conserve. Since the evidence presented earlier may be interpreted as indicating that ATPs are harmful for the shareholders of the adopting issuers (but are nevertheless adopted), this explanation seems appealing, just as the same phenomenon fits the predictions of the above-mentioned signaling argument.

In any case, accepting Bebchuk's argument regarding the protection of private benefits of control does not necessarily contradict the signaling argument presented above. Bebchuk's argument distinguishes between two groups of firms. In the first group, the preservation of private benefits outweighs the market discount for ATP adoption, and hence their managers should adopt costly defenses at the IPO stage. Conversely, in the group of issuers where the preservation of private benefits falls short of the market discount, ATPs are rejected.

The signaling argument then engages the group of firms that according to the private benefits preservation argument would rather not adopt defenses. Since it is cheaper for the better issuers in this group to adopt ATPs, they may decide to signal their quality with ATP adoption even if considerations of mere preservation of private benefits of control do not justify doing so. For this

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130. Because the indifference curve of the superior type is steeper than the indifference curve of the inferior type, any point on the market valuation line for inferior issuers lies below the superior type indifference curve through D' (as the indifference curve for the inferior type only meets such valuation at the point of no defenses).

131. For a numerical example, see supra note 58 and accompanying text.
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signaling procedure to succeed, however, the market must first distinguish between the issuers that adopt ATPs because of the signaling consideration, and those that do so due to private benefits preservation considerations. While this makes sense in some circumstances, such as in a securities offering of a family enterprise or a sports team with idiosyncratically high private benefits of control, it may be implausible in other circumstances.

C. Rejection of Defenses as a Signal Sent by Firms with Superior Management

Quite a different and somewhat contradicting set of assumptions is needed for signaling with rejection of defenses to occur. This set of assumptions, however, is plausible if the high quality and value of the superior entity is the result of unverifiable managerial skills. The first required assumption is that better managers suffer less from the prospects of a takeover. While I assumed so far that the amount of private benefits consumed by all types of managers is similar, it still makes a great deal of sense that the best managers are less susceptible to hostile takeovers and the resulting loss of benefits. Simply, better managers may more often run their firms in a manner that will guarantee high market values, and hence produce fewer takeover opportunities. Consequently, good managers should fear less from losing their private benefits in a takeover event.

To make this case interesting, I shall further assume that even though good managers are less susceptible to takeovers, they would rather maintain shields, as even the minimized loss of private benefits justifies defense adoption from their point of view. Without this assumption, issuers with good managers will refrain from adopting defenses. The act, however, is not costly and therefore should not be regarded as signaling.

To exemplify possible signaling by rejecting defenses, consider the following scenario: the market consists of two types of issuers—the superior type has an entrepreneur that has excellent managerial skills and thus creates a value of 1100 for the entity she runs, and the inferior type has a manager that justifies a valuation of 900. Both managers also derive control benefits of 400 that are not part of the “market” value of the firm but rather personally accrue to the manager. Each can choose to go public with takeover defenses that

132. In particular, the market should be able to draw a line between quality levels in which defense adoption is privately beneficial for the entrepreneur and quality levels in which defenses are privately costly. Additionally, the market should be able to distinguish between quality reasons for high levels of control benefits and other genres of high private benefits incidences.

133. Family enterprises and sport teams are two genres of verifiably high private benefits incidences that Bebchuk mentions. See Bebchuk, supra note 5.

134. The assumption that good managers consume the same private benefits as less efficient managers is necessary to differentiate this signaling effect from the opposite signaling that is based on the quality of the underlying venture.
would fully preserve the consumption of private benefits, and such a decision also entails a valuation penalty of 100 to reflect the decrease in incentives caused by defenses. Without defenses, the poor type has an 80% chance of losing its private benefits, while the high-end type only suffers a lower 50% chance of losing its benefits. One can see that under complete information, both types would rather adopt defenses since the preservation of private benefits is higher for both than the market discount entailed: $100 < 50\% \times 400 < 80\% \times 400$.

Things, however, change once we assume that the market cannot differentiate between the two types of managers. The inferior type would not mimic the superior type and reject defenses even if the market believes that each rejecting entity is entitled to the highest valuation. The reason is that the valuation of the poor type (900) minus the market penalty (100) is lower than the valuation of the good type (1100) minus the loss in private benefits that the poor type sustains (80%*400): $900 - 100 > 1100 - 80\% \times 400$.

At the same time, the superior type would rather reject defenses than suffer from the belief that firms that adopt defenses belong to the poor type. The superior-type valuation (1100) minus the private benefits sustained by the high-end type (50%*400) is worth more than the valuation of the poor type (900) minus the market penalty for adopting defenses (100): $1100 - 50\% \times 400 > 900 - 100$.

More generally, if the valuations of the good type and the poor type are $V_H$ and $V_L$, respectively, the market penalty is $Q$, and the loss of private benefits is $B(V_i)$, a function decreasing with the quality of the managerial team, then the conditions for a separating equilibrium are:

1. $V_L - Q > V_H - B(V_L)$ accompanied by the logical market belief that each entity rejecting defenses is a superior one; and,

2. $V_H - B(V_H) > V_L - Q$ accompanied by the logical market belief that each entity adopting defenses is an inferior one.

Hence, it is possible that issuers with high-quality managers would reject defenses even if this act were costly for them.

D. Empirical Evidence and Testable Predictions for the Signaling Arguments

Since signaling is a mechanism based on the need of the issuers to overcome the inability of the market to recognize their type, it is hard to trace evidence of a signaling phenomenon. Using variables for the quality of the venture or the managerial team that are publicly known is self-defeating since the available evidence means that signaling was not necessary in the first place.

Testing for the two types of signaling is possible, however, with indirect measures. For instance, one could compare measures of quality, such as Tobin Q or industry P/E ratios of adopting and non-adopting issuers, and control for
all direct evidence of firm quality. If one group is found to be of higher quality than another, a quality that is unexplained by overt data, it could support one signaling hypothesis or the other. Such a test was never conducted, but some hints for the signaling phenomena may be hiding in existing data.

For instance, Daines and Klausner's findings teach us that common justifications for ATP adoption do not easily fit reality. They acknowledge that the question remains why some firms adopt takeover defenses while others do not. If researchers were unable to find any overt characteristic to differentiate between the adopting and non-adopting types, it might be that the market is unable to distinguish among them as well, and that signaling is the cure for the distinguishing problem.

The work conducted by Field sheds light on the insight that better issuers adopt takeover defenses to prove their quality. This is relevant to the signaling mechanism that argues that defenses are adopted by entities with superior business opportunities. Field finds that ATP adoption is significantly more common among firms that use higher-quality underwriters. Seen through the eyes of the signaling argument, better issuers adopt wasteful ATPs to prove their quality to the top underwriters, who are only then willing to represent them. If signaling succeeds, the market does not need underwriters to help it identify the superior quality of the issuers that adopt defenses. Moreover, any underwriter and not necessarily a reputable one could offer a higher pricetag to targets that select to adopt defenses, and thus distinguish between high- and low-quality targets. However, once firms can take advantage of defenses to help underwriters and the market ascertain their type, the high-quality issuers would finally be the ones to receive the services of the better underwriters. This is the result of our earlier discussion, which concludes that all issuers value the services of the best underwriters, while those underwriters select only the best issuers to represent. The signaling apparatus is therefore a coordination mechanism between high-quality firms and reputable investment bankers. As suggested by Coates's study, a similar relationship may exist between issuers and their legal counselors. These findings, however, should not be accepted as facial evidence for the signaling argument, since it is possible that underwriters attached high values to the issuers due to overt information. Hence, it is important to control for all available data on an issuer's quality before using the underwriters' data for signaling matters.

Field finds additional evidence that ATPs are adopted by higher-quality

135. Tobin Q is the ratio of the market value of the firm over its assets, and therefore the higher this ratio, the better the company is using its assets. The P/E ratio is the ratio of the price per share over the earnings per share of the company, and is again indicative of the quality of the underlying company.
136. See Field, supra note 3.
137. See id. at 21.
138. See supra notes 105-107 and accompanying text.
ventures. Adoption of defenses is more common among firms with higher operating income, fewer liabilities, and fewer years of negative operating income in their record the year before the IPO. Unlike the quality of the underwriters, however, these measures are all direct evidence of quality. As noted earlier, if a firm can prove its quality directly to the market by pointing out such measures, it need not signal its quality by adopting costly ATPs. Nevertheless, all these findings are consistent with the prediction that signaling can succeed only among firms that the market can ascertain as having reached some initial threshold of quality. Only beyond such a threshold can the underwriters and the market comfortably assume that the cost of implementing an ATP for the entrepreneur is negatively correlated with the quality of her firm.

VII. NORMATIVE IMPLICATIONS AND THE PERILS OF FEDERAL INTERVENTION

The notion that takeover defenses are more common among better issuers may be surprising to some, but is readily recognized by the empirical literature. One commentator summarizes his empirical findings and conclusions as follows: "Given the findings that companies advised by law firms with more M&A expertise, higher-quality underwriters, and VC funds are all more likely to adopt defenses, and that pre-IPO defenses are more common now than in the past, it seems more plausible that such defenses are optimal for all firms than it is that they are optimal for none." The theory developed in this Article is consistent with, and sheds light on, these empirical findings, without sharing the harsh conclusions stated above. Admitting that better issuers, and especially those that stand out in their vast business opportunities, adopt defenses, does not necessitate the conclusion that defenses are optimal for all firms. Rather, this Article claims that takeover defenses are more likely to appear in firms with high private benefits of control, and that the quality of the firms is a good proxy for the scale of these benefits. Coates reads the fact that more lawyers are advocating defenses today as suggesting that there was a failure in the market for corporate law, a failure that is being amended through time. It is possible, however, that the corporate law market's current problem is that many lawyers mimic the advice of the best lawyers without paying attention to the fact that this advice does not fit all clients.

According to the approach that links takeover defenses to incidences of high control benefits, defenses answer controllers' need to protect the benefits

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139. See Field, supra note 3, at 21.
140. See supra Part III.A.
141. See Coates, supra note 2, at 1381.
of their position from the possibility of a hostile takeover.\textsuperscript{142} Implicitly, this theory also reckons that takeover defenses are harmful for the public shareholders. Otherwise, all firms would adopt takeover defenses, as those would be both in the interest of the controllers and the public shareholders. On the other hand, if defenses are inimical for the public shareholders, and therefore also reduce the value of the firms that go public with defenses, then only controllers with much to lose, namely controllers with high private benefits, would be the ones to adopt defenses. Note that one may easily interpret this theory as claiming that the adopting firms should be the ones that are less valuable for the public shareholders due to the inimical effects of takeover defenses.

Surprisingly, empirical studies hardly found direct traces for high private benefits in the adopting firms, nor did they find that adopting firms were inferior to non-adopting firms. On the contrary, and as summarized in one of the recent studies: “[T]he evidence on private benefits for firms implementing antitakeover provisions is not obvious... However, there is substantial evidence that firms implementing antitakeover provisions before the IPO are of higher quality than firms without provisions.”\textsuperscript{143}

These two findings, the lack of direct evidence of high control benefits in adopting firms and the surprisingly higher quality of the adopting group, are both explained by this Article. This Article argues that high quality by itself may bring about high control benefits without intensifying the costs borne by shareholders. The kernel of the argument is that beneficial control benefits such as prestige and satisfaction always rise with the quality of the firm, while detrimental control benefits such as self-dealing and perks consumption are capped by the legal system and other limits. This argument is especially robust when the higher quality is attributed to high business and growth opportunities. Hence, the higher quality of issuers that adopt defenses is a prediction endogenous to the private control benefits theory, while the inherently higher quality also erases any inimical traces that ATPs may leave on the value of the adopting issuers.

Furthermore, the link between high quality and high control benefits may also indicate that in some cases takeover defenses are signals adopted by better issuers to expose their quality.\textsuperscript{144} If takeover defenses are wasteful for all issuers, but even more wasteful for the inferior ones, then high-quality issuers will adopt defenses to distinguish themselves from their inferior peers. This explanation goes a step beyond the private benefits theory as it reckons that

\textsuperscript{142} See Bebchuk, supra note 5.
\textsuperscript{143} See Field, supra note 3, at 20.
\textsuperscript{144} And the analysis shows that the opposite result—signaling by rejecting defenses—is also possible if high quality is attributed to the eminence of the managerial team.
defenses are adopted for reasons of asymmetric information. Superior issuers adopt defenses to convey information, although such defenses are costly not only for the public shareholders but also wasteful for the controllers that take the firms public.

This explanation too mitigates the tension between the two seemingly contradicting empirical findings. One, takeover mechanisms harm the shareholders of the firm that adopts them. Two, high-end issuers nevertheless choose to adopt such defenses. According to the signaling argument, the cost incurred while adopting a takeover defense is the “price” one has to pay to prove one’s quality to the market. The classic financial literature mentions a few costs that new issuers must bear to prove their type to the market. Adoption of takeover defenses may very well be another strategy for high-quality issuers to choose from.

Finally, the discussion leads us to the counter-intuitive normative implication of the theory presented in this Article. Even if takeover defenses are as detrimental to the value of the firm as most scholars believe, the conclusion that such mechanisms should be banned is hardly justifiable. Takeover defenses are often adopted in the IPO stage to prevent deprivation of control benefits in future control contests. Moreover, the firms that adopt such defenses are systematically the better firms, which have more to lose in terms of control benefits. This means that pre-IPO owners sometimes prefer to sustain the reduction in the firm value that is keyed to defense adoption rather than endanger their benefits of control. Banning defenses at the IPO stage may only re-route controllers’ efforts to less efficient avenues. Maintaining a complete lock on control by holding a control block or refraining from going public altogether may be good examples of this possible social waste.

Put differently, if it was guaranteed that firms go public and ownership becomes dispersed, consideration of control benefits would distort choices towards socially excessive takeover defenses. But if takeover defenses were to become illegal, the fear of losing control benefits would drive firms towards even more distorted ownership structures. Hence, a mandatory restriction on ATP adoption in the IPO stage may not be beneficial for society although ATPs reduce firms’ value, and any mandatory intervention would hurt the best firms the most.

Milder interventions in such firms’ freedom of choice that were presented recently may result in similar costs for society. Rather than mandating

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145. See, e.g., Field & Karpoff, supra note 3, at 25.
146. One of the costs entrepreneurs have to bear to reveal their type and overcome the market asymmetry of information problem is to hold on to a large fraction of cash flow rights after the public offering. Such a retention promises the market that the entrepreneur believes in her venture, but is costly to the entrepreneur in terms of liquidity and risk bearing. See Leland & Pyle, supra note 114.
147. See Bebchuk & Ferrell, supra note 109.
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particular substantive takeover arrangements, Bebchuk and Ferrell suggest a form of federal intervention that would increase shareholder choice without compelling shareholders to act in a single way. Accordingly, federal law should allow the public shareholders, regardless of managers' wishes, to opt for a takeover regime more permissive to takeovers than the state of incorporation currently entertains. If indeed takeover defenses reduce shareholder value, as they most probably do, it would be only a matter of time until shareholders use such an avenue and render vestigial some or all the restrictions on takeover activity that were adopted in the IPO stage. Such a result is therefore similar to a mandatory ban on takeover defenses.

As good as the suggestion may seem ex post when the firms are already public, it may still cause harsh distortions at the IPO stage. Controllers would know that there is no point in adopting takeover defenses, and may therefore alter their decisions regarding ownership structure and going public in the first place. Furthermore, since takeover defenses are priced at the IPO just like any other governance term, changing the rules of the game partway through enriches the public shareholders at the expense of the controllers who already paid for their freedom to adopt defenses. Once again, this Article argues that this possible scenario should not concern all firms, as not all firms are interested in takeover defenses to start with. Surprisingly, only the best firms and their controllers would therefore sustain such harm, caused by seemingly benign federal intervention.
The Concept of Autonomy and the Independent Director of Public Corporations

Daniele Marchesani

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† 2005-2006 law clerk to Justice Carolyn Berger of the Delaware Supreme Court. J.D., The George Washington University; LL.M., Fordham University; Laurea in Giurisprudenza, Università degli Studi di Pavia, Italy. I would like to thank Professor Lawrence E. Mitchell for his invaluable comments and suggestions. I am also very grateful to the staff of the Berkeley Business Law Journal, in particular Sean M. Callagy, for their editorial assistance.
The Concept of Autonomy and the Independent Director of Public Corporations

INTRODUCTION

William T. Allen once wrote: "A commonly used word—seemingly specific and concrete when used in everyday speech—may mask troubling ambiguities that upon close examination are seen to derive not simply from casual use but from more fundamental epistemological problems." The word "independent" in the context of corporate boards of directors is an example of the "the deceptive dependability of language" to which Chancellor Allen referred. This Article will discuss the cause of, and the remedy to, this word's ambiguities.

In the last twenty years, the American corporate governance system has come to see Independent Directors as an effective tool for safeguarding the interests of shareholders and other corporate constituencies. State case law, federal legislation, and stock exchange listing rules rely especially on directors without ties to the company and its executives to serve as watchdogs of management. The 2002 corporate governance reforms, which followed the Enron and WorldCom scandals, are based on such great confidence in the positive role of Independent Directors that today it seems fair to say that "independent" has almost become synonymous with "trustworthy."

During the same period, many legal, financial, and managerial studies recognized that there are several flaws in such an equation. Common definitions of Independence fail to consider all of the ties that affect directors' independent judgment. The absence of ties, moreover, does not alone guarantee that directors discharge their duties effectively; a trustworthy director needs to

1. Katz v. Oak Indus., Inc., 508 A.2d 873, 875 (Del. Ch. 1986) (where the former Delaware Chancellor was referring to the term "coercion").
2. Id.
3. To avoid any confusion, I will use "Independence," "Independent," and "Independent Director" to refer to the special status of certain corporate directors, and "independence" and "independent" to refer to the psychological personal attribute. Under common definitions, a director may be: (i) "Independent" when the director has no relationship with the company and its management other than his directorship; (ii) "inside" when the director is an employee of the company; or (iii) "affiliated" (or "gray") when the director has a relationship with the company such as being the company's lawyer, banker, or consultant. Common definitions also use denominations such as "non-employee," "outside," and "non-interested."
4. By "trustworthy," I intend that the Independent Directors can be trusted to effectively carry out their responsibilities.
possess personal characteristics other than mere independence. Finally, the organizational structure of an entity may itself prevent directors from properly performing their roles, whether by generating obstacles or by failing to provide directors with adequate opportunities for action. The latest series of reforms has strengthened the traditional definition of Independence and has introduced some structural changes. The new rules, however, not only fail to take into account any of the additional personal characteristics that an effective director needs to have, such as motivation, competence, and time availability, but also fall short of addressing all of the existing structural issues.

In this Article, I intend to make a twofold contribution. First, I will suggest a new framework for the analysis of this matter: the very definition of Independence should be modified so that only individuals with both the personal attributes and the institutional resources necessary to be effective would receive the responsibilities and legal status that currently pertain to Independent Directors. Such an approach is consistent with studies of the philosophy of psychology distinguishing “independence,” defined as freedom from external coercion or influence, from the more inclusive concept of “autonomy,” which also requires that a person be free from a wider range of constraints, and that he have adequate opportunities to act. Only autonomous individuals are capable of both formulating and pursuing their own goals. Independence is a condition necessary but not sufficient for such a purpose. A person free from another’s influence may still fail to make or to carry out his plans because he lacks the strength of will, competence, or other necessary qualities. Alternatively, his environment might not provide him with adequate resources.

In light of these categories, current rules of corporate governance clearly rely upon a definition of independence to identify a director as if he were autonomous (i.e., a director who formulates and pursues his objectives, thus effectively carrying out his responsibilities). Such dissonance is not merely semantic but has important practical consequences. The presence of Independent Directors on company boards has become an indicator of good governance. Moreover, special legal effects attach to certain decisions made by directors that qualify as Independent. In both regards, current definitions of Independence do not justify such reliance and should be modified; they should include all of the requirements necessary to identify individuals who will indeed act autonomously and therefore be trustworthy.

The second focus of this Article is to identify the conditions necessary for a director to be truly autonomous, and then to elaborate a set of structural and procedural arrangements that could realize such conditions. In addition to solutions generally discussed by scholars and practitioners, I will advance two
proposals. The first is to create within each corporation a support staff: a group of professionals selected by, and working for, the Independent Directors. It is based on an idea originally proposed during the 1970s. Organizational Design concepts could be used to provide the staff with the tools necessary to effectively support the work of the directors, especially with regard to accessing relevant information within the corporation.

The second proposal addresses how to identify those individuals who possess the motivation and active posture necessary to serve effectively as Independent Directors. Equity ownership has been traditionally proposed as the answer to this problem, but has produced uncertain results. Consistent with modern philosophical views that consider autonomy as an exercise-concept, I shall suggest that directors should be qualified as Independent only after having given proof that they possess the personal qualities that are necessary for a director to be effective. In practical terms, this would translate into a procedure to evaluate and confirm newly elected directors as Independent. Each would be permanently awarded such a status only after a positive finding, made by the existing Independent Directors, that he has demonstrated activeness and independence as a member of the board. The director’s use of the set of powers and resources as suggested by this Article will provide a reasonably objective basis to make such a determination.

Courts would be able to adopt the approach proposed in this Article even without an amendment of the relevant statutory rules. Failure to meet the suggested requirements of autonomy, which are not mandatory under current rules, would not in itself give rise to fiduciary liability. Instead, courts could consider these requirements factual elements relevant to the determination of Independence and deny special legal effects to the actions of directors who do not meet them.

This Article is ultimately an attempt to present a coherent and comprehensive theory of the Independent Director of public companies, one that will foster a better understanding of the dynamics and weaknesses of the current system and provide effective solutions to the existing problems. While I believe that no definitive improvement can occur without a true change in board culture, the suggested approach and solutions could nonetheless contribute toward eliminating a significant weakness within the present governance system.

I. THE DIFFERENT ROLES OF THE BOARD OF DIRECTORS

Under modern corporate governance, the CEO and the other executives manage the corporation: boards of directors do not direct the day-to-day

5. See infra Part V.
Ordinarily, it is the CEO who decides the company’s strategy and oversees its implementation. He sets the budget, hires and fires the top executives, and represents the company publicly. Directors are instead entrusted with different roles, which have been classified into at least three major categories.

The first function is to monitor the company’s management on behalf of the shareholders. To this end, the board selects the CEO and other senior executives, determines their compensation, and reviews their transactions with the company. The board has also been increasingly entrusted with overseeing general compliance with the law in a number of areas, such as auditing, accounting, financial reporting, and disclosures.

Second, directors perform a service/strategic role. The board supports management in the evaluation and development of the chief objectives and strategies of the corporation. In certain instances, such as when the company issues stock or pays dividends as well as in the case of mergers and other changes of corporate structure, the board is directly responsible for making the relevant decisions.

The board also performs a resource-gathering role. The board acts as a bridge between the corporation and the various actors of its social environment. In particular, directors exchange information and otherwise interact with the company’s various stakeholders, the government, and the legal and financial communities to acquire and maintain legitimacy as well as the necessary support within these communities.

The American corporate governance system has adopted the so-called monitoring model, which emphasizes the board’s monitoring role. Accordingly, the board acts prevalently as the monitor of management for the benefit of the shareholders, thereby reducing costs arising from the separation of ownership and control of the corporation and the diffusion of shareholding. The latest


8. See Langevoort, supra note 7, at 801-02.

9. Id. at 802-03.

10. Id. at 802.

11. Id. at 801; see also Lynne L. Dallas, The Multiple Roles of Corporate Boards of Directors, 40 SAN DIEGO L. REV. 781, 805-07 (2003) (including these activities within what professor Dallas refers to as the relational role of the board).

