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ARTICLES

WHY DELAWARE COURTS SHOULD ABOLISH THE *SCHNELL* DOCTRINE

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INTRODUCTION

Today, the proposition that Delaware courts can grant equitable relief is incontrovertible. Apparently, however, this proposition was debatable after the passage in 1967 of the Delaware General Corporation Law ("DGCL").[1]

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1. *See* Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are*

Many scholars credit the *Schnell* doctrine, created in 1971, with securing the current availability of equitable relief.[2] The *Schnell* doctrine permits courts to invalidate conduct that is technically in compliance with applicable law if the court deems that conduct to be inequitable;[3] therefore, compliance with the corporate statute is the minimum, but not necessarily the sole, requirement for legality. Throughout its forty-five-year life, the *Schnell* doctrine has surfaced intermittently in Delaware case law. Recently, the doctrine has moved front and center in Delaware corporate law as Delaware courts have raised the specter of the *Schnell* doctrine to test the validity of contentious director-enacted bylaws if and when corporations implement them.[4] While the *Schnell* doctrine is ingrained in Delaware law, this Article nevertheless offers a bold recommendation: abolish the *Schnell* doctrine entirely. The reason is simple: the *Schnell* doctrine adds nothing positive to existing Delaware law.

The thesis of this Article accepts the view that *Schnell* has served the critical function of establishing the role of equity, but argues that the *Schnell* doctrine is currently superfluous for one reason: there is—or should be—a *Schnell* violation only when there is also a breach of fiduciary duty. Thus, the coexistence of the *Schnell* doctrine and fiduciary breaches incorrectly suggests that a *Schnell* violation is different from a breach of fiduciary duty and imposes costs for this incorrect inference. Since the doctrine imposes costs and offers no discernable current benefit, this Article recommends that Delaware courts abolish the *Schnell* doctrine. Because this Article agrees with the vital role of equity in Delaware corporate law, but contends that the *Schnell* doctrine no longer adds to that

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Circumstances in Which It Is Equitable to Take That Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft, 60 BUS. LAW. 877, 881 (2005) (discussing that some members of the Delaware bar in 1967 believed that the newly-passed Delaware General Corporation Law (DGCL) occupied the "entire field of corporate law").

2. *See infra* notes 17–21 and accompanying text (depicting slightly different views of the early role of the *Schnell* doctrine).

3. *See infra* note 16 and accompanying text.

4. Delaware courts have held that forum-selection bylaws, *see* City of Providence v. First Citizens BancShares, Inc., 99 A.3d 229, 233–34 (Del. Ch. 2014); Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 940 (Del. Ch. 2013), and fee-shifting bylaws in non-stock corporations, *see* ATP Tours, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 557–58 (Del. 2014), are facially valid, but they have also held that they would review these bylaws again under the *Schnell* doctrine should the corporations implement these respective bylaws. *See, e.g.*, *ATP Tours*, 91 A.3d at 558. Subsequent Delaware legislation made the former valid, *see* DEL. CODE ANN. tit. 8 § 115 (West 2015), and the latter invalid for stock companies, *see id.* §§ 102(f), 109(b). The Delaware legislature did not invalidate *ATP*'s holding that fee-shifting bylaws are valid in the context of non-stock corporations. *See id.* § 114(b)(2) (stating that Sections 102(f) and 109(b) shall not apply to non-stock corporations); *see also infra* notes 116–123 and accompanying text.

vitality, this proposal would not weaken the robust protection that equity currently provides.

Part I first discusses the *Schnell* case and how, at its origin, it established the role of equity in judicial review. Thereafter, Part I discusses two other key cases: *Weinberger v. UOP, Inc.*[5] and *Blasius Industries, Inc. v. Atlas Corp.*[6] All three cases are identical in one respect: after finding that the respective directors meticulously complied with the relevant statutory provisions, the Delaware courts in these three cases nevertheless held that such compliance alone was insufficient. The most interesting aspect of these cases for the purposes of this Article is that these courts gave three different responses regarding why the directors' conduct was invalid: (1) the Delaware Supreme Court in *Schnell* held that the directors' conduct was inequitable; (2) the Delaware Supreme Court in *Weinberger* held that directors and controlling shareholders violated their fiduciary duty of loyalty; and (3) the Delaware Chancery Court in *Blasius* also held that the directors violated their duty of loyalty, but reasoned that, because the directors had acted in good faith, this violation was unintentional.

Since the court's response in *Schnell* was that the conduct was inequitable, and the response in *Weinberger* and *Blasius* was that the conduct breached the directors' fiduciary duties, Part II begins by examining all cases where Delaware courts found *Schnell* violations and concludes that all but two were nothing more than fiduciary breaches. Part II then posits that these two outlier cases illuminate the cost of retaining the *Schnell* doctrine because the judges in these two cases invalidated legal conduct based solely on their sense that the directors had acted unfairly. Although legislation has resolved the contentious issues raised in two other recent cases,[7] Part II concludes with an analysis of these two cases that Delaware courts had, prior to this legislation, reserved for a future *Schnell* analysis. As a result, while Part I demonstrates that, at its origin, the *Schnell* doctrine served a valuable function, Part II demonstrates that today, the doctrine is superfluous—as any *Schnell* violation should constitute a breach of fiduciary duties— and dangerous if the forbidden conduct falls short of the fiduciary mark.

Part III questions the status quo, which is that Delaware courts currently can utilize both the *Schnell* doctrine and fiduciary law to invalidate otherwise legal conduct. After examining whether there are benefits from

5. 457 A.2d 701 (Del. 1983).

6. 564 A.2d 651 (Del Ch. 1988); *see also* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127–32 (Del. 2003) (affirming the *Blasius* doctrine).

7. *See ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 555 (Del. 2014); *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013); *see* also *supra* note 4.

using these overlapping tools, the Article rejects all arguments that favor maintaining the *Schnell* doctrine. In addition, Part III concludes that while there are no costs, there are benefits to abolishing the doctrine. Thus, the Article concludes with the recommendation that Delaware courts consider abolishing the *Schnell* doctrine.

I. THE *SCHNELL* DOCTRINE AND ITS ROLE IN DELAWARE LAW

A. Schnell

When the Delaware legislature passed the DGCL in 1967, the debatable issue was not whether directors had to comply with the statute, but whether such compliance alone was sufficient. Now Chief Justice of the Delaware Supreme Court, but then-Vice Chancellor of the Delaware Court of Chancery, Leo Strine, wrote that "some elements of the Delaware bar believed that the then-new DGCL should be viewed as more or less occupying the entire field of corporate law . . . ."[8] This view of the DGCL was tested in *Schnell v. Chris-Craft Industries, Inc.* when incumbent directors of Chris-Craft Industries, fearing they would lose a proxy fight, took two actions that the corporate statute and the corporation's governing documents authorized: the directors accelerated the annual meeting by five weeks, and they moved the meeting location from its usual place in New York City to a remote part of upstate New York.[9] The dissidents sued, claiming that the directors' actions effectively thwarted the dissidents' ability to conduct a proxy contest that they had planned for the original meeting date.[10] In contrast, the directors argued that they had the power to take the two steps that they did—a view the Delaware Court of Chancery shared. The Delaware Court of Chancery reasoned that, since the board's actions complied with the statute, the corporation's certificate, and its bylaws, the court could not order any relief.[11]

The Delaware Supreme Court reversed the lower court's decision.[12] In a three-page opinion, the Delaware Supreme Court reasoned that because corporate management had attempted to use the corporate statute for the purposes of "perpetuating itself in office"[13] and "obstructing the legitimate efforts of dissident stockholders,"[14] corporate management's conduct was

8. *See* Strine, *supra* note 1, at 881.
9. 285 A.2d 430, 431–32 (Del. Ch. 1971), *rev'd,* 285 A.2d 437 (Del. 1971).
10. *Id.* at 432.
11. *Id.* at 437.
12. *See generally* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).
13. *Id.* at 439.
14. *Id.*

inequitable.[15] The court did not mention the words "fiduciary duties" in describing the directors' conduct. In response to the directors' and the chancery court's view that the directors had the legal authority to take the actions they took, the Delaware Supreme Court created the maxim that has become known as the *Schnell* doctrine: "[I]nequitable action does not become permissible simply because it is legally possible."[16]

Chief Justice Strine has credited the *Schnell* doctrine with changing Delaware law to its current status where directors must comply with both their legal and equitable obligations.[17] Former Delaware Supreme Court Justice Jack Jacobs expressed a slightly different view, arguing that the 1967 DGCL revisions sought to respond to the need of the Delaware bar for predictability but that equity always had some role.[18] Whatever the vibrancy of the role of equity after the DGCL passed, however, all agree that the *Schnell* doctrine ingrained the important role of equity in judicial review.[19] Indeed, another Delaware Supreme Court Justice, Randy Holland, wrote that "*Schnell* made it plain that in Delaware, equity trumps."[20] One article described well the interplay of the Delaware statute and the *Schnell* doctrine:

> [T]he DGCL gives directors a strong hand to manage the corporation, and the primary non-ballot box legal constraint on them is the enforcement of their equitable fiduciary duties. That is, what is critical to recognize is that the powers entrusted to directors by the DGCL may only be exercised to advance proper corporate interests. Modernly, that principle is most famously embodied in the Delaware Supreme Court's decision in *Schnell v. Chris-Craft Industries, Inc.*, which reaffirmed the long-standing notion that 'inequitable action [is] not . . . permissible

15. *Id.*

16. *Id.*

17. *See* Strine, *supra* note 1, at 881 (noting that *Schnell* was the first case to reject "the proposition that compliance with the DGCL was all that was required of directors to satisfy their obligations to the corporation and its stockholders").

18. Jack B. Jacobs, *The Uneasy Truce Between Law And Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 5–6 (2005); *cf.* Robert K. Clagg, Jr., *An "Easily Side-Stepped" And "Largely Hortatory" Gesture?: Examining the 2005 Amendment to Section 271 of the DGCL*, 58 EMORY L.J. 1305, 1320 (2009) ("The role of equity in Delaware's corporate jurisprudence has ebbed and flowed throughout history, always making its exact place somewhat difficult to pin down.").

19. *See* Jacobs, *supra* note 18, at 7 (stating that *Schnell* "marked the birth of the 'equity' model first in Delaware and later in other states"); Strine, *supra* note 1, at 883.

20. DELAWARE SUPREME COURT: GOLDEN ANNIVERSARY 1951-2001 92 (Randy J. Holland & Helen L. Winslow eds., 2001); *see also* Clagg, *supra* note 18, at 1320–21 (noting that *Schnell* "gave rise to the basic equitable dynamic inherent in Delaware's corporate jurisprudence today"); J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. CORP. L. 391, 418 (2011) (noting that the DGCL gave directors wide discretion that is tempered by the *Schnell* doctrine).

> simply because it is legally possible.' In *Schnell*, the Delaware Supreme Court emphatically voiced its acceptance of the importance of fiduciary duty review in ensuring that the capacious authority granted to directors by the DGCL was not misused.[21]

Thus, if there had been any question of the existence or vitality of the role of equity after the DGCL passed, *Schnell* ended that debate.

B. Weinberger

In *Weinberger v. UOP, Inc.*,[22] the Delaware Supreme Court resolved the contentious issue of the requirements for a controlling-shareholder merger that freezes out minority shareholders. Although the directors complied with the merger requirements of the DGCL,[23] the Delaware Supreme Court in *Weinberger* invalidated the going-private transaction at hand without mentioning the *Schnell* doctrine.[24] Instead, the court reasoned that the directors had breached their fiduciary duties in this conflict-of-interest transaction because the directors denied critical information both to the corporation's outside directors and to the minority shareholders, thus negating any validation of the transaction from the shareholder vote.[25] Moreover, because the shareholder vote was invalid, defendants had to demonstrate that the merger was entirely fair, a burden they failed to meet.[26] Noting that it was a long-held view that majority shareholders and

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21. Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporate Law*, 98 GEO. L.J. 629, 641–42 (2010). The interplay of the *Schnell* doctrine and fiduciary review, as conveyed in the quoted text, is central to this Article's thesis and will be discussed in more detail *infra* Part II.

22. 457 A.2d 701 (Del. 1983).

23. DEL. CODE ANN. tit. 8 § 251 (West 2015).

24. While not criticizing *Weinberger* for failing to discuss the *Schnell* doctrine, one article noted that *Weinberger*'s significance is tied to the *Schnell* doctrine, stating that "[i]n fairness, *Schnell* . . . is the real genesis of this change, permitting courts to set aside otherwise lawful transactions if they find unfairness, thus elevating equity over law." William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 18 n.94 (2009).

25. *Weinberger*, 457 A.2d at 712. The Delaware Supreme Court also held: (i) Plaintiffs, in challenging a cash-out merger, shoulder the initial burden of alleging specific acts of fraud, misrepresentation, or other misconduct to demonstrate the unfairness of the merger terms to the minority, *id.* at 703; (ii) Where corporate action has been approved by an informed vote of a majority of the minority shares, plaintiffs bear the burden of showing the transaction was unfair to the minority, *id.*; (iii) Going-private transactions no longer need to have a valid business purpose, *id.* at 705–06; (iv) Entire fairness requires both fair dealing and fair price, *id.* at 711; (v) The valuation methodology in an appraisal proceeding should be based on all relevant valuation criteria rather than the traditional Delaware block method, *id.* at 712–13; and (vi) The remedy of quasi-appraisal rights would be available to certain shareholders so they could utilize *Weinberger's* new valuation methodology, *id.* at 714–15.

26. *Id.* at 703.

the directors they designate owe the target corporation and its minority shareholders an "uncompromising duty of loyalty,"[27] the court wrote: "There is no 'safe harbor' for such divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[28]

C. Blasius

In *Blasius Industries, Inc. v. Atlas Corp.*, the directors acted in full compliance with both the DGCL and Atlas Corporation's ("Atlas") charter when, in the midst of a proxy contest from Blasius Industries ("Blasius"), the Atlas directors increased the size of the board by two positions and then filled those two board vacancies.[29] While the directors' actions increased the Atlas board from seven to nine members, Atlas' charter permitted a fifteen-member board.[30] The net effect, however, thwarted Blasius' chance to elect a majority of directors, as now there were only six open seats—instead of eight—on the fifteen-member Atlas board. Blasius attacked the Atlas board's action as an entrenchment tactic, in violation of the *Schnell* doctrine.[31] The Delaware Court of Chancery reasoned that if Blasius was correct that the Atlas board was acting for selfish reasons, the board's action would clearly violate the *Schnell* doctrine: "[P]laintiffs say . . . that asserted policy differences were pretexts for entrenchment for selfish reasons. If this were found to be factually true, one would not need to inquire further. The action taken would constitute a breach of duty. *Schnell* . . . ."[32] Chancellor William Allen ultimately concluded, however, that the board was acting in good faith, not selfishly, in order to thwart Blasius' plan which the directors feared would harm the corporation.[33] Despite this finding, the Atlas directors were not off the hook, as the court reasoned that the directors' good faith could not create power for the board that it lacked; instead, the court held that directors lacked the power to act for the sole or primary purpose of thwarting a shareholder vote:[34]

> The only justification that can . . . be offered for the action taken is that

27. *Id.* at 710.

28. *Id.*

29. 564 A.2d 651, 656 (Del Ch. 1988).

30. *Id.* at 654.

31. *Id.* at 657.

32. *Id.* at 658. *But see infra* notes 92–93 and accompanying text (delineating other cases that have mixed holdings on whether defendants must act with an improper motive to violate the *Schnell* doctrine).

33. *Blasius*, 564 A.2d at 658.

34. *Id.* at 661.

> the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant... when the question is who should comprise the board of directors. The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters .... [T]here is a vast difference between expending corporate funds to inform the electorate and exercising power for the primary purpose of foreclosing effective shareholder action.[35]

The Delaware Court of Chancery formulated a test whereby, if the directors' primary purpose is to disenfranchise their shareholders, the directors must show a compelling purpose for their actions[36]—a burden that the directors in *Blasius* failed to overcome.[37] Moreover, despite finding that the directors had acted in good faith, the court held that the board's action "constituted an unintended violation of the duty of loyalty that the board owed to the shareholders."[38]

To be sure, *Blasius* is a controversial decision from a number of perspectives, largely due to the incongruities of the compelling-purpose test.[39] What has not been under attack, however, is the court's reasoning that directors are not home-free simply because their actions complied with the statute. The most noteworthy point for this Article is the court's

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35. *Id.* at 663.

36. *Id.* at 661; *see also* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003) (affirming the *Blasius* test).

37. *Blasius*, 564 A.2d at 662.

38. *Id.* at 663. The court noted that unintended breaches of the duty of loyalty are "unusual but not novel." *Id.* (citing to Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980), and AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986)). For other cases where courts have found that the directors had not acted in their own self-interest but were nevertheless held to have committed a technical violation of the duty of loyalty, see generally *Johnston v. Pedersen*, 28 A.3d 1079 (Del. Ch. 2011), where the directors enacted a provision in a Series B Preferred stock plan to give these shareholders veto power over any change in control to maintain stability in the corporation rather than to entrench themselves in control, and see generally Thorpe v. CERBCO, 676 A.2d 436 (Del. 1995), where the controlling shareholder, as a director, voted against an offer for the corporation to sell all of its assets because he knew he would veto the transaction if the board submitted it to a shareholder vote.

39. One criticism is that the compelling purpose test in not a true test as no directors are ever likely to be able to provide a satisfactory reason for purposefully disenfranchising their shareholders. *See* Mercier v. Inter-Tel, Inc., 929 A.2d 786, 806 (Del. Ch. 2007) (noting that *Blasius*' compelling-justification test is almost impossible to satisfy); Strine, *supra* note 1, at 892 (describing the compelling-justification test as an "admittedly onerous standard"). Another criticism is, despite Chancellor Allen's reasoning to the contrary, that the board did have the power to take the action it took. *See id.* at 891 ("The Atlas board deprived Blasius of no legal right; it merely closed off an opportunity that had dropped in Blasius's lap because of the Atlas board's prior inattention .... [T]he Atlas board was empowered to do just what it did.").

conclusion that because the directors were not acting selfishly, they could violate their fiduciary duty of loyalty unintentionally but could not violate the *Schnell* doctrine.[40] In so holding, Chancellor Allen articulated a view that the *Schnell* doctrine invalidates only selfish conduct.[41] Moreover, Chancellor Allen delineated the capacious breadth of the duty of loyalty as encompassing both selfish as well as good-faith violations.[42]

D. Summary of Schnell, Weinberger, *and* Blasius

While *Schnell* established equitable review in Delaware corporate law, *Weinberger* and *Blasius* added to that dynamic. Both *Schnell* and *Blasius* pertained to directors' attempts to interfere with shareholder voting, while *Weinberger* concerned a going-private transaction. Both *Schnell* and *Weinberger* held that directors acted out of self-interest, while the court in *Blasius*, in contrast, found that the directors were not acting selfishly.[43] The court in *Blasius* nevertheless held that the directors breached their duty of loyalty, as did the court in *Weinberger*. Finally, while *Schnell* does not mention fiduciary duties and *Weinberger* does not mention the *Schnell* doctrine, *Blasius* discusses both the *Schnell* doctrine and fiduciary duties.

The import of considering *Weinberger* and *Blasius* together is to highlight that there can be both inequitable as well as good-faith breaches of the duty of loyalty. While it is clear that *Schnell*'s inequitable conduct is different from *Blasius*' good faith breach of fiduciary duties and there are different judicial views on whether a bad motive is required to violate the *Schnell* doctrine,[44] the pivotal remaining issue is whether *Schnell*'s inequitable conduct is different from *Weinberger*'s inequitable breach of fiduciary duty. The next section will demonstrate that a true *Schnell* violation is nothing more than a breach of fiduciary duty.

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40. *See supra* notes 33, 38, and accompanying text.

41. Some subsequent cases disagree that *Schnell* violations require an improper motive. *See infra* notes 92–93 and accompanying text (delineating cases that hold improper motive is not required to violate the *Schnell* doctrine from cases that hold the opposite).

42. Delaware courts have enlarged the contours of the duty of loyalty not only by including both intentional and unintentional violations, *supra* note 38 and accompanying text, but also by including issues outside of the traditional financial self-dealing, such as breaches of the duty of good faith. *See* Stone v. Ritter, 911 A.2d 362, 370 ("Good faith is a subsidiary element . . . of the fundamental duty of loyalty.") (internal quotations omitted).

43. *See supra* notes 13, 25, 33, and accompanying text.

44. *See infra* notes 92–93 and accompanying text (discussing the conflict among cases regarding whether an improper motive is needed to violate the *Schnell* doctrine).

II. IS *SCHNELL*'S INEQUITABLE CONDUCT DIFFERENT FROM A BREACH OF FIDUCIARY DUTY?

As noted above,[45] the Delaware Supreme Court in *Schnell* invalidated the directors' action on equitable grounds, but it never addressed whether the directors had breached their fiduciary duties. The issue of whether *Schnell*'s failure to label the directors' inequitable conduct a breach of fiduciary duty meant that Delaware courts view these as different doctrines has mixed support in the *Schnell* cases: some *Schnell* cases fail to mention fiduciary duties;[46] some *Schnell* cases discuss fiduciary duties without concluding that the directors breached them;[47] and other cases invoke the *Schnell* doctrine to warn fiduciaries of the courts' equitable powers[48] but instead base the holding on a violation of fiduciary duty.[49]

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45. *Supra* notes 13–16 and accompanying text.

46. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (holding that management's conduct was inequitable without mentioning "fiduciary duties" in describing the directors' conduct); Lerman v. Diagnostic Data, Inc., 421 A.2d 906, 914 (Del. Ch. 1980) (holding that the board's bylaw amendment was inequitable under *Schnell* without mentioning fiduciary duties); Telvest, Inc. v. Olson, 1979 WL 1759, at *7 (Del. Ch. Mar. 8, 1979) (finding that the board's distribution of preferred stock was the kind of conduct "deplored in *Schnell*" without mentioning fiduciary duties even though the board's decision was self-serving and improperly motivated).

47. *See* Esopus Creek Value LP v. Hauf, 913 A.2d 593, 602–05 (Del. Ch. 2006) (discussing fiduciary duties, but finding that the directors' decision, although made without improper motive or entrenchment effect, was unfair under *Schnell*); Linton v. Everett, No. 15219, 1997 WL 441189, at *10 (Del. Ch. July 31, 1997) (finding that the directors' bylaw amendment was inequitable under *Schnell* without discussing fiduciary duties in this part of the opinion); Packer v. Yampol, 1986 WL 4748, at *13-18 (Del. Ch. Apr. 18, 1986) (discussing the board's fiduciary duties but finding that the creation of preferred voting stock was a violation of *Schnell* without concluding that the board violated its fiduciary duties); Dart v. Kohlberg, Kravis, Roberts & Co., No. 7366, 1985 WL 21145, at *5 (Del. Ch. May 9, 1985) (dismissing the plaintiffs' allegations that they could state a claim for breach of fiduciary duty but finding that it was possible that a leveraged buy-out could have "resulted in an impermissible inequity" to the shareholders under *Schnell*).

48. *See, e.g.*, Delaware Ins. Guar. Ass'n v. Christiana Care Health Servs., Inc., 892 A.2d 1073, 1078 (Del. 2006) (citing, but not applying, *Schnell* to the issue of whether a successor corporation in a merger became the insured party under an insurance policy); Farahpour v. DXK, Inc., 635 A.2d 894, 901 (Del. 1994) (citing *Schnell* and suggesting that courts could invalidate a corporation's conversion from a nonprofit, non-stock corporation to a for-profit stock corporation, but ultimately declining to do so); Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982) (citing *Schnell* to warn fiduciaries that "careful judicial scrutiny will be given a situation in which the right to vote for the election of successor directors has been effectively frustrated and denied by the willful perpetuation of a shareholder-deadlock and the resulting entrenched board of directors" but not basing the holding on the *Schnell* doctrine); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975) (citing to *Schnell* but declining to use the doctrine to invalidate directors' attempt to redeem preferred shares).

49. *See, e.g.*, MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003) (citing *Schnell* but basing the holding on other cases and concluding that the directors

Complicating this analysis is that there are only a handful of *Schnell* cases, and, as yet, courts have not established any unifying set of rules to cabin this doctrine.[50] Specifically, courts in only fourteen cases, including *Schnell* itself, have invalidated conduct based on the *Schnell* doctrine.[51] In two of these fourteen *Schnell* cases, the courts found both a *Schnell* violation and a breach of the duty of loyalty;[52] in five other cases, the

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breached their fiduciary duties); Phillips v. Insituform, Inc., No. 9173, 1987 WL 16285, at *9–10 (Del. Ch. Aug. 27, 1987) (citing *Schnell* but basing the holding on another doctrine and concluding directors breached their fiduciary duties); Am. Pac. Corp. v. Super Food Servs., Inc., No. 7020, 1982 WL 8767, at *325 (Del. Ch. Dec. 6, 1982) (citing *Schnell* but granting injunctive relief based on Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) and finding that the directors breached their fiduciary duties); Young v. Valhi, 382 A.2d 1372, 1378 (Del. Ch. 1978) (citing *Schnell* but holding that the directors breached their fiduciary duty).

50. Of the fourteen cases discussed, *infra* note 51, six are about shareholder voting for directors. *See Schnell*, 285 A.2d at 437; Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 45 (Del. Ch. 2008); *Linton*, 1997 WL 441189, at*1; Hubbard v. Hollywood Park Realty Enters., Inc., No. 11779, 1991 WL 3151, at *1 (Del. Ch. Jan. 14, 1991); *Packer*, 1986 WL 4748, at *1; *Lerman*, 421 A.2d at 912. The remaining eight cases are about mergers or are transactional law related. *See* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1100 (Del. 1985); Singer v. Magnavox Co., 380 A.2d 969, 971 (Del. 1977), *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Berger v. Intelident Solutions, Inc., 911 A.2d 1164, 1166 (Del. Ch. 2006); *Esopus*, 913 A.2d at 598–601; Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1028–30 (Del. Ch. 2004); Hamilton v. Nozko, No. 13014, 1994 WL 413299, at *1 (Del. Ch. July 27, 1994); *Dart*, 1985 WL 21145, at *1; *Telvest*, 1979 WL 1759, at *1. Four of these cases involved shareholder voting on transactions. *See Esopus*, 913 A.2d at 598–601; *Berger*, 911 A.2d at 1166; *Dart*, 1985 WL 21145, at *1; *Telvest*, 1979 WL 1759, at *1. *See generally* Mary Siegel, *Going Private: Three Doctrines Gone Astray*, 4 N.Y.U. J.L. & BUS. 399, 420–21 (advocating that, while the *Schnell* doctrine facially has no subject-matter limits, courts should limit the doctrine to cases that negatively impact shareholders' voting rights).

51. *Rabkin*, 498 A.2d at 1107; *Singer*, 380 A.2d at 979–80; *Schnell*, 285 A.2d at 437; *Portnoy*, 940 A.2d 43, at 74–75; *Esopus*, 913 A.2d at 604–05; *Berger*, 911 A.2d at 1174–75 ; *Hollinger*, 844 A.2d at 1081; *Linton*, 1997 WL 441189, at *9–10; *Hamilton*, 1994 WL 413299, at *6–7; *Hubbard*, 1991 WL 3151, at *7, *12 n.9; *Packer*, 1986 WL 4748, at *15; *Dart*, 1985 WL 21145, at *5; *Lerman*, 421 A.2d 913; *Telvest*, 1979 WL 1759, at *1–2. Courts in a few other cases have considered applying the *Schnell* doctrine but found the defendants' strategic maneuvers were not inequitable under *Schnell* because the election process ultimately allowed shareholders to vote. *See* Accipiter Life Sci. Fund, L.P. v. Helfer, 905 A.2d 115, 126–27 (Del. Ch. 2006); Dolgoff v. Projectavision, Inc., Civ.A. No. 14805, 1996 WL 91945, at *7–8 (Feb. 29, 1996); Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1123 (Del. Ch. 1990). One court applied the *Schnell* doctrine in the partnership context. *See* Twin Bridges Ltd. P'ship v. Draper, No. Civ.A. 2351-VCP, 2007 WL 2744609, at *21 (Del. Ch. Sept. 14, 2007).

52. *See Portnoy*, 940 A.2d at 74–75 (finding the CEO breached fiduciary duties and violated the *Schnell* doctrine by intentionally using corporate assets to coerce shareholders into voting as the CEO wanted); *Hollinger*, 844 A.2d at 1081 (finding that the conduct of the CEO and controlling shareholder was a breach of fiduciary duty and a violation of *Schnell* because the shareholder-enacted bylaws' sole purpose was to prevent the board from performing its statutorily-authorized duties and to effectuate illegal or inequitable activities).

courts stated, in rejecting a motion to dismiss[53] or in granting a preliminary injunction,[54] that they could find a fiduciary breach and a *Schnell* violation based on the complaint. Thus, in seven of the fourteen cases, the court both applied the *Schnell* doctrine and held, or strongly intimated, that there was a breach of fiduciary duties.

There are two approaches to analyzing the remaining seven cases. In these cases, the respective judges held that there were *Schnell* violations, but the judges either did not mention fiduciary duties or mentioned fiduciary duties only in passing without analyzing or applying them.[55] On the one hand, one can view these cases as involving breaches of fiduciary duty even though the respective judges did not articulate this breach either directly or indirectly. On the other hand, if the prohibited conduct in these cases did not constitute a breach of fiduciary duty, such a holding would suggest that fiduciary conduct can violate the *Schnell* doctrine simply by failing to pass a judge's "smell" test. A review of these seven cases easily puts five in the former category.[56] The directors' conduct in the remaining two cases, *Esopus Creek Value LP v. Hauf*[57] and *Dart v. Kohlberg, Kravis, Roberts & Co.*,[58] however, did not constitute a breach of fiduciary duty. As such, these cases are significant for both exposing a weakness in the *Schnell* doctrine and providing support for abolishing the doctrine.

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53. *See Rabkin*, 498 A.2d. at 1106 (reversing the chancery court's dismissal of the plaintiffs' allegation of a "breach of fiduciary duty under *Schnell*. . . ."); *Singer*, 380 A.2d at 980 (reversing the chancery court's dismissal and concluding under *Schnell* that the controlling shareholders manipulated their "corporate power solely to eliminate the minority" in violation of the "fiduciary duty owed by the majority to the minority stockholders"); *Berger*, 911 A.2d at 1174–75 (denying defendants' motion to dismiss under *Schnell* because the defendants intentionally deprived the shareholders of their statutory right to seek appraisal and because the controlling shareholder violated its "fiduciary duty of disclosure"); *Hamilton*, 1994 WL 413299, at *6–7 (denying defendants' motion to dismiss under *Schnell* because the board intentionally delisted the corporation to force the minority to sell their shares at a grossly unfair price, which constituted "an actionable breach of fiduciary duty").

54. *See Hubbard*, 1991 WL 3151, at *7, *12 n.9 (granting a preliminary injunction and finding that the plaintiff was likely to succeed on his claim that directors' failure to waive advance notice bylaws, when the board materially changed its position after the nomination date passed, could constitute a breach of fiduciary duties and a violation of *Schnell*).

55. *See generally Schnell*, 285 A.2d 437; *Esopus*, 913 A.2d 593; *Linton*, 1997 WL 441189; *Packer*, 1986 WL 4748; *Dart*, 1985 WL 21145; *Lerman*, 421 A.2d 906; *Telvest*, 1979 WL 1759.

56. *Schnell*, 285 A.2d 437; *Linton*, 1997 WL 441189; *Packer*, 1986 WL 4748; *Lerman*, 421 A.2d 906; *Telvest*, 1979 WL 1759.

57. 913 A.2d 593 (Del. Ch. 2006); *see* discussion of *Esopus infra* notes 79–85, 90–94, and accompanying text.

58. 1985 WL 21145 (Del. Ch. May 9, 1985); *see* discussion of *Dart infra* notes 86–89, 95–96 and accompanying text.

The first of these seven cases is *Schnell*, where the court reasoned that because corporate management had attempted to use the corporate statute for the purposes of "perpetuating itself in office"[59] and "obstructing the legitimate efforts of dissident stockholders,"[60] management's conduct was inequitable. Similarly, in *Linton v. Everett*, the court found the directors' actions of manipulating the timing of the shareholder meeting—so as to give shareholders short notice of the meeting—deprived the shareholders of a chance to run an opposition slate.[61] Despite the courts' failure in both cases to label the directors' conduct a breach of fiduciary duty, many cases specifically hold that directors or controlling shareholders violate their fiduciary duties if they manipulate the corporate machinery to perpetuate their own control.[62] Indeed, as noted above in *Blasius*,[63] even if directors manipulate the corporate machinery to perpetuate control for unselfish reasons, such manipulations nevertheless constitute a breach of fiduciary duty. As such, the directors in *Schnell* and *Linton* violated their fiduciary duties.

Similarly, if the facts in *Schnell* constitute a breach of fiduciary duty, it is beyond debate that the conduct in the third of these seven cases, *Lerman v. Diagnostic Data, Inc.*,[64] is a breach of fiduciary duty as well. In *Lerman*, the directors of Diagnostic Data, Inc. ("Diagnostic") amended a bylaw so that directors could change the date of the annual meeting from a fixed date to a date to be determined by management. Diagnostic's management then

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59. *Schnell*, 285 A.2d at 439.

60. *Id.*

61. *Linton*, 1997 WL 441189, at *9–10.

62. *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969, 979–80 (Del. 1977) ("[T]hose who control the corporate machinery owe a fiduciary duty to the minority in the exercise thereof over corporate powers and property, and the use of such power to perpetuate control is a violation of that duty."), *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 185 (Del. Ch. 2005) ("Corporate fiduciaries may not utilize corporate machinery for the purpose of perpetuating themselves in office."); Hamilton v. Nozko, No. 13014, 1994 WL 413299, at *6 (Del. Ch. July 27, 1994) (ruling affirmatively and applying the *Schnell* doctrine when answering the question of whether "corporate fiduciaries commit an actionable breach of fiduciary duty" in manipulating the corporate machinery for personal advantage); Chrysogelos v. London, Civ. A. No. 11910, 1992 WL 58516, at *6 (Del. Ch. Mar. 25, 1992) ("[I]f corporate directors manipulate the corporate machinery . . . for the sole or primary purpose of perpetuating themselves in office, they violate a fiduciary duty owed to the corporation and its shareholders.") (internal quotations omitted) (citing Pogostin v. Rice, 480 A.2d 619, 627 (1984)); Societe Holding Ray D'Albion S.A. v. Saunders Leasing Sys., Inc., C.A. No. 6648, 1981 WL 15094, at *1 (Del. Ch. Dec. 16, 1981) (citing *Singer*, 380 A.2d at 979).

63. *See supra* note 38 and accompanying text.

64. 421 A.2d 906, 907, 914 (Del. Ch. 1980).

fixed the date sixty-three days in the future.[65] Since another bylaw required insurgents to submit the names of their nominees more than seventy days before the meeting, the newly-adopted bylaw that changed the meeting date to sixty-three days made it impossible for the insurgents to run a competing slate of nominees.[66] Given that the Schnell board's actions had the effect of hindering insurgents' efforts and that the Lerman board's actions went a step further and actually prevented the insurgents' efforts, the conduct giving rise to the *Schnell* violation in *Lerman* also constituted a breach of fiduciary duty.