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corporate reforms have confirmed this tendency by focusing on means that improve board monitoring. These include an audit committee responsible for the oversight of auditing and internal accounting controls, as well as a compensation committee which sets and reviews executive compensation.13

The monitoring model assigns a crucial role to Independent Directors. The underlying rationale is that these directors, being free from ties to the corporation and its management, are in a better position to monitor the CEO and the other executives and, when necessary, to take action to protect the interests of the corporation or its shareholders.14 Along with the diffusion of the monitoring model, corporate governance rules have given increasing importance to the role of Independent Directors. As a result, “a cornerstone of so much of corporate law today is the monitoring model, and more specifically, the outside director.”15

II. INDEPENDENT AS SYNONYMOUS WITH TRUSTWORTHY

The importance of Independent Directors to the monitoring model of the board is reflected in modern state jurisprudence, federal legislation, Securities and Exchange Commission (S.E.C.) regulations, and stock exchange listing rules. In certain situations, the decisions of Independent Directors receive special deference, and their presence on the board is generally believed to ensure good governance.

Delaware courts give special significance to decisions made by directors deemed Independent under applicable judicial definitions. In derivative litigation, before initiating an action a shareholder must first demand that the board of directors bring suit on behalf of the corporation.16 If the shareholder


14. [Independence] provides a director with the distance and objectivity necessary to examine management action in the most effective manner. . . . Insofar as management is concerned, director independence brings accountability and responsibility. Responsibility to a watchful intermediary will likely spur thoughtful decisionmaking and reflection on management’s part. These results will not occur unless the intermediary is in fact independent of the examined party, thus making board independence a critical component of modern governance theory. Elson, supra note 12, at 497-98 (footnotes omitted); see also ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 202-03 (1995); James D. Cox, The Paradoxical Corporate and Securities Law Implications of Counsel Serving on the Client’s Board, 80 WASH. U. L.Q. 541, 547-49 (2004).

15. See Cox, supra note 14, at 549.

16. See Beam v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); Kaplan v. Peat, Marwick, Mitchell & Co., 540 A.2d 726, 730 (Del. 1988) (“Pre-suit demand under Chancery Court Rule 23.1, is an objective burden which must be met in order for the shareholder to have capacity to sue on behalf of the corporation.”).
alleges sufficient facts to create a reasonable doubt that the majority of the directors are Independent, he is entitled to proceed with the litigation without making any demand, as this would be considered futile. Courts determine whether a director is Independent on a case-by-case basis depending on the factual circumstances of the case. When a shareholder makes a pursuit demand, instead of deciding on its own whether to comply, the board may delegate to a special committee of Independent Directors the task of evaluating the appropriate course of action. Even when no demand is made because it is deemed excused as futile, the board may still appoint such a committee to decide whether to seek dismissal of the derivative action.

Director Independence is also relevant in interested transactions. These include transactions between a director and his corporation, or transactions between the corporation and another corporation in which the director has a financial interest. Section 144 of the Delaware General Corporation Law provides a safe harbor for interested transactions approved by a majority of Independent Directors who do not have a personal interest at stake. Delaware courts have taken considerably different positions on the effect of the approval. It may result in the application of the business judgment rule to the interested transaction. Other courts have instead held that the fairness standard applies, but the approval has the effect of shifting the burden of proof.

18. A court must review the complaint on a case-by-case basis to determine whether it states with particularity facts indicating that a relationship—whether it preceded or followed board membership—is so close that the director's independence may reasonably be doubted. This doubt might arise either because of financial ties, family affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis-à-vis an interested director. Beam, 845 A.2d at 1051.
20. See Zapata Corp. v. Maldonado, 430 A.2d 779, 785-89 (Del. 1981). The Delaware Supreme Court has declined to decide "whether the substantive standard of independence in a [Special Litigation Committee] case differs from that in a presuit demand case." Beam, 845 A.2d at 1055.
21. See Del. Code Ann. tit. 8, § 144 (2003). Section 144 "deals with the... problem of the conditions under which a corporate contract can be rendered 'un-voidable' solely by reason of a director's interest" but does not say what standard of review applies to the transaction. Cinerama, Inc. v. Technicolor, Inc. 663 A.2d 1134, 1154 (Del. Ch. 1994), aff'd, 663 A.2d 1156 (Del. 1995).
22. See Edward Brodsky & M. Patricia Adamski, Law of Corporate Officers and Directors: Rights, Duties and Liabilities § 3:8 (2004); see also Robert J. Brown, Jr., The Irrelevance of State Corporate Law in the Governance of Public Companies, 38 U. Rich. L. Rev. 317, 342 (2004) (noting that court decisions on interested transactions have "sharply restricted the reach of the duty of loyalty").
23. See Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971); cf. Oberly v. Kirby, 592 A.2d 445, 465 n.14 (Del. 1991) (supporting, although in dictum, this position). The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) (quoting Aronson v. Lewis, 473 A.2d at 812).
to the plaintiff.\textsuperscript{24}

In a takeover context, in deciding whether to apply the protection of the business judgment rule to defensive measures adopted by the board of the target corporation, courts give great weight to the approval of such measures by a board comprised of a majority of outside Independent Directors.\textsuperscript{25} "An 'outside' director has been defined as a non-employee and non-management director . . . Independence 'means that a director's decision is based on the corporate merits of the subject before the board rather than on extraneous considerations or influences.'\textsuperscript{26}

As for federal laws and regulations, the Internal Revenue Code allows public corporations to benefit from an exception to a $1,000,000 limit upon corporate tax deductions for compensation paid to their executives. The exception applies to salaries that are "performance based" and that are approved by a committee composed of two or more outside directors.\textsuperscript{27} The Securities Exchange Act of 1933 also exempts from insider trading restrictions a transfer of securities from a company to one of its officers or directors if the transfer is approved by a board committee composed of two or more "non-employee" directors.\textsuperscript{28} Although mutual funds present governance issues different from those of traditional corporations, it is important to mention the funds' rules as they relate to Independent Directors. The Investment Company Act of 1940 requires that at least 40\% of investment company directors be

\begin{itemize}
\item \textsuperscript{24} The entire fairness standard always applies in transactions involving self-dealing by a controlling shareholder; "the burden, however, may be shifted from the defendants to the plaintiff through the use of a well functioning committee of independent directors." Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (citing Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994)); \textit{see also} Krasner v. Moffett, 826 A.2d 277, 286 (Del. 2003) ("The independence of the special committee involves a fact-intensive inquiry that varies from case to case.").
\item \textsuperscript{25} \textit{See} Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985).
\item \textsuperscript{27} \textit{See} 26 C.F.R. § 1.162-27 (2004). A director qualifies as an "outside director" if he:
\begin{itemize}
\item (A) Is not a current employee of the . . . corporation;
\item (B) Is not a former employee of the . . . corporation who receives compensation for prior services . . . during the taxable year;
\item (C) Has not been an officer of the . . . corporation; and
\item (D) Does not receive remuneration from the . . . corporation, either directly or indirectly, in any capacity other than as a director.
\end{itemize}
\item \textsuperscript{28} \textit{See} 17 C.F.R. § 240.16b-3 (2004). A "non-employee" director:
\begin{itemize}
\item (A) Is not currently an officer . . . of the [corporation] or a parent or subsidiary of the [corporation], or otherwise currently employed by the [corporation] or a parent or subsidiary of the [corporation];
\item (B) Does not receive compensation, either directly or indirectly, from the [corporation] or a parent or subsidiary of the [corporation], for services rendered as a consultant or in any capacity other than as a director . . .
\item (C) Does not possess an interest in any other transaction for which disclosure would be required . . . and
\item (D) Is not engaged in a business relationship for which disclosure would be required . . .
\end{itemize}
\end{itemize}
“non-interested” persons. Moreover, as a condition for benefiting from certain exemptions, S.E.C. rules require that funds comply with specific governance standards, some of which concern Independent Directors. A special status is also reserved for Independent Directors within the banking industry. For instance, as a result of the 1991 amendments to the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation adopted rules providing that insured depositary institutions establish an audit committee composed solely of “outside directors who are independent of management of the institution . . . .”

Following the 2002 corporate governance reforms, companies are increasingly required to have a substantial presence of Independent Directors on their boards. Rule 301 of the Sarbanes-Oxley Act of 2002 mandated that the S.E.C. adopt rules requiring national stock exchanges to include in their listing requirements certain obligations for company audit committees, and in particular requiring that such committees be composed only of Independent Directors. The S.E.C. set forth the minimum requirements for Independence.


30. See Investment Company Governance, 69 Fed. Reg. 46,378 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270). For example, funds are required to have at least 75% of Independent Directors on their boards, which must meet separately at least once quarterly. Furthermore, the chairman of the board must be Independent and the selection of new Independent Directors is reserved to the existing ones. The S.E.C. Final Rule uses the term Independent Directors to refer to directors who are not “interested persons” as defined by 15 U.S.C. § 80a-2(a)(19) (2003). See Investment Company Governance, 69 Fed. Reg. at 46,381 n.23.


33. In order to be considered to be independent . . . a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof . . . or

(B) Be an affiliated person of the issuer or any subsidiary thereof. . . . In order to be considered to be independent . . . a member of an audit committee of a listed issuer that is an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof . . . or

(B) Be an “interested person” of the issuer as defined in . . . 15 U.S.C. 80a-2(a)(19).


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The New York Stock Exchange (NYSE) and NASDAQ have both adopted new listing rules requiring companies to have a majority of Independent Directors on their boards. Both sets of listing rules set forth definitions of Independence. Companies listed on the NYSE must have a nominating/corporate governance committee and a compensation committee comprised of Independent Directors. The new NASDAQ rules require that a majority of Independent Directors, or a committee comprised of Independent Directors, decide or recommend the CEO’s and executive officers’ compensation as well as select or recommend director nominees.

It now seems fair to say that “[a]fter the 2002 [r]eforms, it is unquestionable that Delaware, the Exchanges, and the federal government each have policies that express the belief that genuinely independent directors who owe their allegiances entirely to their corporation and its stockholders are valuable to investors.” The above overview shows how corporate governance rules treat Independent Directors as the individuals upon whom shareholders and other corporate constituencies can rely to ensure that corporations are properly managed. As I will now discuss, however, independence alone does not justify this special trust in the positive role of Independent Directors.

III. A DIFFERENT VIEW OF INDEPENDENT DIRECTORS

Corporate governance rules have increasingly enlarged the role of Independent Directors. However, many commentators have argued that Independent Directors are not in the position to adequately discharge their duties because of deficiencies in their personal attributes and in the structural

34. See NASDAQ Marketplace Rule 4350(c), IM-4350-4 (“Independent directors ... play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the companies they oversee and guard against conflicts of interest. Requiring that the board be comprised of a majority of independent directors empowers such directors to carry out more effectively these responsibilities.”); N.Y.S.E. Listed Co. Manual § 303A.01 (The Commentary notes that “[e]ffective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.”).

35. See NASDAQ Marketplace Rule 4200 (“‘Independent director’ means a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.”); N.Y.S.E. Listed Co. Manual § 303A.02(a) (“No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company . . . .” ) Both rules identify a number of specific relationships that prevent a director from being qualified as Independent.


37. See NASDAQ Marketplace Rule 4350(c).

features of the corporation.\footnote{39} Before examining these positions, it is worth noting that these ideas find some support in many empirical studies’ inability to discover a clear correspondence between the presence of Independent Directors on the board and a firm’s performance.\footnote{40} There are, however, some caveats to be made in interpreting the results of such studies. First, the studies generally adopt unsophisticated definitions of Independence, and definitions often differ from one study to another.\footnote{41} Additional problems arise because almost all of the variables used are endogenous or because the empirical results can often be interpreted as either equilibrium or out-of-equilibrium phenomena.\footnote{42} Overall, it is still unclear what consideration should be accorded to these empirical studies. Nevertheless, their results are consistent with the idea that Independence alone is not sufficient to guarantee good director performance.

A. Directors’ Personal Attributes

Most definitions of independence do not consider all of the ties that may exist between a director and the company or its managers. In particular, indirect economic relationships as well as personal and social connections affect the ability of directors to act independently.\footnote{43} Indeed, many corporate governance guidelines and codes of best practice have supported the adoption of stricter definitions of Independence.\footnote{44} Enron represents a good example of what may


\footnote{41} See Sanjai Bhagat & Bernard Black, The Uncertain Relationship between Board Composition and Firm Performance, 54 Bus. Law. 921, 952 (1999); Lynne L. Dallas, The Relational Board: Three Theories of Corporate Boards of Directors, 22 J. Corp. L. 1, 18 (1996); Fisch, supra note 13, at 278-79 (“Defining independence appropriately for purposes of these studies is particularly difficult. Many studies rely on relatively superficial criteria in classifying directors as independent . . . .”); Langevoort, supra note 7, at 798-99; Lin, supra note 39, at 922.

\footnote{42} See Hermelin & Weisbach, supra note 40, at 8 (“The... problems of joint endogeneity... plague these studies. For instance, firm performance is both a result of the actions of previous directors and itself a factor that potentially influences the choice of subsequent directors.”).

\footnote{43} See Brudney, supra note 39, at 612-13; Charles M. Elson, Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure, 30 SMU L. Rev. 127, 161 (1996); Gilson & Kraakman, supra note 39, at 875.

\footnote{44} See Holly J. Gregory, Comparison of Corporate Governance Guidelines and Codes
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...happen when directors have indirect economic links with the company. The 2002 reforms and recent Delaware decisions have addressed this issue by recognizing the relevance of family, professional, or financial ties that endanger a director's independence of judgment. The new rules, however, do not adequately consider personal friendships and, more generally, social ties.

An Independent Director may also fail to effectively carry out his responsibilities because he lacks competence. Specifically, a director may not have the experience and knowledge necessary for the job. State laws generally do not provide mandatory director qualifications, and few are the cases in which corporations fill the gap. The 2002 reforms have not taken any steps in this regard. The new NYSE listing rules only require that companies adopt and disclose corporate governance guidelines addressing director qualification standards and director orientation and continuing education. An exception exists within the context of audit committees. The Sarbanes-Oxley Act requires that corporations disclose in annual reports whether any of the Independent Directors serving on the audit committee is a financial expert. If none is present, the report must explain why. The new listing rules do require that, at the very least, all of the committee members are financially literate.

Another issue arises from many directors' inability to devote sufficient time to their position because they either have full-time jobs or serve on other...
corporate boards.\textsuperscript{54} To remedy this problem, some corporate governance guidelines and codes of best practice suggest a requirement that directors have sufficient time for their duties or a limit on the number of boards on which they may sit.\textsuperscript{55} Furthermore, board meetings are so infrequent that the directors do not have sufficient opportunities to make a valuable contribution to the management of the corporation.\textsuperscript{56}

Nothing guarantees, moreover, that Independent Directors will have sufficient incentive to actively monitor the company's management even when they are in the position to do so. Instead, the following factors suggest Independent Directors will lack such an incentive. First, as part of the vast phenomenon of cross-directorships, many directors are also managers of other companies.\textsuperscript{57} As such, they have no incentive to make waves within the board of another company whose managers serve on the board of their company.\textsuperscript{58} Second, the phenomenon of \textit{groupthink} within the boardroom poses an additional obstacle to the directors' willingness to confront the management.\textsuperscript{59} Third, interpersonal board dynamics tend to create a nonconfrontational environment where dissent is strongly discouraged.

The traditional argument to the contrary is that the market for directors creates the incentive to monitor the company's management: allegedly, directors will try to foster their reputation to maintain their office and to be elected to additional boards.\textsuperscript{60} Commentators, however, generally reject this argument and claim that lack of motivation typically limits the effectiveness of Independent Directors.\textsuperscript{61}

\textsuperscript{54} See LORSCH & MACIVER, supra note 49, at 178; MONKS & MINOW, supra note 12, at 189-90; Brudney, supra note 39, at 609; Gilson & Kraakman, supra note 39, at 875; see also \textit{The Role of the Board of Directors in Enron's Collapse: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs, 107th Cong. (2002)} (statement of Herbert S. Winokur, Jr.) (discussing the limited role of directors within a large corporation and the part-time nature of their job).

\textsuperscript{55} See GREGORY, supra note 44, at 27-28.

\textsuperscript{56} See Lipton & Lorsch, supra note 39, at 64-65. According to the 2003 Corporate Board Member study, the mean number of meetings per year is 5.6. \textit{CORP. BOARD MEMBER, WHAT DIRECTORS THINK STUDY 2003} 3 (2003).

\textsuperscript{57} See MONKS & MINOW, supra note 12, at 188-89.

\textsuperscript{58} See Elson, supra note 43, at 159, 161-62 ("While such board composition may lead to affable board gatherings, the oversight function may be severely compromised. . . . [C]onflict with a manager who is also a member of one's own board may lead to future retribution of one's own turf, thus reducing the incentive to act."); cf. Gilson & Kraakman, supra note 39, at 875.

\textsuperscript{59} See Dallas, supra note 11, at 804. \textit{Groupthink} is defined as "a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' striving for unanimity overrides the motivation to realistically appraise alternative courses of actions." \textit{IRVING JANIS, VICTIMS OF GROUPTHINK} 78 (1978). For an analysis of the deleterious effect of \textit{groupthink} in the Enron case, see Marleen A. O'Connor, \textit{The Enron Board: The Perils of Groupthink}, 71 U. CIN. L. REV. 1233 (2003).


\textsuperscript{61} See WILLIAM G. BOWEN, INSIDE THE BOARDROOM 48 (1994) (noting with regard to Independent Directors that "[c]ourage and the will to act are often the attributes in scarcest supply"); see
Additionally, fiduciary duties and personal liability rules fail to create a sufficient incentive to act in the best interest of the corporation. In particular, the standard of care that governs the directors' duty to monitor, the business judgment rule, the possibility of limited monetary damages for breach of the standard of care, and the availability of insurance coverage all make it unlikely that a director's exposure to liability will provide a serious incentive to act.

In monitoring management and company operations, directors have a general obligation of care. Technically, courts will not apply the business judgment rule to the directors' failure to act unless a conscious decision not to act has been made. Conversely, directors violate their fiduciary duties if they do not exercise "the amount of care that ordinarily careful and prudent men would use in similar circumstances." Directors fail to meet this standard not only if they ignore a red flag, but also if they do not "attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."

This standard of care does not seem to provide sufficient incentive to monitor, especially if the following factors are taken into consideration. First, it has generally been common practice for corporations to maintain a minimum reporting system, which will likely allow directors to meet their duty of care in this regard without taking any further action. Second, directors will not be held responsible if they reasonably rely on the opinions and information provided to them by the management. Third, directors have no duty to actively inquire into a matter that is not connected to a specific event. In addition, in the late 1980s, Delaware law was amended to allow stockholders to exonerate directors from damage liability arising out of violations of their fiduciary duty of care. Such limitations clearly weaken any motivational effect of state fiduciary rules. Even though Sarbanes-Oxley's rules on audit committees may result in an increase of director liability for breach of either federal law or the duty of care

also Bebchuk et al., supra note 39, at 771 (in the context of compensation committees); Brudney, supra note 39, at 613; Elson, supra note 43, at 159; Gilson & Kraakman, supra note 39, at 873-76.
62. See Langevoort, supra note 7, at 818-23; Lynn A. Stout, On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board), 28 DEL. J. CORP. 1, 5-8 (2003).
64. See Aronson v. Lewis, 473 A.2d 805, 813 (Del. Ch. 1984); In re Caremark Int'l Inc. Derivative Lit., 698 A.2d 959, 967 (Del. Ch. 1996).
67. Delaware corporate law shields directors from liability in their reliance on inside or outside sources of information; however, the law requires that such reliance be reasonable. See DEL. CODE ANN. tit. 8, § 141(e) (2003).
68. § 102(b)(7).
under state law, directors' overall exposure to liability for breach of their duty of care will continue to be very limited.

The business judgment rule tends to shield directors from personal liability in relation to their business decisions. Although the rule is a cornerstone of American corporate law because it allows boards to make business decisions without always being second-guessed by courts, the rule provides directors with many opportunities to fail to act in the best interest of the corporation without breaching their fiduciary duties. The business judgment rule generally applies to directors' actions, such as the approval of executive compensation, and to the actions of special litigation committees. With respect to director responses to takeover attempts, Delaware case law sets forth more specific guidelines. In the case of the director's duty to maintain an internal control system, courts, by incorporating such guidelines into fiduciary duty, have created some incentive to actually follow such practices in order to avoid the risk of personal liability.

B. Structural Constraints

Structural concerns further impair the effectiveness of Independent Directors. First, commentators have pointed out that the traditional involvement of the CEO in the selection of director candidates raises serious doubts as to...
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whether board members are in the position to effectively monitor the CEO.\(^7\) In this respect, the new NYSE and NASDAQ listing rules have restricted, at least in theory, the selection of candidates for the position of director to the competences of Independent Directors.\(^6\)

Second, a CEO who also serves as the chairman of the board will be able to control, at least partially, the body that is supposed to monitor his actions.\(^7\) The chairman of the board has control over the agenda, the information that supports it, and the schedule of meetings. Combining the role of CEO and chairman makes it less likely that directors will be in the position to monitor effectively and, if necessary, to challenge the CEO. Possible solutions for this problem include the appointment of an Independent Director as chairman and the designation of an Independent Lead Director to chair meetings of Independent Directors, as well as to serve as a liaison between the Independent Directors and the executives.\(^7\) The new NYSE and NASDAQ listing rules require that Independent Directors meet regularly outside of the presence of management.\(^7\) These meetings clearly promote a more open discussion among Independent Directors, who have the opportunity to express their views and concerns outside of the presence of the CEO.

More generally, when the board relies only on the information provided by the CEO, its ability to monitor the management effectively is impaired.\(^8\) Particularly important is the access that directors have to lower management.\(^8\)

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\(^{76}\) See supra notes 36-37 and accompanying text.

\(^{77}\) See Bowen, supra note 61, at 86 (recognizing that a single CEO-chairman “deprive[s] the board of an important protection against abuses of power.”); Lorsch & MacIver, supra note 49, at 82-83; Monks & Minow, supra note 12, at 179-80 (noting that “when the chairman of the board is also the CEO, it makes management accountable to a body led by management.”); William R. Ide, Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight, 54 Mercer L. Rev. 829, 840 (2003); Lin, supra note 39, at 914.

\(^{78}\) See Bowen, supra note 61, at 89-93; Gregory, supra note 44, at 15-18; Lipton & Lorsch, supra note 39, at 70-71. According to the 2003 Corporate Board Member study, 57.3% of the boards with CEO as chairman had a lead director. See Corp. Board Member, supra note 56, at 3.

\(^{79}\) See NASDAQ Marketplace Rule 4350(c); N.Y.S.E. Listed Co. Manual § 303A.03.

\(^{80}\) See In re Caremark Int’l Inc. Derivative Lit., 698 A.2d 959, 970 (Del. Ch. 1996) (“relevant and timely information is an essential predicate for satisfaction of the board’s supervisory and monitoring role . . . ”); Lawrence L. Mitchell, Structural Holes, CEOs, and the Missing Link In Corporate Governance (George Washington Univ. Law Sch., Pub. Law Research Paper No. 77, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=467980 (discussing how structural deficiencies may allow the management to control and manipulate the information available to the board); Monks & Minow, supra note 12, at 174-75; Lin, supra note 39, at 914; Ide, supra note 77, at 838; see also Cox, supra note 32 (Professor Cox analyzes the issue in the context of special litigation committees and determination of fairness in merger transactions, using the information provided by legal counsel to the directors. He underlines the importance that the committee’s counsel be truly independent.).

\(^{81}\) Unless a subordinate manager has independent network ties to one or more of the independent
In this respect, the 2002 reforms failed to address the existing issues. The new obligations regarding certification of financial reporting by external auditors are important in this context, because the work of the auditors will guarantee, at least to a certain extent, the reliability of the information that the board receives.\textsuperscript{82} Nevertheless, no adequate action has been taken to ensure the overall quality and completeness of the information provided to the board.\textsuperscript{83}

As even the most recent definitions of Independence focus exclusively on the lack of ties between the directors and the company or its management, the 2002 reforms have generally failed to give adequate consideration to the additional personal characteristics and structural conditions necessary for a director to be an effective monitor of management.\textsuperscript{84} It therefore appears that the job of fully realizing the beneficial role of the Independent Directors is far from finished.

IV. AUTONOMY V. INDEPENDENCE

A. The Concept of Autonomy in Contemporary Philosophy

Independence is traditionally defined as freedom from the control or influence of others.\textsuperscript{85} Although common dictionaries report the two words as synonyms, contemporary studies of philosophy have distinguished the concept of “independence” from the more inclusive concept of “autonomy,” which encompasses both freedom from interference and a positive aspect of self-governing.\textsuperscript{86} Independence is therefore viewed as a condition necessary but not sufficient for autonomy. Because “the notion of autonomy is utilized in various contexts in ways that suggest it names a cluster of disparate concepts,” I will

\begin{itemize}
  \item directors, the CEO is in the sole position to control and manipulate information flows to the board. This leaves the CEO in an enormously powerful position, with every incentive to present the board in a light that is most favorable to him.\textsuperscript{82}
  \item See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2003); see also Mitchell, supra note 80, at 49 n.93, (maintaining that the role of independent auditors following Sarbanes-Oxley only mitigates, but does not eliminate, the problem of CEO control over the information provided to the board).
  \item The NYSE listing rules only require that corporation governance manuals address the issue of directors’ access to management and independent advisors. N.Y.S.E. Listed Co. Manual § 303A.09.
  \item See Chandler III & Strine, Jr., supra note 32, at 967 (“Unsurprisingly, the 2002 Reforms’ approach to defining director independence has largely been a negative exercise . . . .”).
  \item See, e.g., OXFORD ENGLISH DICTIONARY (2d ed. 1989) (defining independence as “the fact of not depending on another . . . exemption from external control or support; freedom from subjection, or from the influence of others; individual liberty of thought or action.”).
\end{itemize}
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first clarify the concept of autonomy upon which this Article will rely.  

One account of personal autonomy focuses on the internal psychological processes of the individual and seems, therefore, to be of little help in legal analysis. This theory is based on the works of Harry Frankfurt and Gerald Dworkin, who elaborate a distinction between first-order desires (those upon which a person acts) and second-order evaluation of first-order desires. According to Dworkin, to be autonomous, a person must be able to reflect critically on his own first-order desires as well as to have some capacity to alter them. The higher-order evaluation, furthermore, must satisfy “conditions of procedural independence” in that it must not be influenced by external factors to the point where it cannot be considered the person’s own. As long as a person chooses his first-order desires freely, he is autonomous; even a person who lives under the control of others will be considered autonomous if living in such a way is the result of his own act of volition.

A second conception of autonomy considers not only individual volitional choices, but also the ability of the individual to act on such choices, as affected by the characteristics of both the person and the environment in which he acts. Because of its broader scope, this Article will rely on this account of autonomy as a helpful conceptual tool in the analysis of the role of Independent Directors within the corporate governance system. This conception of autonomy, embraced by Robert Young as well as others (some with minor variations), considers “autonomous” a person who not only formulates his life plan in accordance with his own values and desires, but also carries through with it. “Autonomous” identifies a person who chooses a course of action in a non-coerced and conscious manner, who has the capacity and opportunity to pursue such a course of action free from constraints, and who actually pursues it. As a consequence, “to be autonomous is not merely to have a capacity, nor the

87. John Christman, *Introduction, in THE INNER CITADEL: ESSAYS ON INDIVIDUAL AUTONOMY* 3 (John Christman ed., 1989). For example, Joel Feinberg illustrated how the word “autonomy” may refer to four different concepts: the capacity to govern oneself, the condition of governing, the character ideal, which stems from the concept of autonomy as a condition, and the right to be autonomous. Joel Feinberg, *Autonomy, in THE INNER CITADEL: ESSAYS ON INDIVIDUAL AUTONOMY* 4.

88. See DWORKIN, supra note 86 (using the example of a person who has a first-order desire to smoke but at the same time a second-order wish not to have such desire); Harry G. Frankfurt, *Freedom of the Will and the Concept of a Person, in THE INNER CITADEL: ESSAYS ON INDIVIDUAL AUTONOMY* 63.

89. See DWORKIN, supra note 86, at 15-18.

90. *Id.* at 18 (listing manipulation, hypnotic suggestion, and coercion as examples of causes of lack of procedural independence).

91. See KUPFER, supra note 86; YOUNG, supra note 86, at 37 (“The autonomous person orders his (or her) life according to a plan or conception which fully expresses his own will.”); Oshana, *supra* note 86, at 99-126. Cf. DIANA T. MEYERS, *SELF, SOCIETY AND PERSONAL CHOICE* (Columbia University Press 1989) (considering “autonomous” a person who has autonomy competency, i.e., a repertory of skills necessary for self-governance, not impaired by either internal or external factors); RAZ, *supra* note 86, at 372 (for whom the necessary conditions of autonomy are mental abilities, independence as freedom from influence of others, and an adequate range of options).
opportunity to exercise a capacity. Autonomy is an exercise-concept . . . ."92

To achieve autonomy, a person needs to be free from constraints and to have the positive qualities necessary to formulate and pursue his own goals. These positive qualities include self-awareness and rationality. Self-awareness permits a person to be immune from manipulation by others. Rationality is needed to make the valid judgments necessary to successfully devise and carry out one’s goals. This theory also calls for the absence of what Joel Feinberg classified as external and internal (positive and negative) constraints;93 an autonomous person will be free from either type.94 Internal constraints include weakness of will, deficiencies in talent or skills, neurosis, or addiction. External constraints are lack of opportunities and resources, and subjection to the control or influence from others (i.e., lack of independence).95 Clearly, independence, defined as freedom from others’ influence, is just one of the preconditions of autonomy. A person will be able to both elaborate and pursue his objectives only when all of the conditions for autonomy are satisfied.

One final elaboration of the concept of autonomy seems noteworthy for our purposes. Lawrence Haworth has addressed the issue of how the environment of social institutions, including the family, the church, and also large corporations, affects personal autonomy.96 He concludes that institutions are neutral with respect to autonomy; that is, depending upon their structure, they may either be receptive to autonomy or limit it. Haworth does not identify a specific structure which would enhance autonomy.97 However, he acknowledges that “[a] fuller account of domains for autonomy would identify the elements of a social structure that affect development of people’s capacity for autonomy and their motivation to exercise that developed capacity . . . .”98

Upon examination of the concept of autonomy as it relates to Independent

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92. YOUNG, supra note 86, at 49. The view that a person is autonomous only if he actually exercises his ability to be autonomous is shared by KUPFER, supra note 86, at 28-29; MEYERS, supra note 91, at 87; RAZ, supra note 86, at 371-73; Oshana, supra note 86, at 100-02. But see LINDLEY, supra note 86, at 68-69 (distinguishing between being autonomous, as possessing “certain intellectual and practical capabilities” from actually exercising autonomy).

93. See JOEL FEINBERG, SOCIAL PHILOSOPHY 13 (1973). Kupfer, Young and Oshana all adopt the categories of internal and external constraints. See KUPFER, supra note 86; YOUNG, supra note 86; Oshana, supra note 86. Meyers analyzes the internal and external factors that may prevent a person with competency autonomy from being autonomous. See MEYERS, supra note 91, at 89.

94. Young recognizes that whether one approaches the conditions to autonomy in terms of absence of constraints or presence of positive qualities is not crucial, being “often a matter of perspectives . . . .” YOUNG, supra note 86, at 35. For example, strength of will could be considered as a positive requirement for autonomy, and weakness of will could be an internal obstacle to it.

95. In this regard, Oshana focuses on the necessity that a person’s social-relational conditions provide an adequate opportunity to be autonomous. A person “must find herself within a set of relations with others that enable her to pursue her goals in a context of social and psychological security.” Marina Oshana, Personal Autonomy and Society, 29 J. SOC. PHIL. 81, 94 (1998).

96. HAWORTH, supra note 86.

97. Haworth only discusses traits of the institution that affect autonomy, such as flexibility, accessibility, and controllability. Id. at 113-19.

98. Id. at 119 (citation omitted).
Directors in the next section, it becomes clear that the identification of the structural conditions of autonomy is indeed one of the objects of this Article.

B. Autonomy, Independence, and Corporate Governance

The corporate governance system has embraced the notion that the presence of Independent Directors on company boards is important to achieving good governance. Statutory rules and case law, moreover, give special deference to certain decisions made by Independent Directors in a number of different contexts. This approach stems from the idea that a director’s independence ensures that he will properly discharge his duties, and in particular, that he will be an effective monitor of management. Accordingly, the definition of Independence serves to identify persons who are truly free from constraint or influence by the corporation and its management.

Such reliance, however, is unjustified. In light of the conceptual categories discussed above, independence alone is not sufficient for a director to effectively carry out his responsibilities. To formulate and achieve his objectives, an individual needs to have certain additional personal characteristics, and he must act within a context that provides him with the opportunity to exercise autonomy. Thus, the current definition of Independent Director is misleading because it purports to identify someone who will be an effective and therefore trustworthy director, but the requirements of the definition are inadequate for this purpose. This shortcoming is very dangerous because the governance system mistakenly relies upon individuals to have qualities of autonomy by virtue of meeting the definition of independence. Since Independent Directors are often the primary means of protecting shareholders’ interests, it follows that in many situations the shareholders in fact have little or no protection.

Governance rules should instead adopt a definition of Independent Director that contains all of the requirements necessary to identify what “Independent Director” is intended to signify: an autonomous director. The definition should require that a director be free from compromising ties and have the motivation, skills, and other characteristics necessary for him to be effective. It should also account for structural and procedural elements that may affect the director’s ability to act. Only a person who satisfies all of the conditions for autonomy will be reliable as a director who will set his own objectives and effectively pursue them to satisfy his obligations under the law. This conclusion is

99. See supra, Part II.
100. It seems appropriate to clarify that when we apply the theory of autonomy to the actions of corporate directors, we recognize that corporate law sets the values upon which directors act as well as the ultimate goals that they try to achieve. Within those limits, however, the system relies on them as actors that operate autonomously in formulating their own intermediate goals and take appropriate
consistent with the views that question the positive role of Independent Directors because of their lack of motivation, competence, and time, as well as because of structural barriers. As discussed in Part VI, the suggested definition of Independent Director relies on many of the requirements that scholars and practitioners have indicated as necessary for making a director trustworthy.

Before attempting to identify the conditions of autonomy, I would like to make one additional remark. Only Independent Directors should be required to possess the suggested qualifications. This approach finds its roots in recognizing that the structure of each company's board varies depending on the role with which the directors are entrusted. Although the monitoring role may be dominant, the board must also carry out strategic and resource-gathering duties. "[B]oards are expected to perform multiple roles, with the effective performance of these roles requiring different types of directors. Some boards perform some roles better than others, depending on their composition." The proposed definitions target individuals who will efficiently perform the monitoring role. Not all of the requirements should be imposed on the entire board.

C. The Conditions of Autonomy

As it has long been recognized, Independent Directors should be free from ties that may impair their freedom of action and should possess personal attributes necessary to discharge their duties effectively. In particular, they ought to be motivated, competent, and able to devote the necessary time to their office.

More is needed, however: the environment in which Independent Directors operate should provide them with adequate resources and opportunities. First, the directors should have access to complete and accurate information, which actions accordingly.

101. See Fisch, supra note 13, at 284 ("Ideal board structure . . . depends on board function. . . . Companies can have very different needs from their boards of directors, and . . . a universal model board may be incapable of meeting those needs.") (footnote omitted).
102. Dallas, supra note 11, at 815.
103. This suggests that a director who does not possess all of the requirements necessary to be autonomous may still be capable of effectively performing roles other than monitoring. For example, to provide strategic support to the board, a director who is also the CEO of another company may not need to have access to company information to the same extent as an Independent Director. Where the CEO has an honest interest in utilizing the director's advice, he would provide the director with all of the information he needs. If the CEO failed to submit a certain strategy to the board's attention or tried to manipulate the director by taking advantage of his informational advantage, the Independent Directors would be able to intervene and address the problem, as they would have access to all of the necessary information to monitor the CEO. Furthermore, for resource-gathering purposes a company could benefit from having on its board a prominent public figure, although he may devote only limited time to his work as a director.
104. The ties may be economic as well as personal, such as friendships and relevant social ties. Indeed any relationship that could reasonably result in an improper restraint of a director's actions should be taken into consideration. Cf. supra Part III.A.
they should receive in a timely manner and in a workable form. They should be able to request and receive specific data as well as follow-up information. Their sources should not be limited to the top management, because CEO control over informational routes undermines the directors’ ability to receive complete and accurate data, thus giving the CEO a position of dominance over the board.\textsuperscript{105} Instead, the directors should be able to access relevant information from different sources at all hierarchical levels, within and outside the corporation.\textsuperscript{106}

Second, Independent Directors should have the resources to elaborate and formulate proposals about the information received. It is unreasonable to believe that one individual, devoting a limited amount of time to this activity, can properly perform such tasks in conjunction with the operations of a large public company. Instead, directors should have access to all financial, human, and institutional resources they may need.

Third, directors should have the necessary opportunities and powers to operate. They must be able to articulate their positions not only during board meetings, but also in preparation thereof, and propose actions they deem necessary.\textsuperscript{107} To this end, they should be able to access the rest of the board before meetings and should actively participate in preparing meeting schedules and agendas. Furthermore, the composition and voting procedures of the board should put them in the position to determine the outcome of deliberations.

Fourth, directors’ ability to act should not be impaired by indirect constraints arising from within the corporation. If the CEO, or other executives, have the power to affect directors’ status within the corporation, directors are not in the position to freely take advantage of any power and opportunities provided to them. Management should not have any influence over the nomination of directors, their remuneration, or any other sources of direct or indirect power over them.

Finally, there is a necessary corollary to the above conditions: Independent

\textsuperscript{105} See Mitchell, supra note 80; GREGORY, supra note 44, at 39-40; see also Ide, supra note 77, at 838-39 (suggesting that the heads of each corporate division/department meet regularly with the board or its committees), 867 (suggesting that the board have access to the various “service” functions of the corporation such as finance/accounting, legal, regulatory/compliance, and human resources, and that reporting be directed upstream to the head of the respective function that should then report to the board); Lipton & Lorsch, supra note 39, at 71-72. Interestingly, the words that Young uses with regard to autonomous individuals aptly describe the approach corporate directors should take. See YOUNG, supra note 86, at 12. “[T]hose who draw invalid inferences or make use of incomplete or partially reliable information are likely to suffer in their overall autonomy . . . Autonomous persons, then, do not accept what they are told without any reason, or with too little reason to regard the testimony as reliable.” Moreover, “[w]here there is antecedent ground for doubting the impartiality of a particular investigation or source of information, autonomous persons must quite literally make up their own minds in light of the total available evidence.” Id at 13.


\textsuperscript{107} See id. at 108.
Directors should be able to control their position within the institutional environment.\textsuperscript{108} By this, I mean that they should determine the company-specific arrangements concerning their roles and powers. Within the limits of mandatory rules, each company will choose and adapt governance structures and procedures to fit its specific needs. This gives each corporation a certain degree of discretion, which extends to the arrangements concerning the Independent Directors. The Independent Directors themselves should control the exercise of such discretion. They should be in charge of implementing the structural and procedural solutions that satisfy the conditions of autonomy such as access to resources, salaries, manners of interaction with other directors, and access to information inside and outside the corporation. Without this specific power, even an organizational layout that might in principle foster directors' ability to act could be ineffective in practice.

V. REALIZING THE CONDITIONS OF AUTONOMY

\textit{A. Directors' Personal Attributes}

I will first address elements pertaining to the individual serving as a director, regardless of his position within the corporation. Nonetheless, one should be mindful that the personal attributes of the Independent Directors are necessarily affected by the structural settings in which they operate. At the same time, an individual's capabilities may overcome structural barriers within a corporation. These two aspects of the directorial function are deeply intertwined and should not be considered as if one were independent from the other.

An Independent Director should have no personal or economic relationships that could impair his ability to act. In this regard, I believe that relevant ties are not only those with the company and its management, but also those with the other directors; any significant relationship with any of these subjects might in fact have an improper influence on an Independent member of the board. In addition to identifying a number of specific types of connections that would normally endanger the director's independence of judgment, the existing Independent Directors should affirmatively determine that a candidate director has no other relationship that, regardless of its nature, could have such an effect.\textsuperscript{109} This open-ended approach allows all ties to be taken into consideration, including personal friendships and social links that might have a material influence.

A very important concern is to identify directors who possess the necessary motivation to discharge their duties effectively. The solution traditionally

\textsuperscript{108} Cf. Haworth, supra note 86, at 113-19 (suggesting that one of the conditions of an institutional autonomous task environment is controllability, the ability to control that environment).

\textsuperscript{109} This is the approach adopted in the NYSE and NASDAQ listing rules. See supra note 35.
proposed in this respect is compensating the director in part with company stock. The director's long-term financial interest in the company allegedly gives him the incentive to actively monitor management.\textsuperscript{110} \textsuperscript{110} Empirical studies suggest that stock ownership improves director-monitoring ability.\textsuperscript{111} \textsuperscript{111} To render this solution more effective, additional requirements can be added. Directors should not be able to sell the stock until a number of months after leaving the company.\textsuperscript{112} \textsuperscript{112} Moreover, they should not be permitted to use derivative transactions to eliminate or reduce the risk of price fluctuations.\textsuperscript{113} \textsuperscript{113}

Remunerating directors with corporation equity has become common practice. This solution alone, however, has not guaranteed that directors are adequately active and motivated in performing their duties. After elaborating the structural and procedural arrangements that should provide Independent Directors with the necessary resources and opportunities for action, in Part V.D I suggest a procedural solution that addresses the problem of director motivation and active participation.

Independent Directors should also meet a minimum level of skills and industry-specific experience as well as devote sufficient time to their duties as board members. While each director should also have specific additional knowledge, such a requirement will vary depending on the competencies that the other directors bring to the board, and whether he is also a member of a particular committee.\textsuperscript{114} \textsuperscript{114} In this case as well, existing Independent Directors

\begin{itemize}
\item \textsuperscript{110} See R. Franklin Balotti et al., \textit{Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?}, 55 Bus. Law. 661 (2000) (providing a review of judicial decisions giving consideration to director substantial stock ownership and proposing an equity-based presumption of care within the context of directors' fiduciary duties); Elson, supra note 43, at 165-66; Langevoort, supra note 7, at 806; see also NACD, \textit{Report of the NACD Best Practices Council: Coping with Fraud and Other Illegal Activity} 16 (1998).
\item \textsuperscript{111} Sanjai Bhagat et al., \textit{Director Ownership, Corporate Performance, and Management Turnover}, 54 Bus. Law. 885, 918-19 (1999).
\item \textsuperscript{112} See Richard C. Breton, \textit{Restoring Trust}, \textit{Report to the Hon. Jed S. Raskoff On Corporate Governance For The Future of MCI}, Inc. 79 (2003), available at http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf; Gregory, supra note 44, at 27-28; Lorsch & Maciver, supra note 49, at 176-77 (suggesting that directors be remunerated with stock options that vest "the fifth to ninth year out") (footnote omitted); Monks & Minow, supra note 14, at 216 (suggesting "the use of awards of restricted stock vesting 12 to 36 months after the director retires from the board" because directors could "attempt to engineer a short-term increase in the stock price at the sacrifice of long-term viability for the company . . . ."); Elson, supra note 43, at 131,134. Elson argues that in order to make outside directors "substantial shareholders" and create an incentive for them to "examine questionable management initiatives with the vigorous, independent, and challenging eye of an owner," outside directors should be compensated with company stock that they cannot sell during the term of their office.
\item \textsuperscript{114} See Jay A. Conger et al., \textit{Corporate Boards: Strategies for Adding Value at the Top} 39-43 (2001); Gregory, supra note 44, at 9-10; cf. Breton, supra note 112, at 40-41 (suggesting a skill set that each director should possess).
\end{itemize}
should be required to make a positive determination that the candidate possesses the necessary competence. To ensure that a director dedicates sufficient time to his responsibilities, there should be a maximum number of boards on which the director may sit, which would vary depending on whether a director also has a full time job or other commitments. Serving on a special committee should count as an additional commitment.

B. The Independent Director Staff

1. The Central Role of the Independent Director Staff

I believe that the autonomous action of Independent Directors would greatly benefit from the support of a staff of their own. The staff (to which I will refer as the Independent Director Staff or IDS) should be composed of a group of professionals working under the exclusive control of the Independent Directors and not subject to the authority of the CEO. This idea is not new; however, not only has it long been forgotten within the context of traditional corporations, but more importantly it has never been developed to its full potential. By applying Organizational Design concepts, I will propose an IDS that would enhance the structural autonomy of Independent Directors and mitigate the shortcomings related to their competence, their motivation, and the time that they dedicate to their duties.

Among the benefits that establishment of the IDS would bring about, the most important would be the flow of information generated between the

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115. Directors, once elected, should also be required to participate in education and training programs. These programs allow directors to acquire specific knowledge about the industry in which the company is active and to become familiar with the corporation as well as with their own role and legal obligations. See BRENTON, supra note 112, at 36; GREGORY, supra note 44, at 13-14.

116. According to the 2003 Corporate Board Member study, the mean of hours spent on board matters, including meeting attendance, preparation time and travel is 19.2 per month. CORP. BOARD MEMBER, supra note 56, at 3; see also BRENTON, supra note 112, at 63-64; CONGER ET AL., supra note 114, at 45-46; GREGORY, supra note 44, at 28; LORSCH & MACIVER, supra note 49, at 192 (suggesting instead that "directors stipulate... that they will have adequate time to serve"); E. Norman Veasey, An Economic Rationale for Judicial Decisionmaking in Corporate Law, 53 BUS. LAW. 681, 699 (1998) ("The directors should limit to a reasonable number the major boards on which they serve. What is a reasonable number depends on the extent to which each director is able to carry out his responsibilities to each board in a professional manner.") (citation omitted).

117. The idea was first advanced by Arthur J. Goldberg, Debate on Outside Directors, N.Y. TIMES, Oct. 29, 1972, at F1. It was then taken up by Professor Harvey Goldschmid and by Ralph Nader and Christopher Stone. See Symposium, The Greening of the Board Room: Reflections on Corporate Responsibility, 10 COLUM. J.L. & SOC. PROBS. 15, 27-28 (1973) (statement of Harvey Goldschmid); RALPH NADER ET AL., TAMING THE GIANT CORPORATION 121 (1976); CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 148-49 (1975). Recently, the S.E.C., as a condition for benefiting from certain exemptions, has required mutual funds to authorize their Independent Directors to hire their own staff. See supra note 30 and accompanying text.

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different organizational units of the corporation and the Independent Directors. Each company should establish an IDS along an independent hierarchical line separate from the company’s management and other employees. The IDS would be under the exclusive control of the Independent Directors but would work in collaboration with the rest of the corporation. This would allow Independent Directors to create and have access to channels of communication throughout the corporation at different organizational levels. To this end, the IDS should be able to access any unit within the different divisions of the corporation to obtain whatever information the Independent Directors may need. While it should be the general obligation of all units to provide the IDS with the necessary support, the IDS should not have the authority to enforce such obligations or compel others to comply with its demands for collaboration.119 At the same time, the IDS should notify the CEO of any such request, and the CEO should not have to worry about Independent Directors acting behind his back. Maintaining trust between the CEO and the directors is an essential ingredient of a successful corporate board.