While *Schnell* and *Lerman* involved directors manipulating election-related bylaws, Delaware courts have held that other mechanisms that entrench directors in office will also violate the *Schnell* doctrine. Defendant directors in the fourth case, *Packer v. Yampol*, sought to perpetuate themselves in office by issuing newly created preferred stock with supervoting features to the CEO and other defendants.[67] Citing *Schnell,* the Delaware Court of Chancery held that the directors' "primary purpose was to obstruct the plaintiffs' ability to wage a meaningful proxy contest in order to maintain themselves in control."[68] Once again, any manipulation of the corporate machinery to perpetuate control is a violation of fiduciary duties.[69]

Two other cases held directors violated the *Schnell* doctrine for manipulation of shareholder voting, not for the election of directors but for the statutorily-required shareholder vote for organic changes.[70] In the fifth case, *Telvest, Inc. v. Olson*, the board created and sought to dividend preferred stock that required a supermajority vote for organic changes with any shareholder owning twenty percent or more of the common stock.[71]

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65. *Id.* at 911.

66. *Id.* at 912.

67. 1986 WL 4748, at *3 (Del. Ch. 1986).

68. *Id.* at *14–15. Although finding that the business judgment rule did not apply because defendants were not disinterested or independent, the court did not analyze whether defendants breached their fiduciary duties and instead held that they violated the *Schnell* doctrine. *See supra* note 47 and accompanying text (delineating a series of *Schnell* cases that discuss fiduciary duties but do not explicitly hold that the directors or controlling shareholders breached such duties).

69. *See supra* note 62 and accompanying text (delineating cases that hold that, if directors or controlling shareholders manipulate the corporate machinery to perpetuate their own control, they have violated their fiduciary duties).

70. The Delaware corporate statute requires a shareholder vote for mergers and consolidations, *see* DEL. CODE ANN. tit. 8 § 251 (West 2015), sales of substantially all assets not sold in the ordinary course of business, *see id.* § 271, and voluntary dissolution, *see id.* § 275. The Delaware default rule requires a majority of outstanding shares to approve these transactions. *See id.* §§ 251(c), 271(a), 275(b).

71. 1979 WL 1759, at *1, *6 (Del. Ch. Mar. 8, 1979).

This newly created preferred stock effectively altered the voting process for the common stock: instead of a majority vote for organic changes, a supermajority would now be required, thereby diluting any challenge to management's incumbency.[72] Plaintiff, the owner of twenty percent of the stock, sought a preliminary injunction against the issuance of this preferred stock and alleged that the board's action was self-serving and improperly motivated.[73] The Delaware Court of Chancery doubted that the new stock was valid preferred stock[74] and, further, doubted that the board could effectively amend the certificate of incorporation's voting requirements simply by a board resolution.[75] Nevertheless, the court assumed, *arguendo*, that the board could legally take the actions proposed.[76] The court nevertheless granted the preliminary injunction, reasoning that the board's conduct "would fall within the type of conduct deplored in *Schnell*."[77] Similar to many other cases that violated the *Schnell* doctrine, the directors' actions that served to entrench them in office constituted a breach of fiduciary duty.[78]

The sixth case, *Esopus Creek Value LP v. Hauf*,[79] is similar to *Telvest* in that the directors in *Esopus* manipulated the voting requirements for organic changes, but it was different in that the *Esopus* directors did not seek to entrench themselves in office. The board in *Esopus* sought to avoid the need for a shareholder vote on a sale of all of the corporation's assets by voluntarily putting the corporation in bankruptcy where no such vote was required.[80] The shareholders sought a preliminary injunction to enjoin the corporation from executing an agreement for the sale of the corporation's assets without a shareholder vote.[81] The Delaware Court of Chancery found that the directors acted in good faith[82] and without an

72. *Id.*

73. *Id.* at *2.

74. *See id.* at *5 (questioning whether the First Series Preferred was really preferred stock because "any supposed preference as to dividends or liquidation rights seems illusory at best").

75. *See id.* at *6 (finding the board's resolution could not "have the effect of amending or supplementing in some respect [the] corporation's original certificate of incorporation") (citing DEL. CODE ANN. tit. 8 § 104).

76. *Id.* at *7.

77. *Id.*

78. *See supra* note 62 and accompanying text (delineating cases that hold that, if directors or controlling shareholders manipulate the corporate machinery to perpetuate their own control, they have violated their fiduciary duties).

79. 913 A.2d 593 (Del. Ch. 2006).

80. *Id.* at 596.

81. *Id.* at 601.

82. *Id.* at 602–03.

entrenchment motive;[83] in fact, the directors' actions would unseat, rather than entrench, them in office.[84] The court nevertheless granted the injunction, reasoning that since the corporation was financially healthy and had admitted that it was using the bankruptcy route to avoid the required shareholder vote: the proposed scheme "work[ed] a profound inequity upon the company's common stockholders and is thus prohibited by the teaching of *Schnell*."[85]

Finally, *Dart v. Kohlberg, Kravis, Roberts & Co.*[86] was not a voting case at all but was instead a suit by a preferred stockholder complaining about various aspects of the defendants' leveraged buy-out ("LBO"). In a motion to dismiss, the court dismissed all of plaintiff's allegations that could possibly state a claim for breach of fiduciary duty; [87] the one allegation that remained attacked the effect of the LBO on the security of the preferred stockholders' investment.[88] Citing *Schnell*, the court explained that

> [a]lthough everything done by defendants may have been in strict compliance with the letter of Delaware law, it is possible that the totality of actions resulted in an impermissible inequity to the holders of the preferred stock. The difficulty with the challenged transaction is that it was highly leveraged and the majority of the preferred stockholders ended up still owning their shares . . . . The assets of the corporation were used as sole security for the loans obtained for the purpose of buying out the common stock and the public preferred stockholders were left holding their shares in a corporation which, as a result of the transaction, has a much greater debt and therefore perhaps a lessened ability to pay preferred dividends. Such a leveraged buy-out calls for judicial scrutiny to prevent possible abuse.[89]

The courts' invocation of the *Schnell* doctrine in these last two cases, *Esopus* and *Dart*, is troubling. The court's holding in *Esopus* is based on the view that the directors' decision to sell the corporation's assets in bankruptcy was inequitable. The holding is troubling, however, because the judge found that the directors were acting in good faith and that their

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83. *Id.* at 603.

84. *See id.* (reasoning "a result of the proposed transaction is that Metromedia's board will cease to exist following the plan of reorganization").

85. *Id.* at 604.

86. No. 7366, 1985 WL 21145 (Del. Ch. May 9, 1985).

87. *See id.* at *6 (dismissing fiduciary duty claim based on defendants paying an unfair price); *id.* at *7 (dismissing fiduciary duty claim for disclosure violations in the proxy materials); *cf. id.* at *6 (dismissing claims regarding defendant management getting an ownership interest in the new venture because such claims are derivative in nature and thus could not be brought in its current form as a class action).

88. *See id.* at *5.

89. *Id.*

conduct did not entrench them in office;[90] in contrast, all other *Schnell* violations, except *Dart*,[91] were cases where the directors breached their fiduciary duties.[92] Quite remarkably, in *Esopus*, the challenged conduct

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90. *Supra* notes 82–84 and accompanying text.

91. *See supra* note 87 (noting that the court in *Dart* dismissed all fiduciary duty claims).

92. As *supra* note 50 explains, the *Schnell* cases can be broken down into two categories: those pertaining to voting for directors and those pertaining to transactional issues. Out of the six voting cases, *see supra* note 50, the courts found that the directors were acting with improper motive in three of them. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439–40 (Del. 1971) (granting a preliminary injunction because the board manipulated corporate machinery for the purpose of perpetrating itself in office); Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 74 (Del. Ch. 2008) (setting aside election results because the directors used their power for the purpose of entrenching themselves in office); Packer v. Yampol, 1986 WL 4748, at *15 (Del. Ch. Apr. 18, 1986) (granting a preliminary injunction because the directors' "primary purpose was to obstruct plaintiffs' ability to wage a meaningful proxy contest in order to maintain themselves in control"). The remaining three voting cases invalidated board action when defendants engaged in entrenchment action despite the lack of bad of faith or subjective intent. *See* Linton v. Everett, No. 15219, 1997 WL 441189, at *9 (Del. Ch. July 31, 1997) (setting aside director bylaw amendment because the "conduct of management . . . was both inequitable (in the sense of being unnecessary under the circumstances) and [. . .] had the accompanying dual effect of thwarting shareholder opposition and perpetuating management in office" and stating that "it is not required that . . . actual subjective intent to impede the voting process[] be shown"); Hubbard v. Hollywood Park Realty Enters., Inc., No. 11779, 1991 WL 3151, at *7, *12 n.9 (Del. Ch. Jan. 14, 1991) (granting a preliminary injunction because the "board action constitut[ed] an inequitable manipulation of the corporate machinery that affected adversely the shareholders' right to conduct a contested election of directors" even though the directors "acted in good faith and took no steps overtly to change the electoral rules themselves" and stating that "to be inequitable, such conduct does not necessarily require a dishonest, selfish, or evil motive"); Lerman v. Diagnostic Data, Inc., 421 A.2d 906, 912 (Del. Ch. 1980) (invalidating directors' bylaw amendment because, "whether designedly inequitable or not, [the amendment] has had a terminal effect on the [shareholders' ability to wage a proxy contest]"). In six of the eight transaction cases, *see supra* note 50, the court found that directors or controlling shareholders were improperly motivated and self-interested. *See* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1106–07 (Del. 1985) (reversing the Delaware Court of Chancery's dismissal because the directors, in bad faith, took inequitable action to avoid its contractual commitment to cash-out the minority shareholders at a fixed price); Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977), *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (reversing the Delaware Court of Chancery's dismissal because the merger was made for the sole purpose of freezing out minority shareholders); Berger v. Intelident Solutions, Inc., 911 A.2d 1164, 1174–75 (Del. Ch. 2006) (denying defendants' motion to dismiss because the controlling stockholder, who stood to benefit from not having to pay fair market value, purposefully manipulated the timing of the proxy process in a cash-out merger to intentionally deprive the minority shareholders from seeking their statutory right to appraisal); Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1081 (Del. Ch. 2004) (granting a preliminary injunction because "the plain purpose of these [b]ylaw [a]mendments was to disable the [i]nternational board" to keep the controlling shareholder in control); Hamilton v. Nozko, No. 13014, 1994 WL 413299, at *6 (Del. Ch. July 27, 1994) (denying the defendants' motion to dismiss because the defendants

would cause the directors to lose their power, rather than entrench them in it.[93] Thus, there was no finding that the directors were not disinterested or independent or that their decision-making process was faulty. Instead, Vice Chancellor Stephen Lamb's conclusion in *Esopus* that the board's decision was inequitable was based solely on his gut feeling that the directors' decision was unfair. Similarly, in *Dart*, the court dismissed all of the plaintiffs' allegations that could state a claim for breach of fiduciary duty.[94] Despite considering and rejecting all possible fiduciary claims, Vice Chancellor Maurice Hartnett nevertheless held that there could be a *Schnell* violation simply because he perceived the effect of the LBO might increase the risk of the preferred stockholders' investment.[95] Concluding that *Esopus* and *Dart* might be wrongly decided, however, would miss the more important point: *Esopus* and *Dart* expose a critical weakness in the *Schnell* case law.

The weakness in the *Schnell* cases is that, in deciding to invalidate directors' decisions, courts sometimes bypassed the most well-established judicial methodology of reviewing directors' decisions: the business judgment rule. The business judgment rule is designed to preclude judges from second-guessing directors' business decisions by limiting initial judicial review solely to the process by which directors made their decision.[96] In this process, directors enjoy a presumption of propriety.[97] As such, plaintiffs must dislodge this presumption by making a prima facie case that the directors were either not disinterested, not independent, acting

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"committed the Company [to going private] for self-interested purposes, unrelated to any disinterested business judgment as to what was in the corporation's best interests"); Telvest, Inc. v. Olson, 1979 WL 1759, at *1–2 (Del. Ch. Mar. 8, 1979) (granting a preliminary injunction because the directors' distribution of preferred stock, which was done for the sole purpose of preventing a twenty-percent stockholder from securing a merger, was self-serving and improperly motivated); *see also supra* note 32 and accompanying text (noting that the court in *Blasius* assumed that all *Schnell* violations required improper motive).

93. *See supra* note 84 and accompanying text; *cf. Dart*, 1985 WL 21145, at *1 (supporting proposed leveraged buy-out where directors would get an equity position in the refinanced corporation but would lose control of it).

94. *See supra* note 87 and accompanying text.

95. *Dart*, 1985 WL 21145, at *5.

96. *See* STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE 45 (6th ed. 2009) ("[C]ourts give deference to directors' decisions reached by a proper process, and do not apply an objective reasonableness test in such case to examine the wisdom of the decision itself.") (internal citation omitted).

97. *See id.* at 42 (noting that Delaware law "presumes 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 interest of the company") (internal quotations omitted); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting that, under the business judgment rule, courts will not disturb the judgment of directors absent abuse of their decision-making power).

in bad faith, or grossly negligent.[98] If plaintiffs are successful, then—and only then—can the court review the directors' decision. Even then, directors can attempt to show that they nevertheless produced a fair result for the corporation.[99]

In contrast, when judges engaged in a *Schnell* review, they typically did not acknowledge the business judgment rule.[100] Instead, upon receiving the plaintiffs' *Schnell* claims, some courts either did not review the directors' decision-making process, or they did such a review and found the process without fault; nevertheless, some judges concluded that the defendants violated the *Schnell* doctrine.[101] While some *Schnell* cases engaged in this

98. *See* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporate Law*, 56 BUS. LAW. 1287, 1298 (2001) ("[A] standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process.").

99. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (holding that, if the business judgment rule is rebutted, the burden shifts to defendant directors to prove the transaction was entirely fair to the shareholders).

100. Seven *Schnell* cases did not mention the business judgment rule. *See* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099 (Del. 1985); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977), *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971); Berger v. Intelident Solutions, Inc., 911 A.2d 1164 (Del. Ch. 2006); Hubbard v. Hollywood Park Realty Enters., Inc., No. 11779, 1991 WL 3151 (Del. Ch. Jan. 14, 1991); Dart v. Kohlberg, Kravis, Roberts & Co., No. 7366, 1985 WL 21145 (Del. Ch. May 9, 1985); Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980). Three *Schnell* cases mentioned the business judgment rule but not in connection with the *Schnell* analysis. *See* Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 69 (Del. Ch. 2008); Linton v. Everett, No. 15219, 1997 WL 441189, at *7 (Del. Ch. July 31, 1997); Telvest, Inc. v. Olson, 1979 WL 1759, at *6–7 (Del. Ch. Mar. 8, 1979). Only three *Schnell* cases provided an explanation regarding why the business judgment rule was inapplicable. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1060–61, 1078 (Del. Ch. 2004) (reasoning that the business judgment rule did not apply because the defendant breached his fiduciary duties); Hamilton v. Nozko, No. 13014, 1994 WL 413299, at *6 (Del. Ch. July 27, 1994) (holding the business judgment rule did not apply to these directors because they were neither disinterested nor independent); Packer v. Yampol, 1986 WL 4748, at *14 (Del. Ch. Apr. 18, 1986) (rejecting the defendants' argument that the directors were disinterested and, therefore, protected by the business judgment rule because the directors "stood to benefit" from the "increased likelihood of the directors' continued incumbency").

101. *See* Esopus Creek Value LP v. Hauf, 913 A.2d 593, 602–03 (Del. Ch. 2006) (examining the directors' decision-making process and finding no fault with it but nonetheless evaluating the decision); Dart v. Kohlberg, Kravis, Roberts & Co., No. 7366, 1985 WL 21145, at *5 (Del. Ch. May 9, 1985) (failing to mention the business judgment rule and dismissing all of plaintiffs' allegations that could state a claim for breach of fiduciary duty but nonetheless examining the possible negative impact of the directors' decision); *see also infra* notes 103–05 and accompanying text (discussing how the courts' decisions in *Esopus* and *Dart* transgressed the business judgment rule). One can also question whether courts found *Schnell* violations based on the

major departure from the business judgment rule, all *Schnell* cases except *Esopus* and *Dart* ended up in the right place: in all of the other cases, the courts' explicit or implicit findings that the directors breached their fiduciary duties[102] would have prevented these directors from enjoying the protection of the business judgment rule. Therefore, even if those courts had followed the business judgment rule, they ultimately would have been able to evaluate the directors' decision.

Esopus turns this paradigm on its head. After finding that the directors did not have any entrenchment motive or bad faith, the court nevertheless proceeded to evaluate the directors' conduct anyway, decided that conduct was unfair, and then equated unfair conduct with a *Schnell* violation.[103] The court in *Esopus* should not have been able to second guess the fairness of the board's decision unless it first found fault in the process. In other words, although the court found no fault in the process that the directors employed in making their decision, Vice Chancellor Lamb simply invalidated the directors' conduct because he did not like it. Tellingly, in *Dart*, the court explicitly rejected any allegation that could relate to a breach of fiduciary duty.[104] Despite that determination, Vice Chancellor Maurice Hartnett proceeded to evaluate the directors' conduct and concluded it could be unfair. Former Delaware Supreme Court Chief Justice Myron Steele, in an unrelated case, dissented on the same grounds that *Esopus* and *Dart* are faulty; among other reasons, the court found the directors' conduct inequitable without finding they had violated their fiduciary duties.[105]

Thus, the fourteen *Schnell* cases are instructive in two ways. First, all conduct that violates the *Schnell* doctrine is, or should also be, a breach of fiduciary duty, and the failure of *Schnell* and other cases applying the *Schnell* doctrine to state so clearly does not negate this truism. As the court in *Rabkin v. Philip A. Hunt Chemical Corp.* aptly described, these cases are a "breach of fiduciary duties under *Schnell*."[106] Second, if a judge applies

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entrenchment effect of the directors' actions despite also finding that these respective directors had no improper motive. *See generally Linton*, No. 15219, 1997 WL 441189; *Hubbard*, No. 11779, 1991 WL 3151; *Lerman*, 421 A.2d 906.

102. *See supra* notes 52–54, 59–78, and accompanying text.

103. *See supra* notes 82–85 and accompanying text.

104. *See supra* note 87 and accompanying text.

105. *See* Omnicare Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 946–50 (Steele, J., dissenting) (disagreeing with the majority's invalidation of a contract when "the board of directors acted selflessly pursuant to a careful, fair process and [acted] in good faith . . . .").

106. Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1105 (Del. 1985); *see also supra* notes 52-54 and accompanying text (delineating *Schnell* cases that held, or strongly intimated, that there was a breach of fiduciary duties).

the *Schnell* doctrine to a case where the directors did not breach their fiduciary duties, the judge has invalidated legal conduct based simply on his or her gut instinct. The implications of judges deciding cases based solely on their instincts are profound.

Just as judges ought to find a breach of fiduciary duty if they find a *Schnell* violation, so too have scholars equated *Schnell* violations with a breach of fiduciary duties. For example, Chief Justice Strine—as Vice Chancellor—wrote an article analyzing a different aspect of the *Schnell* doctrine from the one explored here.[107] In his article, Chief Justice Strine often interchanged the concepts of *Schnell* violations and breaches of fiduciary duties.[108] Similarly, Professor Larry Ribstein used *Schnell* as one of two cases to support the principle that "fiduciary duties . . . trump statutory authorization."[109] Finally, in a group-authored article about the duty of loyalty, the authors wrote, "[i]n *Schnell*, the Delaware Supreme Court emphatically voiced its acceptance of the importance of fiduciary review in ensuring that the capacious authority granted to directors by the DGCL was not misused."[110]

A. The Current Bylaw Cases — More Confusion about the Schnell *Doctrine and Breaches of Fiduciary Duties*

There are several Delaware cases where judges have declared a given bylaw to be facially valid, while also holding that shareholders can again challenge the situational validity of the bylaw if their corporation ever implements it.[111] For example, in *Moran v. Household Internationa'l,*

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107. *See* Strine, *supra* note 1, at 880 (discussing the role of law and equity in Delaware-corporate law and the need for judges to "respect the law side of the law-equity divide in exercising their equitable powers," such as when judges are engaged in a *Schnell* review).

108. *See, e.g., id.* at 880 (discussing *Schnell* violations in the context of breaches of fiduciary duties); *id.* at 881 (noting that *Schnell* reinforced the role of equity and defined equity as "the judge-made common law of corporations as reflected in judicial articulations of the fiduciary duties of directors and officers"); *id.* at 882 (stating that *Schnell* reinforced "[t]hat equitable principles of fiduciary duty would be an overlay to and a constraint on the statutory powers of directors"); *id.* at 887 (identifying the key disputes in *Schnell* cases and noting that they "were about whether legally permissible actions were . . . equitable in the sense that they were not tainted by a breach of fiduciary duty"); *id.* at 903 (finding that *Schnell* "permits the invalidation of legally permitted acts that result from a breach of an equitable duty"); *see also* supra note 21 and accompanying text.

109. Larry E. Ribstein, *Preemption as Micromanagement*, 65 BUS. LAW. 789, 795 (2010).

110. Strine et al., *supra* note 21, at 642.

111. *See generally* ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 555 (Del. 2014); Stroud v. Grace, 606 A.2d 75 (Del. 1992); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); City of Providence v. First Citizens BancShares, Inc., 99 A.3d 229 (Del. Ch. 2014); Edgen

Inc.,[112] the Delaware Supreme Court upheld a director-enacted poison-pill bylaw[113] but cautioned that the court would review the bylaw again under fiduciary standards if its implementation is challenged:

> When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the Rights Plan.[114]

Note that the Delaware Supreme Court reasoned that implementation would be subject to fiduciary review,[115] but the court made no mention of the *Schnell* doctrine.

Before the Delaware legislature's recent amendments to the DGCL to outlaw fee-shifting in stock corporations and to permit forum-selection clauses,[116] Delaware courts again used *Moran*'s two-step model to rule on the facial validity of director-enacted bylaws on these two subjects. Unlike the court in *Moran*, the Delaware courts mentioned *Schnell* in both of the recent cases. In an *en banc* opinion in *ATP Tour, Inc. v. Deutscher Tennis Bund*, the Delaware Supreme Court responded to four certified questions of law regarding the validity of a director-adopted bylaw in a non-stock corporation that shifted attorneys' fees and costs to unsuccessful plaintiffs in intra-corporate litigation.[117] Although declaring such a bylaw to be facially valid,[118] Justice Carolyn Berger warned, without mentioning fiduciary duties—but still citing to *Schnell*—that "[b]ylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose."[119] Following *Moran*, Justice Berger further held that the future enforceability of any fee-shifting bylaw would depend on the

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Grp. Inc. v. Genoud, C.A. No. 9055-VCL (Del. Ch. Nov. 5, 2013); Boilermakers Local 154 Ret. Fund v. Chevron, 73 A.3d 934 (Del. Ch. 2013).

112. 500 A.2d 1346 (Del. 1985).

113. *Id.* at 1357; *see also* MELVIN ARON EISENBERG & JAMES D. COX, BUSINESS ORGANIZATIONS CASES AND MATERIALS 1239 (11th ed. 2014) (defining a poison-pill bylaw as "a plan under which the board of directors of a corporation creates Rights that are distributed or distributable to shareholders . . . [and] upon the occurrence of certain events shareholders . . . have the right to purchase stock in the corporation . . . at a deep discount. Because the potential exercise of the Rights would dramatically dilute the value of the target stock that the bidder proposes to acquire, the mere potential that the Rights will be exercised may serve as a deterrent to making a bid in the first place.").

114. *Moran*, 500 A.2d at 1354.

115. *Id.*

116. DEL. CODE ANN. tit. 8 §§ 102(f), 109(b), 114(b)(2), 115 (West 2015).

117. 91 A.3d 555 (Del. 2014).

118. *Id.* at 560.

119. *Id.* at 558.

facts under which the directors actually implement the bylaw.[120]

Similarly, in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, then-Chancellor Strine held that board-adopted forum-selection bylaws were facially valid.[121] The court further held that "valid bylaw[s] may operate inequitably in a particular scenario" and would be dealt with by the *Schnell* doctrine.[122] The court warned that, if and when the directors implement the bylaw, "a court will have a concrete factual situation against which to . . . analyze, *à la Schnell,* whether the directors' use of the bylaws is a breach of fiduciary duty."[123]

Thus, in discussing the standard for monitoring director bylaws when they are actually implemented, the Delaware Supreme Court in *Moran* discussed only fiduciary duties and in *ATP* discussed only *Schnell*; however, the Delaware Court of Chancery in *Boilermakers* discussed both fiduciary duties and *Schnell* interchangeably. *ATP,* a 2014 *en banc* Delaware Supreme Court opinion, demonstrated that Delaware courts have not yet incorporated the interplay between *Schnell* violations and breaches of fiduciary duties.[124]

III. WHY HAVE TWO DOCTRINES?

In an intriguing article,[125] former-Justice Jack Jacobs asked a perceptive question about the logic of the Delaware Supreme Court's opinion in *Alabama By-Products Corp. v. Neal*, a case which admonished courts to

120. *Id.* at 558–60.

121. 73 A.3d 934 (Del. Ch. 2013).

122. *Id.* at 949.

123. *Id.* at 959; *see also id.* at 954 (remarking, "the real-world application of a forum selection bylaw can be challenged as an inequitable breach of fiduciary duty" and citing to *Schnell*); *id.* at 958 (reasoning that the plaintiff may mount an argument under *Schnell* that the bylaw "should not be enforced because the bylaw was being used for improper purposes inconsistent with the directors' fiduciary duties").

124. Unlike the *Schnell* doctrine, all Delaware equitable remedies need not monitor only fiduciary duties. For example, the equitable remedy of quasi-appraisal rights can monitor breaches of the fiduciary duty of disclosure as well as non-fiduciary breaches. *Compare* Gilliland v. Motorola, Inc., 873 A.2d 305, 308 (Del. Ch. 2005) (reasoning the directors "breached their fiduciary duty of disclosure by not providing any disclosure relating to [the corporation's] financial condition to the stockholders faced with the decision of whether to take the cash or demand appraisal"), *with* Nebel v. Southwest Bancorp, Inc., 1995 Del. Ch. LEXIS 80 (Del. Ch. July 5, 1995) (reasoning that although the directors failed to provide shareholders with an accurate copy of the appraisal statute in connection with a short-form merger, directors did not breach their fiduciary duties). *See also* Mary Siegel, *The Dangers of Equitable Remedies*, 15 STAN. J.L. BUS. & FIN 86, 110 (2009) (stating that, in quasi-appraisal cases, "the primary fact pattern is that defendant allegedly violated its fiduciary duty to disclose, and that violation impacted plaintiffs' process of deciding whether to take the merger consideration or demand appraisal rights").

125. Jacobs, *supra* note 18.

limit the *Schnell* doctrine to cases that either "threaten the fabric of law" or would "deprive a person of a clear right."[126] Specifically, Justice Jacobs wrote:

> How does one decide whether fiduciary conduct 'threatens the fabric of the law?' And if equity can be used to override the law only where an 'improper manipulation of the law would deprive a person of a clear right,' why is equity needed at all, since if the right being violated is clear, that alone would afford a basis for relief.[127]

In other words, Justice Jacobs pointed out that, under the Delaware Supreme Court's standards delineated in *Alabama By-Products*, the *Schnell* doctrine would serve no purpose; the standard is both too amorphous to decide what is threatening to the fabric of law, and it is superfluous if a clear right exists. Similarly, this Article asks the same question about the need for the *Schnell* doctrine, but this time, the question is based on *Schnell*'s redundancy: why is the *Schnell* doctrine needed when Delaware courts incontrovertibly have the power to invalidate otherwise legal conduct based on a breach of fiduciary duties? Phrased differently, having established that all *Schnell* violations are, or should be, breaches of fiduciary duty, what are the costs and benefits of maintaining the *Schnell* doctrine, and what would be the costs and benefits from abolishing it?

A. Are There Benefits and Costs of Maintaining the Status Quo?

Four possible arguments exist for retaining the *Schnell* doctrine as a tool for judicial review. The first is that the *Schnell* doctrine is still needed to require fiduciaries to comply with both legal and equitable duties. A second argument is that the *Schnell* doctrine is case-specific while some case holdings delineating fiduciary duties have broader applicability. Third, if the *Schnell* doctrine remained available, it could serve as the reservoir for analyzing all voting cases instead of maintaining the current patchwork of voting monitors.[128] The final argument is that the *Schnell* doctrine permits the court to have a broader reach: a judge could use the doctrine to invalidate conduct that simply does not "feel" right even when the judge cannot find a breach of fiduciary duty. All four of these arguments, however, lack merit.

First, while *Schnell* may have been necessary—or at least instrumental—in establishing the role of equity in Delaware corporate law,[129] the *Schnell* doctrine is no longer needed for this purpose. No one would seriously

126. 588 A.2d 255, 258 n.1 (Del. 1991).

127. Jacobs, *supra* note 18, at 11.

128. *See infra* note 139 and accompanying text.

129. *See supra* notes 17–21 and accompanying text (discussing the role of *Schnell* after the passage of the DGCL in 1967).

challenge that directors must comply not only with the DGCL and the corporation's own legal documents but also with the directors' fiduciary duties. As Chancellor Allen reasoned in *Stahl v. Apple Bancorp, Inc.*, "[i]t is an elementary proposition of corporation law that . . . fiduciary duties constitute a network of responsibilities that overlay the exercise of even undoubted legal power."[130] One may further ask how instrumental the *Schnell* doctrine continues to be since its initial foundational contribution to Delaware corporate law if there have only been fourteen violations in the doctrine's forty-five year history.[131]

Second, some may argue that fiduciary duties and *Schnell* violations differ in that Delaware courts apply the *Schnell* doctrine in discrete situations, affecting the rights of one corporation's shareholders. In contrast, in at least some cases where courts have held that directors breached their fiduciary duties, the court's articulation of those duties has had broad applicability, extending beyond the particular case. *Weinberger*, for example, delineated requirements for directors to satisfy their fiduciary duties in a conflict-of-interest going private transaction.[132] *Unocal Corp. v. Mesa Petroleum Co.*, as modified by *Unitrin, Inc. v. American General Corp.*, similarly gave content to directors' fiduciary duties in the context of their enacting defensive tactics,[133] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* did so for so-called "*Revlon*" transactions.[134] As now Chief Justice Strine wrote, "[b]ecause of the importance of fiduciary duty review to our system of corporate law, the judiciary will often issue decisions that have more than case-specific influence."[135] Whether decisions finding fiduciary breaches have narrow or broad applicability does not detract, however, from the fundamental fact that since *Schnell* review constitutes fiduciary review, the existence of two doctrines is redundant.

Third, an argument can be made that the *Schnell* doctrine should be the

130. 579 A.2d 1115, 1121 (Del. Ch. 1990).

131. *See supra* note 51 (delineating the fourteen cases where courts have found *Schnell* violations).

132. *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (requiring fair dealing and fair price in a conflict-of-interest going-private transaction); *see also supra* notes 22–28 and accompanying text.

133. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985), and Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (requiring directors who enact defensive tactics to demonstrate a threat to the corporation's policies, and to have reacted reasonably, including but not limited to not enacting coercive or preclusive defensive tactics).

134. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985) (requiring directors to attempt to maximize profits for shareholders when the corporation is in so-called *Revlon* mode).

135. Strine, *supra* note 1, at 904–05.

go-to monitor for shareholder voting, the most likely candidate for a topic that "threatens the fabric of corporate law."[136] Two problems exist with this argument. One is that, although most *Schnell* cases are about shareholder voting,[137] the *Schnell* doctrine has no topical limits.[138] Second, even if the Delaware Supreme Court cabined the *Schnell* doctrine to cases about shareholder voting, that decision alone would not effectuate a consolidation of all voting cases, given that Delaware courts have reviewed cases about shareholder voting under myriad monitors.[139] Furthermore, to date, Delaware courts have given no indication either that all voting issues should be corralled into one monitor or, if so, that the monitor of choice would be the *Schnell* doctrine.[140]

The final argument supporting retention of the *Schnell* doctrine—and perhaps the only contentious one—is that the *Schnell* doctrine permits judges to invalidate action that simply does not "feel" right without the conduct constituting a breach of fiduciary duty. The argument is that the doctrine empowers judges to utilize their equitable powers to effectuate the result they instinctively believe is correct by labeling the conduct as inequitable as the courts did in *Esopus* and *Dart*.[141] Invalidating legal action that simply does not "feel" right to a judge, however, is a standard

136. Alabama By-Products v. Neal, 588 A.2d 255, 259 n.1 (Del. 1991); *see also supra* text accompanying note 126.

137. *See supra* note 50 (noting that six of the fourteen *Schnell* cases are about shareholder voting for directors and that another four cases involve shareholder voting on transactions).

138. *See, e.g.*, Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1106–07 (Del. 1985) (applying *Schnell* when defendants attempted to evade the corporation's contractual commitment to cash-out the minority shareholders at a fixed price); Singer v. Magnavox Co., 380 A.2d 969, 980 (Del. 1977), *overruled on other grounds by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (applying *Schnell* when defendants froze out minority shareholders without a valid corporate purpose); Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1081 (Del. Ch. 2004) (applying *Schnell* when the CEO and controlling shareholder enacted a bylaw to disable the board from performing its statutorily-authorized duties); Hamilton v. Nozko, No. 13014, 1994 WL 413299, at *6–7 (Del. Ch. July 27, 1994) (applying *Schnell* when the defendants intentionally delisted the corporation to force the minority to sell their shares at a grossly unfair price).

139. Delaware courts have reviewed some voting cases under the business judgment rule, *see* City of Westland Police & Fire Ret. Sys. v. Axcelis Tech., Inc., 1 A.3d 281, 291 (Del. 2010), under enhanced business judgment, *see* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985), and under the compelling purpose test, *see* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661–02 (Del Ch. 1988); *see also* discussion of *Blasius supra* notes 34–37 and accompanying text (discussing voting monitor).

140. *Cf.* Mercier v. Inter-Tel, Inc., 929 A.2d 786, 810 (Del. Ch. 2007) (suggesting that the enhanced business judgment monitor would be preferable to the compelling-purpose test as a monitor of voting issues).

141. *See* discussion of *Esopus* and *Dart*, *supra* notes 90–95 and accompanying text.

most jurists would eschew.[142] Why permit courts to invalidate directors' otherwise legal conduct based on feel instead of by an articulation of why the conduct constitutes a breach of fiduciary duty? Moreover, as demonstrated above,[143] since nearly all *Schnell* cases are breaches of fiduciary duties, neither *Schnell* nor its progeny seem to authorize judges to invalidate legal conduct based simply on an uneasy feeling. Perhaps this lack of authority is the answer as to why there are only fourteen cases decided under *Schnell*: Delaware judges instinctively know that they should articulate why they choose to invalidate conduct that is legally sufficient and that invalidation inevitably becomes a discussion of a breach of fiduciary duty rather than about the judge's gut instinct. One of Chief Justice Strine's earlier articles forcefully echoed this concern about *Schnell* violations:

> [A] determination that legally permitted action should be enjoined *requires the court to find that there was a specific breach of an equitable duty.* That does not necessarily mean that the judge must conclude that the directors acted for a disloyal purpose. But, at minimum, *it requires the court to articulate why the directors did not fulfill their fiduciary duties in the circumstances they confronted* . . . The very requirement to explain how actual businesspersons violated the equitable standard of conduct required of them tempers judicial overreaching and encourages modesty.[144]

In other words, articulating the contours and causes of the fiduciary breach has the concomitant effect of preventing judges from invalidating action that simply does not feel right and "tempers judicial overreaching."[145] It is thus not surprising that Justice Strine articulated the breach of fiduciary duty in all opinions in which he applied the *Schnell* doctrine.[146] If judges are indeed utilizing some gut feeling instead of a

142. *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1378 (Del. 1993) ("The court's decision should not be the product solely of subjective, reflexive impressions based primarily on suspicion or what has sometimes been called the 'smell test.'"); KE Prop. Mgmt., Inc. v. 275 Madison Mgmt. Corp., Civ. A. No. 12683, 1993 WL 285900, at *9 (Del. Ch. July 27, 1993) (citing *Nixon* for the same proposition); *see also infra* notes 144–45 and accompanying text (noting Chief Justice Strine's statement that a judge must "articulate why the directors did not fulfill their fiduciary duties" to "temper[] judicial overreaching").