For these informational routes to work, it is necessary to elaborate a structural design that not only ensures the cooperation of the various units, but does so without interfering with the CEO’s authority over his subordinates. For this purpose, I draw on Organizational Design studies on linkages between separate, but interdependent, organizational units.120 To facilitate the exchange of information, organizations can utilize lateral linkage devices such as liaison positions, indirect hierarchical solutions, task forces, standing committees, integrating managers, and matrix structures. These organizational tools can be utilized to elaborate a solution applicable to the IDS.

In light of the suggested structural position of the IDS, I suggest the use of a set of integrating mechanisms consisting of liaison roles, a hierarchical solution, and in limited cases, task forces.121 Within the hierarchical structure of

119. Justice Goldberg, supra note 117, suggested in his original formulation of the idea that the staff be “assured of full and complete cooperation from management and from lower-level employees in filling requests for information.” An unlimited right to collaboration, however, is not advisable. In practice, it would result in altering the hierarchical line existing within the corporation by subjecting all units to the direct control of the IDS and the indirect control of the Independent Directors, even if only for purposes of information gathering. Such a solution would probably undermine the CEO’s de facto control over management.

120. Organizational Design has analyzed the problem of ensuring collaboration between units that need to exchange information to perform their work, but are not in a direct hierarchical relationship which gives any of them the authority to compel the other to collaborate. See, e.g., Jay R. Galbraith, Organization Design: An Information Processing View, in ORGANIZATIONS BY DESIGN: THEORY AND PRACTICE 496 (Mariann Jelinek et. al eds., 1981); HENRY MINTZBERG, THE STRUCTURING OF ORGANIZATIONS 162-63 (1979); NADLER ET AL., supra note 118, at 96.

a corporation, the IDS would be vertically linked to the Independent Directors. All of the other units would be located within a structure, with the CEO at the top. The Independent Directors and the CEO both serve on the board of directors, which has ultimate control over the entire corporate structure. It is not advisable that the board directly interfere with the hierarchical lines that link the CEO with the rest of the corporation. The IDS on one side, and any of the other organizational units on the other, should be located on different hierarchical lines, which, while they might eventually converge at the top, are mutually independent at lower levels.

The primary means of enhancing the flow of information is establishing liaison positions within the IDS and in each of the other organizational units. As a general matter, the individuals working in such roles organize and facilitate collaboration between units, including the exchange of information, without having the authority to impose their decisions on their counterparts. The establishment of such a formal position carries with it a number of benefits. First, the direct linkage between the source of information and the recipient improves the timeliness of the information and decreases the likelihood of its distortion. Avoiding going up and down the hierarchical line facilitates communication. This linkage device is inexpensive because it requires only the part-time attention of a few persons without any need of an additional organizational structure. When the liaison role is assigned to individuals with a lower status in the organization, those individuals find themselves in a better position to absorb frictions and maintain good working relations between the higher-level members of the different hierarchical lines. Finally, the establishment of open channels of communication between the liaison individuals facilitates the development of personal relationships, which in turn increases frankness and openness in communication.

The establishment of liaison positions alone, however, will not always guarantee the necessary flow of information. Two principal factors might contribute to a failure to collaborate. A liaison individual, or his unit, may be incapable of providing adequate assistance. Alternatively, management may

122. See NADLER, supra note 118, at 96 ("[Liaison roles] serve as sources of information and expertise and as contacts and advisers on work involving their respective groups. In essence, they serve as information conduits deep within the organization. . . . The Liaison role is not usually a full-time responsibility but rather is done in conjunction with other activities.") (illustration omitted); see also MINTZBERG, supra note 120, at 162-63.


124. DANIEL ROBEY, DESIGNING ORGANIZATIONS 244 (2d ed. 1986); see also Galbraith, supra note 120, at 501 ("Liaison men are typical examples of specialized roles designed to facilitate communication between two independent departments and to bypass the long lines of communication involved in upward referral. Liaison roles arise at lower and middle levels of management.").

125. NADLER ET AL., supra note 118, at 102.

126. ROBEY, supra note 124, at 244.

discourage him or his unit from providing full support to the IDS. The failure to collaborate may come about in two different forms. First, the information transmitted upon request for collaboration may be incomplete or incorrect. Second, the unit might squarely withhold information unknown to the IDS.

To remedy these failures, corporations should supplement the liaison roles with a procedure that relies on the hierarchical links of the different units. A common solution to integration problems is to report them up along the hierarchical chain until they reach the organizational unit that can resolve the conflict. If the unit's failure to collaborate is due to lack of professional skills, the problem would probably be solved with the input of the manager in charge of the unit division, avoiding any need to go further up the line. The real problem arises when a unit withholds information for "political" reasons. In this case, reporting the problem to the top management, which was probably the cause of the failure to collaborate in the first place, would probably not be the proper solution. Instead, the conflict should be referred to the top of the corporate hierarchical structure and should therefore be presented to the board of directors.

Bringing the issue before the board creates a risk of undermining the authority of the CEO and management in general. I believe, nonetheless, that in practice this procedure would be effective and would intrude upon the CEO's power relationships to an acceptable extent. Both the Independent Directors and management would work hard to solve the conflict in order to prevent it from reaching the board. Both parties would naturally be aware of the damaging effect that such a confrontation could have upon the working relations within the board. In addition, the failure to solve the problem would probably reflect negatively on the professional skills of the individuals handling the conflict on both sides at a lower level, who would therefore have an additional incentive to solve it. The CEO, moreover, might have good reason to withhold full collaboration and thus might be able to convince the directors to accept his decision, possibly even before the matter reaches the board. Ordinarily, this procedure would preserve the effectiveness of the corporation's hierarchical structure. The only individual with the authority to give lower management and other employees a direct order to collaborate would remain the CEO. Neither the Independent Directors—directly or through the IDS—nor the board, would have such power.

It is still possible that the board would compel the CEO to order his subordinates to cooperate fully. That, however, would happen only if the CEO were not able to convince the board of the wisdom of his point of view, and both parties were not willing to back down from their positions, even at the risk

128. See NADLER ET AL., supra note 118, at 95-96; Galbraith, supra note 121, at 110.
of disrupting working relations and undermining the authority of the CEO. This would happen only in extreme cases, in which a drastic intervention on the part of the board would not only be acceptable, but also advisable.

The above procedure would not work where Independent Directors and the IDS were not aware of the existence of relevant information. However, they would have the ability to create channels of communication that could directly reach any of the corporate divisions at different hierarchical levels and could thus gain access to all of the necessary information. Although the top management could firmly control those channels, its ability to successfully keep information concealed from the Independent Directors would be dramatically diminished because of the numerous informational routes and because of the personnel working within them.

In exceptional cases, such as corporate reorganizations or acquisitions, as well as during financial and operational crises, a member of the IDS could join the task force set up by management to work on the matter, and allow Independent Directors to have direct access to pertinent information. Through the IDS, the Independent Directors would obtain first-hand information in a timely manner, and be in the position to properly evaluate the appropriate actions under the circumstances.

2. The Multiple Benefits of the Independent Director Staff

The suggested establishment of the IDS would provide the Independent Directors with the informational strength necessary for autonomous action. The IDS could also aid the Independent Directors in many other respects. The IDS could serve as an institutionalized memory of the governance issues specific to each corporation. Both the specific personnel and the office as an organizational unit could be an important means of preservation and transmission of previous experience to new Independent Directors. Veteran members of the IDS would assist new directors in elaborating proposals for those governance arrangements that, as we will discuss in Part V.E, should be within the control of the Independent Directors.

The IDS would be able to elaborate on the information that the Independent Directors receive directly from management. The IDS would also make sure that the information was presented in workable form and received in a timely manner before board meetings. It could also request follow-ups and clarifications and allow directors to communicate and exchange information among themselves well in advance of meetings. The IDS, moreover, would assist Independent Directors in performing any additional tasks that are part of their duties, and facilitate control over the implementation of board

129. On the role of task-forces as a lateral linking device, see MINTZBERG, supra note 120, at 163-64; Galbraith, supra note 120, at 501-02.
decisions. The IDS would also limit the directors' deficiencies related to personal attributes. The Independent Directors would greatly benefit from the competence and experience of the professionals on their staff. The IDS would also relieve the directors of part of their workload, easing the problems created by lack of time availability. Finally, the establishment of the IDS would indirectly cause directors to be more active and involved in the corporation's affairs. The IDS, in fact, would require input and direction from the Independent Directors; this would create a constantly open channel of communication between the directors and the corporation, leading directors to be more heavily engaged in their institutional roles.

Creating the IDS would have one additional important effect on the work of the Independent Directors: the formation of an evidentiary trace having important repercussions on the courts' application of fiduciary standards. What is now a job performed exclusively by one individual, albeit within the context of the entire board or one of its committees, would be performed with the assistance of a team of people. Consequently, evaluative and decisional processes that are now confined within the sometimes inscrutable mind of the director would be "externalized" and developed along the lines of interaction between the directors and the professionals supporting their work. In many instances, the ability to observe the processes behind directorial action, or failure to act, would make it possible to express a much more informed judgment on its appropriateness. Without reaching the substance of the decisions, the duty of care could expand to include additional specific obligations in regard to the mechanics of such processes. The duty of good faith could also be at issue in situations where the directors unreasonably disregard information from the IDS.

C. The Latest Structural and Procedural Solutions

Some additional structural and procedural solutions seem necessary to provide Independent Directors with sufficient powers and opportunities to act. As commentators have discussed these solutions at length, I will only give them cursory attention. First, as currently required by NASDAQ and NYSE listing rules, boards should be composed of a majority of Independent Directors. Such an arrangement gives the latter the necessary decision-

130. See STONE, supra note 117, at 148-49.
131. The IDS could also include a corporate governance expert, who would give the directors support in dealing with the various issues related to their role and obligations.
133. See NASDAQ Marketplace Rule 4350(c); N.Y.S.E. Listed Co. Manual § 303A.01. On the
making power. Furthermore, Independent Directors should regularly hold separate meetings apart from management and inside directors. These meetings should be regularly scheduled so that they will not be perceived as unusual or threatening.

Independent Directors should also exercise greater control over board meetings. They should participate in developing the schedule and the agenda for the meetings, as well as have some control over the information provided in support thereto. I do not believe that any particular structure, such as the designation of a leading Independent Director or the appointment of an Independent Director as chairman, should be preferred. Rather, companies should be free to find the solution that best fits their needs. Independent Directors should also have the ability to hire outside experts and have access to independent counsel.

Finally, in order to prevent informal constraints on Independent Directors’ actions, decisions regarding their nomination and compensation must be strictly reserved to a committee composed exclusively of other Independent Directors. The CEO or any other member of the management should not have any control or influence over such decisions.

D. Independent Director Confirmation

Lack of motivation and active involvement remains one of the open issues in the work of Independent Directors. Equity ownership, the solution traditionally advanced in this respect, does not constitute the definitive answer to this problem. In this section, I elaborate a procedural device consisting of a confirmation process of newly elected directors, which I believe has the potential to provide an effective tool for identifying motivated and active

benefits of having a majority of independent directors on the board, see Chhaochharia & Grinstein, supra note 38, at 9; Developments in the Law—Corporations and Society, supra note 47, at 2195.  

134. See Brenton, supra note 112, at 35; Gregory, supra note 44, at 33-34; Veasey, supra note 116, at 699. According to the 2003 Corporate Board Member study, 50% of the companies that participated in the study held meetings quarterly and 7.8% never held meetings at all. Corp. Board Member, supra note 56, at 2.

135. Gregory, supra note 44, at 41-42.

136. See, e.g., id. at 15-16 (noting codes of best practices leave the adoption of such solutions to the discretion of each corporation). See also Bowen, supra note 61, at 87; Brenton, supra note 112, at 49-51.

137. I believe that a minimum number of meetings per year should be mandated regardless of director Independence. Frequent meetings seem to be necessary for any director to be effective. See Lipton & Lorsch, supra note 39, at 69-70.

138. See Gregory, supra note 44, at 57-58; see also Cox, supra note 32, at 1090 (maintaining that, whenever an Independent Director has to decide a conflict of interest situation involving management or the controlling shareholders, those advising the directors should also obey independence standards); Greg Rogers, How the Outside Can Help the Inside, 13 Bus. L. Today 51 (2004); cf. 17 C.F.R. § 240.10A(b)(4) (providing public companies audit committees with the authority to hire “independent counsel and other advisers” as they deem necessary to discharge their responsibilities).

139. See Stout, supra note 62, at 3-5.
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directors.
The philosophical conception of autonomy adopted by this Article considers "autonomous" individuals who not only have the capacity and the opportunity to exercise such capacity, but who also actually exercise it. Thus, the most effective test to assess whether an individual should be considered autonomous is to see whether he acts in such a manner. With regard to a corporate director, such a determination should be made on the basis of the person's actual conduct on the board. In practice, corporations could achieve this result by adopting a procedure requiring each director elected as Independent to undergo an evaluation process at the end of his first or second year in office. At such time, the current Independent Directors would determine whether the new director has proven himself to be sufficiently active and independent. The evaluation should be strictly limited to the autonomous quality of the director's work; the substance of his decisions should not be at issue. Only upon a positive finding could he be confirmed as an Independent Director.

At first sight, this procedure closely resembles current evaluations of directors in their individual capacity. Thus far, such processes have largely failed to keep ineffective directors off the board. Upon closer examination, however, it becomes clear that the suggested procedure is immune to the many shortcomings of current evaluations. Furthermore, it has the potential to become an effective procedural tool for improving the performance of Independent Directors while creating a positive dynamic within the board.

Many different factors prevent current director evaluations from being a widespread and successful means of preventing the reelection of ineffective directors. First, generally all of the directors are evaluated at the end of each year, or near the end of their term. The frequency and the generality of the evaluations increase the likelihood that directors will wrongly perceive evaluation as a routine procedure or formality bearing little importance.

140. See supra notes 91-92 and accompanying text.
141. In this context, by independent I mean that the director's decisions are made on the basis of an evaluation process that is not entirely dependent upon the input and information received from the CEO.
143. Statistics indicate that only 24% of U.S. boards have ever asked a director to resign for poor performance. See KORN/FERRY INTERNATIONAL, ANNUAL BOARD OF DIRECTORS STUDY 23 (2001); Jeffrey A. Sonnenfeld, What Makes Great Boards Great, 108 HARV. BUS. REV. 106, 113 (2002) ("I can't think of a single work group whose performance gets assessed less rigorously than corporate boards.").
144. Only 19% of boards in the U.S. are evaluated individually. See KORN/FERRY INTERNATIONAL, supra note 143, at 23.
145. See CARTER B. COLIN & JAY W. LORSCH, BACK TO THE DRAWING BOARD 127 (2003) (discussing how the excessive frequency of the evaluations reduces their effectiveness).
Next, the process generally aims at assessing whether each of the board members is effective as a director overall, and whether his presence is beneficial to the work of the board. This evaluation generally relies upon the personal perceptions of the other directors. The broad scope and the subjective basis of this process make it more difficult to reach a conclusion that a director is clearly ineffective and should not be reconfirmed to the board.

Third, the fact that all of the directors evaluate each other creates a dynamic that does not foster open and truthful assessment. Each director must judge the work of his peers, with whom he has often been serving on the board for several years. Directors, furthermore, may be disinclined to give frank and open evaluations to avoid preventing the development of trust and collaboration among directors and thereby damaging the board's working environment. Studies of groupthink show in fact that these evaluations have a negative impact on intra-group relations. More importantly, I believe that few people would give a negative evaluation, which could lead to the non-reelection of a director, knowing they could be the next to suffer the same fate the following year.

A final shortcoming is that the only meaningful sanction that can follow a negative evaluation is that the director concerned will not be selected to be a candidate for reelection. The harshness of this sanction makes it unlikely in practice that the other directors will be willing to espouse it. As a result, negative evaluations will likely only lead to a warning, which, although it might create some incentive to do better the following year, would nonetheless ultimately have little effect on removing inadequate or incompetent directors.

The proposed confirmation procedure not only appears generally immune from the problems described, but also has the potential to create a productive dynamic within the boardroom. First, only individuals recently elected to serve as Independent Directors would be subject to evaluation during their first or second year in office. The suggested process would take place less

147. Cf. CONGER ET AL., supra note 114, at 111-12 (for the proposition that universal evaluation criteria fail to recognize the value of the different manners in which a director may contribute to the work of the board).
148. See id. at 124 (“Every time we work with a board, we are told it is difficult to remove a director who is not pulling his weight. No one wants to be critical of a longtime colleague... [D]irectors do not like to sit in judgment of their peers...”).
149. See NAT'L ASS'N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM 18 (2001). On the damaging effect of peer evaluations to director cohesion within the board, see CONGER ET AL., supra note 114, at 111-2; WILLIAM A. DIMMA, EXCELLENCE IN THE BOARDROOM 55 (2002). See also Langevoort, supra note 7, at 810-11 (discussing the importance of collegiality in creating a better environment for productive work with respect to board of directors).
150. See O'Connor, supra note 59, at 1301-03 (“Literature on small group decision making, however, warns against such self-evaluations because it can undo the peering of the group.
151. A negative evaluation after the first year should not be determinative. If a director is not
frequently, and the directors would have to focus on the performance of only one or a few individuals. It would thus be likely that the directors would be more engaged in the confirmation process.

Second, the evaluation would be very specific: it would address only whether a director has proven to be active and independent. These are the attributes that, together with the others discussed throughout this Article, are necessary to make a director autonomous and therefore trustworthy. The existing Independent Directors would have the opportunity to assess what use the new director makes of all of his prerogatives. Confirmed directors could in fact observe the new director’s attendance and behavior within the board, on special committees, and during Independent Directors’ separate meetings. In particular, they could look at whether he carefully scrutinizes the proposals advanced by the CEO, and whether he requests or, when appropriate, proposes alternatives. The Independent Directors could also monitor the new director’s use of the power to seek information within the corporation, to access outside consultants and independent counsel, and to make requests regarding the schedule and agenda of board meetings. Finally, they could evaluate what use he makes of the IDS and how he interacts with it. All of these are reasonably verifiable elements that could form the basis of a sufficiently objective evaluation.

Next, this procedure would not impair the collaborative atmosphere within the board. Only the directors recently elected to serve as Independent would be subject to the confirmation process; it would not be a peer evaluation because the new director would have a status different from that of the other directors. Upon confirmation, a new member of the board would become a full-fledged Independent Director. If not confirmed as Independent but still reelected, he would probably not harbor any resentment because he would ultimately still be on the board.

Finally, a negative evaluation of the new director’s activeness and independence would not necessarily result in his failure to be selected for reelection. He could simply be denied the qualification as Independent. A director who is not truly an insider, but who is not qualified to be Independent either, could still be very helpful to the work of the board.152 The other directors could decide that an individual not confirmed as Independent should nonetheless continue serving on the board because, for example, of his ability to perform the strategic or relational role. The possibility to administer a less extreme sanction following a negative evaluation will make it more likely that the current Independent Directors would make proper use of the confirmation

confirmed after his first year, he should have a second opportunity, which would give him time to become more knowledgeable about the corporation and modify his conduct as necessary.

152. See supra note 103.
procedure.

I believe that this solution could be very effective in practice. The existing Independent Directors would have a strong interest in confirming as their peers only individuals that are active and independent. They would indeed benefit from the new director's active participation in managing the increasing Independent Director workload and in monitoring the CEO. Furthermore, the confirmation process would remind both old and new Independent Directors of their duty to be active and independent. In addition, the Independent Directors would feel partly responsible for ensuring that the new colleague adequately performs his directorial role. On the other hand, the possibility of an evaluation that may potentially lead to a meaningful sanction would provide the new director with a serious incentive to be proactive.

Although the procedure would subject the directors to scrutiny only during their first or second year, I believe that it would be effective beyond such a period of time. An individual, once proven to be an active and independent member of the board, will presumably continue working in the same manner throughout his permanence on the board. If a director substantially altered his behavior after having been confirmed, he would run a serious risk of not being selected as a candidate for reelection or of being reelected as a non-Independent Director. The new director's work, moreover, would have a lasting beneficial effect on the work of the Independent Directors in two respects. First, the director would contribute to setting the proper tone on the board with respect to activeness and independence. Second, to be confirmed, he would make proper use of the powers and opportunities for action provided to him. By doing so, the director would draw the other Independent Directors' attention to the procedural and structural tools available to be active and independent and make it more likely that they would take advantage of them. In turn, more widespread director activeness and independence would make it more common and therefore easier for directors to question, and disagree with, the CEO.

One may contend that this procedure would be completely ineffective where many or all of the Independent Directors already in office were, or over time became, passive and subordinated to the CEO and had no interest in properly evaluating any new board member. The very purpose of the suggested process, however, is to prevent a board from evolving in such a direction; this is indeed the kind of situation that would be less likely to occur after implementation of the confirmation process. Where the initial set of Independent Directors properly discharged their duties, the confirmation procedure would make it more likely that subsequent directors would be active and independent as well.

154. On the importance of legitimizing dissent within the boardroom, see COLIN & LORSCH, supra note 145, at 174.
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I recognize that the new procedure would give the current Independent Directors the power to pressure the new director in relation to substantive issues under the examination of the board. I think, however, that in practice this would rarely be the case. Under ordinary circumstances, the procedure would provide new directors with an incentive to be active and independent, as well as serve as a road map for their work. A director lacking such qualities would either be denied qualification as Independent or would not be reelected to the board. It could happen, however, that on a matter unrelated to the confirmation, a serious conflict would arise between the new director and the existing Independent Directors, and the latter would try to put pressure on the former. In such a case, the new director could easily keep a record of his activity on the board and access the court system to redress any improper use of the confirmation procedure.155

To summarize, the suggested approach provides for an up-front evaluation of a candidate director’s qualifications and independence.156 Upon a positive finding, a director could then be elected to the board, but subject to confirmation as Independent by the Independent Directors already in office.157 I believe that, pending confirmation, the director should serve as Independent and be considered as such for the purpose of reaching a majority of Independent Directors on the board. The director, however, should not participate as Independent in approval of specific acts or transactions when such qualification triggers special legal effects, as in the case of derivative litigation.

E. Control Over the Institutional Environment

One final requirement necessary to realizing the conditions for autonomous action concerns the power to determine the specific governance arrangements of each particular company. As a general matter, corporations should have as much flexibility as possible in devising their organizational features; each corporation should be able to adapt governance structures to its specific needs. By doing so, companies would also play an active and creative role in

155. A breach of the duty of good faith on the part of the Independent Directors could be alleged where they denied confirmation to an active and independent new director. A finding that the director actively engaged in his directorial role by making use of his prerogatives and by reaching his decision upon accessing sources of information not limited to management would be sufficient for reversal of the confirmation decision, regardless of the substance of the directors’ actions.

156. See supra Part V.A.

157. I recognize that there may be special circumstances where the entire board would have to be replaced and it would not be possible to complete the confirmation process before declaring the new directors Independent. This, however, would be an extraordinary occurrence that should not impinge on the validity of the procedure under ordinary circumstances. Moreover, alternative solutions could be elaborated for these types of situations such as electing, as confirmed Independent Directors, individuals already confirmed as Independent on the board of one or more other corporations.
developing effective solutions to common governance issues.

The exercise of such discretion, however, should be under the control of the Independent Directors when it comes to the specific arrangements concerning their action within the corporation. Otherwise, the management or the inside directors could undermine the work of the Independent Directors by limiting their access to necessary powers and resources. Within the framework suggested, Independent Directors should control the specific arrangements regarding, for example, separate meetings, budget, and IDS organization. As long as Independent Directors compose a majority of the board of directors, the board itself will remain the appropriate body to decide these matters. Within that context, the directors and the CEO will be able to confront problems and to develop the solutions that best fit the particular needs of the corporation. Nonetheless, the board’s voting procedures should ensure that the CEO does not obtain control over the Independent Directors by co-opting one or more of them.

VI. A NEW JUDICIAL DEFINITION OF INDEPENDENCE

Having identified and elaborated upon the elements that should be incorporated into the definition of Independent Director, it remains to discuss the role played by courts in this regard. In every situation in which they assign specific legal effects to the status of Independent Director, courts should follow the approach suggested in this Article. Before giving special deference to the actions of certain directors, courts should evaluate whether they satisfy all of the conditions that justify such deference. Directors should therefore not be qualified as Independent unless they meet all of the requirements related to autonomy with respect to the specific action at issue in each case.

The validity of this approach is not undermined by the recent refusal of the Supreme Court of Delaware to consider good corporate governance practices when evaluating director liability. The court held that the failure to maintain certain practices such as separate Independent Director meetings cannot lead to a court’s determination of liability, as such practices are not mandatory under state law. I suggest a different approach. Courts would not assess director

158. Cf 17 C.F.R. § 240.10A-3(b)(5) (2004) (requiring public companies to provide audit committees with appropriate funding, as determined by the same audit committees).
159. A possible solution would be to provide that the approval of board deliberations regarding arrangements concerning Independent Directors require not only a majority of votes, but also the vote of the majority of the Independent Directors.
160. See Lin, supra note 39, at 963. Lin suggests that courts should not treat all outside directors as equally effective, but “to the extent that the concept of director ‘independence’ is the law’s shorthand way of determining whether outside directors are capable of acting as effective monitors of management, the courts should consider the factors... that may bear on directors’ incentive and abilities.”
161. See Brehm v. Eisner, 746 A.2d 244, 256 & n.29 (Del. 2000).
162. See id.; cf. Veasey, supra note 116, at 699-700 (suggesting seven aspirational norms, but
liability based on whether a company implements certain governance practices. Instead, the requirements of the improved definition of Independence would constitute factual elements that affect the determination of whether a director is Independent under case law. Such a change in perspective could take place without amending state statutory law.

In deciding on director Independence, courts should not only determine whether a director is independent, but also whether he possesses all of the other characteristics necessary for autonomous action. For example, courts should look at whether the director has the necessary competence, whether the method for his selection and compensation ensures that he has the necessary motivation, and whether the company’s governance structure provides him with the necessary resources and opportunities for action. These factual elements should be considered equal to elements that courts already consider, such as whether a director has economic or family ties with the company or the CEO. Accordingly, courts should deny the status of Independent to directors who do not meet all of the relevant requirements in any situation where such status carries with it special legal effects, such as in derivative litigation.

Courts are obviously not in the position to require corporations to implement immediately the suggested structural and procedural solutions as a condition for recognizing directors as Independent. A more comprehensive definition of Independent Director, however, would give courts greater leverage in promoting the realization of the conditions of autonomous action within corporate boards.

CONCLUSION

The corporate governance system has long relied on Independent Directors as monitors of the company’s management on the assumption that, being free from compromising ties, they effectively protect the interest of the corporation and its shareholders. Notwithstanding the crucial role assigned to Independent Directors, the complexity of their function and the multiplicity of the issues arising from this role have not been fully recognized. As a result, two problems have long been left without an adequate solution: how to identify those individuals who will indeed act as effective monitors of management, and how to provide them with the resources necessary to adequately perform their job.

The concept of autonomy provides a useful conceptual tool to sort out such complexity and address issues related to Independent Directors—both existing issues and issues that will inevitably arise as Independent Directors become increasingly important. In particular, the suggested approach would support the adoption of a more comprehensive judicial evaluation of the status of recognizing that “[t]hey do not necessarily drive liability considerations . . .”.

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Independent Director. At the same time, the specific structural and procedural solutions formulated in this Article have the potential to provide an effective answer to the problems that appear most compelling: the lack of active involvement and lack of information and resources.
Bankruptcy Law and Inefficient Entitlements

Dr. Irit Haviv-Segal†

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† Senior Lecturer, Tel-Aviv University, Faculty of Law. LLB, Hebrew University, 1984; LLM, Yale Law School, 1987; JSD, Yale Law School, 1989.
Bankruptcy Law and Inefficient Entitlements

Dr. Irit Haviv-Segal

ABSTRACT

The justification for bankruptcy law remains an open question. The literature tends to emphasize the conflict and the inability to compromise between the different normative outlooks of the insolvency law system. A deeper reflection on the existing theories of bankruptcy law reveals, however, that all theories agree that the enforcement of contractual bankruptcy arrangements maximizes aggregate efficiency. Social theories calling for increased levels of coercion and redistribution do not dispute the efficiency of enforcing prior entitlements, but rather, place an overriding premium on normative considerations of distributive justice and rehabilitation values. This Article presents a new theory of bankruptcy law that challenges this shared starting point. To be sure, the Article supports the economic analysis’ focus on efficiency considerations—it calls for bankruptcy law rules that would maximize the aggregate value of the debtor’s assets to his or her creditors and equity holders. Yet the analysis shows that under particular circumstances, efficiency-based considerations can support the coercive avoidance of existing entitlements, a result ordinarily advocated by the social theories. Accordingly, I will argue that the role of bankruptcy law is to provide the procedural and substantive framework for severing the debtor’s economic resources from his or her inefficient liabilities. The analysis proceeds to show how the new theoretical framework explains many of the positive legal arrangements of bankruptcy law. First, it explains why courts prefer reorganization plans over liquidation proceedings. Second, it explains why the law affords special priority to post-petition creditors. Finally, it explains the arrangements regarding executory contracts.

INTRODUCTION

The justification for bankruptcy law remains an open question. The literature tends to emphasize the conflict and the inability to compromise between the different normative outlooks of the insolvency law system. 1 In

particular, the literature emphasizes the conflict between the economic perspectives that focus on the efforts to maximize the value paid to creditors in the event of insolvency, and the social perspectives that emphasize the social and rehabilitative values of the law. Naturally, the specific laws that derive from each of these perspectives differ greatly, and it appears that the compound that developed in the positive law over the years is a quasi-amalgam, lacking any clear preference towards any of the different approaches.

Contemporary theories of bankruptcy law conflict on two main issues: first, the appropriate level of justified coercion that should be involved in the bankruptcy proceedings; and second, the appropriate level of justified intervention with prior entitlements. While contemporary economic analysis of bankruptcy law calls for contractual bankruptcy arrangements, the social theories support a more interventionist approach to protect the "weak" parties against the losses of insolvency. Thus, while economic analysis challenges bankruptcy courts' coercive interference with contractual arrangements made prior to insolvency, social theories support such court-enforced redistribution schemes.

A deeper reflection on the existing theories of bankruptcy law reveals, however, that all theories agree that efficiency considerations justify the enforcement of contractual bankruptcy arrangements. All theories presume that the protection of entitlements that were formed ex ante would maximize aggregate efficiency. The enforcement of prior entitlements secures the efficient planning of credit transactions by solvent corporations. Social theories


2. See Alan Schwartz, A Contract Theory Approach to Business Bankruptcy, 107 YALE L.J. 1807, 1851 (1998) (hereinafter, Schwartz, Contract Theory) ("This Essay's central claim is captured in a variation on a trendy slogan: Privatize bankruptcy."); Alan Schwartz, Bankruptcy Contracting Reviewed, 109 YALE L.J. 343, 343 (1999) ("If the rule against contracting for a preferred bankruptcy system were relaxed, parties would write bankruptcy contracts that would induce a borrowing firm to choose the system that would be optimal for it and its creditors were it to become insolvent."); see also Barry Adler et al., Regulating Consumer Bankruptcy: A Theoretical Inquiry, 29 J. LEGAL STUD. 585 (2000); Robert K. Rasmussen, Resolving Transnational Insolvencies through Private Ordering, 98 MICH. L. REV. 2252 (2002); Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 STAN. L. REV. 751 (2002).

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calling for increased levels of coercion and redistribution do not dispute the efficiency of enforcing prior entitlements, but rather, place an overriding premium on normative considerations of distributive justice and rehabilitation values.4

This Article presents a new theory of bankruptcy law that challenges this shared understanding. To be sure, the Article supports the economic analysis' focus on efficiency considerations—it calls for bankruptcy law rules that would maximize the aggregate value of the debtor's assets to his or her creditors and equity holders. Yet the analysis shows that under particular circumstances, efficiency-based considerations can support the coercive avoidance of existing entitlements, a result ordinarily advocated by the social theories. Under these particular circumstances, the existing entitlements drive the business into an inefficient use of its economic resources, which in turn leads to financial distress. It would seem that rational parties should then renegotiate their contracts, and restructure the company's liabilities. However, I will point out several factors that may obstruct the renegotiation process and preclude the possibility of contractual settlement. When these factors are present, the coercive interference of the bankruptcy proceedings may become essential for shifting the company resources back to efficient business activity.

This argument will provide the framework for defining both the circumstances that should trigger the commencement of bankruptcy proceedings, and the role of bankruptcy law itself. In particular, the law must regulate the commencement of bankruptcy proceedings when the following three conditions are satisfied: first, the debtor's existing entitlements produce an inefficient use of economic resources; second, the debtor has failed in his or her attempt to restructure the existing liabilities; and third, the inefficient entitlements have lead the debtor into financial distress. If these three conditions are met, then in the absence of any legal intervention, the company would encounter a perpetually inefficient use of its economic resources, and the costs of this inefficiency would compound over time. Accordingly, I will argue that the role of bankruptcy law is to provide the procedural and substantive framework for severing the debtor's economic resources from his or her inefficient liabilities. Thus, bankruptcy proceedings inherently involve some level of coercion and redistribution.

Finally, I will show that the new theory can explain many of the positive legal arrangements of bankruptcy law. First, it explains why courts prefer reorganization plans over liquidation proceedings. Second, it explains the special priority that the law affords to post-petition investors. Finally, it provides the normative framework for the legal arrangement of executory contracts.

Part I of the Article presents the main conflicting views concerning the role and content of bankruptcy law. Part II presents the efficiency-based justification for coercive avoidance of existing entitlements. Part III explains how bankruptcy law leads to the severance of the debtor’s assets from his or her contemporary liabilities. Finally, Part IV discusses the concrete legal arrangements, and shows how positive arrangements reconcile with the above theory.

I. THE EXISTING LITERATURE

A. Economic Goals vs. Social Goals

The main conflict between the different approaches of bankruptcy law is the familiar one between the economic and social approaches to the law. The economic approach emphasizes the efficiency aims of the law, that is, its aims are directed toward enlarging the “aggregate pie which is to be divided.” Social approaches emphasize the policy considerations relevant in deciding how to distribute “the aggregate pie” among the different parties. In the context of bankruptcy law, the economic approaches emphasize the goal of enlarging the value of the bankrupt estate, while the social perspectives focus on the appropriate distribution rules governing the creditors.

Beginning with the economic approach, it is insightful to distinguish between the earlier and later economic approaches to bankruptcy law. In the seminal 1986 work, The Logic and Limits of Bankruptcy Law, Professor Jackson argued that the source of bankruptcy law is in the “common pool” problem and the prisoner’s dilemma that it causes. In the case of insolvency, a company’s assets are inadequate to cover payment of the company’s debts in their entirety. The law grants the creditors the right to confiscate the assets to satisfy their unpaid claims; however, it is clear at the outset that the mutual reserves of company assets are insufficient to pay back the debts in full. Consequently, collection laws create an arbitrary method where “the early bird catches the worm”—the creditors who reach the end of the collection process before the other creditors will succeed in getting their debts repaid in full, while the rest of them will be left empty-handed. This method creates a “race” of creditors towards the communal fund. This will have the effect of diminishing the amount of assets in the communal reserves and limiting the amount of debts.


that can be paid from the reserves. In other words; in the case of insolvency, the ordinary collection laws create a situation in which every single one of the creditors acts in a fashion that is detrimental to the common, collective interests of the aggregate of creditors. Bankruptcy law attempts to solve this dilemma by pooling all creditors together and subjecting them to collective proceedings.

Later in the book, Professor Jackson delves into an in-depth discussion on the contents of bankruptcy law, while trying to show that the existing set of laws does indeed match the idea of "the communal reserves." Furthermore, the author claims that the aims of bankruptcy law must be limited to that of solving the prisoner's dilemma, which is created as a result of the communal reserves phenomenon. Bankruptcy law's deviation from this goal would produce inefficient outcomes.

Professor Jackson's theory greatly influenced the development of the later literature. In particular, authors that support social insights of bankruptcy law emphasized the limited spectrum that the idea of "the communal reserves" places on this field of law, while stressing that bankruptcy law provides answers for a wide variety of problems, not just the prisoner's dilemma problem. Gradually, even those supporting the economic analysis began to voice criticism towards Professor Jackson's theory. From these authors' point of view, the idea of communal reserves is problematic, since it appears to provide justification for the massive interference of the law in the relationship among the creditors themselves, and between them and the shareholders.

The modern economic approach states that when individuals are given sufficient freedom, they will design their own contractual solutions to a possible insolvency ex ante. For instance, creditors who are interested in securing their payment in case of insolvency will make certain to obtain a security interest in the company's assets. The security interest mechanism is a bargained-for contractual term through which the creditors and the company bring to fruition their own desired solution. Likewise, if the parties fail in their attempts to design this possible solution at the outset, then they may, as a corrective measure, reach a private settlement agreement, which would again be outside the law's interference. When creditors are faced with a company that is undergoing hardships, they have incentives to try to rehabilitate the

9. See JACKSON, supra note 7.
10. See Warren, Bankruptcy Policy, supra note 3, at 790.
11. See Schwartz, Contract Theory, supra note 2, at 1831-34.
12. The most radical manifestation of this approach is found in Baird & Rasmussen, The End of Bankruptcy, supra note 2, at 751-56.
company, and voluntary efforts are preferable to legally-obligated efforts.\textsuperscript{14}

Professor Alan Schwartz calls this solution "Contractual Bankruptcy Law."\textsuperscript{15} If this concept is indeed correct, then the dominant approach in bankruptcy law should be to leave matters to private agreement. The law must respect, to the degree possible, the contracts which the parties have signed in anticipation of a possible insolvency.\textsuperscript{16}

It is worth noting that this approach does not necessarily oppose the alternative of reorganization. However, it does oppose the element of coercion that is involved in every legal solution forced upon the parties by the court. In other words, a redistribution of the claims reached by agreement amongst the creditors is preferable to a redistribution mandated by the legal system.\textsuperscript{17}

*The End of Bankruptcy* presents a contemporary variation of this approach that challenges the justification for reorganization proceedings.\textsuperscript{18} In this article, the authors Baird and Rasmussen claim that in the modern day, these proceedings are rarely used for the original purpose of "reviving failed businesses," and they actually serve the interests of the companies' owners, who wish to sell their businesses for more than they would have received had they sold the assets directly via the free market.\textsuperscript{19} Baird & Rasmussen claim that most reorganization proceedings culminate in a sale of the "going concern" to a third party.\textsuperscript{20} The companies no longer undergo the regular reorganization process, where the going concern remains in the hands of the creditors and the original shareholders. Rather, the assets are sold to a willing buyer, and the original investors are rewarded financially for their holdings in the failed company.\textsuperscript{21} Additionally, in many cases, the bankruptcy court settles for enforcing the parties' pre-determined distribution of risks.\textsuperscript{22} In such cases, these proceedings lose their original character and become traditional proceedings for enforcing contracts. The element of coercion, which depicts the original bankruptcy proceedings, is gradually disappearing, in favor of proceedings in which the court implements the insolvency clauses that the parties agreed upon at the outset of their dealings.\textsuperscript{23}

The authors base the explanation of this phenomenon on the inconsistent character of the market at the beginning of the third millennium.\textsuperscript{24} In the past,

\begin{itemize}
\item \textsuperscript{14} See Schwartz, *Contract Theory*, supra note 2, at 1831.
\item \textsuperscript{15} Id.
\item \textsuperscript{16} Id. at 1842-44.
\item \textsuperscript{17} Id. at 1849-51.
\item \textsuperscript{18} See Baird & Rasmussen, *supra* note 2, at 772-77.
\item \textsuperscript{19} Id. at 777-78.
\item \textsuperscript{20} Id.
\item \textsuperscript{21} Id. at 788.
\item \textsuperscript{22} Id. at 778-79. See also Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 345, 367-75 (1997).
\item \textsuperscript{23} See Baird & Rasmussen, *supra* note 2, at 786-88.
\item \textsuperscript{24} Id. at 755.
\end{itemize}
the value of traditional reorganization proceedings was based on the existence of special sources of value (known as "firm-specific assets") which were owned by the insolvent company, and which could not be transferred to a different entity without creating losses.\footnote{For the notion of firm-specific assets as the basis for incorporation, see Ronald H. Coase, \textit{The Nature of the Firm}, 4 \textit{ECONOMICA} 386 (Nov. 1937).} Given that the company does indeed have special sources of value, reorganization of the company is the preferable solution—in liquidation proceedings, the liquidator must sell the company's assets, and therefore loses its special sources of value.\footnote{This claim was first made by Baird. See Douglas G. Baird, \textit{The Uneasy Case for Corporate Reorganizations}, 15 \textit{J. LEGAL STUD.} 127 (1986).} When selling the company's assets part by part, it is impossible to realize the special sources of value, since these cannot be transferred to any other entity. Similarly, in the case of selling a company's business as a "going concern," the company will have to hand over the entirety of the company's assets to the buyer, who in turn, will not be able to enjoy the company's special sources of value.\footnote{See Baird & Rasmussen, supra note 2, at 756-58.} Only in the case of reorganization can the company continue to exploit its firm-specific sources of value, for the benefit of its creditors and shareholders.\footnote{Coase's theory relies on the existence of transaction costs. As the efficiency of the market improves, these costs lessen. \textit{Id.} at 778-79. Therefore, according to Baird & Rasmussen, as the market becomes more efficient with lower transaction costs, there is no longer an economic justification for reorganization. \textit{Id.}}

The traditional example of reorganization of bankrupt companies with firm-specific assets concerns the American railroad companies, which collapsed at the beginning of the previous century. These companies could not repay their outstanding debts, even though they had valuable assets, such as train cars, railroad tracks, and the like. Had the companies been forced to sell these assets, the value they would have received would have been substantially lower than the value of these assets within the framework of the railroad companies themselves. In this reality, the alternative of reorganization was the one most beneficial for the creditors and the shareholders of those companies. Thus, their creditors supported an "equity receivership," where the railroad companies had effectively been reorganized before the reorganization alternative was even incorporated into the Bankruptcy Code.\footnote{See Douglas Baird & Robert K. Rasmussen, \textit{Control Rights, Priority Rights, and the Conceptual Foundation of Corporate Reorganizations}, 87 \textit{VA. L. REV.} 921 (2001).}

The main claim of \textit{The End of Bankruptcy} is that this economic reality has changed, and today, the economic reality that is analogous to that of the railroad companies exists in only a very small number of companies.\footnote{See Baird & Rasmussen, supra note 2, at 758-60.} In the vast majority of cases, the failed companies do not hold any special sources of value which cannot be realized when sold to a third party.\footnote{\textit{Id.} at 773-77.
Rasmussen point out a number of metamorphoses that the economy has undergone over the past few decades that have led to the gradual nullification of the companies’ firm-specific assets. They claim that, especially in the current economic situation, the market is divided into “winning players” and “losing players,” where the former succeed in taking control of the relevant market in its entirety, while the others gradually cease to exist. In a “winner takes all” reality, the losing players no longer hold any special sources of value which cannot be realized by selling the company’s business to the winning players.

Therefore, the need and justification for the existence of complex judicial proceedings, in which the judge and the trustee seek a reorganization plan that will enable the continued existence of the company and that will satisfy a large number of the creditors, is gradually dissipating. In current reality, the legal system can make due with enforcing the insolvency terms that the parties agreed to at the outset of their contract.

The article, The End of Bankruptcy, aroused much criticism among those who specialize in economic analysis of the law. In particular, the critics claim that Baird & Rasmussen develop their theoretical analysis on the basis of a factual description that is completely unrealistic. Empirical research shows that in most cases of insolvency, the legal system continues to enforce arrangements that coincide with the classic model of reorganization, where existing shareholders and creditors are the ones that receive possession of the company after rehabilitation. Selling businesses to a third party occurs only in the minority of cases. Likewise, empirical research emphasizes that Baird & Rasmussen’s analysis is based on the assumption that “the company’s assets” establish the central justification for its existence. This assumption allows Baird & Rasmussen to claim that the court and the parties prefer the selling of assets to a third party, if the sale occurs without losses. However, in reality, “the company’s assets” are not its main resource. Instead, “relationships” between the company and its clients, between the company and its suppliers, between the company and its human resources, are what constitute its main source of value and what justify the existence of the legal entity. In every case, modern day sales of companies’ assets to third parties result in losses. See generally Lynn M. LoPucki, The Nature of the Bankrupt Firm, A Response to Baird and Rasmussen’s The End of Bankruptcy, 56 STAN. L. REV. 645 (2003). The criticism points to a consistent rise in bankruptcy and reorganization filings. Likewise, it shows that many substantial proceedings are customized to coincide with the traditional procedure, which Chapter 11 brought about. Finally, the criticism points to the companies’ special sources of value today, and in doing so, single out the special relationships that the company has cultivated with its clients, employees, suppliers, etc.

32. Id. at 766-68.
33. The criticism is directed at the claim that modern day sales of companies’ assets to third parties result in losses. See generally Lynn M. LoPucki, The Nature of the Bankrupt Firm, A Response to Baird and Rasmussen’s The End of Bankruptcy, 56 STAN. L. REV. 645 (2003). The criticism points to a consistent rise in bankruptcy and reorganization filings. Likewise, it shows that many substantial proceedings are customized to coincide with the traditional procedure, which Chapter 11 brought about. Finally, the criticism points to the companies’ special sources of value today, and in doing so, single out the special relationships that the company has cultivated with its clients, employees, suppliers, etc.
34. Id. at 660-65.
35. Id. at 652-57.
36. See Baird & Rasmussen, supra note 2, at 786-88.
37. See LoPucki, supra note 33, at 665-70.
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proceeding involving selling assets to a third party, whether the sale is for the entire "going concern" or for its individual parts, the relationships meaningful to the legal entity are lost. This is essentially the justification for preferring reorganization over liquidation, and this justification is what the critics of The End of Bankruptcy point to in explaining why most courts are not satisfied with simply enforcing the pre-existing contracts between the parties.

Until now, I have focused on the criticisms voiced by those who specialize in economic analysis of the law. However, the social approaches regarding bankruptcy law take issue with the exclusive focus on the economic aspect of the collective proceedings. Professor Korobkin's opinion is that bankruptcy law aims to provide answers with respect to all aspects of the financial distress phenomenon, including its emotional, political-social, moral, and indeed, its economic aspects. Insolvency exacerbates the conflicts of interest between the parties involved. Therefore, the law attempts to provide a forum where interests and values can be expressed, without having to choose one of them exclusively. As Professor Warren emphasizes, in contrast to the advocates of the economic approach, whose sole aim is to enlarge the value paid to the creditors in the event of insolvency, the advocates of the social approaches stress the multitude of aims and values that form the basis of bankruptcy law.

Warren claims that the central aim of bankruptcy law is the distributive consideration: given that the losses of the failed business must be distributed, the primary role of the law is to determine how to distribute those losses. She claims that there are different kinds of values that must be taken into account when deciding the distribution scheme, and none of the values outweighs any other.