143. *See supra* notes 52–54, 59–78, and accompanying text (explaining twelve of fourteen *Schnell* cases are also fiduciary breaches).

144. *See* Strine, *supra* note 1, at 904 (emphasis added); *see also id.* at 888 ("Importantly, even when a court was deploying the tightened reasonableness standard, its ability to strike down lawful action required it to identify expressly why the directors had acted unreasonably in the circumstances and therefore breached their fiduciary duties.").

145. Strine, *supra* note 1, at 904.

146. *See* Portnoy v. Cryo-Cell Int'l, Inc., 940 A.2d 43, 75 (Del. Ch. 2008) (finding the CEO breached fiduciary duties and violated the *Schnell* doctrine by intentionally

reasoned fiduciary analysis, they are making bad law.

There is no current benefit to retaining the *Schnell* doctrine, but there is a cost to maintaining the status quo: the coexistence of the *Schnell* doctrine and fiduciary law implies that there is a difference between the two forms of review. Twelve of the fourteen *Schnell* cases counter that inference, and the remaining two cases, *Esopus* and *Dart*, demonstrate the dangers where *Schnell* violations are not fiduciary breaches. Thus, the current coexistence of the *Schnell* doctrine and fiduciary review is confusing if all *Schnell* violations are—or should be—a breach of the duty of loyalty and of great concern if they are not.

B. Would There Be Benefits or Costs to Abolishing the Schnell *Doctrine?*

The major benefit of abolishing the *Schnell* doctrine would be judicial recognition that directors' legal actions can be invalidated only if the directors breached their fiduciary duties. A clear process that adheres to the tenets of the business judgment rule and that is thoroughly articulated would enhance the clarity and consistency that is a hallmark of Delaware law.[147] An ancillary benefit is abolition of the doctrine obviates any need to resolve the different judicial views on whether *Schnell* violations require directors to have acted with an improper motive.[148] Since identifying the directors' "true" motive can be a daunting task,[149] abolishing the *Schnell*

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using corporate assets to coerce shareholders into voting as the CEO wanted); Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1081 (Del. Ch. 2004) (finding that conduct of the CEO and controlling shareholder was a breach of fiduciary duty and a violation of *Schnell* because the shareholder-enacted bylaw amendments' sole purpose was to prevent the board from performing its statutorily-authorized duties and to effectuate illegal or inequitable activities); *cf.* Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 949 (Del. Ch. 2013) (reasoning by then-Vice Chancellor Strine that the directors' implementation of their bylaw could, in the future, violate *Schnell* if the directors breached their fiduciary duties).

147. *See, e.g.*, *The Hon. Myron T. Steele: Delaware Courts, Corporate Governance And Corporate Counsel*, METRO. CORP. COUNSEL, Nov. 1, 2004, at 52, http://www.metrocorpcounsel.com/articles/4765/delaware-hon-myron-t-steele-delawar e-courts-corporate-governance-and-corporate-counsel ("We must be sure that our opinions continue to be characterized by three words that are the hallmark of Delaware courts: predictability, consistency and clarity.").

148. *See supra* notes 92–93 (noting inconsistent holdings on whether *Schnell* violations require an improper motive).

149. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971) (reasoning that, if shareholders got their *pro rata* share of the benefits of each of the three challenged transactions, the court would conclude that the directors had not been motivated by self-interest); Mary Siegel, *The Problems and Promise of "Enhanced Business Judgment"*," 17 U PA. J. OF BUS. L. 47, 73–74 (2014) (identifying that Delaware courts have looked for tangible harm to the corporation to determine whether directors were truly motivated to act in the best interest of the corporation or whether they instead had a selfish motive either when they enacted defensive tactics or when the corporation was in a "*Revlon*" mode).

doctrine would help courts considerably.

If one accepts the premise that *Schnell* violations are simply a subset of breaches of the duty of loyalty, there is no cost to abolishing the *Schnell* doctrine. Abolition of the *Schnell* doctrine should not cause shareholders any concern that such abolition empowers directors to implement any bylaw under any circumstance, manipulate the voting process, or take any other inequitable action that constitutes a breach of fiduciary duty. Similarly, courts should not fear that abolition of the *Schnell* doctrine dilutes their equitable powers.

CONCLUSION

At its inception, the *Schnell* doctrine undoubtedly served the important function of establishing the role of equity in Delaware corporate law. A clear-eyed view of the doctrine, however, demonstrates that *Schnell* violations are nothing more than breaches of fiduciary duty and should be nothing less. Importantly, if the *Schnell* violation is less than a breach of fiduciary duty, then the doctrine wrongly empowers judges to invalidate otherwise legal conduct based only on intuitive unease with directors' or controlling shareholders' conduct.

All arguments for keeping a doctrine that allows the courts to effectuate their perception of a fair result may appear reasonable, but the dangers of such an approach have been well-documented. In fact, the *Schnell* doctrine has become a wolf in sheep's clothing by transgressing the business judgment rule. Given the unassailable benefits of the business judgment rule, applying the *Schnell* doctrine in violation of the rule has broad negative implications for Delaware corporate law.

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REVISITING THE BANK HOLDING COMPANY STRUCTURE: DO COMMUNITY AND REGIONAL BANKS STILL NEED A BANK HOLDING COMPANY?

V. GERARD COMIZIO,* LAURA E. BAIN,** AND KRISTIN S. TEAGER***

INTRODUCTION

There has been a dramatic rise in the last thirty years toward the adoption of the bank holding company ("BHC") structure by banks. Inherent in this trend is an apparent accepted orthodoxy about the need of such structures from both a business and regulatory perspective. The percentage of U.S. banks owned by BHCs has more than doubled since 1980, from 34.3% to

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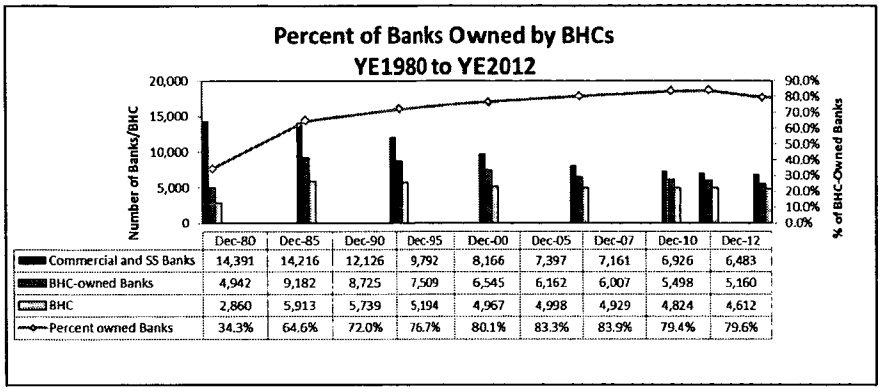
approximately 84% today.[1] Notably, though, federal banking agencies ("FBAs") do not require banks to form a BHC.[2] Thus, the uptick in BHC-owned banks has largely been driven by perceived legal, regulatory, and business advantages. Since 1980, the majority of banks presumably (1) identified significant advantages to forming a BHC that outweighed the increased costs of corporate governance and regulatory compliance and/or (2) saw their peers forming BHCs and generally accepted this industry trend as the orthodoxy of modern banking organization structure.



	Dec-80	Dec-85	Dec-90	Dec-95	Dec-00	Dec-05	Dec-07	Dec-10	Dec-12
Commercial and SS Banks	14,391	14,216	12,126	9,792	8,166	7,397	7,161	6,926	6,483
BHC-owned Banks	4,942	9,182	8,725	7,509	6,545	6,162	6,007	5,498	5,160
BHC	2,860	5,913	5,739	5,194	4,967	4,998	4,929	4,824	4,612
Percent owned Banks	34.3%	64.6%	72.0%	76.7%	80.1%	83.3%	83.9%	79.4%	79.6%

Figure 1. Showing the percentage of bank ownership by BHCs from Dec. 1980 to Dec. 2007.[3]

Despite the emergence of BHCs as the "must have" organizational structure for the banking industry, approximately 16% of banks have opted to remain outside of the BHC structure. This statistic suggests at the very least that, for certain banks, the perceived advantages of forming a BHC are not compelling. More significantly, the 16% rate of hold-outs suggests that the BHC structure's advantages do not always outweigh the structure's ever-increasing bank regulatory compliance and corporate governance

1. *Bank Holding Companies and Financial Holding Companies*, P'SHIP FOR PROGRESS, https://www.fedpartnership.gov/bank-life-cycle/grow-shareholder-value/bank-holding-companies (last visited Apr. 10, 2016).

2. *See id.* (encouraging organizations to individually consider the advisability of forming a BHC and noting that the Federal Reserve is neutral on their creation).

3. *See id.* (follow "Bank Ownership by BHCs Dec. 1980 to Dec. 2007" hyperlink) ("The black bars in the chart above represent the number of commercial banks in the U.S. at year-end 1980 and every five years since then and at year-end 2012, while the green bars show the number of banks owned by BHCs during the same time periods. The red line shows the percentage of banks owned by BHCs, which increased sharply in the early 1980s as the movement to form BHCs gained momentum; this movement has continued to increase gradually, but steadily, before declining slightly in recent years.").

costs, particularly as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Notably, the banks that have avoided forming a BHC are not limited to one particular size or business model. Instead, the hold-out banks range from small community banks with less than $10 billion in total assets,[4] to mid-sized banks with $30 billion in total assets and a number of non-bank subsidiaries engaged in broker-dealer and investment advisory activities,[5] and to large regional banks with total assets exceeding $50 billion.[6] The diversity of these hold-outs calls into question the need for a BHC.

As a general matter, the U.S. banking industry's BHC structure "is unique" in comparison to the generally BHC-less European banking model, and the U.S. model did not emerge until 1956.[7] The Bank Holding Company Act of 1956 ("BHC Act") established BHCs and defined the "terms and conditions under which a company can own a bank in the U.S."[8] While initially BHCs could engage in only a limited range of activities, over time, the BHC Act was amended to significantly expand the

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4. *See, e.g.*, *Bank Information – Northwest Bank*, FDIC, https://research.fdic.gov/bankfind/detail.html?bank=28178&name=Northwest%20Bank&searchName=Northwest&searchFdic=&city=&state=&zip=&address=&searchWithin=&activeFlag=&tabId=1 (follow "Financials" hyperlink) (last updated Apr. 6, 2016) (indicating that Northwest Bank has less than $10 billion in total assets); *Bank Information – Opus Bank*, FDIC, https://research.fdic.gov/bankfind/detail.html?bank=33806&name=Opus%20Bank&searchName=Opus&searchFdic=&city=&state=&zip=&address=&searchWithin=&activeFlag=&tabId=1 (follow "Financials" hyperlink) (last updated Apr. 6, 2016) (indicating that Opus Bank has less than $10 billion dollars in total assets).

5. *See, e.g.*, *Bank Information of Signature Bank*, FDIC, https://research.fdic.gov/bankfind/detail.html?bank=57053&name=Signature%20Bank&searchName=Signature&searchFdic=&city=&state=&zip=&address=&searchWithin=&activeFlag=&tabId=1) (follow "Financials" hyperlink) (last updated Apr. 6, 2016 (indicating that Signature Bank has a little over $30 billion in total assets); *see also About Signature Bank Overview*, SIGNATURE BANK, https://www.signatureny.com/about-us/about-signature-bank (last visited Feb. 22, 2016) (stating that a subsidiary of Signature Bank, Signature Securities Group Corporation, is a licensed broker dealer and investment adviser).

6. *See, e.g.*, *Bank Information of First Republic Bank*, FDIC, https://research.fdic.gov/bankfind/detail.html?bank=59017&name=First%20Republic%20Bank&searchName=First%20Republic&searchFdic=&city=&state=&zip=&address=&searchWithin=&activeFlag=&tabId=1 (follow "Financials" hyperlink) (last updated Apr. 6, 2016) (indicating that First National Bank has over $50 billion in total assets); *see also Company Profile*, First Republic, https://www.firstrepublic.com/aboutus/company profile (last visited Feb. 22, 2016) (listing the different regions where First Republic Bank offers its services).

7. *Bank Holding Companies and Financial Holding Companies*, *supra* note 1. *See generally* Tatiana V. Tkacheneko, *Legal Status of Bank Holding Companies (BHCs): U.S. and European Bankruptcy Issues*, 19 NORTON J. BANKR. L. & PRAC. 573, 594 (2010).

8. *Id.*

range of permissible activities.[9] During the late 1980s and 1990s, a BHC's range of permissible activities dwarfed the scope of activities permissible for a bank without a BHC.[10] During the late 1990s and early 2000s, however, the powers of banks gradually expanded,[11] substantially narrowing this gap.

While the perceived advantages of BHCs over banks have been steadily eroding, the regulatory burdens imposed on BHCs have been significantly increasing, especially following the 2010 enactment of Dodd-Frank.[12] Given the growing regulatory burden on BHCs in conjunction with the expanding range of activities that banks may engage in without them, the BHC structure may no longer be the most advantageous corporate structure for many banks, especially those engaged primarily in banking and certain financial services activities.

This Article explores whether the BHC model remains a compelling organizational structure for the majority of banks in light of the steady erosion of the gap between BHC-permissible activities and bank-permissible activities combined with the ever-mounting BHC regulatory compliance costs. Part II will review an organization's fiduciary duty to consider the optimal corporate structure. Part III will review the evolution of BHC and bank powers. Part IV will evaluate the shrinking advantages of forming a BHC. Part V will assess the mounting regulatory burdens BHCs face in a post-Dodd-Frank regulatory environment. Part VI will review the remaining advantages of BHCs. Part VII will offer some conclusions regarding the merits of the BHC structure for community and regional banks.

II. FIDUCIARY DUTIES REGARDING BHC STRUCTURE

As a general matter, one of a corporation's primary objectives is to conduct its business activities to maximize corporate profit and shareholder

9. Dafna Avraham et al., *A Structural View of U.S. Bank Holding Companies*, 18 FED. RES. BANK N.Y. ECON. POL'Y REV. 65, 67 (2012), https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf; *see also* 12 C.F.R § 225.84 (2015).

10. *See supra* note 9.

11. *See* OFFICE OF THE COMPTROLLER OF CURRENCY, COMPENDIUM OF ACTIVITIES PERMISSIBLE FOR A NAT'L BANK 1 (Apr. 2012), https://web.archive.org/web/20160114100143/http:/www.occ.gov/publications/publications-by-type/other-publications-reports/bankact.pdf (on file with author); Christine E. Blair & Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision*, 18 FDIC BANKING REV. 1, 3 (2006), https://www.fdic.gov/bank/analytical/banking/2006mar/article1/article1.pdf (discussing how states enacted statutes that allowed state-chartered banks to engage in all activities permitted national banks).

12. Avraham et al., *supra* note 9.

gain.[13] Thus, director leadership responsibilities include informed decision-making regarding corporate policies and strategic goals. From a fiduciary prospective, bank management bears a responsibility to periodically review its corporate governance structure.[14] The FBAs have emphasized that "financial institutions are encouraged to 'periodically review their policies and procedures related to corporate governance and auditing matters.'"[15] In addition, fiduciary duty requires management to periodically "evaluate which corporate governance policies and procedures are more appropriate [for an institution's] size, operations and resources."[16]

In this context, a corporate governance review should include an assessment of regulatory compliance and corporate governance costs and a consideration of what corporate structure is optimal for the entity to best maximize profitability, streamline regulatory burdens—consistent with the institution's business plans—and operate safely and soundly.[17] As discussed *infra*, given the decreasing advantages and mounting compliance costs associated with BHCs, banks should evaluate the relative merits of maintaining a BHC.

III. THE EVOLVING POWERS OF BHCS AND BANKS

In the middle of the Great Depression, the U.S. Congress passed and President Roosevelt signed into law the Banking Act of 1933, commonly referred to as "Glass-Steagall," which was intended to forever separate commercial and investment banking.[18] After the 1929 stock market crash and resulting Great Depression, Congress worried that commercial banks "were incurring losses from volatile equity markets" and sought to prevent the limited bank credit available from being used for speculation; rather, Congress believed bank credit should be directed toward "more productive

13. THE CLEARINGHOUSE, GUIDING PRINCIPLES FOR ENHANCING BANK ORGANIZATION'S CORPORATE GOVERNANCE: EXPOSURE DRAFT FOR PUBLIC COMMENT 9 (Sept. 10, 2014); *see also* AM. BANKERS ASS'N., THE BOARD'S ROLE IN STRATEGIC PLANNING (2004); Am. Bar Ass'n, *Corporate Director's Guidebook*, 56 BUS. LAW. 1517, 1578 (2001).

14. *See* AM. BANKERS ASS'N., CORPORATE GOVERNANCE FOR MUTUALS 2, 8 (2007), https://www.aba.com/Tools/BankType/Mutual/Documents/CorporateGovernanceforMutuals.pdf. ("Proper corporate governance is essential to the fulfillment of directors' and officers' fiduciary duties . . . . [I]t is a valuable exercise to reexamine the provisions of the charter and bylaws in order to determine whether these documents provide for structures and procedures, which, in the best judgment of management, facilitate effective corporate governance . . . .").

15. *Id.* at 3.

16. *Id.*

17. *See id.* at 2, 8.

18. Julia Mauers, *Banking Act of 1933*, FED. RES. HISTORY (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/25.

uses, such as industry, commerce and agriculture."[19] Upon the enactment of Glass-Steagall, national banks were prohibited from underwriting or dealing in securities, and their activities were generally limited to accepting deposits and making loans.[20] The companies owning banks, however, could own a wide range of non-bank firms, allowing them to engage in substantially more activities than permitted for banks under Glass-Steagall.[21]

In 1956, the BHC Act was enacted and imposed conditions and restrictions on the companies owning banks (*i.e.* BHCs).[22] Under the BHC Act, BHCs became subject to regulation and supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve")[23] and were restricted from participating, directly or through subsidiaries, in non-traditional banking activities.[24] Unlike the Glass-Steagall enactment, and the Section 619 of Dodd-Frank (the "Volcker Rule") enactment[25]—which has been criticized as restricting activity that not only did not cause the financial crisis but poses relatively little risk to the insurance fund of the Federal Deposit Insurance Corporation ("FDIC")[26]—the BHC Act's enactment stemmed not from any identified abuse in the banking system but rather as "a solution in search of a problem."[27]

Although the BHC Act initially imposed similar activity restrictions on BHCs as Glass-Steagall imposed on banks, subsequent legislation and

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19. *Id.*

20. *Id.*

21. Joe Mahon, *Bank Holding Company Act of 1956*, FED. RES. HISTORY (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/31.

22. *See Bank Holding Companies and Financial Holding Companies*, *supra* note 1.

23. *Id.*

24. Avraham et al., *supra* note 9.

25. Bank Holding Company Act, 12 U.S.C. § 1851 (2012).

26. Philip Swagel, *A Modest Volcker Rule*, N.Y. TIMES (Dec. 13, 2013, 12:35 PM), http://economix.blogs.nytimes.com/2013/12/13/a-modest-volcker-rule/?_r=0 (criticizing the Volcker Rule as restricting activity that was not "an especially important factor behind the recent financial crisis" and noting that it generally imposes relatively little risk to the federal government as it involves relatively little FDIC insured funds).

27. *See e.g.*, 101 Cong. Rec. 7957 (1955) (statement of Rep. Harris Ellsworth) ("We did not hear any testimony in our committee to the effect that [the BHC Act] was for the purpose of correcting any present or existing difficulties."); Mehrsa Baradaran, *Reconsidering the Separation of Banking and Commerce*, 80 GEO. WASH. L. REV. 385, 395 (2012) (explaining that the BHC Act was enacted as a preventative measure—"to stop the feared expansion of Transamerica into a national banking conglomerate"—rather that as a reaction to identified abuse within the banking system); *see also* Thomas E. Wilson, *Separation Between Banking Commerce Under the Bank Holding Company Act – A Statutory Objective Under Attack,* 33 CATH. U. L. REV. 163, 166 (1983).

actions by the FBAs gradually expanded the permissible activities of BHCs throughout the 1970s, 1980s, and 1990s.[28] These expansions offered substantial advantages to banks operating within the BHC structure. During the 1990s and 2000s, however, the powers of banks likewise began to evolve, gradually reducing the number of activities that only BHCs could conduct. [29] This gap was even further narrowed in 2013, when the Volker Rule substantially restricted the ability of BHCs to engage in certain securities and investment activities.[30]

A. The Trajectory of BHC Powers: What Goes up Must Come (Partially) Down

The 1970 amendments to the BHC Act marked the first fissure in the legal barrier between traditional banking and financial activities.[31] Under the 1970 amendments, BHCs obtained authority to own shares of any company engaged in activities "so closely related to banking or managing or controlling banks as to be proper incident thereto."[32] This new power enabled BHCs to invest in a slightly wider range of financial companies. During the 1980s and 1990s, the FBAs further extended the scope of "closely related to banking" activities to ensure the U.S. banking industry's continued viability in the "increasingly competitive" financial markets.[33] The Federal Reserve, for example, began interpreting Section 20 of the BHC Act–which prohibited BHCs from owning or controlling more than 50% of a company (or the majority of its directors) that engages principally in the business of issuing, underwriting, selling or otherwise distributing securities[34]–to allow BHCs to develop "significant securities operations

28. *See, e.g.*, Saule T. Omarova & Margaret E. Tahyar, *That Which We Call A Bank: Revisiting the History of Bank Holding Company Regulation in the United* States, 31 B.U. REV. BANKING & FIN. L. 113, 125–26 n.41 (2012) (citing cases and other authority that suggest that, in 1978, "the Federal Reserve gradually expanded the range of securities activities permissible to BHCs' non-bank subsidiaries" and that, in 1987, "the Federal Reserve permitted BHCs' to underwrite and deal in corporate securities through Section 20 subsidiaries, subject to the revenue limitation, which was gradually increased to twenty-five percent of a securities subsidiary's gross annual revenue").

29. *See* OCC, *supra* note 11.

30. 12 U.S.C. § 1851; 12 C.F.R. §§ 248.3, 248.10 (2015).

31. *See generally* The Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (1970).

32. *Id.* § 103(4), 84 Stat. at 1765.

33. Omarova & Tahyar, *supra* note 28, at 125. *See generally* Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"*, 63 U. MIAMI L. REV. 1041 (2009) (analyzing the OCC's gradual evolution related to its interpretation of regulations to allow banks to engage in a widening range of financial activities).

34. R. DANIEL PACE, LIMITATIONS ON THE BUSINESS OF BANKING: AN ANALYSIS OF

through the establishment of so-called "Section 20" subsidiaries."[35]

The legislation of the 1970s and the FBAs' regulatory interpretations of the 1980s and 1990s caused a crack in the BHC Act's barrier between commercial and investment banking. In 1999, upon the enactment of the Gramm-Leach-Bliley Act (the "GLBA"), this crack became a hole wide enough for BHCs to engage in a range of non-traditional banking activities.[36] Under the GLBA, BHCs had the power to register as financial holding companies, which were allowed to "engage in a broad range of financial activities, including securities underwriting and dealing, insurance underwriting, and merchant banking activities."[37] Moreover, BHCs could now own securities firms and insurance firms.[38] In the wake of the GLBA, the BHC structure offered substantial advantages to banks. Through the BHC structure, banks could be part of an organization engaged in a far more expansive range of activities than banks could engage in on their own.[39]

This steady trend of BHC power expansion came to an abrupt halt following the aftermath of the 2008 financial crisis, which former Federal Reserve chairman Ben Bernanke has described as "the worst financial crisis in global history, including the Great Depression."[40] Enacted in the aftermath of, and in response to, the 2008 financial crisis, Dodd-Frank "represent[ed] a significant shift toward strengthening regulations governing financial service providers and restricting the scope of activities that BHCs may engage in."[41] The Volcker Rule, in particular, has shrunk the scope of permissible BHC activities, prohibiting all banking entities from engaging in proprietary trading (short term trading of financial instruments on the banking entity's own account) and investing in or exercising control over certain types of funds (*e.g.*, hedge funds and commodity pools).[42] Moreover, the Federal Reserve has the authority, and

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EXPANDED SECURITIES, INSURANCE AND REAL ESTATE ACTIVITIES 12–14 (2012).

35. *See supra* note 30 and accompanying text.

36. Avraham et al., *supra* note 9; *see also* 12 C.F.R. § 225.84(b)(1) (2013).

37. Avraham et al., *supra* note 9; *see also* 12 C.F.R. § 1843(k)(1)(A).

38. Omarova & Tahyar, *supra* note 30, at 121; *see also* Bank Holding Company Act, 12 U.S.C. § 1843(k)(1)(A) (2012).

39. Joe Mahon, *Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley*, FED. RES. HISTORY (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/53.

40. Matt Egan, *2008: Worse than the Great Depression?*, CNN MONEY (Aug. 27, 2014, 5:34 PM), http://money.cnn.com/2014/08/27/news/economy/ben-bernanke-great-depression/.

41. Avraham et al., *supra* note 9.

42. 12 U.S.C. § 1851; 12 C.F.R. §§ 248.3, 248.10 (2015). We note that these restrictions apply to banks as well as to BHCs.

is considering exercising such authority, to further constrain the scope of permissible BHC activities.[43]

B. The Slow but Steady Expansion of Bank Powers

As the powers of BHCs expanded in the 1970s, 1980s, and 1990s, the scope of activities permissible for banks and their subsidiaries through the late 1990s and 2000s expanded as well. Today, national banks and their operating subsidiaries are permitted to engage in a broad array of financial activities previously reserved for BHCs.[44] The powers of state-chartered banks have likewise expanded as most states enacted "wildcard" statutes, permitting their state chartered banks to engage in the same activities permissible for national banks.[45] Banks can conduct, among other things, certain financial, investment and economic advisory services; provide transactional advice; and engage in various insurance and annuities activities as well as securities activities.[46]

1. Permissible Financial, Investment and Economic Advisory Services

During the late 1990s and early 2000s, the Office of the Comptroller of the Currency ("OCC") expanded the powers of national banks, and therefore state banks (as a result of state wildcard statutes),[47] to include providing certain financial advisory services to customers.[48] For example, national banks may serve as the advisory company for a mortgage or real estate investment trust, provide consumer financial counseling, furnish economic information and advice (including economic statistical

43. *E.g., Wall Street Bank Involvement With Physical Commodities: Hearing Before S. Permanent Subcomm. on Investigations*, 113th Cong. 313, 322 (2014) (statement of Daniel K. Taurollo, Member, Bd. of Governors of the Fed. Res. Sys.), http://www.federalreserve.gov/newsevents/testimony/tarullo20141121a.htm (noting that the Federal Reserve issued advance notice of proposed rulemaking in January 2014 requesting public comment regarding imposing further "prudential restrictions or limitations on the ability of financial holding companies to engage in commodities-related activities." He noted that the Federal Reserve received 184 unique comments and over 16,900 form letters and that, since November 2014, it has been assessing "the potential risk of physical commodities activities to the safety and soundness of the financial holding companies engaged in these activities" and considering what steps to take).

44. *See generally* OCC, *supra* note 11 (listing the broad array of activities national banks and their subsidiaries may engage in today).

45. Blair & Kushmeider, *supra* note 11, at 14.

46. *See generally* OCC, *supra* note 11 (listing the different activities).

47. A "state wild card statute" provides that a state bank may engage in the same banking powers as those enjoyed by a National Bank. *See* Christian A. Johnson, *Wild Card Statutes, Parity, and National Banks – The Renascence of State Banking Powers*, 26 LOYOLA UNIV. CHI. L.J. 351, 351 (1995).

48. *See generally* OCC, *supra* note 11, at 7, 10, 47, 49, 52.

forecasting services), furnish industry studies, engage in financial consulting and advisory services for other financial institutions and the public, offer fiscal planning advice regarding structuring bond issues to municipalities, and provide tax planning and preparation services.[49] Additionally, national banks may provide employee benefit consulting services to corporations in connection with establishing qualified benefit plans.[50] Moreover, a national bank's operating subsidiary is authorized to provide benefits counseling to customers (including collecting and disbursing Medicare and Medicaid insurance benefit payments), credit card registration and notification services, and payroll processing services, etc.[51]

2. Transactional Advice

The OCC has also expanded permissible bank activities to include providing transactional advice.[52] This expansion of power includes, but is not limited to, the ability to arrange for commercial real estate equity financing, conduct financial feasibility studies, and provide financial and transactional advice in relation to mergers, acquisitions, joint ventures, recapitalizations, leveraged buyouts, and other financial transactions.[53]

3. Insurance and Annuities Activities

By the mid-1990s, national bank powers further expanded to include authority to engage in certain types of insurance- and annuities-related activities.[54] Generally, national banks may sell insurance products as agents on a nationwide basis provided they comply with the requirements of 12 U.S.C. § 92.[55] Furthermore, banks may act as an agent selling a full range of annuities.[56] In addition to acting as agents, national banks are

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49. *Id.* at 7–10.

50. *Id.* at 8.

51. *Id.* at 7–8.

52. *Id.* at 10.

53. *Id.*

54. *Id.* at 47–52.

55. A national bank with a branch location in town with less than 5000 residents may sell insurance as an agent through that office on a national basis. *See id.* at 49. While 12 U.S.C. § 92 provides that a bank with less than 5000 residents may sell insurance, the OCC interpreted that provision to allow such a branch to offer for sale insurance products to customers nationwide in 1986. Furthermore, a national bank need not be headquartered in such small town; it only needs to have a branch in that town through which the insurance is offered. In 1993, over the objection of agents companies, the D.C. Circuit confirmed the OCC's position. *See* Independent Insurance Agents of America v. Ludwig, 997 F.2d 958, 959 (D.C. Cir. 1993); *see also* Letter from Judith A. Walter, Senior Deputy Comptroller, OCC, to Randall R. Kaplan, Caplin & Drysdale (June 13, 1986) (on file with author).

56. OCC, *supra* note 11, at 48. *See generally* NationsBank of North Carolina v. Variable Annuity Life Insurance Co., 513 U.S. 251 (1995).

permitted to sell credit life insurance and may underwrite a variety of insurance products, including credit life, health, disability, and mortgage life insurance.[57] Additionally, a national bank may establish an operating subsidiary to serve as a captive insurance company to underwrite the bank's own operating risks.[58]

4. Securities Activities

Perhaps, most notably, the scope of permissible activities now includes a wide range of securities activities.[59] Banks may purchase and sell asset-backed obligations and securitize certain assets, may execute and clear securities transactions, and may act as a transfer and fiscal agent.[60] Banks may also engage in various types of broker-dealer activities such as transactions for "trust customers, private placements, issuance and sales of certain asset-backed securities, transactions for certain stock purchase plans, and transactions in "identified banking products" (including generally deposit instruments, banker's acceptances, loan participations (subject to certain sales restrictions), and derivatives)."[61] They may even offer investment advice for and engage in certain derivative activities (*e.g.*, swaps, forwards, and options) as a financial intermediary or for risk reduction purposes.[62] Moreover, banks can provide full-service securities brokerage and act as a futures commission merchant.[63]

The activities listed above represent merely a sampling of the activities permissible for banks. The gradual expansion of bank powers may have eroded many banks' need for a BHC structure.

IV. DIMINISHING ADVANTAGES OF THE BHC MODEL

Although BHCs may still engage in a wider range of activities, the gap between permissible BHC and permissible bank business has narrowed. Given the evolution and expansion of bank powers as discussed above, arguably, many of the advantages of operating within the BHC structure have eroded.

As discussed *infra* in Part IV, a BHC-electing financial holding company status can engage in activities that are "financial in nature" such as securities underwriting and dealing, insurance activities, and certain securities activities beyond what was permissible for a bank without a

57. OCC, *supra* note 11, at 48.
58. *Id.*
59. *Id.* at 52–65.
60. *Id.* at 52, 57.
61. *Id.* at 52.
62. *Id.* at 53.
63. *Id.* at 55.

holding company.[64] However, since the promulgation of the Volcker Rule, the ability of BHCs and their nonbank subsidiaries to engage in many securities and investment activities has been substantially diminished,[65] decreasing one of the major advantages of the BHC structure. Moreover, the OCC now permits bank operating subsidiaries to engage in certain insurance, securities and other activities,[66] further eroding this business advantage.

The waning benefits of the BHC structure are not limited to the reduced gap between authorized BHC and bank activities. Other traditional BHC benefits have also diminished or evaporated. Historically, for example, the BHC structure was the primary means of acquiring and holding multiple bank subsidiaries due to interstate banking prohibitions.[67] However, starting in 1980, national banks could own operating subsidiaries,[68] financial subsidiaries,[69] and bank service companies[70] and maintain certain

64. *See Bank Holding Companies and Financial Holding Companies*, *supra* note 1.

65. *See generally* Bank Holding Company Act, 12 U.S.C. § 1851 (2012); 12 C.F.R. §§ 248.3, 248.10 (2015).

66. For example, the OCC permits national bank operating subsidiaries to, among other things, operate as a captive insurance company to underwrite insurance coverages on the operating risks of the parent bank and its affiliates, sell title insurance as an agent, continue to conduct grandfathered title insurance activities, and engage in many types of securities broker-dealer activities, including transactions for trust customers, private placements, issuance and sales of certain asset-backed securities, transactions for certain stock purchase plans, and transactions in "identified banking products." *See* OCC, *supra* note 11, at 48.

67. *See* Baradaran, *supra* note 27, at 400 (indicating that, before the Riegle-Neal Interstate Banking Act, interstate bank prohibitions provided BHCs with a competitive advantage as the primary way to engage in banking in multiple states); Carl A. Sax & Marcus H. Sloan III, Legislative Note, *The Bank Holding Company Act Amendments of 1970*, 39 GEO. WASH. L. REV. 1200, 1208 (1971).

68. 12 C.F.R. § 5.34(d)(2) (defining an operating subsidiary as "a corporation, limited liability company, limited partnership, or similar entity if: (A) The bank has the ability to control the management and operations of the subsidiary, and no other person or entity exercises effective operating control over the subsidiary or has the ability to influence the subsidiary's operations to an extent equal to or greater than that of the bank; (B) The parent bank owns and controls more than 50 percent of the voting (or similar type of controlling) interest of the operating subsidiary, or the parent bank otherwise controls the operating subsidiary and no other party controls a percentage of the voting (or similar type of controlling) interest of the operating subsidiary greater than the bank's interest; and (C) The operating subsidiary is consolidated with the bank under generally accepted accounting principles (GAAP)").

69. *Id.* § 5.39(d)(6) (defining a financial subsidiary as "any company that is controlled by one or more insured depository institutions, other than a subsidiary that: (i) Engages solely in activities that national banks may engage in directly and that are conducted subject to the same terms and conditions that govern the conduct of these activities by national banks; or (ii) A national bank is specifically authorized to control by the express terms of a Federal statute (other than Section 5136A of the Revised Statutes), and not by implication or interpretation, such as by Section 25 of the Federal

other equity investments.[71]

Moreover, the previously preferential treatment of debt at the BHC level has largely evaporated. Prior to Dodd-Frank, the BHC structure facilitated double leverage where a BHC could engage in trust preferred securities ("TruPS") financing, which could be counted as capital at the BHC level and where the proceeds could be counted as Tier 1 capital at the bank level.[72] By way of background, TruPS are a type of debt instrument issued generally by a special purpose subsidiary of the BHC (often the bank), and the proceeds generally are loaned to the BHC pursuant to a long-term, subordinated note.[73] The BHC's loan payments are eventually used to make dividend payments to the TruPS investors;[74] however, BHCs generally retain generous deferral options regarding repayments.[75] Beginning in October 1996, the Federal Reserve allowed these kinds of instruments to be treated as Tier 1 capital for BHCs.[76] TruPS, along with other cumulative preferred stock, were allowed to account for up to 25% of a BHC's Tier 1 capital, provided that certain conditions were satisfied.[77] This treatment represented a significant benefit of the BHC structure:

> Given the capital treatment[,] . . . TruPS presented BHCs with a way to raise capital without diluting existing shareholders. TruPS also provided BHCs with favorable tax treatment in that TruPS dividend payments are tax deductible for the issuers, unlike dividends paid on preferred stock. A final benefit to using TruPS is that the collateralized debt obligations

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Reserve Act (12 U.S.C. 601-604a), Section 25A of the Federal Reserve Act (12 U.S.C. 611-631), or the Bank Service Company Act (12 U.S.C. 1861 et seq.)").

70. *Id.* § 5.35(d)(1) (defining a bank service company as "a corporation or limited liability company organized *to provide services authorized by the Bank Service Company Act*, 12 U.S.C. 1861 et seq., all of whose capital stock is owned by one or more insured depository institutions in the case of a corporation, or all of the members of which are one or more insured depository institutions in the case of a limited liability company") (emphasis added); *see also* 12 U.S.C. § 1863 (indicating that permissible services include performing the following services "check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar functions performed for a depository institution").

71. 45 Fed. Reg. 68587 (Oct. 15, 1980); *see also* 12 C.F.R. § 5.36 (permitting national banks to make various types of equity investments pursuant to 12 U.S.C. § 24(7) and other statutes).

72. Alan Faircloth, *ViewPoint: Spotlight: A Guide to Trust Preferred Securities*, 27 FIN. UPDATE 1 (2014), https://www.frbatlanta.org/banking/publications/financial-update/2014/q1/viewpoint/spotlight-guide-trust-preferred-securities.aspx.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

> (CDOs) could be issued under SEC Rule 144A, which allowed TruPS CDOs to be unregistered when issued to qualified institutional buyers (QIB) through a broker-dealer and permitted CDO issuers and trustees to provide very limited disclosures.[78]

Post Dodd-Frank, this is no longer the case. The Collins Amendment to Dodd-Frank, along with the related Federal Reserve rules and policies, has largely eliminated TruPS and similar hybrid debt securities from being included in regulatory capital.[79]

BHCs' historic director-and-officer-related advantages have likewise deteriorated. BHCs once had an advantage over banks with respect to director and officer liability. While banks were restricted by the corporate governance provisions of the state of their headquarters, BHCs had the flexibility to select their state of incorporation, allowing them to select states with more favorable indemnification and liability laws. But, in 1986, national banks were granted similar flexibility by the OCC,[80] which allowed national banks to adopt corporate governance provisions in their bylaws from a number of jurisdictions, *e.g.*, from the home state of the bank, BHC, Delaware, or Model Business Corporation Act.[81] Moreover, indemnification by all banks and BHCs is subject to compliance with 12 U.S.C. § 1828(k)[82] and the FDIC's Golden Parachute and Indemnification Rule.[83]

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78. Press Release, Bd. of Governors of the Fed. Res. Sys., Statement Regarding Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities Under the Rules Implementing Section 619 of the Dodd-Frank Act (Dec. 31, 2013), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131227a1.pdf. In assessing the relative merits of the BHC structure today, the authors note that, to the extent the argument is made that the BHC presents increasing and burdensome regulatory requirement imposed by the Dodd Frank Act, this in no way reflects on a highly professional, knowledgeable and experienced Federal Reserve staff who have more than capably implemented rules and policies required by law.

79. *Id.* (noting that TruPs no longer constitute Tier 1 capital for BHCs with greater than $15 billion in assets).

80. 61 Fed. Reg. 4849, 4866 (Feb. 9, 1996).

81. *See* 12 C.F.R. § 7.2000 (2015).

82. *See* 12 U.S.C. § 1828(k) (2006 & Supp. 2011) (granting FDIC authority to prohibit or limit, by regulation or order, any golden parachute or indemnification payment).

83. *See* 12 C.F.R. §§ 359.2, 359.3 (2012); *see also id.* § 359.2 ("No insured depository institution or depository institution holding company shall make or agree to make any golden parachute payment, except as provided in this part."). A "golden parachute payment" is a compensation payment, subject to certain enumerated exceptions, by a bank or bank holding company for the benefit of any current or former institution affiliated party—such as a director or officer of the bank or BHC—and is contingent on that person's employment termination. In such a case, both the person's termination and scheduled payment must occur closely before or after there is a period of insolvency, appointment of a conservator or receiver of the bank, regulatory notice the bank or BHC is in a troubled condition, assignment of a 4 or 5 composite regulatory

BHCs have also lost their previous advantage with respect to director and officer compensation. Initially, BHCs faced fewer regulatory requirements on deferred compensation plans (*e.g.*, salary continuation plans), resulting in lower administrative costs related to such compensation.[84] Currently, not only do safety and soundness guidelines and the golden parachute provisions of the FDIC impose identical limitations and prohibitions on BHC and bank level management severance provisions,[85] but Section 956 of Dodd-Frank also requires the FBAs to develop a rule to "curb excessive incentive compensation at financial services organizations,"[86] which includes both banks and BHCs.[87] Although the FBAs have yet to issue a final rule, the draft rule proposed in 2011, if adopted, would subject BHCs and banks to the same stringent requirements.[88]

As the benefits of the BHC structure erode, its attractiveness as an organizational model dwindles as well.

V. GROWING BHC REGULATORY REQUIREMENTS AND COSTS

As the financial crisis of 2008 was blamed, at least in part, on inadequate supervision of the country's largest and most complex financial institutions,[89] Dodd-Frank was passed to fundamentally overhaul the

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examination rating for the bank, or the possibility of being subject to a proceeding to terminate deposit insurance.

84. Tatiana V. Tkachenko, *Legal Status of Bank Holding Companies (BHCs): U.S. and European Bankruptcy Issues*, 19 J. BANKR. L. & PRAC. 573, 589 (2010).

85. *See* 12 U.S.C. 1828(k).

86. Francine McKenna, *Dodd-Frank Rule to Curb Bank incentive Pay Likely Last to Finish Line*, MARKETWATCH (July 16, 2015, 9:18 AM), http://www.marketwatch.com/story/dodd-frank-rule-to-curb-bank-incentive-pay-likely-last-to-finish-line-2015-07-16.

87. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423–1432 (2010) (codified at 12 U.S.C. § 5365) [hereinafter "Dodd-Frank"].

88. Joint Press Release, Bd. of Governors of the Fed. Res. Sys., Agencies Seek Comment on Proposed Rule on Incentive Compensation (Mar. 30, 2011), http://www.federalreserve.gov/newsevents/press/bcreg/20110330a.htm. ("requir[ing] compensation practices at regulated financial institutions to be consistent with three principles—that compensation arrangements should appropriately risk and financial rewards, be compatible with effective controls and risk management, and be supported by strong corporate governance").

89. *See* Janet L. Yellen, Chair, Bd. of Governors of the Fed. Res. Sys., Remarks at the Citizen Budget Commission (Mar. 30, 2015), http://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm (commenting on the importance of increased Federal Reserve Bank oversight of large financial institutions); Ben S. Bernanke, then-Chairman, Bd. of Governors of the Fed. Res. Sys., Statement before the Financial Crisis Inquiry Commission (Sept. 2, 2010), http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm; President Barack Obama, Remarks on 21st Century Financial Regulatory Reform, (Jun. 17, 2009), https://www.whitehouse.gov/

financial regulatory system and ensure that federal regulators actively managed all financial institutions to mitigate risks.[90] Dodd-Frank granted the Federal Reserve sweeping new powers to regulate large financial institutions and directed the Federal Reserve to impose "heightened prudential standards" in a variety of categories, including leverage capital, liquidity, stress testing, and risk management.[91] Dodd-Frank also directed FBAs to issue upwards of 100 new finalized rulemakings.[92] As a result, the regulatory burden on financial institutions is considered to be at an all-time high.[93]

While certain regulations only apply to BHCs with more than $250 billion in assets, Dodd-Frank also directed the Federal Reserve to impose significant new regulatory burdens on all BHCs with consolidated assets over $50 billion.[94] For example, these BHCs must implement new "global risk management frameworks" overseen by a required risk committee and a chief risk officer ("CRO").[95] BHCs with assets over $50 billion also are now subject, or will eventually be subject, to the new modified liquidity coverage ratio,[96] Comprehensive Capital Analysis and Review ("CCAR") plans,[97] enhanced liquidity risk managements standards, single counterparty credit limits, supervisory run stress tests,[98] and a host of new reporting requirements.[99] The resulting compliance costs are substantial; for instance, in 2015, Citigroup Inc. announced it had spent $180 million in

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the-press-office/remarks-president-regulatory-reform [hereinafter "Obama Remarks"].

90. Obama Remarks, *supra* note 89 (describing the Administration's proposal for the Dodd-Frank Act as "a sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression")

91. Dodd-Frank, § 165, 124 Stat. at 1423–1432.

92. For a comprehensive report on the progress of all Dodd-Frank related rulemaking, *see* DAVIS POLK, DODD-FRANK PROGRESS REPORT: FOURTH QUARTER 2015, 2 (Davis Polk & Wardell 2016), http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

93. *Id.*

94. Dodd-Frank, § 165, 124 Stat. at 1423–1432.

95. Regulation YY, 12 C.F.R. §§ 252.22, 252.132 (2014).

96. Joint Press Release, Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Banking Regulators Finalize Liquidity Coverage Ratio (Sept. 3, 2014), http://www.federalreserve.gov/newsevents/press/bcreg/20140903a.htm.

97. Press Release, Federal Reserve Board, Amendments to the Capital Plan and Stress Test Rules 2–3, 12, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151125a1.pdf (last visited Mar. 27, 2016).

98. *See* 12 C.F.R. §§ 252.51–252.58.

99. *See* Dodd-Frank, § 165, 124 Stat. at 1423–1432. *See generally* 12 C.F.R. §§ 249, 252. For a comprehensive analysis of enhanced prudential standards, *see* DAVIS POLK, *supra* note 92.

just a six month period preparing for its annual CCAR.[100]

While many of the post Dodd-Frank requirements do not affect BHCs with less than $50 billion in total assets, BHCs with total assets between $10 billion and $50 billion have experienced their own steady increase in regulatory burden. Particularly for many smaller banking entities, the increased compliance costs have been difficult to bear. Publicly-traded BHCs with over $10 billion in assets must adopt a risk committee that is required to meet quarterly.[101] The risk committee is charged with establishing a risk management framework, which must incorporate processes for independent evaluation of risk, managerial risk responsibilities, and risk reporting.[102] Moreover, all BHCs with more than $10 billion in assets must conduct annual stress tests and disclose these tests to both their regulators and the public.[103]

The ramped-up regulations imposed on small BHCs have faced considerable criticism, and many argue that the increased regulatory burden greatly outweighs whatever risk small BHCs pose to the national economy.[104] This trend toward heightened regulation is especially disconcerting in light of the fact that Dodd-Frank does not require the Federal Reserve to engage in any risk benefit analysis before it imposes additional regulations.[105]

While BHCs face more regulatory requirements than ever before, many of these heightened prudential standards do not apply to financial institutions without holding companies.[106] Many of Dodd-Frank's most

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100. Kevin Wack, *How One Major Bank Got a Pass on the Fed's Stress Tests*, AM. BANKER (Nov. 13, 2015), http://www.americanbanker.com/news/national-regional/how-one-major-bank-got-a-pass-on-the-feds-stress-tests-1077836-1.html.

101. 12 C.F.R. §§ 252.22, 252.132.

102. *Id.*

103. *Id.* § 252.14(3).; *see also Compliance Implications of Crossing the $10 Billion Asset Threshold,* GRANT THORNTON (Oct. 14, 2015), http://www.grantthornton.com/issues/library/articles/financial-services/2015/BK/10-FIS-banking-crossing-ten-billion-threshold.aspx.

104. *Why One-Size-Fits-All Rules Could Hurt the Recovery: Weekly Wrap*, AM. BANKER (Mar. 13, 2015), http://www.americanbanker.com/bankthink/why-one-size-fits-all-rules-could-hurt-the-recovery-weekly-wrap-1073240-1.html; Carrie Sheffield, *Dodd-Frank is Killing Community Banks*, FORBES (Feb. 9, 2015), http://www.forbes.com/sites/carriesheffield/2015/02/09/dodd-frank-is-killing-community-banks/#217dfcb945ca.

105. *See* Congressman Jeb Hensarling, *Reining in a Sprawling Federal Reserve*, WALL ST. J. (Nov. 19, 2015, 7:10 PM), http://www.wsj.com/articles/reining-in-a-sprawling-federal-reserve-1447978230.

106. While the OCC, FDIC, and state banking regulators could apply similar regulations to banks without holding companies—and perhaps would do so if there was a sudden increase in non-BHC banks—they have generally not elected to do so. *Cf.* 12 C.F.R. §§ 50, 329 (applying annual company run stress test requirements to all depository institutions with over $10 billion in assets).

strenuous requirements were written to exclusively target BHCs with over $50 billion in assets and systematically important financial institutions ("SIFIs") as designated by the Financial Stability Oversight Council ("FSOC").[107] National banks, state banks, and savings and loan holding companies have generally not been subjected to the overwhelming expansion of federal banking regulatory requirements.[108]

Notably, banks with less than $50 billion in assets experience regulatory advantages by *not* having a BHC. While all depository institutions must engage in risk analysis, only BHCs must create a risk management policy, which meets the heightened requirements imposed by the Federal Reserve, and form a separate risk committee.[109] Additionally, only BHCs are required to file quarterly Y-11 reports containing financial statements for their nonbank subsidiaries.[110]

As the level of BHC regulation rises and the final rulemakings required by Dodd-Frank are drafted and implemented, the regulatory burden on BHCs increasingly reduces their value as an organizational structure.[111] In addition to the growth of BHC regulations as a result of Dodd-Frank, the BHC structure faces another significant disadvantage. While state and national banks generally need only report to one federal regulator, the BHC organizational structure faces the substantial regulatory compliance cost of reporting to two regulators: the Federal Reserve for the BHC and the bank's primary regulator.[112] The inefficiencies of double-reporting long have been recognized by the federal government, but despite the recommendation by a mid-1980s task force of the Department of Treasure

107. *See* Dodd-Frank, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423–1432 (2010) (codified at 12 U.S.C. § 5365). *See generally* 12 C.F.R. §§ 249, 252.

108. A particularly notable example is the United Services Automobile Association ("USAA"), which has assets of approximately $134 billion. *See* USAA, WE THE MEMBERS 2014 REPORT TO MEMBERS (2014), https://content.usaa.com/mcontent/static_assets/Media/report-to-member-2014.pdf?cacheid=1896096673_p. USAA has not been designated as a SIFI, and as such, it has escaped many of the additional regulatory costs imposed since Dodd-Frank. Wack, *supra* note 100. With the exception of company-run stress tests, the Federal Reserve has not applied any of the enhanced prudential standards created pursuant to savings and loan holding companies through Dodd-Frank.

109. 12 C.F.R. § 252.

110. OCC, COMPTROLLER'S HANDBOOK ON RELATED ORGANIZATIONS 20 (Aug. 2004), http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/_pdf/pub-ch-related-orgs.pdf.

111. *See also* DAVIS POLK, *supra* note 92 (indicating that there are over twenty-five remaining rulemakings requirements by Dodd-Frank that have not yet been implemented).

112. LYNN S. FOX ET AL., SUPERVISION AND REGULATION, in THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 59–60 (June 2005), http://www.federalreserve.gov/pf/pdf/pf_5.pdf.

to eliminate this inefficiency,[113] Dodd-Frank instead reinforced this double-reporting system.

VI. CERTAIN BHC ADVANTAGES REMAIN STANDING

Notwithstanding the erosion of advantages and mounting regulatory burdens of the BHC structure, BHCs continue to offer certain key advantages. For one, unlike a bank, a BHC may own up to 5% of the voting shares of **any** other company without prior regulatory approval.[114] This additional authority makes BHCs far more efficient for investment and initial business expansion purposes. Additionally, the BHC structure facilitates international banking activities as a BHC has significantly greater flexibility to engage in foreign nonbanking activities than many banks,[115] which generally are restricted to establishing foreign branches or investing in entities "principally engaged" in banking.[116] International activities conducted by a BHC are exempt from § 4 of BHC Act's "closely related to banking" requirement.[117] Unlike its bank counterpart, a BHC may acquire "shares of or activities conducted by, any company which does no business in the United States except as incident to its international or foreign business, if the Board by regulation or order determines . . . . the exemption would not be substantially at variance with the purposes of the Act."[118]

Furthermore, BHCs that qualify as financial holding companies ("FHCs") enjoy additional advantages, for FHCs may engage in activities that are "financial in nature" beyond what is allowable for banks.[119] Only BHCs, not banks, can qualify for FHC status, which allows them to engage in securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking.[120] Although banks may affiliate with an insurance underwriter and insurance sales and brokerage firm, only FHCs may engage in virtually any insurance activity.[121] Moreover, FHCs

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113. THE DEPARTMENT OF TREASURY BLUEPRINT FOR THE MODERNIZED FINANCIAL REGULATORY STRUCTURE 200 (2008), https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.

114. Bank Holding Company Act, 12 U.S.C § 1843(c)(6) (2012).

115. This applies to U.S. bank holding companies and U.S. banks and not necessarily to foreign banking organizations. *See, e.g., id.* § 1841(h)(2); 12 C.F.R. § 211.23.

116. 12 U.S.C. §§ 611–31.

117. *Id.* § 1843(c)(13).

118. *Id.*

119. *See generally id.* § 1843.

120. *Id.* § 1843(k)(4).

121. *See id.* § 1843(k)(4)(B) (providing that an FHC may engage in any of the following: "insuring, guaranteeing, or indemnifying against loss, harm, damage, illness,

may use their merchant banking authority to acquire any ownership interest–even 100% ownership–in any type of entity, including a nonfinancial entity.[122]

BHCs also benefit from greater flexibility in raising capital than banks, which generally can only raise capital by issuing stock.[123] In addition to an increased ability to raise capital, a banking structure helmed by a BHC facilitates better separation of a troublesome subsidiary from the bank to preserve the bank's supervisory and credit ratings.[124] More generally, the BHC structure can more effectively shield banks from potential veil-piercing liability for the acts of its subsidiaries, including from environmental regulatory risk.[125] Depending on a banking entity's activities and liability risks, these advantages may continue to outweigh the enhanced regulatory burdens of the BHC structure.

CONCLUSION

While maintaining a BHC remains necessary for most very large financial institutions that engage in financial activities only permitted for FHCs, a large number of community and regional banks conduct activities that do not require a BHC. Many of the advantages that previously encouraged banks to adopt the BHC model no longer exist, and those advantages that remain may well be outweighed by the onerous and ever-increasing regulatory burden imposed on BHCs. As the regulatory framework has changed, the incentives to form a BHC have disappeared. Currently, many banks appear to subject themselves to inefficient and unnecessary costs by failing to evaluate whether forming or maintaining a BHC is still advantageous. A bank should not simply assume a BHC is necessary or advisable regardless of their particular business model, but rather, it should make an informed assessment and decision as to the need for a BHC in light of its operating plans.

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disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the forgoing").

122. *Id.* § 1843(k)(4)(H) (indicating that an FHC may engage in merchant banking and that it remains allowable despite that the Volker Rule limiting this type of investment).

123. *Bank Holding Companies and Financial Holding Companies*, *supra* note 1.

124. Pauline B. Heller & Melanie L. Fein, *Federal Bank Holding Company Law* §1.04[3], Law Journal Press, Release 27 (2011).

125. *Bank Holding Companies and Financial Holding Companies*, *supra* note 1.

PROTECTING DELAWARE CORPORATE LAW: SECTION 115 AND ITS UNDERLYING RAMIFICATIONS

ANDREW HOLT*

> *"I do not discern an overarching public policy of this State that prevents boards of directors of Delaware corporations from adopting bylaws to require stockholders to litigate intra-corporate disputes in a foreign jurisdiction."*[1]
>
> *— Chancellor Andre G. Bouchard*

INTRODUCTION

On June 24, 2015, Delaware Governor Jack Markell signed legislation amending the General Corporation Law of the state of Delaware

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1. City of Providence v. First Citizens Bancshares, Inc., 99 A.3d 229, 240 (Del. Ch. 2014).

("DGCL"),[2] effectively overruling Chancellor Andre Bouchard's decision in *City of Providence v. First Citizens Bancshares, Inc.*,[3] while codifying then-Chancellor—now Chief Justice—Leo Strine's opinion in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* ("*Chevron*") at the same time.[4] Delaware thus statutorily sanctioned exclusive forum selection clauses—so long as the selected forum is Delaware.[5] The newly added Section 115 states that

> [t]he certificate of incorporation or bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and *no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State.*[6]

In other words, a corporation may now require any or all internal claims against the company to be brought solely in Delaware.[7] Additionally, Section 115 prohibits a corporation from excluding Delaware as a potential forum; a Delaware corporation cannot select another state as an *exclusive* forum to settle internal disputes—rejecting *City of Providence.*[8]

To be clear, Section 115 does not prohibit a corporation from selecting a foreign jurisdiction as an *additional* forum; however, it does "invalidate any provision selecting only non-Delaware courts, or any arbitral forum, to the extent the provision would prohibit litigation of internal corporate claims in the Delaware courts."[9] Forum selection clauses have never been the subject of legislation in Delaware; but, due to an increasing number of Delaware corporations adopting such clauses in their charters and bylaws and the subsequent cases upholding these adoptions in *Chevron* and *City of Providence*, Delaware acted.[10]

This Article will first explore the influential Delaware case law ratifying

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2. *Delaware Governor Jack Markell Signs Legislation Amending the Delaware General Corporation Law,* RICHARDS, LAYTON & FINGER KNOWLEDGE CTR. (June 24, 2015), https://www.rlf.com/Publications/6092.

3. *City of Providence*, 99 A.3d 229.

4. 73 A.3d 934 (Del. Ch. 2013).

5. *See* John L. Reed, *Delaware (Again) Proposes Sledgehammering Fee-Shifting Bylaws*, HARV. L. SCHOOL F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 12, 2015), http://corpgov.law.harvard.edu/2015/03/12/delaware-again-proposes-sledgehammering-fee-shifting-bylaws/#comments.

6. DEL. CODE ANN. tit. 8 § 115 (2015) (emphasis added).

7. *See* Jack B. Jacobs, *New DGCL Amendments Endorse Forum Selection Clauses and Prohibit Fee-Shifting*, HARV. L. SCHOOL F. ON CORP. GOVERNANCE & FIN. REG. (June 17, 2015), http://corpgov.law.harvard.edu/2015/06/17/new-dgcl-amendments-endorse-forum-selection-clauses-and-prohibit-fee-shifting/.

8. *Id.*

9. *Id.*

10. *Id.*

internal corporate forum selection clauses and Section 115's response. Next, it will discuss some concerns raised by the addition of Section 115 including (1) the effect of exclusive forum selection clauses on multijurisdictional litigation, (2) Section 115 as a possible legislative intrusion into the corporate boardroom, and (3) the concern for judicial comity among other states and federal jurisdictions and the Delaware courts. The *leitmotif* of this Article is that Delaware has carved out a sophisticated niche as the premier incorporation state for the majority of large U.S. corporations. Like the ever-evolving Apple Inc. iPhone, there is an increasing need to upgrade and innovate the product that is Delaware corporate law. To maintain this innovative edge and respond to developments in the corporate market place, the Delaware legislature (the "General Assembly"), will act sometimes to the exaltation of legal commentators and practitioners, and at other times, in the face of claims of "protectionism."

II. DELAWARE AND INTERNAL FORUM SELECTION CLAUSES

A "forum selection clause" is a contractual provision in which the parties establish the place for specified litigation between the parties.[11] These clauses are ubiquitous in commercial contracts.[12] As discussed below, however, they were rarely used before 2010 to address the litigation concerning internal corporate claims. "Internal corporate claims," as defined by Section 115, are "claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director of officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery."[13] This Section details the three critical Delaware Court of Chancery (the "Court of Chancery") cases that sparked, and subsequently developed, internal corporate forum selection clause case law.

A. Revlon*: Opening the Door*

Before March 16, 2010, while it was commonplace to find forum selection clauses in a corporation's material contracts, it was, however, exceedingly rare to find them in the organic documents (*i.e.*, the charter or bylaws) of the same corporation.[14] On that date, the Court of Chancery

11. BLACK'S LAW DICTIONARY 770 (10th ed. 2014).

12. *See, e.g.*, Richard D. Freer, *Erie's Mid-Life Crisis*, 63 TUL. L. REV. 1087, 1091 (noting the ubiquity of forum selection clauses).

13. DEL. CODE ANN. tit. 8 § 115 (2015).

14. Joseph A. Grundfest, *The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis*, 37 DEL. J. CORP. L. 333 (2012).

explained in *In re Revlon, Inc. Shareholders Litigation* ("*Revlon*"),[15] that corporations could avoid forum disputes by adopting forum selection provisions in corporate charters.[16] In dicta, Vice-Chancellor Travis Laster observed that if corporate boards of directors (the "Board") and stockholders "believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."[17] Thus, *Revlon* sparked the infiltration of forum selection clauses into corporate charters and bylaws.[18]

In *Revlon*'s wake, prominent law firms immediately endorsed the use of these clauses to their corporate clients.[19] In the sixteen months following *Revlon*, eighty-four corporations installed forum-selection clauses in either their bylaws or charters; by contrast, in the nineteen years preceding *Revlon*, only eleven corporations included forum-selection clauses in their internal documents.[20] The rampant adoption of internal corporate forum-selection clauses is clearly attributable to *Revlon's* mere dicta. Eventually, the Court of Chancery would get a chance to clarify or, rather, confirm Vice-Chancellor Laster's dicta.

B. Chevron*: Choosing only Delaware*

In *Chevron*, the Court of Chancery got its opportunity. Written by Chief Justice Strine, *Chevron* concerned the oil and gas giant's decision to adopt a forum-selection clause in its bylaw that provided for any litigation concerning the corporation's internal affairs to be conducted in Delaware.[21] The stockholders of Chevron sued the Board over its adoption of the bylaws, claiming (1) that the bylaws were *statutorily* invalid under the DGCL and (2) that they were *contractually* invalid.[22]

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15. 990 A.2d 940, 960 (Del. Ch. 2010).

16. *Id.* at 960.

17. *Id.*

18. *See, e.g.*, Timothy P. Crudo & Andrea Cheuk, *Location, Location, Location: The Current State of Corporate Forum-Selection Provisions*, 19 WESTLAW J. SEC. LITIG. & REG. 1, 2 (2013) (explaining how *Revlon* set off a rush to "implement corporate forum-selection clauses").

19. *See, e.g.*, LATHAM & WATKINS, LLP, *Designating Delaware's Court of Chancery as the Exclusive Jurisdiction for Intra-Corporate Disputes: A New "Must" for Delaware Company Charter or Bylaws*, CORP. GOVERNANCE COMMENT. (Apr. 2010) (recommending a specific clause the firm drafted vesting jurisdiction in the Court of Chancery).

20. *Id.*

21. Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 937 (Del. Ch. 2013) (including Fed-Ex's adoption of an exclusive forum-selection clause designating Delaware).

22. *Id.* at 938.

Regarding the stockholders' first claim, Chief Justice Strine held that the forum-selection clause choosing Delaware as the company's forum for internal disputes was valid. Citing Section 109(b) of the DGCL, Chief Justice Strine explained that a corporation's Board is free to adopt "any provision, not inconsistent with law or with the . . . [charter], relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."[23] Chief Justice Strine determined the Board's power to adopt this bylaw fell within the purview of Section 109(b). Ultimately, it is statutory authorization that grants the ability of a corporate charter to confer to the Board the power to adopt, amend, or repeal bylaws.[24] As with a Board's ability to use a poison pill to thwart hostile takeovers, Chief Justice Strine explains that a Board similarly has the authority to "adopt a bylaw to protect against what they claim is a threat to their corporations and stockholders, the potential for duplicative law suits in multiple jurisdictions over single events."[25]

As for the stockholders' second claim, Chief Justice Strine held that the bylaws were contractually valid.[26] The stockholders claimed that the bylaws were invalid because the Board unilaterally adopted them; that is, the bylaws cannot be contractual because the stockholders did not vote ahead of time to approve them.[27] Chief Justice Strine explained that the litany of Delaware Supreme Court decisions illustrate that corporate bylaws "constitute a binding part of the contract between a Delaware corporation and its stockholders."[28] Chief Justice Strine explained that Chevron's stockholders "have assented to a contractual framework established by the DGCL and the certificates of incorporation that explicitly recognized that stockholders will be bound by bylaws adopted unilaterally by their Boards."[29] Here, Chevron's charter explicitly authorized the Board to implement bylaws such as a forum-selection clause.[30] Additionally, should the Board draft a bylaw to the stockholders' dismay, stockholders are free to repeal or amend the displeasing bylaws—a right that cannot be taken

23. *Id.* at 950.

24. DEL. CODE ANN. tit. 8, § 109(a) (2015) ("[A]ny corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors[.]").

25. *Chevron*, A.3d at 953.

26. *Id.* at 958.

27. *Id.* at 954-55.

28. *Id.* at 955.

29. *Id.* at 956.

30. *Id.*

away by the board or the legislature.[31]

Chief Justice Strine discussed the seminal forum-selection clause case, *Carnival Cruise Lines, Inc. v. Shute*,[32] where the U.S. Supreme Court approved the unilateral use of a contractual forum-selection clause on the back of cruise ship tickets.[33] Chief Justice Strinere emphasized that unlike cruise ship passengers, who have no mechanism to amend the terms in their contract, the stockholders of a corporation retain the right to repeal or amend the terms adopted by their Board.[34] Thus, where the Board has adopted a forum-selection bylaw that falls within the DGCL, Delaware courts will ultimately enforce them just as with any other bylaw.[35] Therefore, *Chevron* stands for the proposition that, as long as a forum-selection clause is adopted within Delaware statutory limits, it is lawful—at least if it selects Delaware as the forum.[36]

C. City of Providence*: Choosing Anywhere but Delaware*

In *City of Providence,* Chancellor Bouchard extended the ability of a corporation to use a forum-selection clause in the bylaws to designate a foreign jurisdiction as the *exclusive* forum for internal disputes.[37] This case dealt with a forum selection bylaw "virtually identical to the ones that . . . Chief Justice Strine found to be facially valid in . . . [*Chevron*]."[38] Here, however, the clause designated the U.S. District Court for the Eastern District of North Carolina "or any North Carolina state court with jurisdiction, as the exclusive forum, instead of the courts of Delaware.[39]

City of Providence ("Providence"), as a shareholder of the defendant corporation, challenged First Citizens BancShares, Inc.'s ("FC North") adoption of the forum selection bylaw.[40] FC North, a bank holding company incorporated in Delaware, has its headquarters in Raleigh, North Carolina, and the majority of its deposits and branches in North Carolina.[41] Not only did Providence challenge the Board's right to do this, but it also

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31. *Id.* (citing CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d. 226, 231 (Del. 2008)).

32. 499 U.S. 585 (1991).

33. *Chevron*, 73 A.3d at 957-58.

34. *Id.* at 958 (applying Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991)).

35. *Id.*

36. *See generally id.*

37. City of Providence v. First Citizens Bancshares, Inc., 99 A.3d 229, 240 (Del. Ch. 2014).

38. *Id.* at 230.

39. *Id.*

40. *Id.* at 231.

41. *Id.*

challenged the timing: the Board adopted the bylaw on the same day it had announced a merger agreement to acquire a bank holding company based in South Carolina.[42]

Citing *Chevron*, Chancellor Bouchard explained that "[s]tockholders are on notice that, as to those subjects that are subject of regulation by bylaw under 8 *Del. C.* § 109(b), the Board itself may act unilaterally to adopt bylaws addressing those subjects."[43] While the bylaw in this case chose a forum other than Delaware, Chancellor Bouchard relied on the same analysis used in *Chevron* to address the validity of the bylaw and stated that nothing in *Chevron* prohibits a Delaware corporation from choosing an exclusive forum other than Delaware.[44] As for the timing of the bylaw, Providence asserted that the bylaw was self-serving to an alleged stockholder in connection with a self-interested transaction.[45] However, Chancellor Bouchard stated that the complaint lacked any well-pled allegations of wrongdoing and the fact that the Board adopted the bylaw on a "cloudy" day when it entered into a merger—rather than a "clear" day—was immaterial.[46] Moreover, a forum selection bylaw merely regulates "*where* stockholders may file suit, not *whether* the stockholder may file . . . ."[47]

Lastly, Chancellor Bouchard addressed Delaware's "purported interest" in deciding the case. Providence asserted that Delaware has a strong public policy in favor of the Court of Chancery deciding novel questions of Delaware corporate law.[48] In response, Chancellor Bouchard explained that this novelty as described by Providence was overstated, at least in this case, because, at its core, the complaint alleged self-dealing and waste: claims governed by well-established principles of Delaware law.[49] Such issues are "far from the type of unprecedented claims that might theoretically outweigh Delaware's substantial interest in enforcing a facially valid forum selection bylaw designating a [foreign jurisdiction] as an exclusive forum."[50] Further to his point, he explained that the General Assembly did not express a preference on whether a Board could require

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42. *Id.*

43. *Id.* at 234 (quoting *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 955-56 (Del. Ch. 2013)).

44. *See id.* at 230.

45. *Id.* at 240-41.

46. *Id.* at 241.

47. *Id.*

48. *Id.* at 239.

49. *Id.* at 240 (citation omitted).

50. *Id.*

internal disputes to be conducted in a foreign jurisdiction.[51] To conclude, Chancellor Bouchard explained it was logical—not unreasonable—to select North Carolina as FC North's exclusive forum for internal disputes: that was the situs of its headquarters and the majority of its business.[52]

D. Section 115: Protectionism or Justified Concern

In 1999, in *Elf Atochem N. Am., Inc. v. Jaffari*,[53] a case akin to *City of Providence* but applicable to Delaware limited liability companies ("LLC"), the Delaware Supreme Court upheld a forum-selection clause in the company's operating agreement, which designated a foreign jurisdiction as the exclusive forum for internal disputes.[54] In response, the General Assembly enacted Section 18-109(d) of the Delaware LLC Act that, in effect, prohibited a Delaware LLC from selecting a foreign jurisdiction as its exclusive forum for internal disputes.[55] The legislature amended the Limited Partnership Act in an analogous way.[56]

Nevertheless, fifteen years later, Section 115 has been characterized, by some, as a "protectionist measure designed to funnel litigation into Delaware."[57] Critics of the amendment claim the legislation to be "a solution to a problem that does not exist."[58] Some Delaware practitioners have suggested that Section 115, along with the prohibition on fee-shifting

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51. *Id.*

52. *Id.*

53. 727 A.2d 286 (Del. 1998).

54. *Id.*

55. DEL. CODE ANN. tit. 18 § 109(d) (2015). "In a written limited liability company agreement or other writing, a manager or member may consent to be subject to the nonexclusive jurisdiction of the courts of, or arbitration in, a specified jurisdiction, or the exclusive jurisdiction of the courts of the State of Delaware, or the exclusivity of arbitration in a specified jurisdiction or the State of Delaware, and to be served with legal process in the manner prescribed in such limited liability company agreement or other writing. Except by agreeing to arbitrate any arbitrable matter in a specified jurisdiction or in the State of Delaware, a member who is not a manager may not waive its right to maintain a legal action or proceeding in the courts of the State of Delaware with respect to matters relating to the organization or internal affairs of a limited liability company." *See also* Baker v. Impact Holding, Inc., No. CIVA 4960-VCP, 2010 WL 1931032 (Del. Ch. May 13, 2010) (comparing Section 18-109(d) to, at the time, the lack of such forum selection provision or public policy regarding such provision in the DGCL).