The criticism of the economic approach emphasizes that it is wrong to

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38. Id. at 651-52.
39. See Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, supra note 3, at 718-22. For a later presentation of this approach, in the broader context of the place of theoretical analysis in bankruptcy literature, see Korobkin, The Role of Normative Theory in Bankruptcy Debates, supra note 3, at 75-80.
40. Recently, Korobkin has broadened the approach that views bankruptcy proceedings as a "stage" for expressing the different conflicts of interest, which in light of the insolvency, cannot be bridged. In this analysis, Korobkin draws a comparison between the legal system and the performing arts, and points out the importance of the judicial process as one which gives rise to the expression of different basic insights. In this sense, bankruptcy law is an essential mechanism for dealing with loss and failure. See Korobkin, Bankruptcy Law, Ritual and Performance, supra note 3, at 2124-31.
42. See Warren, Bankruptcy Policy, supra note 3, at 789-93.
43. Id. at 790-93.
expect that contractual solutions will reach better and more efficient results than the arrangements which are forced upon the parties by law. \(^{44}\) In this regard, the literature stresses three central considerations:

1. **Confusion between form and content:** From the point of view of the parties to the dispute, the main question is: what is the content of the applied arrangement, as opposed to its source (whether contract or law)?

2. **Effect on third parties:** In the case of insolvency, every agreement between the debtor and one of his creditors affects the other creditors. The advocates of the economic approach, who rely on settlement and contracts, disregard the effect of such contracts on the other creditors who were not parties to the contracts.

3. **Costs of the agreement:** The assumption that it is cheaper to agree upon a settlement and a solution rather than to utilize the legal mechanism is wrong, since the contractual arrangement and its execution involve substantial costs that are higher than the cost of implementing the law. \(^{45}\)

**B. Procedural Aims vs. Substantive Aims**

An additional conflict that arises from the different approaches revolves around the issue of classifying these laws. According to one of the approaches, bankruptcy laws supply, first and foremost, a mechanism for collecting debts, and as such, they belong in the field of procedural law.\(^{46}\) According to the other view, bankruptcy laws seek to supply effective mechanisms for restoring the company’s economic resources to productive business activity.\(^{47}\) Among other things, reorganization law attempts to give a failed business another opportunity. In order to achieve such rehabilitative goals, bankruptcy laws must completely reorganize all of the company’s legal liabilities. In other words, bankruptcy laws are part of the field of substantive law, which define and formulate individuals’ rights, and do not solely provide the mechanism used to enforce these rights.

This dilemma between procedural and substantive categorization directly affects the contents of bankruptcy law. Scholars who uphold the procedural classification emphasize that bankruptcy laws must avoid “redistributing” the layout of the essential rights. Like any other procedural mechanism, bankruptcy

\(^{44}\) See Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, supra note 6, at 527-29.

\(^{45}\) Id. at 511-18.

\(^{46}\) For a radical expression of this approach, see Mooney, *supra* note 1.

\(^{47}\) For an expression of this approach, see Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, supra note 3.

laws must remain loyal to the rights that existed before the event of insolvency, and must limit themselves to enforcing these existing rights.\textsuperscript{49} In contrast, scholars who advocate the substantive classification emphasize the necessity of reorganizing the rights to the company's assets, in order to enable the realization of the substantive goals of the procedure. In particular, in order to make reorganization of the company possible, all parties must understand and accept that at least some of their pre-bankruptcy rights cannot immediately be enforced.\textsuperscript{50}

It is interesting to note that in the past, this dichotomy with respect to the classification of bankruptcy law was closely bound with the conflict between the economic and social approaches. The supporters of the economic view identified with the procedural classification, while the supporters of the social view gravitated towards the substantive classification of these laws. Therefore, it was the advocates of the economic analysis who so vehemently opposed the reorganization arrangement of the company, since every reorganization plan involves a certain degree of violation of prior entitlements, as well as a violation of the priority rules that govern the distribution of the company's assets in liquidation proceedings.\textsuperscript{51}

For example, an essential pre-condition for the company to return to its efficient activity is the minimization of its outstanding debt; however, the lessening of the burden of outstanding debt is only possible after a process in which some of the creditors waive their debts in exchange for other rights in the rehabilitated company. In other words, reorganization plans involve the restructuring of the company's capital structure, such that some of the creditors will have no choice but to exchange their loans or bonds for stock or options in the reorganized company. This exchange alters the arrangement of the original, substantive rights that the creditors had prior to the event of insolvency.\textsuperscript{52} In a similar manner, the reorganization proceeding affects the distribution of claims between the different creditors in the company, and between them and the shareholders. Even when the law requires that the reorganization plan satisfy the absolute priority rule, reality shows that the reorganization proceeding involves a certain amount of "cram down" of senior debts, to the benefit of the

\textsuperscript{49} This is Jackson's view. See Jackson, supra note 7.

\textsuperscript{50} The most radical expression of stalling the enforcement of original rights is found in denying the secured creditors their right to immediately enforce their security interests. For the effect of reorganization on the rights of secured creditors to immediate foreclosure, see infra Part IV.B.


junior creditors and the shareholders.\textsuperscript{53}

Today, the advocates of the economic approach distance themselves from the procedural classification of bankruptcy law. In particular, Baird & Rasmussen\textsuperscript{54} show how the absolute priority rule, which dominates the priority orders in liquidation, is expected to produce inefficient results in the case of reorganization.\textsuperscript{55} Since the managers of the company before the reorganization procedures are the shareholders' representatives or the shareholders themselves, the shareholders must receive a promise to get a "piece" in the rehabilitated company. Allocating a piece of the new company to the old shareholders is essential, in order to ensure that they will be motivated to act towards effectively rehabilitating the company. Furthermore, a necessary condition for reorganization is injecting new credit into a failed business. Baird & Rasmussen show that the shareholders of the company are the best candidates for investing more money in a failed business.\textsuperscript{56} In contrast to other investors, who fear a reappearance of the past failures of the company, the existing shareholders are aware of the company's potential value and therefore willing to provide the financial sources needed to rehabilitate the company. In order to motivate the shareholders to continue investing in the company, they must share in the increase in the company's value generated by the reorganization. In essence, there must be a deviation from the absolute priority that places creditors over shareholders.

C. Micro-Economic Aims vs. Macro-Economic Aims

Until now, I have assumed that an event of insolvency is a specific event for the individual company, which affects only the creditors and shareholders of that company. In the past, events of insolvency were perceived as merely micro-economic phenomena, and the bankruptcy laws were perceived as part of the private law. However, over the passage of time, reality overturned this underlying assumption. The economic crisis of the late 1920s showed that at times, a company can reach the point of insolvency due to factors affecting the

\begin{itemize}
  \item \textsuperscript{53} See Bebchuk & Chang, supra note 51 and the references therein.
  \item \textsuperscript{54} See Baird & Rasmussen, supra note 29.
  \item \textsuperscript{55} It is interesting to note that these developments reflect the intellectual development of Professor Baird himself. At the beginning, Baird joined Jackson and developed the argument that there is no economic justification to reorganize companies since it is possible to realize the going concern value by selling the business to a third party in liquidation. In light of the redistributive effect involved in reorganization, Baird claimed that this proceeding must be avoided. See Baird, supra note 26. At a later point in time, Baird joined Rasmussen in an article that advocated reorganizations and the avoidance of the absolute priority rule. See Baird & Rasmussen, supra note 29. Finally, the two embarked on an additional article that ostensibly seems to contradict the previous one, and argued that there is no longer any justification for the existing bankruptcy law. In this article, the authors emphasize that the railroads can no longer be used as the guiding example, since the circumstances of that case are substantially different from the circumstances that revolve around most of the cases of insolvency today. See Baird & Rasmussen, supra note 2.
  \item \textsuperscript{56} See Baird & Rasmussen, supra note 29, at 954-58.
\end{itemize}
entire market, leaving the individual company with no control over the situation.

From the macro-economic point of view, there should be an attempt to reorganize failed businesses. According to the modern macro-economic approaches, government and legal systems should interfere in times of depression to prevent an economic crisis which may “snowball” and cause the downfall of many other firms.\textsuperscript{57}

The reorganization of failed companies is desirable because it contributes to limiting the crisis, while liquidation is undesirable because it encourages the “snowball” effect.\textsuperscript{58} When a company is liquidated, its assets are put on a quasi-“public auction,” and its employees fall outside of the workforce. As long as the insolvency phenomenon is specific, these occurrences have no macro-economic effect. However, when the market is in a crisis, many companies reach insolvency and liquidation. Great numbers of assets are put up for sale and many employees are discharged from the workforce. The liquidation proceedings intensify the economic crisis—selling the assets contributes to the drop in the market prices of the economic resources, and the discharge of the employees from the workforce contributes to further minimization of aggregate demand.

In contrast, reorganization contributes to moderating an economic crisis—the postponement in selling the companies’ assets and in discharging the employees supplies the time necessary to recover from the crisis. Likewise, in the event that the reorganization attempt succeeds and the company returns to productive business activity, the selling of the companies’ assets is avoided and the employees remain in the workforce. Finally, when dealing with relatively large companies which have relatively large liabilities, settlements made with banks to delay due dates and to perfect terms of credit are multi-partied arrangements, in which not only the failing company’s direct creditors take part, but also the creditors of the banks themselves. Thus, reorganization allows avoidance of the “snowballing” effect of crisis-induced insolvency.\textsuperscript{59}

\textsuperscript{57} See, e.g., Carl A. Auerbach, \textit{Is Government the Problem or the Solution?}, 33 SAN DIEGO L. REV. 495 (1996) and the references therein.


\textsuperscript{59} See, e.g., Margaret Howard, \textit{Bankruptcy Empiricism: Lighthouse Still No Good}, 17 BANKR. DEV. J. 425, 436 (2001) (reviewing \textit{Teresa A. Sullivan et al., The Fragile Middle Class: Americans In Debt} (2000)).
II. INEFFICIENT ENTITLEMENTS AND LEGAL COERCION

A. General

The above discussion of conflicting views of bankruptcy law demonstrates how all of these views share the premise that efficiency considerations support the preservation and the enforcement of prior entitlements. Jackson limits the interventionist effect of bankruptcy law to the resolution of the “common pool” problem. 60 Schwartz’s “Contractual Bankruptcy Law” emphasizes the efficiency value of enforcing pre-existing contracts dealing with the allocation of insolvency risks. 61 Baird & Rasmussen highlight the decline of firm-specific assets as a justification for avoiding the redistributive effect of reorganization. 62 While the social theories call for alternative solutions, they all rely on policy considerations that are not related to efficiency. Warren emphasizes the rehabilitative and distributive values of bankruptcy law. 63 Korobkin emphasizes the need to provide the parties who suffer the losses of insolvency the right to express their frustration in order to reach collective solutions. 64 Accordingly, the debate remains loyal to the traditional conflict between efficiency-oriented laws and legal arrangements that aim at optimizing distributive justice.

This accepted starting point relies on two major normative considerations. First, the enforcement of contractual arrangements is necessary to enable efficient planning of credit transactions by solvent companies. 65 When creditors anticipate that a company’s insolvency will leave them unpaid, they can choose to increase their interest rates or subject the company to more restrictive covenants. Furthermore, any uncertainty involved in the expected outcome of bankruptcy proceedings is reflected in higher risks and higher costs of finance. Thus, ex post interference with prior entitlements increases the cost of capital ex ante, to the detriment of solvent companies and their shareholders. 66 To avoid this effect, bankruptcy courts should refrain from interfering with existing entitlements, and settle for enforcing the pre-planned allocation of insolvency risks. 67

Second, when parties cannot expect the court to alter the existing entitlements in their favor, they will be encouraged to structure an efficient process of renegotiation. Inefficient contracts and liabilities would be altered to reflect the parties’ better understanding of their relevant needs. 68

60. See JACKSON, supra note 7.
62. See Baird & Rasmussen, supra note 2.
63. See Warren, Bankruptcy Policy, supra note 3.
64. See Korobkin, Bankruptcy Law, Ritual and Performance, supra note 3.
66. See supra note 13 and the references therein.
67. Id.
68. See Jagdeep S. Bhandari & Lawrence A. Weiss, The Untenable Case for Chapter 11: A Review
Nevertheless, any acquaintance with the practical reality of insolvency cases teaches that while the above policy considerations are powerful, they cannot fully exhaust the relevant efficiency-based considerations. In many cases, corporations reach financial distress because they had engaged in contracts and liabilities that bound them into conducting inefficient activities. These corporations file for reorganization after they fail to renegotiate their contracts with their creditors, namely their lenders, employees, vendors, and customers. In real world cases, companies do not go bankrupt at the point of insolvency, but rather at the point when they cannot acquire new financial resources to meet their current liabilities. In turn, their failure to obtain new capital is the result of the existing inefficient entitlements, since every potential new investor expects that after the company fulfills its current liabilities, no resources would remain to cover his or her new debt, or to provide him or her with positive returns on equity investment. Under these conditions, bankruptcy law can never fully enforce the existing entitlements, and the above policy considerations cannot be fully upheld. Furthermore, even if some of the company’s creditors have contracted \textit{ex ante} for the allocation of insolvency risks, the full enforcement of these contracts in bankruptcy proceedings will usually decrease, rather than increase, the aggregate value to all other creditors. In other words, some of the agreements between the company and its creditors for the allocation of insolvency risks may involve inefficient entitlements. Then, in order to reconvert the company’s assets into efficient business activity, some contractual provisions must be avoided.

The more challenging task is to translate this unfortunate reality into a theoretical framework of bankruptcy law. To do so, one must inquire into the sources of inefficient entitlements and into the reasons that the renegotiation process fails.

\textbf{B. The Meaning and Sources of Inefficient Entitlements}

Prior entitlements are inefficient when they drive the company into sub-optimal actions. Thus, inefficient entitlements are characterized by two elements: first, the company partakes in a sub-optimal activity subsequent to the entitlement; and second, there exists a causal relationship between the entitlement and the future sub-optimal activity. (Figure No. 1 presents this of the Evidence, 67 AM. BANKR. L.J. 131, 133 n.8 (1993) and the references therein.


70. In many cases, bankruptcy proceedings are essential for obtaining the necessary credit for maintaining the business activity. \textit{See infra Part IV.B.}

71. For example, secured creditors contract \textit{ex ante} for immediate foreclosure upon the commencement of bankruptcy proceedings. Nevertheless, an immediate sale of assets may impede the survival of the going concern. If the going concern's value is higher than the asset value, then the full enforcement of the rights of secured creditors would decrease the aggregate value of the bankrupt estate. Accordingly, 11 U.S.C. § 362 (2000) subordinates the secured creditors to the automatic stay.
Figure No. 1: The Chain of Events on the Time-Axis

How can a contract at some earlier point in time, $t_0$, yield a sub-optimal activity at some later point in time, $t_n$? The answer to this question stems from the gap between the expected profitability of the contract, \textit{ex ante}, and its actual profitability, \textit{ex post}, and from the impact of the unprofitable contract on the future activities of the company. When the company enters into the initial contract, it expects this contract to be profitable. The company measures the expected profitability of the contract by its expected returns, that is, it relies on a probability analysis of all possible factors. For example, when the company employs a new employee, it expects that his or her contribution to the company’s value will exceed the costs of employment. When the expected contribution is unknown, the company estimates the contract’s value by using the expectation function. The company estimates the probability distribution over all possible scenarios, and then sums up the products of the assigned probability values and the expected cash flows under each of the identified scenarios.

Only one of these expected scenarios will manifest itself to be the actual scenario. The real contribution of the contract will usually differ from its expected value.\footnote{72 The following simplistic example clarifies this point: assume that a company employs a sales agent to market new products. The employment contract is made under uncertainty, both as to the actual demand for the new product, and as to the capability of the sales agent. Assume that the expected value is calculated according to the following possible scenarios: 1. Under the first scenario, both the demand for the product and the agent are favorable. Then, the firm would earn from this agent’s sales a value of ten; 2. Under the second scenario, either the agent or the demand is less favorable, and therefore, the firm would earn only five; 3. Finally, under the last scenario, the actual demand is much lower than expected, and therefore, the firm’s value from the sales is reduced to zero. If all scenarios are equally probable, then, the expected value is five. The firm would be willing to pay the agent a salary of two. Now, if the third scenario is the one that materializes, then, the contract is revealed to be unprofitable.}

If the real contribution of the contract is substantially lower than the expected value, then the contract may prove to be unprofitable. For
example, if the contribution of the employee described in footnote 72 is significantly lower than what the company had expected, then the employment of this particular employee is unprofitable. A contract may also be revealed to be unprofitable due to macro-economic events. For example, in the context of employment, the boom of the hi-tech industry towards the end of the last century led to a dramatic increase in the average salary of software developers. Then, following the collapse of this industry in 2002, the average salary dropped dramatically. As a result, companies that hired developers in 1999 and in 2000, found themselves bound by sub-optimal contracts in 2002.

It has generally been thought that unprofitable contracts only involve distributive effects. For example, in the context of employment, it appears that the negative returns for the company are counteracted by positive returns for the employees, such that aggregate efficiency remains unchanged. Deeper reflection reveals, however, that unprofitable contracts may drive the company into inefficient activities. For example, the excessive employment costs may force the company to reduce its investment in new technologies or in new products. Because this company continually competes against other similar companies over potential investors, it must retain a competitive level of net returns. Thus, if the company incurs excessive employment costs, it must, ceteris paribus, reduce its other costs. In the long run, the sub-optimal investment may result in sub-optimal returns.

In sum, unprofitable contracts lead to sub-optimal activities because they influence the subsequent decisions of the company and because they may distort the incentives of the company's incumbents to maximize aggregate returns. The following examples demonstrate concrete cases of inefficient entitlements:

a. Unreasonable burden of debt: At times the company is led, either by choice or otherwise, into a situation in which its burden of debt is incredibly high. The high leverage ratio is likely to lead to inefficient activity, since the

73. Indeed, the parties may contract against the pessimistic events, but as will become apparent in the following discussion, any form of defense measure against the risks of suboptimal contracts is inherently incomplete and is not without costs.

74. While these firms could theoretically dismiss these employees, the termination of employment contracts involves tremendous costs.

75. See, e.g., Juliet P. Kostritsky, Illegal Contracts and Efficient Deterrence: A Study in Modern Contract Theory, 74 Iowa L. Rev. 115, 118 n.8 (1988), and the references therein.

76. Otherwise, the company will not be able to compete with other players over new investments.

77. Indeed, the law does not support the possibility of adapting a contract to new events and realities. Contract law states that a mistake as to the profitability of a contract will not justify the nullification of the contract. See La. Power & Light Co. v. Allegheny Ludlum Indus., 517 F. Supp. 1319, 1327 (E.D. La. 1981); Wooldridge v. Exxon Corp., 473 A.2d 1254, 1257 (Conn. Super. Ct. 1984); L-J, Inc. v. S.C. State Highway Dep't, 242 S.E. 2d 656, 662-63 (S.C. 1978); Hill v. A.O. Smith Corp., 801 F.2d 217, 222 (6th Cir. 1986). All of these cases rely on the doctrine requiring that the mistake refer to past or present facts that already exist at the time the contract is made. A mistake cannot refer to erroneous predictions of the parties concerning future facts.
company is acting under immediate pressures to pay its outstanding debt.

b. *Substantial alterations in interest rates:* Interest rates change from time to time, and this variance affects the advantageousness of the company’s existing loans. In the event that the market interest rate drops substantially below the interest rates on the company’s existing debt, the cost of the company’s credit becomes excessively expensive. The company is forced to pay higher interest rates than it could have attained through a current credit transaction. High credit costs are likely to lessen the company’s competitive power in the market. The company will be forced to sell its products at higher prices than its competitors, or be satisfied with smaller profits, or both. In any event, reducing the profitability is expected to lessen the shareholders’ incentives to continue investing in the company.

c. *Gradual growth over time, beyond that which is expected, in the total value of required investments:* Despite management’s best efforts to accurately estimate the costs of development, production, and operation at the outset, its foresight is far from perfect. In many cases, these costs will be higher than expected. Then, the company will be bound to enlarge its fixed liabilities beyond the budgeted amount. Higher costs are likely to cause inefficient utilization of the company’s assets—management is likely to be swayed by its interest to minimize those costs, even at the price of deviating from its output goals. In other cases, the heightened costs could lead to the need to raise additional capital, under less favorable conditions than those which existed at the original planning stage.

d. *Development of inefficient control:* The holding of shares determines corporate control. The guiding principle places the control in the hands of the shareholder who holds more than 50% of the company’s shares. In many cases, this principle can lead the company into inefficient control. For example, the controlling group may be comprised of a number of shareholders who suffer from major disagreements and coordination problems. Another example is the struggle for power among the founders of a start-up company and its investors, which is likely to lead to inefficient decisions. In general, collective action problems may thwart the efficient management of assets.

e. *Substantial alterations in the supply and demand for the business’s workers:* The company determines employment conditions with each employee according to the conditions of the relevant job market at the beginning of the employment. As a result, substantial changes in the relevant job market are expected to affect profitability and efficiency. For example, should the customary employment conditions of the market deteriorate after the employment of some of the workers, and assuming that the company is bound to the original salary agreements, then the company will be in a position in which the costs of its workforce are substantially higher than the same costs of competitor companies that hire similar employees at later dates. Naturally, the
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compacty will seek to terminate its current employment contracts, but it will not always succeed in doing so. Uniquely skilled workers, who by definition would be hard to replace, will tend to insist on the continuance of their original employment terms. Further difficulties in altering the employment contracts will ensue if the workers are part of a union.

f. Substantial decrease in the demand for the company’s products: Long-term changes may decrease the demand for the company’s products. For instance, novel technologies obviate the demand for old technologies. In addition, changes in the course of business activity eliminate the need for certain products and services, and create demand for new products and services. The passing of generations and changes in consumption habits have similar effects.

In some cases, the company will succeed in adapting its production channels to the dynamic market, and will thus succeed in retaining efficient activity. In other cases, the company will not be so fortunate. In these cases, efficiency dictates the release of the assets from the existing arrangement of liabilities. This can be done by selling the assets piecemeal so that every buyer makes varying use of them, or by selling the assets as a “going concern” to a buyer who will be able to make the necessary adjustments in the company’s products. Notwithstanding efficiency considerations, incumbents may object to such sales for personal reasons, and in doing so, would maintain the misallocation of resources in the company’s hands.

g. Macro-economic changes in the economy: Finally, macro-economic changes are expected to affect the advantageousness of the existing activity in the company. The salient example of this in the Israeli economy is that of the tourist industry, which was severely harmed as a result of the outbreak of the second Intifada, and has not yet recovered. Investors would most likely never have invested in this field had they been able to foresee these developments.78

On a higher level of abstraction, inefficient entitlements may emerge from one or more of the following three potential sources:

a. Unprofitable Contracts (hereinafter, the first source of inefficiency): The major source of financial distress concerns the sub-optimal terms of the company’s contracts. An excessively high leverage ratio, sub-optimal employment contracts, or sub-optimal interest rates are examples of this possibility. Under these conditions, the sub-optimal contracts deter new investment because potential investors expect that the company would lose too much value from zeroing out its current liabilities.

78. Note that the latter two paragraphs assume a wider definition of the term “entitlement.” They assume that entitlements refer to a wide spectrum of commitments towards third parties. For example, if the firm engages in various investments, such as the construction of new hotels, it inherently engages in various contracts such as contracts with contractors. As a result, the firm provides these third parties various entitlements.
b. Inefficient control (hereinafter, the second source of inefficiency): The second possibility is that problems in the company’s management or its control are preventing it from optimal activity.

c. The lack of potential cash-flow (hereinafter, the third source of inefficiency): Finally, it is also possible that changes in the times and customs will lead to a decrease in the demand for the company’s products, or that the price of manufacturing these items will rise dramatically. These possibilities would serve to diminish the company’s expected stream of income.