56. *Baker*, 2010 WL 1931032, at *2 (discussing the General Assembly's amendment to the Limited Partnership Act in the same "fashion" as Section 18-109(d)).

57. Andrew D. Cordo and F. Troupe Mickler IV, *Significant Fee-Shifting and Forum Selection Amendments Proposed to the DGCL*, ASHBY & GEDDES, P.A. (Mar. 25, 2015), http://www.ashby-geddes.com/blogs-bankruptcy,Significant-Fee-Shifting-Forum-Selection-Amendments-Proposed-DGCL.

58. *Id.*

passed in the same bill, "lends the appearance of a legislation land grab."[59]

The Council of the Corporation Law Section of the Delaware State Bar Association (the "Council")—composed of members of the Delaware bar who annually propose amendments to the DGCL—drafted the 2015 amendments that included Section 115.[60] Explanations for the Council's amendments range from the cynical protectionism claims mentioned above to more practical public policy concerns. These concerns include enabling Delaware to maintain oversight over its laws, and as Reed explains, to combat the "proliferation of other courts trying to interpret [Delaware's] laws without parties having recourse to Delaware's courts."[61] The export of Delaware corporate law to foreign jurisdictions has long been a concern.[62] From a practical point of view, Professor Stephen Bainbridge maintains that keeping internal disputes in Delaware is preferable because of the expert judges and "[n]o home-state bias in favor of one side or the other, since usually both sides will have their principal place of business elsewhere."[63] Moreover, Delaware is "more rigorous than most in policing plaintiff lawyers bringing suits not in the best interest of the corporation or its shareholders as a whole."[64]

If stakeholders of Delaware corporations—mainly the shareholders,

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59. Reed, *supra* note 5.

60. William Chandler et al., *Wilson Sonsini Discusses Proposed 2015 Amendments to the Delaware General Corporation Law*, THE CLS BLUE SKY BLOG (Mar. 18, 2015), http://clsbluesky.law.columbia.edu/2015/03/18/wilson-sonsini-discusses-proposed-2015-amendments-to-the-delaware-general-corporation-law/.

61. Reed, *supra* note 5.

62. *See* Sternberg v. O'Neil, 550 A.2d 1105, 1124-25 (Del. 1988) (citing Armstrong v. Pomerance, 423 A.2d 174, 178 (Del 1988)) ("The Delaware courts and legislature have long recognized a 'need for consistency and certainty in the interpretation and application of Delaware corporation law and the desirability of providing a definite forum in which shareholders can challenge the actions of corporate management without having to overcome certain procedural barriers which can be particularly onerous in the context of derivative litigation.'"); *In re* Topps Co., 924 A.2d 951, 959 (Del Ch. 2007) (explaining that the "benefits created by our judiciary's handling of corporate disputes are endangered if our state's compelling public policy interest in deciding these disputes is not recognized and decisions are instead routinely made by a variety of state and federal judges who only deal episodically with our law"). *See generally* Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57 (2009) (discussing Delaware's interests in other jurisdictions applying its laws).

63. Stephen Bainbridge, *Airgas and Choice of Forum Article Provisions*, PROFESSORBRAINBRIDGE.COM (Feb. 16, 2011), http://www.professorbainbridge.com/professorbainbridgecom/2011/02/airgas-and-choice-of-forum-article-provisions.html#tp.

64. *Id.*; *see also* Liz Hoffman, *The Judge Who Shoots Down Merger Suits*, WALL ST. J. (Jan. 10, 2016), http://www.wsj.com/articles/the-judge-who-shoots-down-merger-lawsuits-1452076201 (discussing Vice Chancellor Laster's proclivity to dismiss meritless strike suits).

officers, and directors of the corporation—are to expect consistency and expertise in the application of the DGCL, Delaware is most likely the proper forum for the review of internal disputes rather than, as Chief Justice Strine put it, "state and federal judges who only deal episodically with [Delaware] law."[65] Therefore, Section 115's codification of *Chevron* is apt; there is no plausible reason why a Delaware corporation should not be able to choose Delaware as the exclusive forum for its internal disputes. The controversy is not whether Delaware courts are more qualified at to interpret and apply the DGCL—they clearly are—but whether it is for the General Assembly to ban corporations from choosing a foreign jurisdiction as an exclusive forum for their internal disputes.

Delaware judges, legal practitioners, and lawmakers have developed a unique and sophisticated corporate jurisprudence that is unmatched. It is predominately for this reason that sixty percent of the Fortune 500 companies have chosen to incorporate in Delaware.[66] Justifying Section 115's prohibition on excluding Delaware as a forum, the Council maintains that "the value of Delaware as a favored jurisdiction of incorporation is dependent on a consistent development of a balance of corporate law, and that the Delaware courts are best situated to continue to oversee that development[.]"[67] Additionally, Delaware courts should be able to reel in corporate actors attempting to escape Delaware oversight for nefarious reasons.[68] Delaware has a vested interest in maintaining oversight over the application of its laws and the avoidance of another court misinterpreting and misapplying nuanced corporate fiduciary requirements; as the Council believes, the survival of Delaware's corporate framework may very well depend on it.[69]

As suggested by Vice-Chancellor Laster in *Revlon*, "Delaware courts [need to] retain some measure of inherent residual authority so that entities created under the authority of Delaware law [can not] wholly empty themselves from Delaware oversight."[70] Vice-Chancellor Laster did not indicate what those measures could or should be or the potential ramifications thereof. As with any piece of legislation, there are inherent and inevitable concerns that flow from Section 115: (1) the effect on multi-jurisdictional litigation; (2) an overreaching by a legislature into the corporate boardroom; and (3) the effect on judicial comity among other

65. *In re* Topps Co., 924 A.2d. at 959.

66. Stevelman, *supra* note 62, at 66.

67. Chandler, *supra* note 60.

68. *See* City of Providence v. First Citizens Bancshares, Inc., 99 A.3d 229, 240 (Del. Ch. 2014).

69. *See* Cordo, *supra* note 57.

70. *In re* Revlon, Inc., 990 A.2d 940, 961 n.8 (Del. Ch. 2010).

state courts, Delaware, and the federal court system.

III. RAMIFICATIONS OF SECTION 115

A. Effects on Multi-Jurisdictional Litigation

Exclusive forum selection clauses were supposed to cure the plague that is multi-jurisdictional litigation on Delaware corporations and their officers and directors.[71] Vice-Chancellor Laster practically prescribed this cure in *Revlon*: "if [a Board] and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."[72]

Multi-jurisdictional litigation occurs when different sets of plaintiffs' counsel file class action lawsuits challenging a proposed transaction, such as a merger, in both the state in which the company is incorporated, often Delaware, and the state where the corporation has its principal place of business.[73] This "rush to the courthouse" consists of lawsuits that typically raise virtually identical claims on behalf of the same stockholder class.[74] As noted by Chief Justice Chandler, "[d]efense counsel is forced to litigate the same case—often identical claims—in multiple courts."[75]

Practitioners, judges, and legal commentators have documented the monetary costs and other evils of this phenomenon.[76] The costs are

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71. *See* Edward B. Micheletti & Jenness E. Parker, *Multi-Jurisdictional Litigation: Who Caused This Problem, and Can It Be Fixed*, 37 DEL. J. CORP. L. 1, 25 (2012) (discussing forum selection clauses as a solution to multi-jurisdictional litigation); Minor Meyers, *Fixing Multi-Forum Shareholder Litigation*, U. ILL. L. REV. 467, 524 (2014) ("The most prominent approach to dealing with multi-forum shareholder litigation is for companies to adopt forum selection clauses in their organizational documents."). *But see* Mark Gideon, *Multijurisdictional M&A Litigation*, 40 IOWA J. CORP. L. 291, 313 (2015) (explaining that exclusive forum selections clauses are a sub-optimal and flawed solution to multijurisdictional litigation).

72. *Revlon*, 990 A.2d at 960.

73. Micheletti & Parker, *supra* note 71, at 12-13; *see also* Brian JM Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, 45 U.C. DAVIS L. REV. 137 (2011) (discussing thoroughly multi-jurisdictional litigation).

74. *See* Micheletti & Parker, *supra* note 71, at 5.

75. *In re* Allion Healthcare Inc., No. 5022-CC, 2011 Del. Ch. LEXIS 48 at *12. (discussing the "Multi-Forum Deal Litigation Problem" further).

76. *See* Robert Borowski, *Combatting Multiforum Shareholder Litigation: A Federal Acceptance of Forum Selection Bylaws*, 44 Sw. L. Rev. 149 (2014); William Savitt, *The Genius of the Modern Chancery System*, 2012 COL. BUS. L. REV. 570, 599 (2012) ("Extensive litigation of Delaware fiduciary claims in the courts of other states imposes significant costs on litigants and society."). *But see* Randall S. Thomas, *What Should We Do About Multijurisdictional Litigation in M&A Deals?*, 66 VAND. L. REV. 1925, 1941-49 (2013) (arguing the benefits and suggesting that the costs are

ultimately borne by shareholders by way of attorneys' fees to both plaintiffs' and defense counsel. The net result of this phenomenon is that it "forces defendants to consider settling deal litigation that, but for the risks posed by multi-jurisdictional litigation, defendants might otherwise have moved to dismiss."[77] Further, judicial resources are also wasted "as judges in two or more jurisdictions review the same documents and at times are asked to decide the exact same motions."[78]

One of the primary reasons for filing *outside* of Delaware—even when a corporation is incorporated in Delaware—is to avoid the experienced corporate oversight of the Court of Chancery.[79] Plaintiffs' lawyers know that a claim for breach of fiduciary duty that might otherwise be dismissed by the Court of Chancery may gain traction in a non-Delaware forum.[80] Thus, a foreign court unfamiliar with Delaware law may permit a plaintiff's case to continue even though it would have been tossed out by an experienced corporate law judge in Delaware.[81] In addition to plaintiffs' lawyers escaping the purview of the Delaware judiciary, as discussed by Professor Minor Meyers, multijurisdictional litigation can inhibit the incorporation state from deciding "important cases with which to shape the content of their corporate law"[82]—one of the primary concerns of Delaware.[83]

For the foregoing reasons, corporations (and jurists) prefer to corral internal corporate claims into one forum, avoiding multi-jurisdictional suits and. It is also apparent why Delaware would prefer that those internal corporate claims be litigated in the state of incorporation; it wants oversight of both the application of its laws and the actors formed within its borders. Section 115 does not entirely restrict a corporation's use of an exclusive forum selection clause to avoid multi-jurisdictional litigation. To the contrary, the statute codifies a corporation's ability to select Delaware as its exclusive forum for internal corporate claims.[84] If a corporation designates only Delaware as its forum, it both eliminates multijurisdictional litigation (and the evils that come with it) and satisfies Delaware's interest in the application, development, and evolution of Delaware corporate law within its borders.

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overstated).

77. Micheletti & Parker, *supra* note 71, at 12.
78. *Allion,* 2011 Del. Ch. LEXIS 48 at *5.
79. *Id.* at *6.
80. *Id.*
81. *See id.* at *7.
82. Meyers, *supra* note 71.
83. *See* Chandler, *supra* note 60.
84. *See* DEL CODE ANN. tit. 8 § 115 (2015).

Section 115 does, however, eliminate options for a Delaware corporation. It states that "no provision of the certificate of incorporation or the bylaws may *prohibit* bringing such claims in the courts of this State."[85] A corporation like FC North, therefore, can no longer choose the state it does most of its business in—or any other state except Delaware—as an exclusive forum to resolve internal corporate claims.[86] If a corporation intends to keep open its principal place of business as a forum a forum selection clause by inserting a forum-selection clause in its charter or bylaws, it cannot do so at the exclusion of Delaware, thus subjecting itself to multi-jurisdictional litigation.[87] The practical effect of Section 115 is that the only forum a corporation could choose that would eliminate the risk of multi-forum litigation is Delaware.[88]

B. An Intrusion into the Boardroom

Two months prior to the passage of Section 115, Barry Harris, Chief Legal Officer for FC North, blasted the then-proposed Section 115 as a legislative intrusion into the corporate boardroom in a letter to the Secretary of the State of the State of Delaware ("Secretary of State").[89] Citing *Chevron* and *City of Providence*, Harris explained that Delaware courts recognized the contractual rights of corporations and Section 115 "interferes unnecessarily with the sound judgment of its Board, which is in the best position to determine the forum that is most convenient and beneficial to the corporation and its stockholders."[90] Harris described Section 115 as "legislatively over[riding]" a Board's reasoned decision that intra-corporate litigation be conducted elsewhere.[91] In another letter to the Secretary of State from Michael Cunningham, General Counsel of Red Hat, Inc. ("Red Hat"), assailed the legislation as "micromanag[ing] corporate governance"; whereas, historically Delaware has been "remarkable[y] flexibl[e]" and "hands off."[92]

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85. *Id.* (emphasis added).

86. *See id.*

87. *See* Chandler, *supra* note 60 (citing the Council's concerns for the need to eliminate Multi-jurisdictional litigation).

88. *Id.*

89. *See* Letter from Barry P. Harris, IV, Vice President and Chief Legal Officer, First Citizens Bancshares, to Jeffrey W. Bullock, Secretary of State, Delaware Department of State (Apr. 8, 2015) (on file with the Delaware state legislature) [hereinafter "Harris Letter"], http://legis.delaware.gov/LIS/lis148.nsf/e955250df0285a27852568ac0070372a/e0a816faaba21d6585257e4a006400ce/.

90. *Id.*

91. *Id.*

92. Letter from Michael Cunningham, Executive Vice President and General Counsel, Red Hat, Inc., to Jeffrey W. Bullock, Secretary of State, Delaware

Historically, the DGCL has been "widely regarded as the most flexible in the nation because it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints and to the policing of director misconduct through equitable review."[93] The DGCL is an enabling act that is intended to be a "skeletal framework" from which the "flesh and blood" of corporate law is crafted by judges.[94] The General Assembly has historically preferred against "regulatory prescription" and deferred to the judicial expertise on corporate legal matters.[95] Legal scholars have noted that even the Delaware courts have demonstrated hostility toward legislative intrusions into the corporate arena.[96]

With the permissive and enabling nature of the DGCL and the expertise of the judiciary to police and mold corporate law in mind,[97] one can understand why the corporate officers of Red Hat, FC North, and likely other Delaware corporations were disconcerted at the release of then-proposed Section 115.[98] The Delaware judiciary had spoken: (1) *Revlon* proposed that exclusive forum selections clauses were permissible;[99] (2) *Chevron* approved Delaware as an exclusive forum;[100] and (3) *City of Providence* held a corporation may select a foreign jurisdiction as an

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Department of State (May 7, 2015), http://legis.delaware.gov/LIS/lis148.nsf/e955250df0285a27852568ac0070372a/e0a816faaba21d6585257e4a006400ce/ (on file with the Delaware state legislature).

93. Jones Apparel Grp. v. Maxwell Shoe Co., 883 A.2d 837, 845 (Del. 2004).

94. E. Norman Veasey & Christine T. Di Gulielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1411 (2004) ("Enabling acts, such as the Delaware General Corporation Law (DGCL), are part of the corporate law. They create only a skeletal framework, however. The "flesh and blood" of corporate law is judge-made.").

95. *See* Omar Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1159 (2008) ("As a result of the legislature's preference against regulatory prescription and its deference to the judicial branch, Delaware courts are often the first responders to corporate law controversies.").

96. *See e.g.*, Marcel Kahan and Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1594-97 (2005) (citing numerous examples where Delaware courts have narrowly construed provisions of the DGCL).

97. *See* Chandler, *supra* note 60; Harris Letter, *supra* note 89.

98. As discussed above, the General Assembly typically allows the Delaware judiciary to craft the "flesh and blood" of Delaware corporate law. Here, however, the General Assembly enacted Section 115 notwithstanding the judiciary's blessing. Corporations may be at a loss when attempting to calculate whether or not a case law will be trumped by the General Assembly.

99. *See In re* Revlon, Inc., 990 A.2d 940, 960 (Del. Ch. 2010).

100. Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013).

exclusive forum-thus eliminating Delaware as a forum for potential litigants.[101] In those decisions, Chief Justice Strine and Chancellor Bouchard—two of the most respected corporate law jurists on the bench—endorsed exclusive forum selection clauses selecting Delaware and foreign jurisdictions.[102] Why would the General Assembly do an end run around the Delaware judiciary—who is typically left to craft the "flesh and blood" of corporate law?

In its proposal of Section 115, the Council recognized the broadly enabling nature of the DGCL.[103] The Council also acknowledged, however, that "it is the General Assembly, not the courts, that should evaluate whether, on public policy grounds, the [DGCL's] authorizing breadth should be narrowed."[104] Rejecting claims of protectionism, the Council explained that the normally broad enabling nature of the DGCL should be trimmed back to address a denial of access to Delaware courts, which an exclusive forum selection clause designating a foreign jurisdiction arguably does.[105]

Norman Monhait, then-Chair of the Corporate Law Section of the Delaware State Bar Association,[106] testified to the Delaware House Judiciary Committee that the "restriction *protects* fairness in litigation by preventing corporations from exploiting the advantages of local courts while still benefitting from Delaware's favorable corporate climate."[107] Of course, Mr. Monhait used the word "protect" but most likely not in the sense used by critics who assail Section 115 and similar maneuvers by the legislature as "protectionism."[108] Mr. Monhait's testimony did not elaborate on what "exploiting the advantages of local courts" meant, but one can infer from the various opinions of the Delaware judiciary that these "advantages" include foreign "state and federal judges who only deal episodically with [Delaware corporate law]."[109] And, these advantages are

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101. City of Providence v. First Citizens BancShares, Inc., 99 A.3d 229, 240 (Del. Ch. 2014).

102. *See supra* Sections II.B and II.C.

103. CORPORATION LAW SECTION OF THE DELAWARE STATE BAR ASSOCIATION, *Explanation of Council Legislative Proposal*.http://www.skadden.com/newsletters/Proposed_DGCL_Amendments_Related_Documents.pdf (last visited Feb. 10, 2016).

104. *Id.* at 10.

105. *Id.* at 4.

106. As discussed above, the Council, who in effect drafted Section 115, is a part of the Corporate Law Section. *See supra*, note 51.

107. *An Act to Amend Title 8 of the Delaware Code Relating to the General Corporation Law: Hearing on SB 75 Before H. Judiciary Comm.*, 2015 Leg. 148th Sess. (De. 2015) (statement by Norman Monhait) (emphasis added).

108. *See* Harris Letter, *supra* note 89 (suggesting the amendment comes off as a "protectionist" move).

109. *In re* Topps Co., 924 A.2d. 951, 959 (Del. Ch. 2007).

the underlying reasons why plaintiffs' attorneys choose to file outside of Delaware.[110] Even if Mr. Monhait's statement was a Freudian slip, a legislature's concern is not the views of those outside of Delaware who would question its actions as being protectionist but that of the constituency that elects them. The people of Delaware obviously have a vested interest in seeing the maintenance of their edge in the corporate market place and the evolution of their law. As Mr. Monhait suggested, Section 115 protects Delaware (and its interests in maintaining suits within the state), which provides a favorable corporate climate from those that would exploit other jurisdictions' lack of corporate legal wherewithal.

Nevertheless, Section 115 is not the first—nor is it the last—amendment to the DGCL that directors and officers may view as an interference with corporate governance.[111] Similar to the legislature's response to *City of Providence* by way of Section 115, the legislature added Section 145(f) in response to *Schoon v. Troy Corp.* in 2009.[112] In *Schoon*, the Court of Chancery upheld a bylaw that abrogated a director's claim for advancement and indemnification rights provided under Section 145(e) of the DGCL.[113] The court held that a former director was not entitled to the advancement of litigation expenses because the provision of the bylaw granting that right was eliminated in an amendment passed *after* the director left office but *prior* to the initiation of claims against him.[114]

Section 145(f) responded to *Schoon* by providing that a right to indemnification or advancement contained in the charter or bylaws cannot be eliminated by an amendment adopted after the occurrence of the act or omission that is the subject of litigation for which indemnification or advancement is being sought.[115] Notwithstanding Section 145(f)'s

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110. *See supra* Section II.D.

111. Section 145(f) is simply an illustrative example. There are several other examples of amendments to the DGCL, which arguably infringe on the corporate governance of a board of directors. Such as, in 2005, the legislature's amendment of Section 271 in response the Court of Chancery's decision in *Hollinger v. Hollinger Int., Inc.* 858 A.2d 342 (Del. Ch. 2004). That amendment strengthened shareholder protection when a corporation sells all or substantially all of its assets. *See* DEL CODE ANN. tit. 8 § 271 (2015); *see also* Alex Righi, Note, *Shareholders on Shaky Ground: Section 271's Remaining Loophole*, 108 NW. U.L. REV. 1451 (2014) (detailing the amendment to Section 271).

112. Schoon v. Troy Corp., 948 A.2d 1157 (Del. Ch. 2008).

113. *See id.*

114. *See id;* Robert S. Reder, et al., *Proposed Amendments to the DGCL*, LAW 360 (Mar. 18, 2009), http://www.law360.com/articles/92396/proposed-amendments-to-dgcl.

115. DEL. CODE ANN. tit. 8 § 145(f) (2015) ("A right to indemnification or advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to the certificate of incorporation or a bylaw after the occurrence of the act or omission that is the subject

"interference" with a corporation's ability to amend its charter and bylaws regarding indemnification and advancement for former directors, scholars and practitioners praised the legislature for "preserv[ing] drafting flexibility that can accomplish 'elimination or impairment' of advancement and indemnification rights after the occurrence of the challenged act or omission."[116] While Section 145(f) prevents a corporation from eliminating indemnification or advancement of expenses for a director or officer after the fact, it carves out an exception permitting elimination if a provision in effect at the time of such occurrence authorized such elimination, thus preserving flexible for corporate Boards.[117]

Section 102(b)(7) of the DGCL is another example of meticulous legislative maneuvering by the General Assembly. This piece of legislation empowered Delaware corporations through a charter provision (adopted by stockholders) to protect corporate directors from monetary liability for breach of the duty of care. In *Smith v. Van Gorkom*,[118] the Delaware Supreme Court had held that a Board was grossly negligent because it quickly approved a merger without sufficient inquiry with the result that the director defendants were exposed to multi-million dollar personal liability.[119] Critics described the holding as "one of the worst in the history of corporate law."[120] The fallout from this decision included a mass panic among current and prospective directors of public corporations across the United States because of the potential for personal civil liability and subsequent monetary damages imposed on them by a court.[121]

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of the civil, criminal administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, *unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred.*") (emphasis added).

116. William D. Johnston, *Flexibility Under Delaware Law in Drafting Advancement Provisions on a "Clear Day," and Potential Surprises for Those Who Do Not Take Advantage of That Flexibility*, 13 DEL. L. REV. 21, 27 (2011).

117. *See* DEL. CODE ANN. tit. 8 § 145(f).

118. 488 A.2d 858 (Del. 1985).

119. *See id.*

120. Daniel Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985).

121. *See e.g.*, Sondra J. Thorson, *Protecting Shareholders: Illinois Needs a Director Liability Statute*, 26 J. MARSHALL L. REV. 105, 127 (1992) ("The award of monetary damages in *Van Gorkom* triggered a national panic among directors and prospective directors. Their concerns were two-fold. First, corporate managers, the corporate bar, and commentators feared that qualified persons would refuse to serve as outside corporate directors rather than expose themselves to the possibility of personal liability. Second, these same parties contended that even if qualified persons agreed to serve as directors, they would react to the threat of personal liability by making overly conservative, risk-averse decisions that would ultimately be harmful to the interests of the corporation.").

Consequently, the price for director and officer insurance skyrocketed: so much so that some Boards could not get sufficient coverage at any price.[122] Perceiving unnecessary exposure to civil liability on the part of directors, the General Assembly, in response, drew up Section 102(b)(7), which empowered corporations to exculpate directors and officers for breaching their duty of care.[123] The General Assembly knew, however, that it had to draw this line carefully so as to *not* enable exculpation for acts not made in good faith or in violation of the duty of loyalty.[124] Section 102(b)(7) remains a heralded piece of legislation in which the General Assembly reacted to both preserve the ability of corporations to enlist corporate directors and protect Delaware's corporate framework from a perceived mistake by the judiciary.

Section 115 preserves flexibility for corporations and protects Delaware's corporate framework in a similar fashion. Corporations may still avoid multi-jurisdictional litigation by selecting Delaware as an exclusive forum.[125] They may also choose their principal place of business (or any other forum) as a selected forum so long as Delaware remains an option.[126] In the examples discussed above, the General Assembly acted in spite of judicial rulings to the contrary. It perceived an error by the judiciary—one that would negatively affect Delaware's corporate legal framework. Sections 102(b)(7), 145(f), and 115 all infringe on how a Board governs its corporation; however, in all instances, the legislation empowers Boards in some manner and responds to changes in the corporate marketplace. Ultimately, most amendments to the DGCL will attempt to maintain and preserve flexibility for corporate Boards while protecting all stakeholders involved,[127] including Delaware and its interest in maintaining oversight of the development and evolution of its law.

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122. *See* Bernard S. Sharfman, *The Enduring Legacy of* Smith v. Van Gorkom, 33 DEL. J. CORP. 287, 302 (2008).

123. Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After* QVC *and* Technicolor*: A Unified Standard (And the End of Regulation)*, 49 BUS. LAW. 1593, 1625 (1994) ("Section 102(b)(7) was a response to the Delaware Supreme Court's imposition of due care liability in *Van Gorkom*, which the Delaware legislature was convinced threatened exposing management to undue civil liability.").

124. *See* Johnathan W. Groessl, *Delaware's New Section 102(B)(7): Boon or Bane for Corporate Directors*, 37 DEPAUL L. REV. 411, 433-35 (1988) (discussing the General Assembly's adoption of 102(b)(7) and permitting the elimination of liability for duty of care violations but not that of loyalty).

125. *See* DEL. CODE ANN. tit. 8 § 115 (2015).

126. *See id.*

127. *See* Johnston, *supra* note 107, at 22 (pointing out that corporations still have flexibility in how they draft their indemnification protection).

C. Concern for Comity

In *City of Providence*, Chancellor Bouchard explained that, if non-Delaware courts are to enforce valid bylaws designating Delaware as an exclusive forum for intra-corporate disputes, then, as a matter of comity, Delaware should recognize and enforce bylaws designating non-Delaware jurisdictions as exclusive forums.[128] In his letter to the Secretary of State, Harris pointed out that Section 115 ignores any concern for judicial comity.[129] Certainly, the implementation of Section 115 does raise concern for judicial comity; Delaware corporations and Delaware courts will expect foreign courts to recognize corporate charters and bylaws designating Delaware as an exclusive forum. With the enactment of Section 115, the chances of a corporation selecting a foreign forum (along with Delaware) are much slimmer now than prior to Section 115 because corporations will look to corral litigation into one forum via an exclusive forum selection clause and can only do that by designating Delaware.[130] Foreign courts may not look favorably on forum selection clauses designating Delaware as an exclusive forum when Delaware legislation has all but forced the hand of corporations to choose Delaware.

Comity is the mutual recognition of legislative, executive, and judicial acts.[131] In the context of American jurisprudence, judicial comity is "a principle by which the courts of one state or jurisdiction give effect to the laws and judicial decisions of another, not as a matter of obligation, but out of deference and respect."[132] The intimate nature of the states' relationships with each other leads to a greater degree of comity toward each other than a state or the United States may give to a foreign nation's law or judicial opinion.[133] The purpose of comity is to foster cooperation and harmony and to encourage amiable and respectful relationships among the states.[134]

Prior to the enactment of Section 115, courts outside of Delaware generally enforced forum selection bylaws designating Delaware as an exclusive forum.[135] In *Butorin v. Blount,*[136] although the U.S. District

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128. *See* City of Providence v. First Citizens Bancshares, 99 A.3d 229, 242 (Del. Ch. 2014).

129. *See* Harris Letter, *supra* note 89.

130. *See supra* Section III.A.

131. *Comity*, BLACK'S LAW DICTIONARY (10th ed. 2014).

132. Head v. Platte Cty., 749 P.2d 6 (Kan. 1988); *see also* Schoeberlein v. Purdue Univ., 544 N.E. 2d 283 (Ill. 1989) (discussing judicial comity at great length).

133. *Schoeberlein*, 544 N.E. 2d at 378.

134. *See id.* (discussing the purpose of comity).

135. *See* Bonnie J. Poe et al., *Forum Selection Bylaws Continue to Gain Ground, But Questions Remain*, Cohen & Gresser LLP (July 1 2015), https://www.cohengress

Court for the Southern District of Texas recognized that one of the plaintiffs' claims was federal, the court *sua sponte* transferred the case to the U.S. District Court for the District of Delaware because of a forum selection bylaw designating Delaware courts as the exclusive forum for derivative suits.[137] In 2014, a federal court in Ohio also recognized a corporation's bylaw selecting Delaware courts as the exclusive forum for intra-corporate disputes and transferred the case to a federal court in Delaware.[138]

Since Section 115's enactment, at least one court has recognized the validity of the exclusive forum selection clauses designating Delaware. Overruling a lower court's decision to reject the exclusive forum selection clause, the Supreme Court of the State of Oregon explained that comity and respect for Delaware's corporate legal framework weighed against interfering and attempting to regulate the relationship between TriQuint's directors and shareholders.[139] Citing *Chevron*, the court alluded to Delaware's framework, which allows corporate directors to unilaterally amend the corporation's bylaws to designate an exclusive forum for intra-company disputes and the shareholders' ability to repeal them.[140] That court, therefore, held an exclusive forum selection clause that designated Delaware as the exclusive forum for disputes was facially valid and did not violate Oregon public policy.[141]

In connection with comity, the General Assembly made sure not to run afoul of the Full-Faith and Credit Clause of the U.S. Constitution.[142] One might wonder why the General Assembly did not entirely preclude corporations from designating foreign jurisdictions even if keeping Delaware as option—aside from preserving flexibility as noted above. In *In re Kloiber*,[143] Vice-Chancellor Laster suggested why by quoting the U.S. Constitution: "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings over of every other State."[144] And, should "Delaware . . . preclude a sister state from hearing a

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er.com/assets/site/Forum_Bylaw_6_29.pdf.

136. 106 F. Supp. 833 (S.D. Tex. 2015).

137. *Id.* at 835.

138. North v. McNamara, 47 F. Supp. 3d 635, 646 (S.D. Ohio 2014).

139. Roberts v. TriQuint Semiconductor, Inc., 358 Or. 413, 428, 430 (2015).

140. *Id.* at 428-29.

141. *Id.* at 430.

142. *See* U.S. CONST. ART. IV. § 1.

143. 98 A.3d 924 (Del. Ch. 2014) (vacated by Imo Daniel Kloiber Dynasty Trust, 214 Del. Ch. LEXIS 190 (Del. Ch. Sept. 3, 2014)).

144. *In re Daniel Kloiber Dynasty Tr.*, 98 A.3d at 939 (quoting U.S. CONST. ART. IV. § 1).

matter of Delaware law, it would not be giving constitutional respect to the judicial proceedings of its sister states."[145] In other words, Delaware "cannot unilaterally preclude a sister state from hearing claims under its law."[146] Therefore, if Section 115 maintained that internal claims concerning Delaware corporations shall *only* be brought in the state of Delaware, then the General Assembly may have "unilaterally" precluded other states from hearing those claims, running afoul of the Full Faith and Credit Clause.[147]

If Section 115 is to have a real effect on another court's disposition on Delaware's alleged protectionism, it is likely to reaffirm other courts' concern for comity and Delaware's interest in its corporate legal framework. Years after Delaware's enactment of Section 18-109(d) of the Delaware LLC Act[148]—the LLC equivalent to Section 115—a Vermont court entertained a judicial request for dissolution of a Delaware LLC.[149] Citing concern for comity and the general principle that dissolution should be left to the state of formation, the Vermont court dismissed the action.[150] The court noted Section 18-109(d)'s flexibility of permitting members of an LLC to consent to the non-exclusive jurisdiction of a state other than Delaware.[151] Section 18-109(d) did not affect the outcome of the case. As with Section 18-109(d), Section 115 leaves open the door for corporations to designate other jurisdictions to resolve intra-corporate disputes—albeit on a non-exclusive basis. Simply because Section 115 narrows the options for corporations to draw up forum-selection clauses, it does not mean a court is going to enforce selection clauses differently. An exclusive forum-selection clause that designates Delaware for intra-corporate disputes should be interpreted and enforced all the same after Section 115 as it was before much like the enforcement of LLC agreements after Section 18-109(d).[152] If nothing else, Section 115 reinforces the concern for comity among the states and Delaware's interest in its legal framework.

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145. *Id.*

146. *Id.*

147. *See id.*

148. DEL. CODE ANN. tit. 18 § 109(d) (2015).

149. Casella Waste Sys., Inc. v. FT Tech., Inc., No. 409-6-07, 2009 Vt. Super. LEXIS 14, at *1-2 (Vt. Super. Ct. Feb. 6, 2009).

150. *Id.* at *9.

151. *Id.* at *8.

152. Other than the Vermont case, there is little case law outside of Delaware discussing Section 18-109(d). More to the point, there was little fanfare among legal commentators concerning an LLC's ability to select courts other than Delaware as an exclusive forum for intra-company disputes.

CONCLUSION

The string of case law regarding internal forum selection clauses illustrates the legal savvy and prowess with which the Delaware judiciary analyzes and applies corporate law. Ironically, the General Assembly annulled one of these decisions—*City of Providence*—in an effort not only to protect the stakeholders of corporations who seek the expertise and consistency that Delaware provides but also to ensure the very existence and evolution of *Delaware* corporate law.

Any time that the General Assembly acts, or any legislature for that matter, there are inevitable and inherent side effects. Legislatures often overstep their bounds and meddle unnecessarily, and Delaware's legislature is no exception. The General Assembly, however, strategically acts when it perceives public policy concerns arising out of the judiciary's application of the DGCL. Claims of "legislative intrusion" by the General Assembly are often overheated and overstated. Adjustments like Section 102(b)(7) often empower and embolden Boards rather than hamper them. The General Assembly attempts to preserve the inherent flexibility of the DGCL, while adjusting to changes in the market. As with any commodity in which a state or country is the market leader, there will be calls of "protectionism" when a legislature acts to preserve it and even strengthen it.

COMMENTS

THROTTLE ME NOT: 2015 OPEN INTERNET ORDER PROTECTS UNLIMITED DATA PLAN USERS

SHAWN MARCUM*

Cellphone carriers, also known as mobile broadband Internet access service ("BIAS") providers, often implement throttling policies to avoid investing in infrastructural development and to save on their bottom line. Throttling is an intentional action to degrade or limit one's access to the Internet, and speed limits are a great analogy to throttling policies. The most visible throttling polices affect unlimited data plan users, where mobile BIAS providers choose to severely degrade unlimited data users' access speed to the Internet once they reach a specified data cap—a limit on the amount of data a user may use within a pay period. However, by definition, an unlimited data plan cannot have a data cap.

Just recently, the Federal Communications Commission ("FCC") released three new prophylactic rules in the 2015 Open Internet Order that regulate how BIAS providers are to manage the Internet. This Comment considers whether the "no throttling" rule successfully prohibits cellphone carriers from targeting unlimited data users and throttling them or whether targeting and throttling unlimited data users fits within the exception to the "no throttling" rule. This Comment also considers the negative impacts of throttling, especially on rural areas.

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INTRODUCTION

Throttling is an intentional practice that mobile broadband Internet access service ("BIAS") providers use to slow down users' data throughput speeds.[1] One major issue has arisen over the past few years: unlimited data users have seen their Internet speeds dramatically slowed down after using more than a predetermined amount of data within a pay-period even though these users are supposed to receive "unlimited" data.[2] President

1. *See generally* Mark Sullivan, *What Happens When You Get Throttled?*, PCWORLD.COM (Feb. 29, 2012, 6:00 PM), http://www.pcworld.com/article/251008/what_happens_when_you_get_throttled_.html.

2. *See* Phil Goldstein, *T-Mobile: Throttling Policy for Unlimited Customers Who Hit 21 GB is OK Under Net Neutrality*, FIERCEWIRELESS (June 25, 2015), http://www.fiercewireless.com/story/t-mobile-throttling-policy-unlimited-customers-who-hit-21-gb-ok-under-net-n/2015-06-25; Joel Hruska, *AT&T claims it will throttle*

Bill Clinton even pointed out on Jon Stewart's Daily Show that cellphone carriers like AT&T Inc. ("AT&T") and T-Mobile US, Inc. ("T-Mobile") want to quickly regain their infrastructural investments by implementing throttling policies to side-step an open Internet instead of continuing to develop mobile broadband infrastructure in rural areas.[3]

Throttling unlimited data is analogous to an unlimited mileage automobile rental agreement. Consider a car rental agreement which clearly states that a rental car may be driven as far as desired during the rental period. Imagine that the renter takes the car for a drive under the impression that she can drive unlimited miles. After she drives 100 miles, the car automatically slows down to five miles per hour and can go no faster for the rest of the rental period. Clearly, no one would find this unlimited mileage car rental plan to be practical, or even as fitting with the deal that was advertised, if the unlimited plan only applied to the distance and not the speed at which the car may be operated. Likewise, mobile Internet users do not find their unlimited data plans to be what they paid for when their data is intentionally throttled after reaching a certain data cap.[4]

This Comment argues that the FCC's 2015 Open Internet Order's "no throttling" rule successfully prohibits cellphone carriers—here, mobile BIAS providers—from targeting unlimited data users and throttling them. Considering the FCC's past regulatory problems in this area, the "no throttling" rule must be proven applicable to mobile BIAS providers and within the regulatory jurisdiction of the FCC. Additionally, the carriers' practice of throttling unlimited data users must be shown to fall within the purview of the "no throttling" rule and not its exception.

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users after 22 GB of data, not 5GB, but forgets to inform customers, EXTREMETECH.COM (Sept. 17, 2015, 10:12 AM), http://www.extremetech.com/extreme/214472-att-claims-it-will-throttle-users-after-22gb-of-data-not-5gb-but-forgets-to-inform-customers; Peter Jenkins, *Sprint announces Connection Speed Throttling for Unlimited Data Customers Using Over 23 GB*, STOCKWATCH (Oct. 18, 2015, 6:30 AM), https://advance.lexis.com/api/permalink/bd0706cc-2612-4a14-8fb1-09b70f0e06a2/?context=1000516. *But see* Roger Cheng, *Verizon's Grandfathered Unlimited Data Users Face $20 Price Hike*, CNET (Oct. 5, 2015, 6:40 AM) http://www.cnet.com/news/verizons-grandfathered-unlimited-data-users-face-20-price-hike/ (seeing an increase in their monthly bill and have to pay full price for phones, unlimited data users, as of yet, will not be throttled).

3. Interview by Jon Stewart with President Clinton, in New York, NY (June 17, 2015) [hereinafter "President Clinton Interview"].

4. *See, e.g.*, Goldstein, *supra* note 2 (upsetting customers when T-Mobile's new policy throttles its unlimited data users' mobile Internet speeds once they use twenty-one gigabytes of data); Margaret Harding, *AT&T Hit With Class Action Over Misleading Data Plans*, LAW360 (June 23, 2015, 3:40 PM), http://www.law360.com/articles/671122/at-t-hit-with-class-action-over-misleading-data-plans (reporting that a woman filed a class action lawsuit because AT&T breached its contract by throttling unlimited data users).

Section II of this Comment provides background on the throttling issue and illustrates a need for throttling regulation. It then shows how past regulatory attempts at throttling failed. Finally, it presents the FCC's latest attempt at regulating throttling. From this background, Section III concludes that targeting and throttling unlimited data users is illegal under the FCC's latest regulatory attempt. To do so, Section III(A) analyzes the reasonableness of the FCC's reclassification of mobile BIAS providers as telecommunications. Section III(B) considers whether the "no throttling" rule is within the FCC's regulatory jurisdiction. Section III(C) discusses how the targeting and throttling of unlimited data users does not fit within the legitimate network management practice exception to the "no throttling" rule.

Lastly, Section IV recommends that the FCC's "no throttling" rule remain unchanged and effective because it is good public policy that promotes business competition in the United States. Consequently, Section V concludes that the "no throttling" rule is good for the public because it not only considers the needs of mobile BIAS providers, but it also takes into account the interests of cellphone carriers' customers, while enhancing economic stability throughout the United States via more reliable mobile broadband in rural areas.

II. BIAS PROVIDERS' CLASSIFICATION IMPACTS THROTTLING PRACTICES

This Section will illustrate the need for regulation. First, it will reveal who is throttling and how prevalent throttling is in the mobile broadband market. Afterwards, this Section will explain why throttling has not been regulated. And third, it will describe the FCC's current attempt to regulate the practice.

A. Prevalent Throttling Policies Illustrate the Need for Regulation

Limited competition in the mobile broadband market contributes to the increased use of throttling policies. There are only four cellphone carriers that provide mobile BIAS for most of the mobile broadband users in the United States.[5] However, in many rural areas, there are even fewer carriers.[6] With a small mobile BIAS market, users are limited in their

5. *See Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993*, Seventeenth Report, 29 FCC Rcd. 15311, 15317, ¶ 12 (2014) [hereinafter "2014 Mobile Wireless Competition Report"] ("As of year-end 2013, there were four facilities-based mobile wireless service providers in the United States that industry observers typically describe as 'nationwide.' These providers include AT&T, Sprint, T-Mobile, and Verizon Wireless. Although none of these four providers has a network that covers the entire land area or population of the United States, each has a network that covers a significant portion of both . . . .").

6. *See National Broadband Map: Number of Broadband Providers*, FCC,

choice of a cellphone carrier with favoring policies.[7] At the time of this writing, Verizon Wireless ("Verizon") is the only national mobile BIAS provider of the four nationwide providers—AT&T, Sprint Corporation ("Sprint"), and T-Mobile—to give up its unlimited data throttling policies.[8] As a result, if an unlimited data user lives in an area not covered by Verizon, then that user will likely experience throttled data after consuming a predetermined amount of data.[9] For example, Sprint just recently decided to throttle its unlimited data customers after they use more than twenty-three gigabytes in a monthly pay period.[10]

Moreover, cellphone carriers argue that throttling is an effective way to manage networks because of the increased use of mobile broadband.[11] Consequently, most nationwide cellphone carriers have implemented or are currently implementing throttling polices.[12] To put this in perspective, almost all mobile broadband users are customers of the four major BIAS providers, where, at one time, all four throttled their customers and where, now, three continue to throttle for what they claim are network management purposes.[13] Similarly, throttling users in underdeveloped, rural areas is easier than investing in upgrading the rural infrastructure by building new towers and updating old ones.[14] As such, carriers often do

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http://www.broadbandmap.gov/number-of-providers (last visited Feb. 14, 2016).

7. *See id.*; *see also supra* note 2.

8. *See supra* note 2.

9. *See supra* note 2 (pointing out that T-Mobile throttles after 21 GB; AT&T throttles after 22 GB; and Sprint throttles after 23 GB).

10. *See* Jenkins, *supra* note 2.

11. *Protecting and Promoting the Open Internet*, 30 FCC Rcd. 5601, 5636–37, ¶ 90 (2015) [hereinafter "*2015 Open Internet Order*"] (illustrating that "consumers . . . increasingly rely on mobile broadband as a pathway to the Internet"); *id.* at 5636, ¶ 89 ("[T]here has been an increase of more than 200,000 percent in the number of LTE subscribers, from approximately 70,000 in 2010 to over 140 million in 2014. Concurrent with these substantial changes . . . mobile data traffic has exploded, increasing from 388 billion MB in 2010 to 3.23 trillion MB in 2013."); *id.* at 5639–40, ¶ 96 ("[S]ignificant concern has arisen when *mobile providers' have attempted to justify certain practices as reasonable network management practices*, such as applying speed reductions to customers using 'unlimited data plans' in ways that effectively force them to switch to price plans with less generous data allowances.") (emphasis added); *see also, e.g.*, *id.* at 5636, ¶ 89 (raising AT&T's and T-Mobile's comments that their wireless data traffic has grown exponentially year after year).

12. *See supra* note 2.

13. *See 2014 Mobile Wireless Competition Report*, *supra* note 5, at 15317, ¶ 12; *see also* Thomas Gryta, *An Early Net-Neutrality Win: Rules Prompt Sprint to Stop Throttling*, WALL ST. J. (June 17, 2015, 10:41 PM), http://www.wsj.com/articles/an-early-net-neutrality-win-rules-prompt-sprint-to-stop-throttling-1434595276 (reporting that Sprint stopped throttling as soon as it saw AT&T got fined for throttling right after the 2015 Open Internet Order became effective); Jenkins, *supra* note 2 (showing that Sprint now throttles as a way to manage its network).

14. *See Connecting America: The National Broadband Plan*, FCC at 136 (Mar. 17,

not have or want to spend the capital to invest in rural broadband infrastructural development.[15]

The prevalence of throttling policies among mobile BIAS providers is concerning for rural areas.[16] There are many rural areas where access to mobile broadband is limited to only a few choices (and in some locations, only one choice) of mobile BIAS providers.[17] So, when a mobile BIAS provider throttles these users' data, these users have degraded broadband access to the Internet, which typically means they have no broadband access at all during the throttling times. Additionally, with fewer choices or even no choices at all in mobile BIAS providers, rural broadband users have little to no means of evading unfavorable policies like throttling.[18] For example, the costs facing subscribers to switch providers is high and likely prohibitive for many users to move to another carrier's mobile broadband service.[19]

B. BIAS Providers' Prior FCC Classification Prevented Regulation

The FCC has the responsibility to take immediate action to remove

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2010), https://transition.fcc.gov/national-broadband-plan/national-broadband-plan.pdf [hereinafter "*The National Broadband Plan*"] ("Because service providers in [rural] areas cannot earn enough revenue to cover the costs of deploying and operating broadband networks, including expected returns on capital, there is no business case to offer broadband services in these areas."); *see also Broadband in Rural Areas*, FCC, http://www.broadband.gov/rural_areas.html (last visited Oct. 23, 2015) ("Because of relatively low population density, topographical barriers, and greater geographical distances, broadband service may be more difficult to obtain in some rural areas.").

15. *See supra* note 14; *cf. Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996, as Amended by the Broadband Data Improvement Act*, 30 FCC Rcd. 1375, 1402, ¶ 42 (2015) [hereinafter "*2015 Broadband Progress Report*"] (adopting broadband at similar rates, where rural Americans adopt at twenty-eight percent and urban Americans at thirty percent).

16. *See 2015 Open Internet Order, supra* note 11, at 5636–37, ¶ 90 (noting, after considering several studies, that "rural consumers . . . are more likely to rely on mobile as their only access to the Internet").

17. *See supra* note 14; *cf. id.* ("[R]ural consumer and businesses often have access to fewer options for Internet service, meaning that these customers may have limited alternatives when faced with restrictions to Internet openness imposed by their mobile provider.").

18. *See supra* notes 17 and 19; *see also 2015 Open Internet Order, supra* note 11, at 5636–37, ¶ 90.

19. *See 2015 Open Internet Order, supra* note 11, at 5641, ¶ 98 ("Based on results from surveys, . . . switching costs have depressed mobile wireless churn rates, meaning that customers may remain with their service providers even when they are dissatisfied."); *see also id.*, at 5641–42, ¶ 98 ("Choices may be particularly limited in rural areas, both because fewer service providers tend to operate in these regions and because consumers may encounter difficulties in porting their numbers from national to local service providers.").

barriers to infrastructural investment and to promote competition in the telecommunications marketplace so that broadband Internet access is "deployed to all Americans in a reasonable and timely fashion."[20] In carrying out this responsibility bestowed by Congress, the FCC determined that the Internet needed to be regulated to prevent unfavorable policies—like throttling—from keeping the Internet open and unrestricted for its users.[21] However, for nearly a decade, the FCC has failed to regulate the Internet in a manner that prevents harmful policies while keeping the Internet equally open to all.[22]

The FCC's regulatory tribulations started in 1980 when it defined "basic services" as common carrier services regulated under Title II and "enhanced services" as non-common carrier services not to be regulated under Title II.[23] The difference between a "basic service" and an "enhanced service" was how the service processed information.[24] For example, a telephone call simply transmits a sound between recipients without processing any information.[25] In fact, the FCC "characterized telephone service as a 'basic' service . . . because it involved a 'pure' transmission that was 'virtually transparent in terms of its interaction with customer supplied information.'"[26] However, a service that allows an individual to access the Internet must process the transmitted information it receives, making it an "enhanced service."[27] For example, BIAS providers must translate e-mails into binary code, which are then subdivided into packets, to be carried out and delivered to the e-mail's respective recipient. Therefore, BIAS providers must operate a service that requires more than just transmitting e-mail in "pure" textual form, thereby qualifying as "enhanced services" not subject to Title II common carrier regulations under this definition.[28]

Against this backdrop, Congress defined telecommunications providers—telephone operators—as "basic service" providers and information service providers—BIAS providers—as "enhanced service"

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20. 47 U.S.C. § 1302(a)–(b) (2015).

21. *See 2015 Open Internet Order*, *supra* note 11, at 5606, ¶ 11.

22. *See* Verizon v. FCC, 740 F.3d 623, 630–35 (D.C. Cir. 2014) (explaining the history of FCC's attempts at Internet regulation).

23. *See id.* at 629–30 (citing *In re Amendment of Section 64.702 of the Commission's Rules and Regulations*, 77 F.C.C.2d 384, 387 (1980) [hereinafter "*1980 Computer II Rules*"]).

24. *See Verizon*, 740 F.3d at 630 (citing *1980 Computer II Rules* at 420–21).

25. *Id.*

26. *Id.* (quoting *1980 Computer II Rules* at 419–20).

27. *See id.*

28. *See id.*

providers in the Telecommunications Act of 1996.[29] As a result, telecommunications providers were subject to the Title II common carrier rules whereas information service providers were not.[30] However, Congress left to the FCC the power to define these terms.[31]

In the 1998 Advance Service Order, the FCC defined Digital Subscriber Line ("DSL") providers—Internet services via telephone lines—as telecommunications providers because they could exempt their Internet services from the Title II common carrier restrictions since they were operating their Internet services through a quasi-independent entity.[32] However, the FCC's 2002 Cable Broadband Order defined cable broadband providers—Internet services via cable television lines—as information service providers because cable BIAS providers offered no telecommunications services to separate out like a telephone communications service, essentially blocking these providers completely from Title II regulation.[33]

Up until this point, the FCC took an unregulated approach to Internet service providers to stimulate broadband infrastructural growth, but that approach soon changed. In *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, the FCC tried to apply Title II common carrier regulations on cable Internet service providers under the theory of Title I ancillary jurisdiction in the 2002 Cable Broadband Order.[34] The agency applied common carrier obligations to "non-common carrier" services so that it could carry out its statutory function of ensuring the advancement of telecommunications and information services.[35] However, in *Brand X*, the Supreme Court did not approve of this ancillary jurisdiction approach,

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29. *See id.*; *see also* 47 U.S.C. § 153(24), (50), (51), (53) (2015).

30. *See* 47 U.S.C. § 153(53).

31. *See Verizon*, 740 F.3d at 630.

32. *See id.* at 630–31 (citing *In re Deployment of Wireline Services Offering Advanced Telecommunications Capability*, 13 FCC Rcd. 24012, 24014 (1998) [hereinafter "*1998 Advance Service Order*"]).

33. *See id.* at 631 (citing *In re Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, 17 FCC Rcd. 4798, 4802, 4824 (2002) [hereinafter "*2002 Cable Broadband Order*"]).

34. *See* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 976–77 (2005).

35. *See* United States v. Sw. Cable Co., 392 U.S. 157, 178 (1968) (ruling that the FCC may exercise authority under its general subject matter jurisdictional grant in Title I of the Communications Act to matters that are "reasonably ancillary to the effective performance of the [FCC]'s various responsibilities" set out in other titles of the Communications Act and other statutes); *see also* Am. Library Assoc. v. FCC, 401 F.3d 689, 700–03 (D.C. Cir. 2005) (holding that the FCC may exercise ancillary jurisdiction if (1) the FCC's general jurisdictional grant under Title I covers the subject of regulation and (2) the regulations are ancillary to the FCC effectively performing its statutory responsibilities).

reasoning that the FCC's classification of Internet service providers as non-telecommunications providers was a reasonable interpretation of the 1996 Telecommunications Act's ambiguous telecommunications provision.[36] Therefore, regardless of ancillary jurisdiction, the FCC's classification of Internet service providers barred application of Title II regulations to those entities providing Internet services.[37]

After *Brand X*, the FCC continued to classify Internet services as non-telecommunications services. The FCC's 2005 Wireline Broadband Order defined all wired services providing Internet access as information service providers—even including DSL—and placed the two main forms of wired Internet (cable and DSL) under the same classification, consequently barring Title II application.[38] Additionally, in its 2007 Wireless Broadband Order, the FCC defined all wireless Internet services as non-telecommunications services, thus exempting cellphone carriers from Title II common carrier regulation.[39] Therefore, the FCC defined all Internet service providers as non-telecommunications service providers, meaning that all Internet service providers were explicitly exempt from Title II common carrier regulation.[40]

Nevertheless, the FCC announced that if any BIAS provider attempted to violate its intention to "preserve and promote the open and interconnected nature of the public Internet," it would not hesitate to take action, even if that meant applying common carrier obligations on broadband providers via ancillary jurisdiction.[41] Just one year later, the FCC presented the 2008 Comcast Order after it discovered that Comcast Corporation ("Comcast") was blocking and degrading its customers' access to BitTorrent Inc., a peer-to-peer file sharing service.[42] The 2008 Comcast Order once again asserted ancillary jurisdiction to place a common carrier obligation——that a broadband provider may not manage its network with policies that intentionally blocked or degraded its customers' access to legal websites—

36. *See id.*; *cf.* Computer and Comm. Indus. Ass'n v. FCC, 693 F.2d 198, 202 (D.C. Cir. 1982), *cert. denied*, 461 U.S. 938 (1983) (finding that the FCC has ancillary jurisdiction to regulate non-common carrier activities of common carriers).

37. *See Brand X*, 545 U.S. at 976–77.

38. *See Verizon*, 740 F.3d at 631 (citing *In re Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities*, 20 FCC Rcd. 14853, 14862 (2005) [hereinafter "*2005 Wireline Broadband Order*"]).

39. *See id.* (citing *In re Appropriate Regulatory Treatment for Broadband Access to the Internet Over Wireless Networks*, 22 FCC Rcd. 5901, 5901-02 (2007) [hereinafter "*2007 Wireless Broadband Order*"]).

40. *See supra* notes 29–39.

41. *Verizon*, 740 F.3d at 631 (quoting *2005 Wireline Broadband Order* at 14,988).

42. *See id.* (citing *In re Formal Complaint of Free Press and Public Knowledge Against Comcast Corp. for Secretly Degrading Peer-to-Peer Applications*, 23 FCC Rcd. 13028, 13059-60 (2008) [hereinafter "*2008 Comcast Order*"].

—on Comcast, a non-common carrier, broadband provider.[43]

However, in *Comcast Corp. v. FCC*, the D.C. Circuit Court vacated the 2008 Comcast Order as an improper exercise of ancillary jurisdiction.[44] Simply put, the FCC was bound by its interpretation of broadband Internet service providers as non-telecommunications service providers, and therefore, it could not impose common carrier obligations on non-common carrier services when the FCC explicitly classified broadband Internet service providers as non-telecommunication services.[45] The court found that the FCC may change its interpretation of broadband Internet service providers with adequate reasons for a policy reversal.[46] With good justification, the FCC could reclassify broadband Internet service providers as telecommunications providers so that Internet service providers are regulated under Title II common carrier obligations.[47]

Instead of reclassifying Internet service providers as telecommunications so that the FCC could regulate them under Title II and impose common carrier obligations—for example, preventing the intentional slowing down of Internet services (*i.e.*, no throttling)—the FCC kept the classification the same in the 2010 Open Internet Order, implementing ancillary jurisdiction once again.[48]

In the 2010 Open Internet Order, the FCC created three prophylactic rules that required BIAS providers to (1) be transparent and (2) not discriminate or (3) block access to lawful websites.[49] The FCC created these rules because it needed to do something to promote the advancement and preserve the integrity of the Internet when a study showed that seventy percent of the nation did not get adequate or any broadband service at all.[50] Once again, the D.C. Circuit Court of Appeals in *Verizon v. FCC* vacated most of the 2010 Open Internet Order on the same grounds as it did in *Comcast* and as the Supreme Court did in *Brand X*: because the FCC attempted to exercise improper ancillary jurisdiction to attach common carrier obligations to entities it had explicitly defined as non-common

43. *Id.* *But see* Am. Library Ass'n v. FCC, 401 F.3d 689, 700–03 (D.C. Cir. 2005); Computer and Comm. Indus. Ass'n v. FCC, 693 F.2d 198, 202 (D.C. Cir. 1982).

44. 600 F.3d 642, 661 (D.C. Cir. 2010).

45. *Id.*; *see also Computer and Comm. Indus. Ass'n,* 693 F.2d at 202.

46. *Comcast Corp.*, 600 F.3d at 661.

47. *Id.*

48. *See* Verizon v. FCC, 740 F.3d 623, 633 (D.C. Cir. 2014) (citing *In re Preserving the Open Internet*, 25 FCC Rcd. 17905, 17905 (2010) [hereinafter "*2010 Open Internet Order*"]).

49. *Id.*

50. *See id.* at 640–41, 47; *see also* 47 U.S.C. § 1302(b) (2015) (stating that the FCC is to encourage broadband "deployment on a reasonable and timely basis").

carriers.[51] Although the court upheld the transparency requirement of the 2010 Open Internet Order, which did not impose common carrier obligations but instead competitive market values, it vacated the anti-blocking and anti-discrimination rules because these rules imposed common carrier obligations on broadband Internet service providers, limiting what BIAS providers could do with their own services.[52]

Notice that up until this point, the courts never overruled the FCC's classification of Internet service providers' as non-telecommunication services nor did the FCC ever reclassify these services to apply Title II common carrier obligations on BIAS providers.[53]

C. 2015 Open Internet Order: BIAS Providers' Reclassification and Common Carrier Obligations

In response to the BIAS provider's unreasonable policies like throttling and the unsuccessful attempts to regulate BIAS providers, the FCC implemented the 2015 Open Internet Order under the same enabling statutes as the 2010 Open Internet Order—Section 706 of the 1996 Telecommunications Act and Title II of the revised 1934 Communications Act.[54] The 2015 Open Internet Order achieves two main objectives: (1) it reclassifies BIAS providers as telecommunications service providers,

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51. *Verizon*, 740 F.3d at 655–59.

52. *Id.* (holding that Section 706 of the Communications Act of 1996 vests the FCC with authority to "enact measures encouraging the deployment of broadband infrastructure" and that the FCC interpreted this statute "to promulgate rules governing broadband providers' treatment of Internet traffic." However, the Court found that the Communications Act prohibits the FCC from regulating broadband providers as common carriers having already "classif[ied] [them] in a manner that exempts them from treatment as common carriers." That is, having previously exempted certain broadband providers as information service providers that are exempt from Title II common carrier obligations, the court found that the FCC could not regulate them by imposing anti-discrimination and anti-blocking obligations on them.).

53. *See id.*

54. Craig D. Dingwall, *Summary of Net Neutrality Rules*, TECHNOLOGY LAW GROUP, LLC (Mar. 24, 2015), http://www.tlgdc.com/pdfs/snaparchives/SnapUPdate%20Net%20Neutrality%20Rules%2003-24-15.pdf ("The FCC noted in its [2015 Open Internet] Order that '[c]hanged factual circumstances cause us to revise our earlier classification' of BIAS, including evolving business relationships among cable operators and their service offerings, as well as a 'rapidly changing market' for broadband Internet access services. The FCC also noted that mobile broadband networks are faster, more broadly deployed, more widely used and more technologically advanced than they were in 2010, and that network connection speed and data consumption have exploded. But do these and other changes justify such a broad change in classification, or are these rules merely a thinly-veiled response to the *Verizon* court remand and President Obama's Internet goals?"); *see also* Press Release, White House, Net Neutrality: President Obama's Plan for a Free and Open Internet (on file at https://www.whitehouse.gov/net-neutrality) (last visited June 27, 2015) [hereinafter "*White House Net Neutrality Press Release*"].

which applies Title II common carrier obligations to broadband providers; and (2) it implements three prophylactic, common carrier rules—no blocking, no throttling, and no paid prioritization.[55] For the purposes of this Comment, only the "no throttling" rule will be presented and subsequently analyzed.

The "no throttling" rule states that a BIAS provider may not slow down Internet access to any lawful Internet use except for a reasonable network management purpose:[56]

> A network management practice is a practice that has a primarily technical network management justification, but does not include other business practices. A network management practice is reasonable if it is primarily used for and tailored to achieving a legitimate network management purpose, taking into account the particular network architecture and technology of the broadband Internet access service.[57]

The FCC deems this exception necessary to the rule because broadband providers need the ability to optimize their network performance to maintain a quality experience for their customers while not being unfair to their customers.[58] For this exception to apply to an infringing throttling practice, the FCC notes that a BIAS provider must show that a *technical* network management matter—instead of some other *business* reason—justifies its practice.[59] However, the FCC considers targeting and throttling unlimited data plans to be a practice where the "reasonable network management" exception does not apply.[60]

Moreover, the 2015 Open Internet Order dedicates an entire section to mobile broadband services because a significant portion of its record concerned mobile BIAS providers' practices.[61] In this Section, the FCC addressed the incentives and technical abilities that mobile BIAS providers

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55. *See 2015 Open Internet Order*, *supra* note 11, at 5604 (executive summary).

56. *See id.* at 5651, ¶ 119 ("A person engaged in the provision of broadband Internet access service, insofar as such person is so engaged, shall not impair or degrade lawful internet traffic on the basis of Internet content, application, or service, or use of a non-harmful device, subject to reasonable network management.").

57. *Id.* at 5700, ¶ 215.

58. *Id.*

59. *Id.* ¶ 216 ("If a practice is primarily motivated by such an other justification, such as a practice that permits different levels of network access for similarly situated users based solely on the particular plan to which the user has subscribed, then that practice will not be considered under this exception.").

60. *Id.* at 5639–40, ¶ 96 ("[S]ignificant concern has arisen when mobile providers' [sic] have attempted to justify certain practices as reasonable network manage practices, such as *applying speed reductions to* customers using '*unlimited data plans*' in ways that effectively force them to switch to price plans with less generous data allowances.") (emphasis added).

61. *Id.* at 5635–43, ¶¶ 86–101.

have to limit the open Internet with policies like throttling.[62] It illustrated that mobile broadband has blossomed over the past five years due to faster network deployment.[63] The growth of the mobile broadband network is so fast, in fact, that more and more people are relying on mobile BIAS.[64] The FCC even pointed out that the "evidence shows that . . . rural consumers . . . are more likely to rely on mobile as their only access to the Internet."[65] Likewise, the National Health Interview Survey presented data showing a large uptick in the number of wireless-only households.[66]

Furthermore, the FCC looked at the technology behind mobile BIAS providers and found that mobile BIAS providers have better means to manage their networks in accordance with the three prophylactic rules in the 2015 Open Internet Order.[67] Consequently, they have the technological means to implement restrictive policies as well, like targeting unlimited data users and throttling them.[68]

The FCC also illustrated that mobile BIAS providers act as gatekeepers to the Internet, which contributes to increased market power that allows them to implement unfavorable, restrictive policies.[69] Since there are typically few mobile BIAS providers in rural areas, and since they have the technical means to implement harmful policies, mobile BIAS providers will implement these policies, like throttling, so long as they maintain strong market power.[70] One anticompetitive policy that all providers implement with their gatekeeper status is unfair switching costs—a measure they employ to keep customers tied to a mobile broadband policy.[71] Switching costs can be extremely high especially when a user has to move every member of a shared plan to another provider.[72] As such,

62. *Id.* at 5631–32, ¶ 81.

63. *Id.* at 5636, ¶ 89.

64. *Id.* at 5636–37, ¶ 90.

65. *Id.*

66. *Id.* ("44 percent of households were 'wireless-only' during January-June 2014, compared to 31.6 percent during January-June 2011.").

67. *Id.* at 5639–49, ¶ 96.

68. *Id.*

69. *Id.* at 5608, ¶ 20.

70. *Id.* ("[T]his has been a period of market and spectrum consolidation, which has decreased the choices available to consumers in many parts of the country. For example, . . . recent mergers . . . have reduced the ability of wireless end users to switch to competing providers . . . .") (internal quotations omitted).

71. *Id.* at 5640, ¶ 97 (citing comments from Microsoft Corp., which provided that "even if there is more than one mobile broadband access provider in a specific market, there may not be effective competitive alternatives . . . and these mobile broadband access providers retain the ability to act in a manner that undermines the competitive neutrality of the online marketplace").

72. *Id.* at 5642–43, ¶ 99.

market power coupled with policies that keep customers tied to a particular service provider allow for mobile BIAS providers to implement throttling policies and the like more easily without customers leaving.[73] Therefore, the FCC illustrated in the 2015 Open Internet Order that high demand, technical ability, and limited competition incentivize restrictive polices like throttling, and thus a need for regulation to keep the Internet open and free from these restrictive policies.[74]

III. THROTTLING IS ILLEGAL AND NEGATIVELY AFFECTS ECONOMIES

Nevertheless, the real question that remains is whether the FCC's 2015 Open Internet Order will be successful upon judicial review or will it sink like the 2010 Open Internet Order did upon the *Verizon* court's review. For the 2015 Open Internet Order to be successful upon judicial review, the FCC's reclassification of BIAS providers as telecommunications must be reasonable, and the Order's rules must be within the FCC's regulatory authority. After analyzing whether the 2015 Order will be successful upon judicial review, this Comment will answer whether the FCC successfully prohibits mobile BIAS providers from targeting and throttling unlimited data plans under the 2015 Open Internet Order's "no throttling" rule.

A. Reasonable Reclassification of BIAS Providers

Judicial history supports the FCC's reclassification of BIAS providers as telecommunications providers as reasonable,[75] and thereby, these providers are subject to the 2015 Open Internet Order's common carrier obligations. In 2005, the Supreme Court in *Brand X* reasoned that the FCC could reclassify BIAS providers if it "adequately explains the reasons for reversal of policy."[76] However, the Supreme Court here upheld the FCC's classification of BIAS providers as non-telecommunications because that was the FCC's classification at the time and because that was a reasonable interpretation of the 1996 Telecommunications Act's ambiguous provision defining telecommunications services.[77]

Then, in 2010, the D.C. Circuit Court in *Comcast Corp.* restated that the Administrative Procedure Act allowed the FCC to define any ambiguous

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73. *See id.*

74. *Id.* at 5628, ¶ 78.

75. *See infra* text and parenthetical accompanying note 76. *See generally* Alexander Hurst, *Neutering Net Neutrality: What Verizon v. F.C.C. Means for the Future of the Internet*, 7 HASTINGS SCI. & TECH. L.J. 43 (2015) (providing general overview of Internet neutrality regulatory history).

76. Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 981 (2005) (finding that the FCC's classification was entitled to deference even if the FCC's interpretation of its classification is inconsistent with its prior interpretation).

77. *Id.* at 991–92.

enabling statute as it as it saw fit, so long as its interpretation was reasonable.[78] The court even stated that the FCC might have had a good reason to reclassify broadband Internet service providers as telecommunications, but the FCC decided not to make a reclassification and instead attempted to implement common carrier obligations on non-common carrier entities via ancillary jurisdiction.[79] As a result, the court held that the FCC lacked the statutory authority to regulate non-common carriers with common carrier obligations under the FCC's classification scheme at the time.[80]

Subsequently, in 2014, the *Verizon* court found that the FCC's classification of broadband Internet service providers as non-telecommunications defers to the FCC's interpretation of the ambiguous 1996 Telecommunications Act, which gives the FCC power to define broadband providers as it sees fit for regulatory purposes.[81] As such, the court allowed the FCC's classification so long as it is reasonable and not arbitrary or an abuse of discretion.[82] Nevertheless, the FCC kept its classification of broadband Internet service providers as non-telecommunications providers,[83] resulting in the failure of the 2010 Open Internet Order upon judicial review when the Court upheld that classification.[84]

As a result of the failed attempts at trying to regulate broadband providers as non-telecommunications providers and after the courts repeatedly stated the FCC could reclassify with good reason, the FCC reclassified BIAS providers as telecommunications in the 2015 Open Internet Order.[85] However, the question still remains as to whether the

78. Comcast Corp. v. FCC, 600 F.3d 642, 661 (D.C. Cir. 2010).

79. *Id.*

80. *Id.*

81. *See* Verizon v. FCC, 740 F.3d 623, 635 (D.C. Cir. 2014).

82. *Id.*

83. *See* Hurst, *supra* note 75, at 61–62 ("One motivation the [FCC] may have had to avoid such a reclassification was that it had previously faced opposition to the proposal of reclassifying broadband providers as common carriers. Besides industry opposition to common carrier regulation, forty-eight members of Congress had requested that the Commission leave any such change in policy to the legislature in a 2010 congressional resolution.").

84. *See Verizon*, 740 F.3d at 659.

85. *See* Sheraz Syed, *Prioritizing Traffic: The Internet Fast Lane*, 15 DEPAUL J. ART TECH. & INTELL. PROP. L. 151, 160 (2014) (explaining that the FCC prevented itself from regulating BIAS providers due to its past classification of these providers even though the Courts, including the Supreme Court, assured that the FCC had the power to reclassify them telecommunications service providers); *see also 2015 Open Internet Order*, *supra* note 11 at 5614, ¶ 43 ("Exercising our delegated authority to interpret ambiguous terms in the Communications Act, as confirmed by the Supreme Court in *Brand X*, . . . the record reflects . . . that broadband providers are offering . . .

FCC's reclassification of BIAS providers as telecommunications providers is reasonable such that the FCC's policy reversal will be upheld upon judicial review.

The FCC explained at length in the 2015 Open Internet Order why its policy reversal of reclassifying BIAS providers as telecommunications providers is reasonable.[86] Besides stating that the courts support the reclassification as shown above, the FCC also illustrated that broadband services have changed so much in recent years that a reclassification is needed to compensate for this change.[87] Therefore, the FCC has likely justified its policy reversal.[88]

B. "No Throttling" Rule is Within the FCC's Regulatory Jurisdiction

The FCC, in developing the 2015 Open Internet Order, relied mainly on Title II of the Communications Act of 1934 and Section 706 of the Telecommunications Act of 1996.[89] This Section will first consider whether the 2015 Open Internet Order's prophylactic "no throttling" rule is statutorily permitted by the 1996 Telecommunications Act. Afterward, this Section will consider whether the Communications Act of 1934 prohibits the implementation of the "no throttling" rule as it did with 2010 Open Internet Order's rules.[90] If the "no throttling" rule is justified by Section 706 of the Telecommunications Act and does not conflict with the Communications Act of 1934, then the rule is within the FCC's regulatory jurisdiction, which will be the conclusion of this Section.