Fixed liabilities, by their nature, endanger the efficient activity of the company, since they limit the company’s ability to adjust to the changing marketplace. The parties set the terms of the fixed liabilities at the time they enter into the contract; however, a reality different from what the parties originally expected may be revealed when actually executing the commitment. The gap between the parties’ expectations at the time of the creation of the fixed liabilities and the business reality that is exposed at the point of their execution, may render the existing arrangement of liabilities unprofitable. The lack of profitability may lead the company to knee-jerk decisions and actions, which may reduce the long-run aggregate value of the company.

Therefore, if it were possible, companies would completely avoid entering into fixed liabilities, and would instead offer all of its parties some share in its aggregate proceeds. In actuality, avoiding fixed liabilities is impossible, and is not necessarily the most efficient choice for the company. Firstly, there are contracting parties who would not agree to residual consideration. Such parties include banks and the company’s employees, suppliers, and consumers. Even if these investors would agree to stipulations that would make the company’s liabilities towards them more flexible, these stipulations would remain marginal without changing the comprehensive character of the contract. The company is therefore forced to bind itself in a fixed commitment upfront, whether it likes it or not. Secondly, a residual claim against the company’s assets is usually related to the investor’s power to influence decision-making in the company. Thus, for example, it is the shareholders who appoint the company’s directors and managers, and who control the company’s decision-making. Other investors as well will seek to condition the requested flexibility of their contract on their power to affect the decision-making in the company. Broadening the number of residual claims entails broadening the number of

79. The vast majority of the employees would like to receive a fixed salary that is independent of the business’s returns.
80. Suppliers would usually require fixed prices that are independent of the company’s returns.
81. Consumers would expect the company to demand some fixed price for its product. While the prices may change over time, they by no means depend on the corporation’s returns.
82. For the connection between residual claims and corporate control, see Henry Hansmann, The Ownership of Enterprise (1996); Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 YALE L.J. 387 (2000).
individuals who take part in the decision-making process of the company. This broadening is likely to lead the company into stagnation and an inability to operate, for the same collective action reasons previously discussed.

In other words, every form of contracting with the company may lead to an arrangement of claims that will thwart the efficient operation of the company's assets. Fixed claims threaten to limit the company's flexibility and ability to adjust itself to the dynamic marketplace; residual claims, like stock, threaten to create an inefficient arrangement of decision-making in the company. Throughout its course of activity, the company attempts to strike a balance between its possible types of inefficiency, and in doing so, varies the kinds of claims made against it. The company balances between generating capital through the issuance of loans and generating capital through the issuance of shares. Likewise, the company can include stipulations in its contracts with the different claimants, thus making the contracts more flexible to change in a dynamic world. However, this attempt to balance between the different types of inefficiency does not always succeed in leading to the efficient management of the company's assets. Whether due to a lack of choice, a case of misjudgment, or as a result of unforeseeable events, the company may be led into a situation in which it will be bound by inefficient contracts. In such a case, releasing the assets from the existing arrangement of liabilities is vital in order to shift the assets back to productive activity.

C. The Failure of the Renegotiation Process

When an inefficient arrangement of liabilities against the company is formed, the problem can be solved in one of two ways: first, the parties can draft new contracts that would serve to nullify the original ones, thus effectuating a private solution that requires some commercial flexibility by the parties; and second, the company can undergo a court-ordered reorganization or liquidation proceeding.83

The discussion in the following paragraphs shows how private solutions to inefficiency are preferable to court-mandated solutions. Therefore, the discussion will show that reorganization or liquidation should become relevant only upon the parties’ failure to solve the inefficiency independently through a redrafting of their contracts.84

There are several reasons why the parties cannot always reach an efficient private solution. In some cases, coordination and cooperation difficulties arise.

83. See Schwartz, Contract Theory, supra note 2, at 1849-51.
84. Under particular circumstances, the debtor's effort to renegotiate his liabilities is considered to be a pre-requisite for establishing good faith. See In re East, 270 B.R. 485, 495 (Bankr. E.D. Cal. 2001) (discussing the duty of former students to make an effort to renegotiate their student loans prior to filing for bankruptcy); see also In re Mort, 272 B.R. 181, 185-86 (Bankr. W.D. Va. 2002); In re Conner, 89 B.R. 744, 747 (Bankr. N.D. Ill. 1988); In re Stern, 288 B.R. 36, 43 (Bankr. N.D.N.Y. 2002).
All of the claimants in the company expect to enjoy an improvement in the existing arrangement of liabilities against the company; however, every investor prefers, of course, that the other investors bear the costs of this expectation. Thus, for example, a lender to the company will prefer to continue to receive the interest that was agreed upon in the loan contract, even when the contractual rate is higher than that of the market, by way of expecting that the company's other creditors will agree to minimize their claims on the company. As another example, when the company is in need of new sources of funding, every shareholder will prefer that the other shareholders will continue to invest further resources in the company. Finally, if new employment contracts are necessary, every worker will prefer that the company subject its other workers to altered employment terms, while maintaining the original terms for his own employment.

When the company's assets are led into inefficient activity, the conflicts of interest between the creditors and the shareholders intensify. Inefficiency causes losses, and these losses are passed on to either the shareholders or the creditors. The party that is harmed from the inefficiency will ask to alter the existing arrangement of liabilities, while the unharmed party will insist on retaining the status quo. Indeed, it will usually be the shareholders who will ask to change the existing arrangement, since they have the incentive to see the assets restored to efficient use. Thus, for example, when the inefficiency is caused by excessively high salaries, the controlling shareholders will try to hold an additional round of bargaining in an attempt to lessen the value of the comprehensive liabilities towards the workers. Naturally, the workers will try to reject the controlling shareholders' objective. Their success in doing so will turn on the uniqueness of their skills and on the strength of their organization. To the extent that the company's workers succeed in preventing alterations to their employment contracts, they are likely to drag the company's assets into inefficient activity. This holds true because the workers are motivated by their own interests, and not by an interest to achieve aggregate efficiency.

In exceptional cases, it will be the company's creditors who will ask to change the existing arrangement of liabilities, and it will be the shareholders who will play spoiler. This situation may occur when the company takes out an additional loan from a later creditor, thus diluting the rights of the earlier creditors. 85 When the comprehensive burden of loans creates substantial

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dangers of insolvency, the earlier creditors will ask that the company direct its
efforts to minimizing the credit burden. In these cases, the shareholders may
refuse to cooperate with the earlier creditors if the benefit from the later
financing outweighs its inefficiency.

D. Financial Distress

Inefficient liabilities threaten to lead the company to financial distress. First, they reduce the company’s returns, and thereby, increase the company’s needs for new funding; and second, they reduce the incentives of new investors to provide the company with new financial resources. As a result, after a while, the inefficient liabilities may lead to a situation where the company lacks the necessary finance to meet its current debts.

This means that the renegotiation process with prior creditors takes place when the company is under time pressure. If the company fails to renegotiate its contracts before it reaches financial distress, it will be in default with some of its creditors. Thus, time pressure reduces the negotiating power of the company, since the party more pressured to complete the negotiation is usually the one which agrees to less favorable terms. In other words, the threat of financial distress reduces the company’s capability of completing the renegotiation processes that are necessary to shift the company’s assets back to productive activity.

E. The Justification of Coercive Interference with Existing Entitlements

When the company engages in inefficient entitlements, these entitlements burden the otherwise productive business activity. Efficiency requires that the assets be severed from these entitlements. If the parties cannot arrive at this solution by negotiation and contract, some alternative procedure must exist to impose this solution on the parties. Otherwise, perpetuated inefficiencies would increase the losses incurred by the inefficient entitlements.

III. THE ROLE AND CONTENT OF BANKRUPTCY LAW

A. General

We can now present the conditions for the commencement of bankruptcy,

86. The reader may wonder how to distinguish between “assets” and “entitlements.” In the legal context, the two concepts seem to overlap, because the one party’s contractual entitlement against some other contractual party may be a part of his or her assets, and vice versa. In the economic context, the two concepts are separate: assets exist in the world, in disregard of their distribution to human beings. Thus, one may identify these assets by exploring their existence, in a world where the concepts of rights and possession do not exist. If the asset in question would have continued to survive in the absence of personal rights and possessions, then it is an asset, and not merely an entitlement. If, on the other hand, the asset in question would have disappeared, together with all personal rights and possessions, then it only reflects an entitlement.
and the role of bankruptcy law itself. This Article’s main claim is that the satisfaction of three conditions will justify the severing of the company’s assets from its existing arrangement of liabilities. The aim of collective collection proceedings is to bring about this essential severance, whether by way of reorganization or by way of liquidation, so as to reinstate the company’s assets back to productive activity.

The three conditions are:

1. The company’s existing arrangement of liabilities leads to inefficient exploitation of its resources;

2. The inefficiency cannot be solved through private agreement; and

3. The company is experiencing financial distress.

Each condition must be satisfied in order to justify the utilization of collective collection proceedings.87 Firstly, as long as the arrangement of liabilities is efficient, there is no reason to change it. In such a case, efficiency considerations and an interest to preserve the autonomy of the individuals justify the continuance of the existing arrangement of liabilities.

Secondly, as long as the parties can solve the inefficiency through their own agreement, there is no reason to seek an alternative course of action. The agreed-upon solution is superior to a collective proceeding since it is expected to be more efficient than a collective proceeding, and because it more accurately reflects the parties’ desires. The private solution is more efficient because it involves lower costs than a lengthy collective proceeding. In addition, the parties will be superior to an external body in designing a new arrangement of liabilities that reflects their particular needs. The agreed-upon solution also preserves the parties’ autonomy since it does not involve the element of coercion that characterizes the collective proceeding.

Finally, the condition of financial distress is vital, since any financial condition short of distress would represent the span of time in which management may attempt to find a solution to the inefficiency problem by itself. According to the agreements drawn up by the parties at the outset, control of the company is given to the shareholders and their representatives. Among other things, their powers consist of the ability to change the existing arrangement of liabilities, if such a change is deemed necessary. In this regard, they have the power to conduct negotiations with each and every one of the company’s investors to change the conditions of the existing contracts. As long as the company is successful in paying its debts on time, there is no need for the court or any of the creditors to intervene. The company’s experiencing of financial distress, however, indicates management’s failure to reach an agreed-upon solution, and thus constitutes the point at which the company’s creditors will be the ones who bear the costs of the failure to reach an agreed-upon

87. In other words, the three conditions are essential.
solution. Therefore, the point of financial distress is the suitable moment from which the responsibility for changing the existing arrangement of rights should be transferred from the controlling shareholders to the court and the trustee.

The existence of the three conditions is sufficient to justify the opening of collective collection proceedings. Firstly, the combination of the inefficiency and the financial distress justifies the change of the existing arrangement of liabilities, so as to reinstate the assets back to productive business activity. The financial distress leads the company into a state in which the burdens of its original arrangement of liabilities call its continued existence into doubt. Any attempt to continue the company’s activity without change will necessarily involve violating some of the original liabilities. Thus, if the company is to survive, then the existing arrangement of liabilities will change regardless of whether the company affirmatively makes any changes, since the company’s breaching of some of its liabilities would amount to an effective rearrangement of its liabilities (hereinafter the “factual progression”). At this point, redesigning the existing arrangement of liabilities through a collective proceeding is preferable to doing so through the factual progression, which would develop as a result of the creditors’ desperate attempts to collect their debts.

Secondly, in light of the failed attempt to reach an agreed-upon solution without a collective proceeding, the element of coercion becomes inevitable. Coercion can take a number of forms. The first possibility is that the trustee may force the parties to release the assets from the existing arrangement of liabilities. Alternatively, the previous paragraph’s factual progression could bring about a coercive change of the creditors’ rights as well. The best form of coercion is through a court-ordered solution, because a court’s solution is likely to be no more coercive than necessary to achieve the objective at hand.

Finally, in order to reinstate efficient use of the company assets, it is essential that the changes in existing entitlements be managed by a third party, such as the trustee, and not by the company’s controlling shareholders or by some of the creditors. Otherwise, the transformation of existing entitlements would be tuned to the interests of particular investors rather than to aggregate efficiency.88

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B. The Essence of Collective Collection Proceedings

Collective collection proceedings release the company's assets from the existing arrangement of liabilities, so as to return the assets back to productive business activity. The liquidation or reorganization proceedings usually feature one or more of the following means to transform the existing arrangement of rights.\textsuperscript{89}

a. Changing the structure of the commitments: The discharge from prior entitlements must focus on the right side of the company's balance sheet. The company's business will continue operating normally, such that the company will remain a going concern; however, the collective proceedings will lead to a reorganization of the claims against the company. Thus, for example, in the event that the company reaches insolvency due to its leverage ratio, the capital structure will have to be reorganized in such a way that some of the fixed liabilities will be replaced by share equity. For this purpose, the collective proceedings erase some of the debts, and some of the creditors will receive preferred or common stock in lieu of their original claims of debt. The creditors would receive an amount of shares that would appropriately reflect the riskier nature of share ownership.

Lowering the interest rates on the loans is another way to change the structure of the capital. Alternatively, the company can obtain new credit during the proceedings to pay off the old loans, and the capital structure would change to include the new debt on the company's books. Finally, any changes in the employment contracts with the company's workers would also fall into this first category.

b. Changing the structure of control: Once the company enters into the liquidation or reorganization proceedings, the creditors seize control of the company's assets from management. Once the collective proceedings begin, the structure of control of the assets will never return to its original state. If, for instance, the company undergoes liquidation, then its assets will be transferred to the ownership and control of other businesses; and if the company undergoes reorganization, then the resulting lower value of the business will prevent the original shareholders from enjoying their previous degree of control.\textsuperscript{90}

c. Selling the assets: The most drastic form of severing the company's assets from its prior liabilities is when the company sells its assets to third parties. Selling the assets causes a change in the existing arrangement of liabilities because it severs the pre-liquidation link between the assets and the

\textsuperscript{89} These changes are depicted in Warren's article. See Warren, Bankruptcy Policy, supra note 3, at 785-86. Although Warren presents bankruptcy law as a procedural process for collecting debts that constitutes an alternative to the states' individual collection proceeding, she points out that bankruptcy law changes the existing arrangement of rights. Warren emphasized with particularity the change that the existing arrangement of rights undergoes when it enters collective collection proceedings.

\textsuperscript{90} See Baird & Rasmussen, supra note 29, at 948.
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company’s shareholders and creditors. In place of this original link, a new ownership relationship emerges between the assets and the buyer. When the assets are sold as a “going concern,” all of the assets become the property of a single buyer. When the sale is done “piecemeal,” the assets are distributed to different buyers. Regardless of how the sale is carried out, the original ownership link is severed.

Reorganization typically features the first two categories, while liquidation features the third category. The type and level of severance of the company’s assets from its initial entitlements should depend on the sources of inefficiencies. The basic guideline is to minimize the impediment of existing entitlements, and thus, to avoid using an unnecessary type of severance. For example, if the company reaches financial distress only because of its leverage ratio, it should undergo reorganization proceedings to design a feasible capital structure. There is no reason to sell the assets to third parties. Similarly, if the source of failure is rooted in the company’s control, then the incumbents must be replaced. However, this shift of control should not lead to any alteration of the debt liabilities, nor should the company be sold to third parties.

IV. CONCRETE ARRANGEMENTS OF BANKRUPTCY LAW

A. The Choice between Reorganization and Liquidation

Previous parts have discussed the conditions under which there is a normative justification to sever a company’s assets from the arrangement of liabilities that was created in relation to those assets. This Article has yet to explore the correct way to release the assets from the existing rights. First, what should the default procedure be: reorganization or liquidation? Second, what policy considerations should guide the selection between these two options?

Positive law does not mandate a bankruptcy court to explicitly examine the choice between reorganization and liquidation. Initially, the party who files the bankruptcy petition also elects one of the proceedings. For instance, the debtor may file a petition for commencement together with a reorganization plan. Then, the Bankruptcy Code provides the debtor with a period of 100-180 days to secure plan confirmation.

Once the proceedings begin, the creditors are stayed from collection efforts, and the debtor has a chance to reorganize the business. This statutory arrangement implicitly prefers reorganization—because the debtor or the

91. See infra Part IV.A.
92. However, soon after commencement, the fate of a reorganization effort is determined by the capability of the trustee to obtain new credit in order to cover the ongoing expenses of the going concern. See infra Part IV.B.
shareholders of the bankrupt firm would usually prefer reorganization, they often preempt their creditors by voluntarily filing a petition. Once they succeed in staying the collection proceedings for 100-180 days, they also gain a strong negotiation position that facilitates the enforcement of reorganization on all of the other creditors. Indeed, the trustee and the bankruptcy court specifically confront and address the sources of inefficiency that had led the firm into financial distress when they deal with issues such as the feasibility of the capital structure, or the adequate protection of secured creditors. Nevertheless, the bankruptcy court is not required to condition the choice between reorganization and liquidation on an inquiry into the sources of inefficiency. As a result, many firms undergo reorganization proceedings even when the circumstances of the particular case may call for liquidation.

On the other hand, traditional law-and-economics supports liquidation over reorganization. In his Uneasy Case of Corporate Reorganizations, Professor Baird presented the possibility (and its reported advantages) of selling the bankrupt going-concern to a third party in liquidation proceedings as a justification for reformulating the choice between the two options. Traditionally, corporate liquidations were associated with selling the corporate assets piecemeal, whereas corporate reorganizations were associated with maintaining the going concern. Accordingly, reorganization was the better choice when the value of the going concern was higher than the sum of its individual parts. Nevertheless, as Baird indicated, if the going concern can be sold in liquidation proceedings, then its excess value cannot be deemed sufficient to support reorganization, because the realization of the higher value would not be unique to reorganization. On the contrary, because reorganizations involve the allocation of new claims against the uncertain value of the reorganized firm, they inherently involve some form of redistribution and avoidance of existing entitlements. Thus, liquidations always remain more efficient than reorganizations—they succeed in providing the same aggregate value, and do so without violating prior entitlements. Baird suggested perceiving reorganizations as hypothetical sales of the company’s assets to their initial investors. The company should undergo reorganization only when the

95. See Bebchuk & Chang, supra note 51.
96. See infra Part IV.B.
100. Id. at 129.
101. Id.
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initial investors are willing to invest the highest value in the business.

Bebchuk & Chang focused on the bargaining power of the shareholders in reorganization proceedings, which derives from their power to stay the collection proceedings for at least nine months. A nine-month delay may force senior creditors to surrender portions of their initial entitlements. Accordingly, Bebchuk & Chang suggested a legal arrangement that would allow the parties to opt-out of the reorganization option *ex ante*, at the time of contracting.

Finally, the recent *The End of Bankruptcy* points to the practical transformation of reorganization proceedings. In this essay, Baird & Rasmussen claim that contemporary reorganizations no longer involve the rehabilitation of failed businesses, but rather they become a source of opportunity for the shareholders to sell their business to a third party for a better price. Baird & Rasmussen suggest that because the initial justification of reorganizations no longer holds, bankruptcy law should instead enforce the pre-existing contracts.

The theory presented in this Article does not support the positive law’s implicit inclination towards reorganization, nor does it follow the law-and-economics preference for liquidation. This new theory calls for a legal arrangement that would mandate a preliminary hearing, at which the bankruptcy court would have the discretion to select the appropriate proceeding for the particular case. This judicial hearing would save the costs involved in futile reorganization efforts, and would ensure that judicial proceedings target the sources of inefficient entitlements.

For example, while the legal system may help in solving the first and second sources of inefficiency, it cannot solve the third. In other words, the court can effectively implement a reconstruction of current liabilities, an avoidance of burdensome contracts, and a change of control, but the legal system cannot affect in any way the demand for the corporation’s products, or the costs of production. Accordingly, liquidation is the only solution for the third source of inefficiency.

The remaining question concerns the legal choice between reorganization and liquidation in bankruptcy cases that emerge from the first and second

102. See Bebchuk & Chang, *supra* note 51.

103. To prove this claim, Bebchuk & Chang present a bargaining model, which shows that in order to save the cost of delay, senior creditors might be willing to surrender portions of their claims on behalf of junior creditors. In this manner, the senior creditors encourage the junior ones to support the reorganization plan at earlier dates. *Id.*

104. *Id.*


106. *Id.* at 777-78.

107. This factual assertion remains controversial. See the reference to LoPucki’s empirical findings, *supra* note 33.

108. For a detailed discussion of the three sources of inefficiency, see *supra* Part II.B.
sources of inefficiency. In these cases, traditional law-and-economics doctrine calls for liquidation proceedings in order to avoid the redistribution effects of reorganization.109 As Baird indicated, liquidation can maintain the pre-petition business activity when the company is sold as a going concern.110

The present theory challenges this argument, and calls for a more refined choice between the two types of procedures. The following discussion develops this argument in two stages. First, I will show that it is incorrect to assume that reorganizations involve a more far-reaching avoidance of existing entitlements. The analysis will show that both types of procedures result in the severance of the bankrupt estate from pre-petition entitlements. Second, I will show that each procedure's degree of coercive interference with existing entitlements is case-specific. In some cases, reorganizations would yield a more severe impact on existing entitlements, whereas in others, reorganizations would better preserve the initial scheme of distribution.

To understand this point, one must note that the pre-petition arrangement of liabilities involves two types of relationships:

a. The relationships between the assets and the contracting parties: Pre-petition entitlements entail legal relationships between the company's assets and its shareholders and creditors. For example, existing entitlements provide the shareholder who holds over 50% of the company shares the right to control its assets. Similarly, existing entitlements define the identity and authority of each of the company's employees, and thereby entail the actions that each employee would perform on behalf of the company. These actions affect the assets and their value. Finally, the company's property interest in its assets excludes other potential holders from having any proprietary rights in those resources.

b. The relationships between the contracting parties themselves: The existing entitlements also entail a distributive scheme among the company's investors. For example, traditional priority orders entail that the shareholders hold the residual claim against the company's assets. This implies that the creditors are entitled to be paid in full before the shareholders gain any positive value. Similarly, the law states that secured creditors are entitled to be paid in full before the unsecured creditors recover any positive value.111 (See Figure No. 2.)

109. See Bebchuk & Chang, supra note 51.
110. See Baird, supra note 26.
111. See Jackson & Kronman, supra note 13.
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Figure No. 2: Two Types of Relationships

2.a. The First Type of Relationship: Existing entitlements yield a function from the set of the company investors to its set of assets:

The set of investors → The set of assets

2.b. The Second Type of Relationship: Existing entitlements yield a distribution scheme among the company investors:

Consumers
Board of Directors
Management
Creditors
Controlling-Shareholder
Minority-Shareholders

Liquidations involve a more far-reaching avoidance of the first type of relationships—in reorganizations, at least some of the initial investors would continue to hold claims against the company assets. In reorganizations, the company’s shareholders and bondholders would hold new securities against the reorganized company, portions of the company employees would continue to work for the reorganized firm, and suppliers and dealers would continue to work with the company. Liquidations, on the other hand, would terminate these relationships, because the assets would be sold to a third party.¹¹²

Reorganizations involve a more far-reaching intervention with the second type of relationships, that is, the relationships among the company’s investors. Because reorganizations violate the absolute priority rule, they yield a

¹¹² For the emphasis on firm-specific relationships as a justification for reorganization, see LoPucki, supra note 12. From this viewpoint, the perception of reorganization as a “hypothetical sale” of the corporation’s assets to their initial owners is flawed. This perception assumes that the assets were already fully detached from their owners, and then turns to explore the adequate way to sell the detached assets to the highest bidder. It is dubious, however, why the assets should be detached from their initial investors and owners in the first place.
redistribution of the initial claims against the company’s assets.\textsuperscript{113}

The level of interference with existing entitlements changes from one case to another. In some cases, liquidations would cause more interference than reorganizations, and vice versa. Therefore, in selecting between the two options, the court must exercise its discretion, and adapt the decision to the particular circumstances of the case. In particular, the following policy considerations must be taken into account:

a. \textit{The source of inefficient entitlements}: The judicial examination must begin with an inquiry into the sources of inefficient entitlements. When dealing with the third source of inefficiency, the court must order liquidation. Otherwise, the court must turn to apply the remaining policy considerations.

b. \textit{The feasibility of acquisition by a third party}: The abstract law-and-economics approach presumes that the trustee would always be able to find a third party buyer for the corporation’s assets (whether individually or as a going concern). This presumption does not always hold. In many concrete cases, there is no potential buyer who is willing to pay a reasonable price for the bankrupt business or its individual components. In such cases, the only option for maintaining the going concern value is reorganization. Therefore, the trustee must seek potential buyers prior to the court’s decision between liquidation and reorganization. If the trustee finds a third party buyer, the court should order liquidation.\textsuperscript{114} Otherwise, the court must continue exploring the choice between reorganization and liquidation, and should select the option that can be realized in the shortest period of time, given the constraints of the remaining policy considerations.

c. \textit{The uncertainty involved in the reorganization plan}: While all reorganizations involve some level of deviation from the absolute priority rule, the degree of avoidance of existing entitlements changes from one case to another. Accordingly, in considering a reorganization plan, the court must take into account the level of uncertainty involved with the post-reorganization value of the going concern. The greater the uncertainty involved with the reorganization plan, the less favorable this option becomes. High risks should be deemed sufficient for dismissing a reorganization plan.

d. \textit{The level of cooperation by the shareholders and management}: Because reorganizations can succeed only upon the full cooperation of existing management and shareholders, the court should take into account their willingness to invest further human and financial resources in the reorganization plan.

e. \textit{The feasibility of new credit in reorganization}: As the discussion below

\textsuperscript{113} See Baird, supra note 26.

\textsuperscript{114} Note, however, that none of these considerations is determinative on its own. For example, even when the trustee finds a third-party buyer, it may still be that the sale to the third party through reorganization proceedings yields a higher value than the sale in liquidation.
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will demonstrate, the best measure of the feasibility of a reorganization plan is
the willingness of new investors to provide the company with new financing
during the reorganization proceedings. Accordingly, the likelihood of obtaining
new financial resources should also guide the court in selecting between
reorganization and liquidation.

f. The proportionality test: Finally, if none of the above tests fully
determines the judicial choice of procedure, the court must turn to apply some
flexible balancing test. The court must balance the costs of inefficiencies that
would result from terminating the relationships between the company investors
and the assets in liquidation, against the costs of inefficiencies that would result
from violating the absolute priority rule in reorganization. The results of this
balancing test would change from one case to another.

B. Obtaining New Credit in Reorganizations

A company commences bankruptcy proceedings due to financial distress—
when it fails to obtain necessary funding for its current activity because its
shareholders and management can no longer attract new investment. When the
bankruptcy proceedings begin, the trustee must find ways to acquire new credit
for the bankrupt business. On many occasions, the capability of the trustee to
obtain new credit determines the practical feasibility of reorganization.

Bankruptcy law facilitates the acquisition of new credit by enabling the trustee
to provide the new investor with a senior position: the trustee can provide the
new creditor with the preferential position of "administrative expenses," or
provide the creditor a lien on the property of the estate. As long as the new
credit is obtained in the ordinary course of business, the trustee has the
authority to act without judicial approval. However, when the acquisition of the
new credit is beyond the ordinary course of business, the trustee must turn to
the bankruptcy court for approval.

The judicial interpretation of section 364 developed two tests to determine
whether credit is obtained in the "ordinary course of business":

The first test is the creditor's expectation, or the "vertical" test. It asks whether
a reasonable creditor would view the transaction as deviating from the debtor's
normal day-to-day operations. The counterpart is the "horizontal" test,
compares the debtor's business with other like businesses to determine
whether the disputed transaction is ordinary for the particular type of business
concerned.

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117. Id.
118. See § 364(b).
119. In re Blessing Indus., 263 B.R. 268, 272 (Bankr. N.D. Iowa 2001); see also Rajala v. Langer,
The bankruptcy courts decline to approve the preferential position of the new creditor retroactively, when the new credit exceeds the ordinary course of business, unless the court finds that the retroactive order will further the purposes of the Bankruptcy Code without unfairly prejudicing parties-in-interest.

The preferential position of post-petition creditors exemplifies the role of bankruptcy law. As long as the company is active, it is required to fulfill its liabilities in their entirety. Every new creditor who agrees to transfer new credit to the company does so as an aggregate to the existing debts. The new creditor knows that the company will be required to pay both its new debt and its other debts to preceding creditors. At a certain point, new potential creditors will fear the possibility that the company’s income will not suffice to pay the liabilities toward them and toward the preceding creditors. Similarly, potential investors in the company’s shares will fear that the existent burden of debts will drain the company’s income, thus leaving no remaining source of value for the shareholders.

The commencement of bankruptcy severs the debtor’s assets from his or her pre-petition liabilities, and thereby enables the trustee to use the bankrupt’s assets to secure the repayment of post-petition credit. Once the business obtains the necessary financial resources, it can return to productive activity. To this end, the trustee does not have unlimited powers to obtain new credit and to provide the new creditor with priority over pre-petition creditors. The trustee may obtain the new credit only when new financial resources are essential for increasing the value of the estate, that is, when the attainment of new financial resources is supported by efficiency considerations.

The power of the trustee to provide the post-petition creditors with a preferential position highlights the conflict between pre- and post-petition creditors. While the post-petition creditor would insist on acquiring some form of seniority, pre-petition creditors may oppose the new credit transaction because it diminishes the value left for the repayment of their debts. Section 364 of the Bankruptcy Act resolves this conflict by subordinating the trustee’s power to the adequate protection of pre-petition holders of security interests. The following examples demonstrate how the actual legal arrangement depends on the judicial interpretation of the concept of adequate protection:

1. Assume, for example, that the trustee seeks to provide the new creditor with superior security interest, and that the prior secured creditors are over-

120. See Rajala, 259 B.R. at 733-34.
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secured. Let the value of the collateral that serves to secure both the pre-petition and post-petition creditors be $1 million; let the pre-petition secured debt be $500,000, and let the value of the new loan be $500,000. A pre-petition creditor opposes the trustee’s plan to provide the new creditor with a superior lien, on the grounds that it would diminish the value of its security interest, in violation of the adequate protection requirement.

In \textit{In re Shaw Industries}, the bankruptcy court dealt with a similar set of facts, and ruled for the pre-petition secured creditor. The court found that even though the pre-petition creditors were over-secured, the new superior security interest would increase the risk that the pre-petition creditor would not be paid in full, since the court agreed with the pre-petition creditor’s expectation that the collateral’s value would decrease over time.\(^\text{125}\)

2. Assume for example, that the trustee desires to shift the initial security interest from one source of collateral to another, in order to provide the new creditor with a superior security interest in the initial collateral.\(^\text{126}\) Let the value of the initial collateral be $1 million, and let the pre-petition secured debt be $500,000. The trustee obtains a new loan in the value of $500,000, and is willing to provide the new creditor with a superior security interest. For this purpose, the trustee shifts the pre-petition security interest to an alternative source of estate collateral that is worth only $600,000. A pre-petition creditor opposes this shift, on the grounds that it increases the risk that the value of the collateral would not be sufficient to cover the pre-petition secured debt in its entirety, in violation of the adequate protection requirement.

These two examples illustrate three possible approaches to the adequate protection requirement. The first approach follows the decision in \textit{In re Shaw Industries}, where the court applies the requirement to elevate the interest of pre-petition creditors over the trustee’s interest in obtaining new credit. This approach would limit the trustee’s ability to avoid existing entitlements, even though such limits may obstruct the reorganization process. Accordingly, in the first example, the court would prevent the trustee from providing the post-petition creditor with a superior lien, even when the pre-petition creditors are over-secured. In the second example, a court using this first approach would prevent the shift of security interest from one source of collateral to another, unless the value of the new collateral is equal to or greater than the value of the


\(^{125}\) For example, following the above numerical example, if the collateral’s value decreases below $1 million it can no longer cover both debts. Thus, if the new security interest is superior to the pre-petition one, then the initial creditor would no longer be repaid in full. Similarly, when the two debts continue to accumulate post-petition interest, then the value of the new debt is expected to increase to above $500,000. Thus, if the new creditor enjoys an absolute priority over the initial one, the remaining value that would be left after the new creditor is paid in full would not be sufficient to cover the initial debt.

\(^{126}\) The possibility of providing adequate protection via a “replacement lien” is fixed in 11 U.S.C. § 361(2) (2000).
initial collateral.\footnote{127} The advantage of this approach is that it succeeds in protecting pre-petition entitlements, and thereby encourages parties to plan efficient credit transactions at the time of contract, well before the business goes bankrupt. The problem with this approach is that it diminishes the trustee’s ability to employ all existing sources of value for the purpose of obtaining new credit. In both examples, the trustee would not be able to use the difference between the value of the collateral and the value of the pre-petition debt to secure the repayment of post-petition credit. Thus, the trustee may unnecessarily fail in his efforts to reorganize the bankrupt business.

The second possible approach would limit the adequate protection requirement to the value of the pre-petition debt at the date of commencement. In the above examples, it would suffice for the trustee to maintain at least $500,000 of security interest on behalf of the pre-petition creditors.\footnote{128} Thus, in the first example, the trustee would be able to provide the new creditor with a superior lien on the collateral because the collateral’s value would still cover the pre-petition debt of $500,000. In the second example, the trustee would be able to shift the initial creditor from the initial source of collateral to an alternative one, as long as the alternative collateral’s value exceeds $500,000. This approach facilitates the capability of the trustee to rearrange the pre-petition security interests, and thereby maximize the remaining value for securing the repayment of new credit. However, this approach involves a far-reaching interference with prior entitlements, and as such, threatens the capability of pre-petition creditors and solvent businesses to pre-plan their credit transactions.

This Article’s theory of bankruptcy law supports a third approach to the adequate protection requirement. Under the third approach, adequate protection entitles the pre-petition secured creditor to a value equal to the value he would have received had the collateral been foreclosed immediately upon the commencement of bankruptcy proceedings. In the above examples, the security interest should continue to cover both the value of $500,000, and the market cost of delay, or post-petition interest calculated according to the market interest rate. Assume, for example, that following reorganization, the post-petition creditor would recover his debt only five years after commencement.

\footnote{127} Similarly, in In re Waste Conversion Techs., Inc., 205 B.R. 1004 (Bankr. D. Conn. 1997), the bankruptcy court ruled that the replacement lien must provide full compensation. Thus, when the initial lien is fully perfected, the creditor is entitled to automatic perfection in the replacement lien as well. See also In re Martin, 761 F.2d 472 (8th Cir. 1985).

\footnote{128} This is the accepted judicial interpretation of adequate protection in the context of undersecured creditors, and creditors whose collateral only covers the value of the debt at the date of commencement. In United Savings Ass’n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 372-73 (1988), the Supreme Court held that adequate protection does not mandate the preservation of a cushion for covering the post-petition interest when the initial collateral covers the debt value at the date of commencement. This decision was distinguished by several later decisions, but never expressly overruled. See, e.g., LNC Invs., Inc. v. First Fid. Bank, 247 B.R. 38 (Bankr. S.D.N.Y. 2000).
Also, assume that the market interest rate is 8%. Then, adequate protection requires that the collateral continue to secure the value of $586,660 for the pre-petition creditor. Then, in the first example, the new secured credit cannot exceed the value of $413,340. In the second example, the alternative collateral must preserve the value of $586,660.

The third approach accomplishes both the purpose of severing the bankrupt's assets from prior inefficient entitlements, and the purpose of protecting the pre-planning of credit transactions. Following this third approach, the acquisition of new credit in reorganizations would become a quasi-monitoring mechanism, which enables only the companies worthy of reorganization to undergo reorganization. To see how this works, consider that reorganization is appropriate only when the value of the company's assets in reorganization is higher than their value in liquidation. In order for the reorganization plan to be efficient, it must ensure its investors a higher value than they can obtain in the market, in exchange for investing money that the company would have received had it immediately sold its assets in liquidation. Thus, for example, if the value of the company's assets in an immediate sale is 100, and the market interest rate is 8%, then reorganization will be advantageous only if the future income of the company is expected to exceed an 8% rate of return. Otherwise, it is advisable to dissolve the company, sell its assets in exchange for 100, and enable its creditors to enter alternative investments with the money that they will receive when the company sells its assets.

Assume, for example, that all of the company's existing assets serve as collateral to pre-petition secured debt. According to the third approach, the trustee will be forced to supply the secured creditors with a value of 100 plus an annual interest of 8%, such that he will not be able to grant any sort of preference to the new creditor. Finally, assume that the company requires new credit at the value of 20. The new credit will raise the current value of the company's assets to 120. However, the new creditor will require a security interest in something more than the new assets which the company obtained through the money from his loan, because he will fear that this security will cover only the value of his loan's principal, and not the interest as well. Therefore, he will agree to invest only if the company's income will have an annual yield exceeding 8 percent. In other words, the new creditor will not be

129. This approach is supported by many jurisdictions. See, e.g., In re Park West Hotel Corp., 64 B.R. 1013 (Bankr. D. Mass. 1986) (holding that the debtor's burden is to show not only that the market value of the property, less costs of sale and tax encumbrances, is greater than the steadily increasing amount of the secured party's debt, but also that it is greater by a margin sufficient to ensure that the secured party's interest is not at risk); see also In re R & H Inv. Co., 46 B.R. 114 (Bankr. D. Conn. 1985); In re Kertennis, 40 B.R. 895 (Bankr. D.R.I. 1984); In re Heath, 79 B.R. 616 (Bankr. E.D. Pa. 1987); Anchor Sav. Bank v. Sky Valley, Inc., 99 B.R. 117 (Bankr. N.D. Ga. 1989); In re Mellor, 734 F.2d 1396 (9th Cir. 1984).
prepared to invest in the company unless he expects the company's business to yield a higher return than he can obtain on the market. In this way, the trustee will be able to meet the adequate protection conditions towards the previous creditors, in addition to ensuring the new creditor's sources of payment.

The company's ability to raise new credit during reorganization acts as an extremely important monitoring mechanism. At the stage of examining the reorganization plan, it is uncertain whether reorganization would be advantageous. The court's decision is a result of valuation formulae, which rely on the future hypothetical values of the reorganized company. Valuation techniques enable much flexibility and may lead to substantial variances in the possible results. Different interested parties will try to distort the results of the assessment by arguing for certain valuations, so as to persuade the court to adopt a procedure in accordance with their personal interests.

Thus, when reorganization is the action taken, it is expected that a group of claimants (for example controlling shareholders, managers of the company, or regular creditors) will ask for a piece of the reorganization yield. Such a group will suggest reorganization plans, which are based on optimistic assessments of the expected revenue of the company, only because the group would profit more from any of its plans than from liquidation. However, when reorganization yields the same value as liquidation, then reorganization harms, rather than benefits, the company's creditors. This is so because reorganization involves considerable costs, which are necessary in order to keep the company active during the collective proceedings, to postpone the payment of the debts, and to entice new creditors to invest in the failing company. Therefore, it is important that the trustee be limited in raising new credit for the reorganization. Adequate protection for the previous secured creditors will ensure that the raising of credit will be done only when there are investors who believe that the company's return will be greater than that of the market.

C. Executory Contracts

The treatment of executory contracts most clearly exemplifies the role of bankruptcy law. A company not in bankruptcy cannot be released from the commitments it created, even if the commitments turn out to be unprofitable. After the commencement of bankruptcy proceedings, the trustee is entitled to choose between performance and avoidance of pre-petition contractual

130. See Bebchuk, supra note 51, at 777-81.
131. See 11 U.S.C. § 365 (2000). Section 365 grants the authority to the liquidator or the trustee to choose whether to assume, assign or to reject an executory contract. Executory contracts are contracts in which both parties, the company and the second party to the contract, have not yet performed all of their commitments. See In re Riodizio, Inc., 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997); In re Parkwood Realty Corp., 157 B.R. 687, 689 (Bankr. W.D. Wash. 1993); Vecchitto v. Vecchitto, 2000 U.S. App. LEXIS 25439 (2d Cir. Oct. 11, 2000).
obligations. If the trustee elects to perform the contract, then both parties (the bankrupt estate and the other contractual party) would have to abide by the pre-petition liabilities. If the trustee chooses avoidance, then the estate would not perform its duties under the contract, and the other parties would be forced to share the value of the estate with the other non-secured creditors.\textsuperscript{132}

In order to clarify the practical meaning of this arrangement, it is important to note the different stages that the company's contracts can be found at the beginning of the collective proceedings:

a. \textit{Either early stages of performance or continuous contracts}: It is possible that the company entered into the contract, but that neither party has yet to perform the majority of the contractual obligations involved in it. A similar possibility is that both parties have already partially performed the contract, but that it is a continuous contract, such that both parties are committed to implementing different commitments over a period of time. In either possibility, the collective proceedings will have begun at a time when there are still many obligations that the parties have not yet performed.

b. \textit{Intermediate stages of performance}: It is possible that the creditor has already fully performed its obligations towards the company, but that the company has not yet fully performed its obligations towards the creditor.

c. \textit{Intermediate stages of performance}: It is also possible that the company has already fully performed its obligations towards a third party, but that the third party has not yet fully performed its contractual obligations towards the company.

d. \textit{Advanced stages of performance}: Finally, it is possible that both parties have fulfilled the majority of their mutual contractual commitments.

In contracts in which the creditor has fully performed but the company has not, the trustee will avoid fulfilling the company's obligation towards the creditor when the creditor can claim its debt in collective proceedings.\textsuperscript{133} In contracts where the company has fully performed but a third party has not, the trustee will be able to file for performance on behalf of the estate. Finally, where both parties have fully performed their contractual obligations, the collective proceedings do not affect the parties' rights.\textsuperscript{134}

Thus, the arrangement of executory contracts refers only to scenarios where both parties have yet to fully perform their contractual obligations. To be more precise, most bankruptcy courts have adopted Professor Countryman's definition of executory contracts: "...a contract under which the obligation of


\textsuperscript{133} There is a conflict on this issue as to how to classify option contracts. The leading approach is that options will not be considered executory contracts, unless the owner of the option decides to realize the option before submitting the request for bankruptcy. See, e.g., \textit{In re Robert L. Helms Constr. & Dev. Co.}, 139 F.3d 702, 706 (9th Cir. 1998).

both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.\textsuperscript{135} Once a court determines that a contract is executory, the law grants the trustee or liquidator the right to reexamine the profitability of the transaction from the point of view of the debtor-company.\textsuperscript{136} If the trustee determines that the company is better off if the parties were to carry out the terms of the contract, then the trustee must implement it. Otherwise, the contract should be perceived as an "unprofitable contract" that should be "avoided."\textsuperscript{137} For example, if we are discussing a contract to purchase an apartment from a real estate company, where the real estate company filed for bankruptcy during the building process, then the trustee will have to estimate the proceeds that the company expects to receive from the buyer and compare it to both the costs of finishing the building and the cost of foregoing an alternative contract (in which the apartment will be sold to a different buyer). The trustee will choose to perform the contract only when the expected proceeds from the buyer are higher than these costs.

The following numerical example clarifies this situation (see Table No. 1 below):

\textsuperscript{135} See In re Knutson, 563 F.2d 916, 917 (8th Cir. 1977); see also In re Craig, 144 F.3d 593, 596 (8th Cir. 1998).

\textsuperscript{136} 11 U.S.C. § 363.

Table No. 1: Examining the Existence of a Burdensome Asset

<table>
<thead>
<tr>
<th></th>
<th>Numerical example</th>
<th>Denoted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs of completing the building</td>
<td>100</td>
<td>$C_b$</td>
</tr>
<tr>
<td>Balance due</td>
<td>150</td>
<td>$E_P_c$</td>
</tr>
<tr>
<td>Current market price of the apartment</td>
<td>400</td>
<td>$V_m$</td>
</tr>
<tr>
<td>Value of implementing the contract</td>
<td>$(150 - 100)$</td>
<td>$(E_P_c - C_b)$</td>
</tr>
<tr>
<td>Transaction costs of alternative contracts</td>
<td>50</td>
<td>$T_C$</td>
</tr>
<tr>
<td>Value of alternative transaction</td>
<td>$(400 - 100 - 50)$</td>
<td>$(V_m - C_b - T_C)$</td>
</tr>
<tr>
<td>The trustee’s necessary decision</td>
<td>Since the value of implementing the contract is lower than the value of the alternative transaction, the trustee must refrain from executing the contract.</td>
<td>Max{$(E_P_c - C_b)$, $(V_m - C_b - T_C)$}</td>
</tr>
</tbody>
</table>

In the numerical example, if the trustee chooses to execute the contract, he would receive the balance due from the buyer and transfer the apartment to him after finishing the building. The liquidation fund will bear the costs of completing the building. In contrast, if the trustee avoids the contract, he would be able to sell the apartment to a new potential buyer. In this case, the trustee would need to find a new buyer and draft a new contract. In addition, the trustee would shoulder the burden of securing funds to complete the building. All of this may well be worth the trouble because, in many cases, the alternative transaction will yield a higher value to the estate than would the performance of the original contract.

The example illustrates that when deciding whether to perform an executory contract, the trustee cannot simply compare the balance due with the costs of completing the construction; rather, he must also take into account the price that he will be able to receive from selling the apartment to a third party. The trustee should only perform the contract when doing so will lead to a higher profit than can be obtained from the alternative transaction. Thus, for example, in a situation where prices of apartments are gradually declining, the trustee may find that performing the original contracts will be more beneficial. In contrast, in a situation where prices of apartments are rising, the more
efficient alternative will usually be to cancel the existing contracts in favor of new transactions at higher prices. Of course, the original buyer can try to entice the trustee into performing the contract by showing a willingness to enlarge the balance due.

Finally, the trustee must consider that partaking in the alternative transaction will bind him to the costs that are entailed in the transaction. Therefore, the trustee’s or the liquidator’s willingness to perform the original contracts will also depend on the fluidity of the company’s assets.

This legal arrangement implies that the commencement of bankruptcy proceedings entitles the trustee to the right to avoid onerous and unprofitable contracts. The law enables the trustee to free the estate from inefficient liabilities in ways that are not available outside the bankruptcy proceedings. The purpose of this legal arrangement is to facilitate the severance of economic resources from inefficient entitlements, so as to enable their return to productive business activity.

CONCLUSION

This Article shows that bankruptcy law can be understood as the legal solution to the phenomenon of inefficient entitlements. Firms initially engage in various contracts and liabilities based upon their expectations regarding future events. Nevertheless, reality may prove their expectations to be mistaken, and their contracts to be unprofitable. Generally, the law does not recognize lack of profitability as a justification for non-performance, and as a result, under certain circumstances, the unprofitable contracts may push these firms into inefficient activities and financial distress. Often, the parties would be able to settle such sources of inefficiency on their own, and enter into new contracts that would supplant the initial ones. Nevertheless, conflicts of interest may obstruct the renegotiation process, and therefore, some legal coercion may become essential for shifting the economic resources back to efficient activity. Bankruptcy law serves this essential role. It provides the legal process with substantive arrangements for severing the firm’s resources from its inefficient entitlements. Legal arrangements such as the trustee’s authority to obtain new credit in reorganization, secured creditors’ entitlement to adequate protection, and the trustee’s discretion to perform executory contracts are examples of the methods by which bankruptcy law enables the avoidance of existing entitlements.