Section 706(a) of the Telecommunications Act gives the FCC regulatory authority to encourage the deployment of advanced telecommunications capability "by utilizing . . . measures that promote competition in the local telecommunications market, or other regulating methods that remove

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straightforward transmission capabilities that the Communications Act defines as a 'telecommunications service.'").

86. *See 2015 Open Internet Order*, *supra* note 11 at 5615, ¶ 47 ("Based on this updated record, this Order concludes that the retail [BIAS] available today is best viewed as separately identifiable offers of (1) a [BIAS] that is a telecommunications service . . . and (2) various 'add-on' applications, content, and services that generally are information services. This finding more than reasonably interprets the ambiguous terms in the Communications Act . . . ."); *see also id.* at 5747–48 ¶ 338 (finding that BIAS providers are reasonably classified as telecommunications services).

87. *See id.* at 5614, ¶ 42.

88. *See id.* at 5615, ¶ 49 ("By classifying [BIAS] as a telecommunications service under Title II of the [Communications] Act, . . . the [FCC] addresses any limitations that past classification decisions placed on the ability to adopt strong open Internet rules, as interpreted by the D.C. Circuit in the *Verizon* case.").

89. *Id.* at 5614, ¶ 41.

90. Verizon v. FCC, 740 F.3d 623, 659 (D.C. Cir. 2014).

barriers to infrastructure investment."[91] The *Verizon* court agreed with the FCC "that Congress . . . 'necessarily invested the Commission with the statutory authority to carry out those acts'"[92] that will "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans."[93] However, the court also found that Congress limited that grant of regulatory authority by two principles: (1) the grant of authority must be read in conjunction with the Communications Act; and (2) the FCC must design its regulation of BIAS for the specific purpose to "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans."[94] The FCC, under Section 706(a), may carry out this responsibility via "*other regulating methods* that remove barriers to infrastructure investment."[95] The "no throttling" rule could be an "other method" and, consequently, could fit into the statutory jurisdiction of the FCC under Section 706(a).[96]

Section 706(b) of the Telecommunications Act of 1996 grants the FCC the ability to "take immediate action to accelerate deployment" if it finds "that broadband is [not] being reasonably and timely deployed."[97] The *Verizon* court found that the FCC had correctly interpreted Section 706(b), giving the FCC the power accelerate broadband deployment whenever it finds that deployment is not "reasonable and timely."[98] The court also agreed with the FCC that Section 706(b) can be interpreted to permit the FCC to implement measures that remove barriers to promote competition and invest in infrastructural development.[99] Consequently, the FCC found that throttling was in fact a barrier that needed to be remedied with the 2010 Open Internet Order and 2015 Open Internet Order.[100] Therefore, and

91. 47 U.S.C. § 1302(a) (2015).

92. *Verizon*, 740 F.3d at 637–38.

93. 47 U.S.C. § 1302(a).

94. *See Verizon*, 740 F.3d at 640 (quoting 47 U.S.C. § 1302(a)).

95. 47 U.S.C. § 1302(a) (emphasis added).

96. *See Verizon*, 740 F.3d at 635–49 (illustrating that the anti-blocking and anti-discrimination common carrier rules of the 2010 Open Internet Order fit into the regulatory jurisdiction of the FCC because there are other methods to knock down barriers to infrastructure development).

97. 47 U.S.C. § 1302(b).

98. *See Verizon*, 740 F.3d at 640 (quoting 47 U.S.C. § 1302(b)).

99. *Id.* at 641.

100. *See 2015 Open Internet Order*, *supra* note 11, at 5607 ¶¶ 16–17 ("The 2010 open Internet rule against blocking contained an ancillary prohibition against the degradation of lawful content, applications, services, and devices, on the ground that such degradation would be tantamount to blocking. This Order creates a separate rule [('no throttling')] to guard against degradation targeted at specific uses of a customer's broadband connection . . . . *The ban on throttling is necessary* both to fulfill the

in accordance with the *Verizon* judicial review, under Section 706, the FCC has the "valid affirmative authority to enact measures[, like the ones in the 2010 Open Internet Order,] encouraging the deployment of broadband infrastructure."[101]

Hence, one question remains: does the 2015 Open Internet Order's "no throttling" rule fit within the limitations of Section 706? Fortunately, the "no throttling" rule is similar and rightly dissimilar to both the anti-blocking and anti-discrimination rules of the 2010 Open Internet Order such that it likely fits within Section 706. The *Verizon* court deemed that both of these 2010 rules fit within the second limitation of Section 706—providing that the FCC must design its regulation of the Internet for the specific purpose to "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans"[102]—because, for example, the FCC could impose an anti-blocking rule to prevent barriers to fast broadband deployment.[103] However, neither of these rules met the first limitation—requiring the grant of authority to be read in conjunction with the Communications Act[104]—because these rules were common carrier obligations that the FCC would impose on clearly defined non-common carriers.[105] As a result, the FCC had the authority to make the 2010 Open Internet Order's anti-blocking and anti-discrimination rules, but it could not carry out these rules because these rules were common carrier obligations to be imposed on BIAS providers classified as information service providers at the time.[106]

The "no throttling" rule is similar and dissimilar to the 2010 rules in a manner that allows it to fit squarely within the courts' interpretation of Section 706. The "no throttling" rule supplements the "anti-blocking"

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reasonable expectations of a customer who signs up for a broadband service that promises access to all of the lawful Internet, and *to avoid gamesmanship designed to avoid the no-blocking rule* by, for example, rendering an application effectively, but not technically, unusable.") (emphasis added).

101. *See* Hurst, *supra* note 75, at 45 (citing *Verizon*, 740 F.3d at 628).

102. *Verizon*, 740 F.3d at 628, 639 (quoting 47 U.S.C. § 1302(a)).

103. *See 2015 Open Internet Order*, *supra* note 11, at 5636–38, 3639–40, ¶¶ 90–92, 96 (blocking lawful Internet traffic allows BIAS providers to handle congestion and priority of Internet access; however, it encourages BIAS providers not to invest in further broadband deployment, but instead to slow down traffic to save costs).

104. *Verizon*, 740 F.3d at 628, 639.

105. *See id.* at 649 ("Even though [S]ection 706 grants the Commission authority to promote broadband deployment by regulating how broadband providers treat edge providers, the Commission may not, as it recognizes, utilize that power in a manner that contravenes any specific prohibition contained in the Communications Act.").

106. *See* Hurst, *supra* note 75, at 46 ("However, even though the majority [in *Verizon*] found that the Commission was authorized to make these rules, the Order contravened one of the Commission's earlier rulings that expressly exempted information services providers from treatment as common carriers.").

rule—completely degrading access to lawful Internet activity—because throttling can serve the same purpose as blocking when degradation would be so severe that it renders access just as worthless as being blocked from lawful Internet activity.[107] In this respect, the "no throttling" rule is similar to, if not the same as, the 2010 rules which the *Verizon* court found that the FCC had the authority to make.[108] However, the "no throttling" rule is rightfully dissimilar to the 2010 anti-blocking and anti-discrimination rules because the FCC reasonably reclassified BIAS providers as telecommunications under the 2015 Open Internet Order that imposes this rule.[109] Therefore, the "no throttling" rule is a common carrier obligation applied to common carriers, allowing them to work in conjunction with the Communications Act and meeting the second limitation of Section 706.[110] Therefore, the "no throttling" rule falls within the FCC's regulatory jurisdiction by meeting both limitations of Section 706.[111]

C. 2015 Open Internet Order Prohibits Throttling Unlimited Data Plans After Reaching a Certain Data Cap

After illustrating that the FCC's reclassification of BIAS providers as common carriers is reasonable and that the 2015 Open Internet Order's "no throttling" rule is within the FCC's regulatory jurisdiction, this Section analyzes whether the "no throttling" rule prohibits mobile BIAS providers from targeting and throttling unlimited data users, or whether this BIAS practice falls within the reasonable network management exception to the "no throttling" rule. At first glance, the "no throttling" rule clearly prohibits cellphone carriers from throttling unlimited data plans.[112] However, the "no throttling" rule states that mobile BIAS providers may not throttle *unless* that throttling practice fits within the "reasonable

107. *See supra* parenthetical accompanying note 100.

108. *See supra* text and parenthetical accompanying note 106; *see also 2015 Open Internet Order*, *supra* note 11, at 5614, ¶ 42 ("The *Verizon* decision thus made clear that [S]ection 706 affords the Commission substantive authority, and that open Internet protections are within scope of that authority.").

109. *See 2015 Open Internet Order*, *supra* note 11, at 5615–16 ¶ 50 ("Having classified broadband Internet access service as a telecommunications service, we respond to the *Verizon* court's holding, supporting our open Internet rules under the Commission's Title II authority and removing any common carriage limitation on the exercise of our [S]ection 706 authority."); *see also supra* Section III(A) (deducing that the FCC reasonably reclassified BIAS providers as telecommunications providers by looking at judicial history and the FCC's reasons for reclassification in the 2015 Open Internet Order).

110. *See supra* note 109.

111. *See supra* note 109.

112. *See supra* parenthetical accompanying note 56 (presenting the "no throttling" rule).

network management" exception.[113] Hence, this Section proceeds to determine whether cellphone carriers' targeting and throttling of unlimited data plans is a practice that fits within the "reasonable network management" exception to the "no throttling" rule. To make this determination, this Section will first consider whether cellphone carriers throttle for business incentives by presenting gatekeeper and market power analyses. If the carriers do, then their throttling is not a "reasonable network management" practice,[114] and consequently, as this Section will conclude, the 2015 Open Internet Order's "no throttling" rule prohibits such throttling.

1. Business Incentives to Throttle

To determine whether cellphone carriers' decision to target and throttle unlimited data users is a reasonable network management practice, any other reason than one that serves as a legitimate network concern will prohibit the throttling practice under the "no throttling" rule.[115] Accordingly, Subsection III(C)(1)(a) of this Comment analyzes economic and technical ability reasons for throttling, and Subsection III(C)(1)(b) analyzes market power reasons for throttling. From these analyses, there are adequate justifications as to why targeting and throttling unlimited data users is a practice that falls outside the "reasonable network management" exception and is prohibited by the "no throttling" rule.

a. Gatekeeper Analysis: Economic and Technical Ability to Throttle

Mobile BIAS providers act as Internet access gatekeepers, where all mobile access to and from the Internet must go through them.[116] As a result, mobile BIAS providers are in a position to easily interfere with mobile user access to the Internet, including slowing down Internet traffic

113. *Id.*; *see also supra* text accompanying note 57 (presenting the "reasonable network management" exception).

114. *See supra* notes 59–60.

115. *See supra* notes 56–60 and accompanying text (illustrating how the "no throttling" rule works in conjunction with its "reasonable network management" exception and pointing out what kind of practice the FCC considered did not fit within the exception).

116. *See* Hurst, *supra* note 75, at 55 (quoting Verizon v. FCC, 740 F.3d 623, 646–47 (D.C. Cir. 2014)) (stating "the [Verizon] court recognized that because end users typically receive broadband from a single provider, that provider 'functions as a terminating monopolist with power to act as a "gatekeeper" to [content] providers'" and as a "gatekeeper" to consumers because of high switching costs). *See generally* JONATHAN E. NUECHTERLEIN & PHILIP J. WEISER, DIGITAL CROSSROADS: TELECOMMUNICATIONS LAW AND POLICY IN THE INTERNET AGE 220–26 (2d ed. 2013) (presenting arguments from both sides of the open Internet debate to illustrate the affect).

to and from a user (*i.e.*, throttling).[117] Consequently, this model provides economic incentives to throttle so long as the mobile BIAS providers have the technical ability to do so.[118]

First, mobile BIAS providers have the technical ability to throttle at varying levels.[119] Instead of limiting the speed of all users on a congested tower (*i.e.*, cell site), some mobile BIAS providers may choose to throttle particular customers with certain plans,[120] while others may choose to limit their heaviest data consumers.[121] Hence, cellphone carriers are able to determine specific tower usage and limit any particular usage as they deem necessary.[122]

Second, mobile BIAS providers have economic incentives to throttle especially in rural areas.[123] Building cell towers for few customers is an expensive venture for mobile BIAS providers because low population densities provide for slow investment recovery.[124] In many rural areas, the population is so low that the number of cellphone users in these rural areas hardly justifies the cost of mobile broadband infrastructure development—*i.e.*, cellphone subscriptions may be too few in some areas to pay for infrastructural investment.[125] Furthermore, thanks to the broadband

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117. *See* Hurst, *supra* note 75, at 55 (citing *Verizon*, 740 F.3d at 645–46) (emphasizing that Verizon did not deny it had the ability to throttle).

118. *Id.*

119. *See id.*; *see also 2015 Open Internet Order*, *supra* note 11, at 5639–40, ¶96.

120. *See, e.g.*, *supra* note 2 (throttling after 21 GB by T-Mobile, after 22 GB by AT&T, and after 23 GB by Sprint).

121. *See, e.g.*, Justin S. Brown & Andrew W. Bagley, *Neutrality 2.0: The Broadband Transition to Transparency*, 25 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 639, 676 (2015) (citing *Important Information About Verizon Wireless Broadband Internet Access Services*, VERIZON WIRELESS, http://www.verizonwireless.com/support/information/broadband.html (last visited Feb. 25, 2015)) (addressing congestion management, Verizon may throttle its customers within the top five percent of Verizon Wireless data customers).

122. *See 2015 Open Internet Order*, *supra* note 11, at 5628–34, ¶¶ 78–85; *see also, e.g.*, *id.*; *supra* note 2.

123. *See 2015 Open Internet Order*, *supra* note 11, at 5639–40, ¶ 96 (pointing out that mobile providers throttle customers using unlimited data plans "in ways that effectively force them to switch to price plans with less generous data allowances"); *see also The National Broadband Plan*, *supra* note 14, at 136–37 (finding that carriers providing BIAS in rural areas have no business case to offer untainted broadband services because the cost of deploying and operating BIAS in low population densities makes it difficult to recover investment costs).

124. *See The National Broadband Plan*, *supra* note 14, at 136.

125. *See generally 2014 Mobile Wireless Competition Report*, *supra* note 5, at 15367–68, ¶¶ 112–13 ("Based on the data, tower operators build and operate more towers and [distributed antenna systems (DAS)] nodes in densely populated areas in order to support better coverage and more wireless data usage. For example as of September 2013, the average number of tower and DAS sites per county is 29 for

availability gap, there are many more upfront costs associated with bringing mobile broadband to rural areas with no broadband access as compared to upgrading already existing urban infrastructure.[126] Therefore, private investment is unlikely to fill in the broadband availability gap when it is easier to throttle than build or upgrade a rural tower to handle the higher demand on the network.[127]

Therefore, throttling allows mobile BIAS providers to unreasonably manage networks instead of investing in infrastructure.[128] Slowing down heavy data users, rather than building new towers or updating old towers to handle the data consumption needs of their customers, is easier and cheaper.[129] In fact, many popular speakers, including former President Clinton, have spoken on this matter.[130] As such, throttling seems to be a pure business policy especially when targeted at a particular customer base.[131] Hence, targeting and throttling unlimited data users is not a

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counties with a population density between 75 and 100 persons per square mile, compared with an average of 377 per county for counties with a population density between 2000 and 4000 . . . . In addition, there are also more tower operators in densely populated counties . . . than less populated counties . . . . The numbers range from two operators per county in rural counties with one person or less per square mile and an average land size of 11,122 square miles to more than seven operators in dense urban counties with a population density of more than 4000 and an average land size of 98 square miles . . . .").

126. *Id.* at 136–38.

127. *See id.* at 15369, ¶ 114 ("[A] significant constraint[] faced by wireless infrastructure providers that need to add or modify tower . . . sites [is] capital expenditure . . . . In terms of capital expenditure, collocating wireless equipment on existing structures is often the most efficient and economical solution for mobile wireless service providers that need new cell sites, either to expand their existing coverage area, increase their capacity, or deploy 4G broadband services. The average cost to build a new tower is between $250,000 and $300,000, whereas the average cost of collocation on an existing tower is less than 25 percent of the total cost of a new tower."); *see also 2015 Broadband Progress Report*, *supra* note 15, at 1457, ¶ 146 ("Broadband service reliability remains a key factor to broadband availability. Low broadband service quality has the potential to affect adoption rates, which in turn may affect customer demand, leading to less deployment.").

128. *See supra* notes 123–127 (providing that costs associated with building and updating cellphone towers are high, where cellphone carriers take business incentive to throttle to avoid high investment costs—slowing unlimited data customers down so much that they effectively force customers to switch to more limited data plans that are less demanding on networks, preventing the need to build and update cellphone towers to handle increased demand on broadband networks).

129. *See* explanatory parenthetical accompanying *supra* note 128.

130. *See* President Clinton Interview, *supra* note 3 and corresponding text.

131. *See 2015 Broadband Progress Report*, *supra* note 15, at 1457, ¶ 146 ("Broadband service reliability remains a key factor to broadband availability. Low broadband service quality has the potential to affect adoption rates, which in turn may affect customer demand, leading to less deployment. Broadband service quality remains an essential *component* of broadband deployment. Providers must maintain and upgrade their broadband offerings to ensure that high-quality broadband remains

"reasonable network management" practice because it is just a business tactic creating user dissatisfaction.[132]

b. Market Power Analysis: Mobile BIAS Providers Throttle Because They Can "Get Away With It"

Mobile BIAS providers have significant market power to implement unfavorable policies in many parts of the United States,[133] with little to no backlash from customers,[134] because many rural customers only have access to one or two cellphone carriers.[135] For example, if a cellphone carrier is the only mobile BIAS provider in the area, then it has considerable market power, and its customers inevitably suffer the unfavorable policies it implements, or they go without cell service.

Likewise, there may be multiple cellphone carriers in an area that act in concert and implement collectively unfavorable policies,[136] rendering switching cellphone carriers practically ineffective. Similarly, maybe not all of the carriers in an area implement unfavorable policies like the practice of throttling, but the switching penalties may be so high that the

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available to consumers.").

132. *See supra* note 4 (showing customer dissatisfaction).

133. *Compare* NUECHTERLEIN & WEISER, *supra* note 116, at 220–21 (citing *2010 Open Internet Order*) ("[M]ost economic advocacy for net neutrality regulation begins with the argument that there is inadequate competition in the residential broadband marketplace and that the government should step in to prevent abuses of the resulting market power . . . [that] 'is highest in markets with few competitors.'"), *with id.* at 220–24 (presenting the general view of the net neutrality opponents that "the retail Internet access market is more competitive and dynamic than net neutrality advocates contend" because, even when there are only a few broadband providers in an area, they will act competitively and fairly for their own interests of keeping their customers satisfied and to attract new customers).

134. *See 2015 Open Internet Order*, *supra* note 11, at 5642, ¶ 99 ("The provision of wireless service involves the interaction between the wireless network operator, the various edge providers, the customer's handset or other equipment, and the conditions present in the specific location the customer wishes to use the service. In this environment, it can be very difficult for customers to ascertain the source of a service disruption, and hence whether switching wireless providers would solve the problem."); *see also 2014 Mobile Wireless Competition Report*, *supra* note 5 at 15325 (Chart II.B.6) (illustrating that only 1.3% to 4% of customers on any of the four national cellphone carriers actually switch).

135. *See National Broadband Map: Number of Broadband Providers*, *supra* note 6 (selecting "wireless" for provider type and comparing minimum at two and three providers and seeing a significant decrease in mobile broadband coverage with three providers. After comparing the minimum provider count at four and five, there is only a small portion of the United States with five or more mobile BIAS providers—keep in mind that data is likely overstated because mobile broadband service may not exist in the entire census block.).

136. *See, e.g.*, *supra* notes 2, 4 (pointing out that all of the major mobile BIAS providers implemented throttling polices at one time or another).

cost of switching outweighs avoiding the throttling policy.[137]

Regardless of the situation presented above, cellphone carriers can make the business move to target and throttle unlimited data users, especially in rural areas, without worrying that they will lose business in these throttled areas[138] because of their significant market power, which is not throttling for "reasonable network management" purposes.

2. *Throttling Unlimited Data Plans Does Not Meet the Network Management Practice Exception*

Knowing how and why mobile BIAS providers throttle their customers,[139] the question that this Comment seeks to answer still remains: can cellphone carriers target and throttle unlimited data users? This Subsection will answer this question in the negative.

The previous sections illustrate that mobile BIAS providers target and throttle unlimited data users for business purposes, not "reasonable network management" purposes.[140] Since cellphone service providers have the economic incentive and technical ability to throttle, then viewing their throttling practices as "reasonable network management" is mentally taxing, especially when targeting specific groups of customers (like unlimited data plan users).[141]

Moreover, a "reasonable network management" practice is not one that treats similarly situated users differently.[142] Cellphone carriers claim that they throttle as a means to manage their networks, where they throttle their unlimited data users over their limited data users as a means to give all its customers an equal opportunity to use fast Internet.[143] However, this

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137. *See supra* parentheticals accompanying note 134 (explaining churn rates and low percentage of customer switching).

138. *See supra* notes 133–135.

139. *See supra* Section III(C)(1)(a) (explaining mobile BIAS providers' gatekeeper power); *supra* Section III(C)(1)(b) (explaining mobile BIAS providers' market power).

140. *See supra* Section III(C)(1)(a) (explaining that mobile BIAS providers have economic and technological abilities to throttle, and they do so by targeting unlimited data users or other specific groups of users for purposes other than network management); *supra* Section III(C)(1)(b) (explaining mobile BIAS providers have strong economic incentives to throttle because they simply can when there is little-to-no competition in many areas in the United States).

141. *See supra* parentheticals and text accompanying notes 56-60 (explaining the "no throttling" rule and its exception).

142. *2015 Open Internet Order*, *supra* note 11, at 5700, ¶ 216.

143. *See, e.g.*, John Saw, *Protecting the 97%*, SPRINT (Oct. 17, 2015, 12:00 AM) http://newsroom.sprint.com/blogs/sprint-perspectives/protecting-the-97.htm ("As we continue to improve our network, and as data usage across the industry continues to skyrocket, we're always looking at ways to better manage our network resources and improve the customer experience. One way we aim to make the customer experience better is to protect against the possibility that a small minority of customers might

throttling practice permits different levels of network access to similarly situated users. So long as a limited data user has not reached her specified data cap, she receives top speeds for the agreed upon price of the limited data plan. By definition, however, unlimited data users cannot reach a data cap, so they are users in the same situation as limited data users who have not reached their limited data caps, yet the unlimited data users are the only ones throttled for network management. This practice is discriminatory[144] and does not satisfy the "reasonable network management" exception to the "no throttling" rule.[145] Therefore, targeting and throttling unlimited data users does not meet the "reasonable network management" exception when throttling everyone for a legitimate network issue would be more reasonable.[146]

Additionally, the other result is that throttling unlimited data users in rural areas does not meet the "reasonable network management" exception on two grounds: (1) it targets a specific group; and (2) it occurs because it is cheaper to do so in rural areas than investing in rural infrastructure. Neither of these are "reasonable network management" practices; rather, they are business choices that are not exception-worthy and are prohibited by the "no throttling" rule.[147]

IV. FCC GOT IT RIGHT WITH THE "NO THROTTLING" RULE

The 2015 Open Internet Order's "no throttling" rule should remain unchanged and effective because it completely bans throttling except for "reasonable network management"[148] and because it serves both consumers and providers equally well, making it a good public policy.[149] For example, a "reasonable network management" practice would be throttling everyone's data usage and not just targeting and slowing down certain users when there is high bandwidth demand on a tower or some other

occupy an unreasonable share of network resources . . . . [I]f [unlimited data customers] use more than 23GB of data during a billing cycle, they will be prioritized on the network below other customers for the remainder of their billing cycle, *only* in times and locations where the network is constrained.").

144. *See 2015 Open Internet Order*, *supra* note 11, at 5700 ¶ 216 (explaining that a practice that applies "different levels of network access for similarly situated users based solely on the particular plan to which the user has subscribed" does not fall within the exception for "reasonable network management").

145. *See supra* parentheticals and text accompanying notes 59–60.

146. *See supra* notes 56–60.

147. *See 2015 Open Internet Order*, *supra* note 11, at 5700, ¶ 216 ("If a practice is primarily motivated by such an other justification, . . . then that practice will not be considered under this exception.").

148. *See supra* parentheticals and text accompanying notes 56–57 (presenting the "no throttling" rule and its exception).

149. *See supra* parentheticals and text accompanying notes 58–60.

legitimate reason. In this scenario, the mobile BIAS providers benefit because they are able to reasonably manage their mobile networks when they see fit, and the consumers benefit because they receive a consistent service while not being discriminated against by their BIAS providers.

However, targeting and throttling unlimited data plan customers (or customers in the top percent of data users) is not an acceptable practice that falls within this exception to the "no throttling" rule.[150] In this situation, the mobile BIAS providers benefit because their throttling practices allow them to save on costs for needed infrastructural development[151] while the consumers do not benefit because they are discriminatorily being throttled. In fact, the throttling here occurs on a small percentage of the customers (*i.e.*, unlimited data users), which is likely not enough to provide a better service for all consumers using the mobile BIAS.[152] The following two sections will provide additional reasoning for the recommendation that the "no throttling" rule and its exception ought to remain unchanged and effective.

A. In a United States Where Unreasonable Throttling Is Allowed

Today's America does not make imagining the lack of a "no throttling" rule difficult considering the FCC just released the rule in March 2015,[153] and cellphone carriers continue to throttle their unlimited data customers as if the rule does not exist.[154] However, if the "no throttling" rule does not exist, not only will mobile data consumers suffer at the expense of the mobile BIAS providers filling their coffers,[155] but consumers will also

150. *See supra* parentheticals and text accompanying notes 59–60 (explaining that the FCC will not consider the practice of targeting and throttling unlimited data users under the "reasonable network management" exception).

151. *See supra* parenthetical and text accompanying notes 125–127 (explaining that the costs associated with building and updating cellphone towers are high and that mobile service providers take the business incentive to throttle to avoid high investment costs. These actions slow unlimited data customers down so much that they effectively force these customers to switch to more limited data plans that are less demanding on the networks, and they also aid these mobile providers by preventing the need to build and update cellphone towers to handle the increased demand on mobile broadband networks.).

152. *But see, e.g.*, Saw, *supra* note 143 (claiming that throttling only "a small minority of customers [who] might occupy an unreasonable share of network resources" will improve overall customer experience).

153. *See Open Internet*, FCC, https://www.fcc.gov/openinternet (last visited June 27, 2015).

154. *See supra* note 2.

155. *See 2015 Open Internet Order*, *supra* note 11, at 5640–42, ¶¶ 97–98 (illustrating that, because of limited competition in many areas and stringent switching policies, consumers will likely be stuck with throttling and other unfavorable policies).

suffer from a lack of broadband infrastructure development.[156] As a result, the United States will likely lose its place as an international leader in broadband development when many American communities still lack sufficient broadband access, which prevents the United States from competing at full economic potential—a consequence that is neither far-fetched nor too far from realization.[157]

1. Case Study: Economic Impact on Rural Areas

Consider the negative economic effects of throttling on rural areas. Allowing throttling in rural areas, just because it is easier and cheaper than investing in rural infrastructure to meet users needs,[158] is bad policy for two reasons: (1) quality broadband access brings jobs; and (2) mobile broadband may be the only efficient way to build up a broadband network in some rural areas.

First, sufficient broadband access brings jobs, causing local economies to thrive since today's economies rely on fast, reliable Internet access.[159] For instance, mobile broadband supports and builds rural economies because rural producers and storeowners can put their products online and manage their online presence on the go.[160] Furthermore, many jobs require broadband access.[161] For example, technology companies thrive in today's market; however, none of these companies are going to move to a rural area that lacks fast, reliable broadband access.

Even though approximately ninety-nine percent of the United States population has access to broadband, only a small percentage of rural areas actually have access to quality broadband service.[162] The same holds true

156. *See supra* parentheticals and text accompanying notes 123–131 (throttling affects broadband infrastructure development in rural areas, negatively affecting economic opportunities in rural areas).

157. *See, e.g.*, Tony Brown, *South Korea: What happened to the broadband wonderland?*, NBN BLOG (Feb. 5, 2015) http://www.nbnco.com.au/blog/south-korea-what-happened-to-the-broadband-wonderland.html (pointing out that South Korea had almost reached a perfect broadband network, increasing competitive advantage).

158. *See supra* notes 125–127 (providing the costs associated with building and updating cellphone towers are high, where mobile service providers take the business incentive to throttle to avoid high investment costs in low population).

159. *See* White House Net Neutrality Press Release, *supra* note 54.

160. *See, e.g.*, *The National Broadband Plan*, *supra* note 14, at 136–37 ("Diller, Neb., population 287, is home to Blue Valley Meats, which has seen its business grow more than 30% and its employee ranks double over the last five years [at the time of this study], thanks in large part to the creation of a website to extend its product reach.").

161. *See White House Net Neutrality Press Release*, *supra* note 54.

162. *The National Broadband Plan*, *supra* note 14, at 136–37; *see also 2015 Broadband Progress Report*, *supra* note 15, at 1457, ¶ 146 (discussing quality of service and broadband deployment affecting broadband adoption rates).

for mobile broadband, except coverage is much more spotty in rural areas, resulting in such an unreliable quality of service that there may be no service where coverage maps show otherwise.[163] As such, some rural users statistically have mobile broadband access but actually do not for a variety of reasons—*e.g.*, a mountain blocks a user's signal, or a user lives at the very edge of a cellphone tower's range.[164] Therefore, there are many areas in the United States that do not have sufficient broadband access to successfully compete economically.

Second, since mobile broadband may be the only efficient way to build up a broadband network in some rural areas, throttling policies threaten infrastructural growth of broadband access in these areas.[165] For example, consider the case of rural Africa where, instead of building costly-wired broadband networks, cellphone towers are installed, and cellphones are passed out to get a very rural community online.[166] However, once demand on these towers outgrows their throughput capabilities, then cellphone carriers have two options: to invest in more capable towers or to throttle the towers' users to keep demand pegged at the capabilities of the towers. As a result of the second option, the economy of the affected area will suffer because it will not be able to compete with other areas that have non-throttled access to broadband Internet. Rural America suffers the same fate when trying to compete with non-throttled, more capable urban broadband networks because jobs likely leave or do not even come to these rural areas.[167]

Hence, throttling and similar policies stifle innovation and infrastructural growth, which is a huge detriment to rural communities lacking adequate broadband access.[168] In fact, throttling is a way to settle with existing infrastructure to handle user capacity instead of building it up to meet consumer needs.[169] Moreover, since cellphone carriers would rather throttle in rural areas for business purposes (it is cheaper to throttle than to

163. *See 2015 Broadband Progress Report*, *supra* note 15, at 1457, ¶ 146; *see also 2014 Mobile Wireless Competition Report*, *supra* note 5, at 15405, ¶ 190 (explaining carriers claim broader service coverage area than actually provided).

164. *See 2014 Mobile Wireless Competition Report*, *supra* note 5, at 15405, ¶ 190.

165. *The National Broadband Plan*, *supra* note 14, at 136–37; *see also 2015 Broadband Progress Report*, *supra* note 15, at 1457, ¶ 146 (discussing quality of service and broadband deployment affecting broadband adoption rates).

166. *See* Amir Efrati, *Google to Fund, Develop Wireless Networks in Emerging Markets*, WALL ST. J. (May 24, 2013, 6:33 PM) http://www.wsj.com/articles/SB10001424127887323975004578503350402434918.

167. *See The National Broadband Plan*, *supra* note 14, at 136–37 (explaining the availability broadband gap); *see also supra* note 135 (showing the need for mobile broadband in many rural areas).

168. *See 2015 Open Internet Order*, *supra* note 11, at 5703-04, ¶ 223.

169. *See supra* notes 123–128.

invest in infrastructure),[170] the 2015 Open Internet Order's "no throttling" rule is especially good policy for rural America since throttling in these areas is not a "reasonable network management" practice necessary to avoid the applicability of the "no throttling" rule.[171]

B. In a United States with the "No Throttling" Rule in Effect

If the "no throttling" rule of the 2015 Open Internet Order were to remain unchanged and effective, then the pace of mobile broadband infrastructure development in the United States would likely quicken because the rule de-incentivizes the idea that throttling is easier than developing broadband infrastructure.[172] Consequently, the United States would prosper from all of its regions having adequate broadband access to sustain economic tranquility and from being able to compete at its full potential in the international arena.

Furthermore, the rule provides a balanced, beneficial situation for both consumers and mobile BIAS providers.[173] This rule permits one to imagine an America without throttling, where mobile BIAS providers implement policies that allow their customers to access the Internet at full speed regardless of the data plan they choose.[174] Accordingly, to ensure that their customers have this full access, they are incentivized to develop mobile broadband infrastructure and create better policies to manage networks

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170. *Id.*

171. *See supra* notes 56–57 and accompanying text (presenting the "no throttling" rule and its exception); *see also 2015 Open Internet Order*, *supra* note 11, at 5653, ¶ 124 ("We emphasize, however, that to be eligible for consideration under the reasonable network management exception, a network management practice that would otherwise violate the no-throttling rule must be used reasonably and primarily for network management purposes, and not for business purposes.").

172. *See 2015 Open Internet Order*, *supra* note 11, at 5700, ¶ 216; *see also* Marc S. Martin, Janis Claire Kestenbaum, and Brendon P. Fowler, *A Closer Look At FCC's $100M AT&T Penalty*, LAW360 (July 7, 2015, 10:10 AM) http://www.law360.com/articles/675909/a-closer-look-at-fcc-s-100m-at-t-penalty ("[T]he language used in the [notice of apparent liability] suggests that the FCC's [proposed $100 million penalty against AT&T] is not merely guided by a neutral mathematical calculation but by broader policy objectives.").

173. *See 2015 Open Internet Order*, *supra* note 11, at 5703, ¶ 223 ("We believe that the reasonable network management exception provides . . . mobile broadband providers sufficient flexibility to manage their networks. We recognize . . . that the additional challenges involved in mobile broadband network management [as compared to fixed broadband] mean that mobile broadband providers may have a greater need to apply network management practices . . . to balance supply and demand while accommodating mobility.").

174. *See id.* at 5663, ¶ 142 ("As the *Verizon* court recognized, Internet openness drives a 'virtuous cycle' in which innovations at the edges of the network enhance consumer demand, leading to expanded investments in broadband infrastructure that, in turn, spark new innovations at the edge.").

without consumer disadvantages like targeting and throttling unlimited data users.[175]

CONCLUSION

Throttling—a popular way for cellphone carriers to manage their networks by slowing down their users—is prohibited by the 2015 Open Internet Order's "no throttling" rule. Considering that the rule is supported by judicial precedent and is within the FCC's regulatory jurisdiction, it is likely to survive judicial review. Moreover, targeting and throttling unlimited data users is not a "reasonable network management" practice but a practice prohibited by the "no throttling" rule. Therefore, the "no throttling" rule should remain unchanged and effective because it protects unlimited data plan users and promotes growth and development of broadband infrastructure, especially in rural areas.

175. *See id.*

THE ANTI-SPOOFING STATUTE: VAGUE AS APPLIED TO THE "HYPOTHETICALLY LEGITIMATE TRADER"

CATRIONA COPPLER*

New technology has made it easier for commodity traders to place larger trades faster. However, this rise in high frequency trading has resulted in an increase in market manipulation tactics. Recently, many traders have adopted manipulative strategies such as spoofing. Spoofing involves placing an order with intent to cancel the order before execution. Armed with the new anti-spoofing statute in the 2010 Dodd-Frank Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the government has cracked down on all trading activity that "is, is of the character of, or is commonly known to the trade as 'spoofing.'" However, as the number of spoofing cases increase, many traders still fear that the anti-spoofing statute is impermissibly vague. Specifically, the broad-blanket provision that prohibits trading that "is of the character of" spoofing could encompass many legitimate trading activities. Additionally, the definition of spoofing itself is problematic because it does not explicitly state when the intent to cancel the order must arise.

In the first criminal spoofing case, United States v. Coscia, *a district court held that the anti-spoofing statute was not impermissibly vague as applied to the defendant. This new precedent established that spoofing is not impermissibly vague in specific situations in which the intent to cancel is clearly manifest. In light of this decision, this Comment explores whether there are still situations in which the anti-spoofing statute remains impermissibly vague.*

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This Comment begins by exploring the history of spoofing and the birth of the anti-spoofing statute. In doing so, it examines the impact that spoofing has on financial markets and business in general. It then explores those situations in which the anti-spoofing statute may still be considered impermissibly vague and recommends that the "is of the character of" language of the anti-spoofing statute be removed and that a new definition of spoofing be adopted.

INTRODUCTION

The launch of the world's first electronic securities market in 1969 marked the beginning of the transition to electronic markets.[1] Since that time, more markets have become electronic, and technology has vastly

1. Adam Adler, *High Frequency Regulation: A New Model for Market Monitoring*, 39 VT. L. REV. 161, 163 (2014).

improved. Every day, billions of trades are being placed worldwide through algorithmic computer trading programs.[2] As a result, traders seek to gain the upper hand by creating more sophisticated and faster computer programs to not only collect and analyze market data but also to place large trades at speeds that were once inconceivable. No longer does it take over a week to complete a trade; today, one can conduct a trade in as little as ten microseconds.[3]

Unfortunately, as is the case with most technological innovation, these computer programs not only facilitate high frequency trading ("HFT"), but they also enable abusive trading practices.[4] In fact, many HFT strategies rely on market manipulation.[5] One such form of market manipulation thrust into the spotlight as a result of HFT is spoofing.[6] Regulators have taken note and warn that they will not tolerate spoofing.[7]

The Commodity Exchange Act ("CEA") defines spoofing as "bidding or offering with the intent to cancel the bid or offer before execution."[8] However, spoofing can most easily be explained through the following example.[9] In hypothetical Market A, the current market price is $10 per share. Trader C places an order in Market A to buy 100 shares at $9 per share. However, because this is below the current market price, no one is willing to sell at such a low price, and as a result, Trader C's order does not execute. But, this non-transaction is not the end of the story because Trader C is a seasoned trader and has a few (illegal) tricks up his sleeve.

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2. Andrew J. Keller, *Robocops: Regulating High Frequency Trading After the Flash Crash of 2010*, 73 OHIO ST. L.J. 1457, 1458 (2012) (stating algorithmic trading accounts for sixty to seventy percent of daily trades on today's U.S. financial exchanges); *see also* Adler, *supra* note 1, at 164 (stating markets today have a daily volume exceeding one billion orders).

3. Adler, *supra* note 1, at 163.

4. *Id.* at 167.

5. *Id.*

6. Matthew Leising, *Oystacher Gets a Second Spoofing Fine, This Time From ICE*, BLOOMBERG (June 9, 2015, 11:49 AM), http://www.bloomberg.com/news/articles/2015-06-09/igor-oystacher-gets-a-second-spoofing-fine-this-time-from-ice (explaining that spoofing has garnered new scrutiny as "lightning-fast electronic trading" makes it easier to spoof).

7. *See* Gregory Meyer, *CFTC Accuses 3Red Trading of 'Spoofing' Markets*, FIN. TIMES (Oct. 19, 2015, 7:02 PM), http://www.ft.com/intl/cms/s/0/cb98026a-767c-11e5-933d-efcdc3c11c89.html#axzz45R1RqIT4 (quoting Aitan Goelman, CFTC Director of Enforcement saying, "[s]poofing seriously threatens the integrity and stability of futures markets because it discourages legitimate market participants from trading. The CFTC is committed to prosecuting this conduct and is actively co-operating with regulators around the world in this endeavour").

8. 7 U.S.C. § 6c(a)(5)(C)(2014); *see also* Biremis Corp., Exchange Act Release No. 34-68456, 2012 WL 658720, at *2 (Dec. 18, 2012).

9. *See* Adler, *supra* note 1, at 171–72, for an additional example of spoofing.

Trader C places 500 sell orders at $10.01, which is just above the market price. Because this $10.01 order is above the market price, no buyers will fill the order. However, this increase in supply will ultimately result in decreased demand, which will cause the market price to drop.[10] This means that competitors will lower the price at which they are willing to sell shares from the previous market price of $10 to $9. Consequently, Trader C's initial buy order of one hundred shares at $9 will execute. Happy that he was able to successfully buy at such a low price, Trader C will then cancel the 500 sell orders, the market will correct itself, and the market price will return to $10 per share. If Trader C wants to be especially deceptive, he can then sell the 100 shares that he previously purchased for $9 per share at $10 per share, which would result in a profit of $100.

Spoofing is not a "vanishingly small or infrequent practice."[11] In fact, each week, numerous complaints are filed alleging spoofing trading practices.[12] The problem, however, is that the definition of spoofing is not clear.[13] Specifically, the mens rea requirement of "intent to cancel the bid or offer before execution" is problematic.[14] The inherent difficulty in proving intent, paired with the fact that almost ninety percent of trades are cancelled as a result of legal trade practices, could result in confusion and legal trading practices being mistaken for and classified as spoofing.[15] Due to the forecasted increase in enforcement actions against spoofers, this ambiguity in the anti-spoofing statute could lead to major problems.[16]

In the first criminal spoofing case, *United States v. Coscia*,[17] a district

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10. Adolph Lowe, *A Reconsideration of the Law of Supply and Demand*, 9 SOC. RES. 431, 433–434 (Nov. 1942).

11. Andrew M. Harris & Matthew Leising, *Market Manipulation Complaints Are Common But Prosecutions Rare*, BLOOMBERG (Apr. 23, 2015, 5:00 AM), http://www.bloomberg.com/news/articles/2015-04-23/market-manipulation-complaints-are-common-but-prosecutions-rare.

12. *Id.*

13. Def.'s Mot. to Dismiss Mem. at 7–8, United States v. Coscia, 100 F. Supp. 3d 653 (N.D. Ill. 2015) (No. 14 CR. 551, 2014 WL 11210343 [hereinafter "Coscia Mot. to Dismiss Mem."] (quoting CFTC roundtable participants. Gary Dewaal, General Counsel of Newedge USA LLC, stated that he was "not sure [i]f the definition of spoofing can be agreed upon by the ten people around [the] table." Similarly, Gregory Mocek, former-CFTC Director of Enforcement, asserted that he was "not quite sure [he knew] what spoofing [was].").

14. 7 U.S.C. § 6c(a)(5)(C) (2014).

15. *See* Jesse Westbrook, *SEC Weighs High-Frequency Trading Rules After Plunge*, BLOOMBERG (Sept, 7, 2010) http://www.bloomberg.com/news/articles/2010-09-07/sec-weighs-highfrequency-trading-rules-after-plunge-update1.

16. Joseph De Simone et al., *Expect Increasing Scrutiny of High-Frequency Trading*, LAW360 (June 4, 2014, 4:47 PM), http://www.law360.com/articles/544458/expect-increasing-scrutiny-of-high-frequency-trading; *see also* Geiger, *infra* note 72.

17. 100 F. Supp. 3d 653 (N.D. Ill. 2015).

court held that the anti-spoofing statute is not void for vagueness as applied to the defendant, Michael Coscia.[18] Coscia was convicted of six counts of spoofing for utilizing computer programs to place and then immediately cancel large orders to create a false impression of the number of contracts available and fraudulently induce others to react to the deceptive market information that he created.[19] However, what if there are some situations in which the spoofing statute is impermissibly vague? Is it possible that this vagueness could result in legal trading practices being mistaken for and classified as spoofing?

To answer these questions, this Comment will begin by offering a brief history of the anti-spoofing statute to show how it came to be what it is today. In doing so, it will explain exactly what spoofing is and its impact on not only financial markets but also on business as well. Next, this Comment will examine the situations in which the anti-spoofing statute may be considered impermissibly vague. To do this, it will first explain what constitutes impermissible vagueness and examine other criminal statutes that have been challenged as impermissibly vague. It will apply this analysis specifically to spoofing and argue that in the context of Fill or Kill ("FOK") orders and pinging, the anti-spoofing statute is impermissibly vague. In light of these problems, this Comment will recommend that the "is of the character of" spoofing provision of the anti-spoofing statute be removed and that Congress adopt a new definition for spoofing.

II. THE CREATION AND EVOLUTION OF THE ANTI-SPOOFING STATUTE AND WHY IT MATTERS

A. A Look Back in Time: Spoofing Pre-Dodd-Frank Act

Before the enactment of the Dodd-Frank Act, the U.S. Commodity Futures Trading Commission ("CFTC") penalized spoofing through two CEA provisions, Section 4c(a)(2)(B) and Section 9(a)(2).[20] Section 4c(a)(2)(B) made it unlawful to "offer to enter into, enter into, or confirm the execution of a transaction" that "is used to cause any price to be reported, registered, or recorded that is not a true and bona-fide price."[21]

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18. *Id.* at 656, 659.

19. *Id.* at 653–55.

20. D. Deniz Aktas, *Developments In Banking and Financial Law: 2013: X. Spoofing*, 33 REV. BANKING & FIN. L. 89 (2013); *see also* Matthew F. Kluchenek & Jacob L. Kahn, *Deterring Disruption in the Derivatives Markets: A Review of the CFTC's New Authority Over Disruptive Trading Practices*, HARV. BUS. L. REV. ONLINE, 120, 130–32 (2013), http://www.hblr.org/wp-content/uploads/2013/03/Kluchenek_Deterring-Disruption.pdf (arguing that pre-Dodd-Frank Act, spoofing did not have the clearest history of enforcement).

21. 7 U.S.C. § 6c(a) (2014).

Section 9(a)(2) prohibited a trader from causing the transmission of "false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce."[22]

For example, in *Bunge Global Markets*,[23] the government charged traders with entering orders for soybean futures contracts in the pre-open session[24] for the sole purpose of determining the depth of support for soybean futures at specific price levels.[25] While the court did not explicitly classify the trading activity as spoofing, it found that the traders clearly were attempting to spoof the market.[26] The traders entered electronic orders for soybean futures contracts with no intention of allowing the orders to be executed, and they ultimately cancelled them prior to open.[27] The traders moved the Indicative Opening Price[28] by entering orders above or below the prevailing bid or offer.[29] The court found that by placing these orders, the traders caused prices to be reported that were not "true and bona fide" in violation of Section 4c(a)(2)(B).[30] Furthermore, the traders violated Section 9(a)(2) because the orders constituted false, misleading, or knowingly inaccurate reports concerning market information that affected or tended to affect the price of soybeans.[31]

B. Spoofing Today

Congress enacted the Dodd-Frank Act in 2010.[32] The Dodd-Frank Act's

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22. *Id.*

23. CFTC No. 11-10, 2011 WL 1099346 (CFTC Mar. 22, 2011).

24. Pre-open session refers to the period of activity that occurs before the regular market session regularly begins. During this period, traders usually watch the market to determine which direction the market will move during the regular session. *Pre-Market*, INVESTOPEDIA, http://www.investopedia.com/terms/p/premarket.asp (last visited Apr. 3, 2016).

25. Bunge Global Markets, CFTC No. 11-10, 2011 WL 1099346, at *2–3.

26. *See id.*; *see also* Aktas, *supra* note 20, at 91; Clifford C. Histed, *A Look at the 1st Criminal 'Spoofing' Prosecution: Part 1*, LAW 360 n.17 (Apr. 20, 2015, 12:01 PM), http://www.law360.com/articles/645167/a-look-at-the-1st-criminal-spoofing-prosecution-part-1.

27. Bunge Global Markets, CFTC No. 11-10, 2011 WL 1099346, *1, *3–5.

28. The Indicative Opening Price is the "probable price at which the market will open or re-open, given the current book and order activity," which is calculated based on orders in the book during the pre-open session. *Indicative Opening Price*, CME GROUP, http://www.cmegroup.com/confluence/display/EPICSANDBOX/Indicative+Opening+Price (last visited Apr. 3, 2016).

29. Bunge Global Markets, CFTC No. 11-10, 2011 WL 1099346, *3.

30. *Id.* at *8.

31. *Id.* at *9.

32. Aktas, *supra* note 20, at 89; Histed, *supra* note 26, at 3 (stating the Dodd-Frank Act became effective in July 2011).

primary function was to introduce various new reforms for regulating the financial industry and to create new federal crimes related to fraud and misrepresentation made by individuals engaging in derivatives trading, futures contracts, and swaps.[33] Specifically, the Dodd-Frank Act amended Section 4c(a) of the CEA to add three types of prohibited transactions that were "disruptive of fair and equitable trading."[34] These additions gave the CFTC a "bigger arsenal of weapons" to fight disruptive trading practices.[35] Included in this "arsenal" is the anti-spoofing statute.[36] This statute prohibits individuals from engaging in any conduct that "is, is of the character of, or is commonly known to the trade as, 'spoofing'."[37]

However, the new anti-spoofing statute gave birth to confusion and fear that the anti-spoofing statute would capture legal trading behavior.[38] As a result, in 2013, the CFTC offered guidance on which activities it would classify as spoofing.[39] The CFTC emphasized that "legitimate, good-faith cancellation or modification of orders" would not constitute spoofing.[40] It then provided four specific examples of acts that would constitute spoofing, including

(i) Submitting or cancelling bids or offers to overload the quotation system of a registered entity;
(ii) Submitting or cancelling bids or offers to delay another person's execution of trades;
(iii) Submitting or cancelling multiple bids or offers to create an appearance of false market depth; and
(iv) Submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards.[41]

The CFTC stated that to distinguish between legitimate trading and spoofing, it would examine the market context, the person's trading

33. Jennifer G. Chawla, Comment, *Criminal Accountability and Wall Street Executives: Why the Criminal Provisions of the Dodd-Frank Act Fall Short*, 44 SETON HALL L. REV. 937, 951 (2014).

34. Kluchenek, *supra* note 20, at 120.

35. *Id.* (internal quotation and citation omitted); *see also* Matthew Leising, *Market Cops Got Power to Pursue Spoofers After Years of Failure*, BLOOMBERG (May 14, 2015, 5:00 AM), http://www.bloomberg.com/news/articles/2015-05-14/market-cops-got-power-to-pursue-spoofers-after-years-of-failure (quoting former CFTC Commissioner Jill Sommers saying that "[e]veryone on the commission, including myself, agreed we needed broader authority in this area" . . . [the goal was] "to not have such a high bar when it came to proving manipulation").

36. *See* Kluchenek, *supra* note 20.

37. 7 U.S.C. § 6c(a)(5)(C) (2014).

38. *See* Antidisruptive Practices Authority, 78 Fed. Reg. 31890, 31896 (May 28, 2013).

39. *See generally id.*

40. *Id.* at 31896.

41. *Id.*

activity, and other relevant facts and circumstances.[42] It is also interesting to note that the CEA does not require a pattern of activity; rather, a single instance of trading activity can violate the CEA so long as that "activity is conducted with the prohibited intent."[43]

C. The First Criminal Spoofing Conviction: United States v. Coscia

Michael Coscia began his career as a commodity futures trader in 1998 and, since 2007, has served as the principal of Panther Energy Trading LLC ("Panther").[44] In 2011, Coscia "developed and implemented a HFT strategy that allowed him to enter and cancel large-volume orders in a matter of milliseconds."[45] Coscia used this strategy to create a "false impression regarding the number of contracts available in the market and fraudulently induce other market participants to react to the deceptive market information that he created."[46] As a result of this scheme, Coscia reaped approximately $1.5 million in profits in less than three months.[47]

The government charged Coscia under the anti-fraud provisions of the Fraud Enforcement and Recovery Act[48] and the anti-spoofing statute.[49] After unsuccessfully challenging the anti-spoofing statute for being too vague, the jury ultimately convicted Coscia of six counts of spoofing.[50]

D. Spoofing's Impact on Financial Markets and Business

On May 6, 2010, the E-mini Standard & Poor's ("E-mini S&P") market[51] dramatically plummeted, causing steep declines in other

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42. *Id.*

43. *Id.*

44. United States v. Coscia, 100 F. Supp. 3d 653, 654 (N.D. Ill. 2015).

45. *Id.* at 655.

46. *Id.*; *see also* Panther Energy Trading LLC, CFTC No. 13-26, 2013 WL 3817473, at *2–3 (July 22, 2013) (stating that Coscia's strategy sought to give the market the false impression that there was significant buying interest, which suggested that prices would soon rise, thus raising the likelihood that other market participants would buy the orders that Coscia was offering to sell); Brian Louis & Janan Hanna, *Swift Guilty Verdict in Spoofing Trial May Fuel New Prosecutions in U.S.*, BLOOMBERG BUS. (Nov. 3, 2015, 6:00 PM), http://www.bloomberg.com/news/articles/2015-11-03/commodities-trader-coscia-found-guilty-in-first-spoofing-trial.

47. *Coscia*, 100 F. Supp. 3d at 655.

48. *Id.*; *see also* 18 U.S.C. § 1348 (2014).

49. *Coscia*, 100 F. Supp. 3d at 653.

50. *Id.* at 653, 658–59; Louis, *supra* note 46.

51. The E-mini S&P is made of 500 individual stocks representing the market capitalizations of large companies and is the leading indicator of large-cap U.S. equities. *E-mini S&P 500 Futures Quotes*, CME GROUP, http://www.cmegroup.com/trading/equity-index/us-index/e-mini-sandp500.html (last visited Apr. 3, 2016).

markets.[52] The E-mini S&P market quickly declined three percent and another 1.7 percent after fifteen seconds elapsed.[53] Other markets suffered declines of approximately five to six percent with some suffering much larger declines.[54] In less than thirty minutes, $1 trillion of securities market values dissipated.[55] Luckily, the markets were able to quickly recover.[56]

After a short time, it became clear that the deceptive and fraudulent trading of one trader, Navidner Sarao, greatly contributed to this market decline.[57] The government accused Sarao of utilizing a manipulative scheme that involved numerous "aggressive" spoofing tactics, which helped to precipitate a multimillion-dollar plunge in the value of U.S. shares.[58] This event came to be known as the "Flash Crash" and serves as a warning of the devastating impact spoofing can have on markets.[59]

To understand why spoofing is so problematic, it is necessary to understand what futures markets are and why they exist. Futures markets are markets in which participants can buy and sell commodities and their future delivery contracts.[60] Futures contracts are agreements in which both parties agree to buy and sell a particular asset of specific quantity at a predetermined price.[61] Futures market prices are determined directly by hedger and speculator demand for and supply of these future markets.[62]

The two greatest benefits of futures markets are risk-shifting and price

52. Complaint at 8, CFTC v. Nav Sarao Futures Ltd., 1:15-CV-03398 (N.D. Ill. Apr. 17, 2015).

53. *Id.*

54. *Id.*

55. Hayden C. Holliman, Comment, *The Consolidated Audit Trial: An Overreaction to the Danger of Flash Crashes from High Frequency Trading*, 19 N.C. BANKING INST. 135, 135–36 (2015).

56. *See* Complaint, *supra* note 52, at 8; *see also* Charles R. Korsmo, *High-Frequency Trading: A Regulatory Strategy*, 48 U. RICH. L. REV. 523, 524–25 (2014).

57. Complaint, *supra* note 52, at 2.

58. *Id.*; *see also* Andrew Trotman, *'Flash Crash' Trader Navinder Singh Sarao Was Worried 'People Will Become Aware of What I am Doing'*, THE TELEGRAPH (Sept. 3, 2015, 11:55 PM), http://www.telegraph.co.uk/finance/financial-crime/11843059/Flash-crash-trader-Navinder-Singh-Sarao-was-worried-people-will-become-aware-of-what-I-am-doing.html.

59. *See* Korsmo, *supra* note 56, at 526–27 (comparing the "Flash Crash" to the "Black Monday" crash of October 19, 1987 in which markets fell more than twenty percent in a single day).

60. *Futures Market*, BUS. DICTIONARY, http://www.businessdictionary.com/definition/futures-market.html (last visited Oct. 12, 2015).

61. *Definition of 'Futures Contract'*, THE ECON. TIMES, http://economictimes.indiatimes.com/definition/futures-contract (last visited Oct. 12, 2015).

62. Anne E. Peck, *Futures Markets, Supply Response, and Price Stability*, 90 THE Q. J. OF ECON., 407, 409 (1976).

discovery.[63] Risk-shifting occurs when a hedger uses futures contracts to shift the price of a risk to another.[64] This risk arises because producers have no way of knowing with certainty at the time they plant crops what price they will receive for those crops at harvest time.[65] Futures markets help to eliminate this risk by allowing producers to sell output at a price fixed in advance.[66] This opportunity to "hedge" increases social welfare by enabling a more optimal allocation of risk.[67]

Price discovery on the other hand is defined as "the use of futures prices to determine expectations of (future) cash market prices."[68] Price discovery facilitates the allocation of resources by providing a basis for producers' production plans and users' consumption plans.[69] Price discovery therefore helps inform those individuals making production, storage, and processing decisions.[70]

Spoofing is problematic for two reasons. First, spoofing creates artificial market conditions that benefit the individual spoofer's interests while harming other market participants.[71] These artificial market conditions include false prices, demand and output.[72] Spoofers create artificial demand when they feign interest in buying or selling at a certain price.[73] This artificial demand causes other traders to move the market in a way that is favorable to the spoofer, which results in artificial prices in that market.[74] Artificial prices interfere with the ability of futures markets to provide a

63. Linda N. Edwards & Franklin R. Edwards, *A Legal and Economic Analysis of Manipulation in Futures Markets*, 4 J. OF FUTURES MARKETS 333, 344 (1984).

64. Kenneth D. Garbade & William Silber, *Price Movements and Price Discovery in Futures and Cash Markets*, 65 THE REV. OF ECON. & STAT. 289 (1983).

65. Edwards & Edwards, *supra* note 63, at 344.

66. *Id.*

67. *Id.* at 345.

68. Jian Yang et al., *Asset Storability and Price Discovery in Commodity Futures Markets: A New Look*, 21 J. FUTURES MKTS. 279, 280 (2001).

69. Edwards & Edwards, *supra* note 63, at 345.

70. Yang et. al., *supra* note 68, at 280.

71. Aktas, *supra* note 20.

72. Keri Geiger, *How Spoofing Contributed to the 2010 Flash Crash*, BLOOMBERG BUS. (Apr. 22, 2015, 8:57 AM), http://www.bloomberg.com/news/videos/2015-04-22/how-spoofing-caused-the-2010-flash-crash.

73. *China Market Manipulation Probe Targets Spoofers After Crash*, BLOOMBERG (July 30, 2015, 10:33 PM), http://www.bloomberg.com/news/articles/2015-07-31/china-targets-spoofing-in-latest-crackdown-on-stock-manipulation [hereinafter "*China Market*"].

74. *Id. But see* Edwards & Edwards, *supra* note 63, at 348 (noting welfare losses may not be very substantial because (1) artificial prices rarely last long and (2) people using futures prices for planning purposes typically plan for a broader period of time, which means it is unlikely artificial prices would be used for planning purposes).

useful price discovery tool.[75] When prices are incorrect, producers and users of futures markets cannot accurately predict future prices.[76] As a result, businesses are unable to make correct managerial decisions.[77]

Second, spoofing undermines confidence in the market.[78] Spoofing may affect the public's perception of the fairness of futures markets.[79] This false confidence-boosting could result in traders weighing the potential losses due to a manipulated market far more heavily than the possible gains from being on the right side of the manipulation.[80] As a result of this cost-benefit analysis, traders might have more incentive to not participate in the futures markets at all.[81] In fact, in China, many hypothesize that recent declines in Chinese stocks are in part a result of increased spoofing and market manipulation practices.[82] Decreased market participation could serve to lower the liquidity, meaning that the futures markets would find it more difficult to facilitate the purchase or sale of assets without causing drastic changes in that asset's price.[83]

If investors lose faith in the markets, they will take business overseas.[84]

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75. *Id.*; *see* Keller, *supra* note 2, at 1466 (stating that there is little incentive to risk capital in markets where pricing is uncertain).

76. Edwards & Edwards, *supra* note 63, at 346–48; *see also* Bradley Hope, *As 'Spoof' Trading Persists, Regulators Clamp Down*, WALL ST. J. (Feb. 22, 2015, 10:34 PM), http://www.wsj.com/articles/how-spoofing-traders-dupe-markets-1424662202 (quoting Benjamin Blander, a managing member of a Chicago trading firm. He stated that "spoofing is extremely toxic for the markets . . . [and that] [a]nything that distorts the accuracy of prices is stealing money away from the correct allocation of resources.").

77. Edwards & Edwards, *supra* note 63, at 346–48.

78. *See* Keller, *supra* note 2, at 1476 (emphasizing that HFT impacts investors' confidence in the markets' ability to provide accurate pricing information and causes the public to perceive HFT as propagating a rigged game).

79. Edwards & Edwards, *supra* note 63, at 350; *see also* Matt Levine, *Regulators Bring a Strange Spoofing Case*, BLOOMBERG VIEW (Oct. 21, 2015, 4:48 PM), http://www.bloombergview.com/articles/2015-10-21/regulators-bring-a-strange-spoofing-case (explaining that people begin doubting their ability to make money when they are often caught on the wrong side of a trade).

80. Edwards & Edwards, *supra* note 63, at 350.

81. *Id.*; Brooksley E. Born et al., *Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010: Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues* 3 (Feb. 18, 2011), http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/jacreport_021811.pdf.

82. *China Market*, *supra* note 73 (stating that while spoofing may have contributed to recent declines in Chinese stocks, the main cause is probably a pullback by leveraged investors).

83. Edwards & Edwards, *supra* note 63, at 350–51.

84. Portia Crowe, *Traders Have Been 'Spoofing' the Market and Now Regulators are Finally Catching on*, BUS. INSIDER (Apr. 21, 2015, 4:13 PM), http://www.businessinsider.com/what-is-spoofing-the-market-2015-4.

The relocation of businesses overseas is problematic because investments in financial markets increase the amount of capital in the economy of the country where it is invested.[85] When capital increases, labor productivity and Gross Domestic Product ("GDP") also increase.[86] An increased GDP results in rising output, which in turn results in higher wages and increased employment.[87] Simply put, investment in financial markets results in an increase in labor, productivity, income, and employment.[88] If investors lose faith in U.S. markets, they will take their business elsewhere. There would be a decrease in capital and, in turn, result in decreased GDP, which means less labor, productivity, income, and employment.[89] In other words, if people lose faith and exit U.S. markets, the economy will suffer.[90]

III. THE ANTI-SPOOFING STATUTE IS STILL IMPERMISSIBLY VAGUE IN MANY CONTEXTS

A. The Void for Vagueness Doctrine

The First Amendment and the Due Process Clause of the Fourteenth Amendment provide avenues for anyone to challenge "vague" laws.[91] A law can be void for vagueness if it "fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement."[92] The "void for vagueness" doctrine helps prevent innocent people from becoming trapped by laws that do not provide fair warning.[93] The Constitution does not permit Congress to "set a net large enough to catch all possible offenders, and [it] leave[s] it to the courts to step inside and say

85. Mack Ott, *Foreign Investment in the United States*, CONCISE ENCYCLOPEDIA OF ECON., http://www.econlib.org/library/Enc1/ForeignInvestmentintheUnitedStates.html (last visited Jan. 24, 2016) (stating that capital includes equipment, buildings, land, patents, copyrights, trademarks, and goodwill).

86. *Id.*

87. *Id.* (explaining that approximately two-thirds of GDP goes to labor as wages, salaries, and fringe benefits).

88. *Id.*

89. *See id.* (explaining the benefits of foreign investments on the host economy).

90. *See id.*

91. Elisabeth M. Gillooly, Comment, Larouche v. Kezer: *A Cursory Look at Connecticut's Hopelessly Vague Media Recognition Statute*, 15 QUINNIPIAC L. REV. 269, 279–80 (1995).

92. Cristina D. Lockwood, *Defining Indefiniteness: Suggested Revisions to the Void for Vagueness Doctrine*, 8 CARDOZO PUB. L. POL'Y & ETHICS J. 255, 257 (2010) (citing United States v. Williams, 553 U.S. 285, 304 (2008)).

93. Robert H. Wright, *Today's Scandal Can be Tomorrow's Vogue: Why Section 2(a) of the Lanham Act is Unconstitutionally Void for Vagueness*, 48 HOW. L.J. 659, 664 (2005) (citing Grayned v. City of Rockford, 408 U.S. 104, 108–09 (1972)).

who could be rightfully detained, and who should be set at large."[94]

However, when the government must prove intent, these requirements "do much to destroy any force in the argument that application of the [statute] would be so unfair that it must be held invalid."[95] A requirement of scienter mitigates a statute's vagueness by ensuring that only those aware of their unlawful conduct face punishment.[96] That is not to say that it is impossible to raise such a challenge when the government must prove intent; rather, there is just an especially heavy burden to succeed on such challenges.[97]

One must examine vagueness challenges to statutes that do not involve First Amendment freedoms in the light of facts of the case at hand.[98] The following cases examine situations in which statutes have succeeded under the void for vagueness doctrine.

i. Statutes Deemed Impermissibly Vague

Courts have held that statutes are impermissibly vague when there is no clear definition of the proscribed conduct.[99] For example, in *Stoller v. CFTC*,[100] the government charged Stoller with placing virtually simultaneous sale and repurchase transactions at substantially the same price.[101] The CFTC alleged that these trades constituted "wash sales" that fell within the prohibitory language of Section 4c(a)(2)(A) of the CEA.[102] The court held that the statute was impermissibly vague because the term "wash sale" was not defined in the CEA, in any applicable regulations, or in any interpretive releases.[103]

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94. United States v. Coscia, 100 F. Supp. 3d 653, 657 (N.D. Ill. 2015) (citing Chicago v. Morales, 527 U.S. 41, 60 (1999)).

95. United States v. Cherry, 938 F.2d 748, 754 (7th Cir. 1991) (internal quotations omitted).

96. United States v. Gaudreau, 860 F.2d 357, 360 (10th Cir. 1988).

97. *See, e.g.*, Kramer v. Price, 712 F.2d 174 (5th Cir. 1983) (finding the statute to be impermissibly vague despite the fact that the statue had an intent requirement).

98. United States v. Mazurie, 419 U.S. 544, 550 (1975); *accord Coscia,* 100 F. Supp. 3d at 658 (citing Chicago v. Morales, 527 U.S. 41, 60 (1999)) ("Because First Amendment rights are not at stake, the Court must assess whether the statute is unconstitutional as applied to Coscia's conduct . . . [and] not to the conduct of the 'hypothetically legitimate traders' who voiced concerns about the [anti-spoofing] statute's applicability . . . .").

99. *See generally* Stoller v. CFTC, 834 F.2d 262 (2d Cir. 1987).

100. *Id.*

101. *Id.* at 264.

102. *Id.* at 262–63; *see also* 7 U.S.C. § 6c(a)(2)(A) (2014) (prohibiting a transaction that "is, of the character of, or is commonly known to the trade as, a 'wash sale' or 'accommodation trade,' or is a fictitious sale").

103. *Stoller*, 834 F.2d at 265 (citing 7 U.S.C. § 6c(a)(2)(A)(i)) (stating that a transaction that "is, of the character or, or is commonly known . . . as, a 'wash sale'" is

Additionally, when statutes are not so well defined that they can be interpreted to encompass other acts, courts have also found those statutes to be impermissibly vague.[104] In *Balthazar v. Superior Court of Massachusetts*,[105] the court held that a Massachusetts law prohibiting "unnatural and lascivious acts" was impermissibly vague in the context of the fellatio and oral-anal contact that the petitioner was alleged to have had.[106] The court held that there was a diversity of conduct that could conceivably fall under the terms "unnatural" and "lascivious."[107] Additionally, because there are acts that are less natural and more universally condemned than the acts of the petitioner, the petitioner could have reasonably believed that the statute was aimed at acts other than his own.[108] As a result, the court found that this statute was vague as applied to the petitioner.[109]

When the language of a statute itself is not obviously unclear, a statute may still be impermissibly vague if it does not provide a standard for enforcement.[110] In *Chicago v. Morales*,[111] the court found an ordinance—that prohibited criminal street gang members from loitering with one another or with another person in any public place— to be impermissibly vague.[112] The court stated that the uncertainty did not arise because of the

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prohibited and not providing an actual definition of wash sale); *see also* D.C. v. City of St. Louis, 795 F.2d 652 (8th Cir. 1986) (finding an ordinance that prohibited cross-dressing and indecent or lewd conduct to be impermissibly vague because the language was too vague to enforce when the ordinance did not define those words, and decisions of Missouri state courts failed to constitute narrow judicial interpretation).

104. *See generally* Balthazar v. Superior Court of Mass., 573 F.2d 698 (1st Cir. 1978); *see also* Coates v. City of Cincinnati, 402 U.S. 611, 621 (1971) (holding that the ordinance was impermissibly vague when it was so imprecise that no standard of conduct was specified and that it therefore encompassed many types of conduct).

105. 573 F.2d 698 (1st Cir. 1978).

106. MASS. GEN. LAWS ANN. Ch. 272, § 35 (West 2016) ("Whoever commits any unnatural and lascivious act with another person shall be punished by a fine . . . or by imprisonment."); *see also Balthazar*, 573 F.2d at 699 (stating the principal witness testified that she performed "an act of fellatio and put her tongue on petitioner's backside").

107. *Balthazar*, 573 F.2d at 701.

108. *Id.* (providing the example of "a range of sado-masochistic behavior").

109. *Id.* at 702.

110. *See* Chicago v. Morales, 527 U.S. 41, 54 (1999); *see also* Cunney v. Bd. of Tr. of Grand View, 660 F.3d 612, 622 (2d Cir. 2011) (finding a zoning law impermissibly vague when the law clearly demonstrated that a reasonable enforcement officer could interpret the law differently, and, as a result, the law provided enforcement officers with the "unfettered latitude" in making compliance determinations).

111. 527 U.S. 41 (1999).

112. *Id.* at 45–46; *see also* Chicago Municipal Code § 8-4-015 (1992) (stating that whenever a police officer reasonably believes a criminal street gang member is loitering in a public place, the police officer should order him or her to disperse and that if the gang member fails to comply, he or she will be in violation of the ordinance).

normal meaning of "loitering" but rather which loitering the ordinance covered.[113] The court held that the statute failed to distinguish between innocent conduct and conduct threatening harm.[114] Therefore, the ordinance was vague "not in the sense that it require[d] a person to conform his conduct to an imprecise but comprehensible normative standard, but rather in the sense that no standard of conduct [had been] specified at all."[115] As a result, the ordinance provided police officers with absolute discretion to determine which activities constitute loitering.[116]

In cases in which the government must prove intent, it is much more difficult to succeed on a vagueness challenge.[117] However, in two cases, courts held the statutes were impermissibly vague despite the fact that the statutes had an intent requirement. In *Kramer v. Price*,[118] the court held that the intent element did not save a statute from vagueness when both the conduct that must be motivated by intent and the standard by which that conduct also remains vague.[119] Similarly, in *Record Head Corp. v. Sachan*,[120] an action for declaratory and injunctive relief, the court held a drug paraphernalia ordinance with an intent requirement to be impermissibly vague.[121] While the ordinance enumerated various factors one should consider, none of those factors helped to define the necessary intent.[122] Further, the factors, which were both "general and unweighted," seemed to exacerbate the vagueness by inviting inquiry into areas of doubtful relevance rather than making the prohibited conduct any more

113. *Morales*, 527 U.S. at 57 (explaining that the definition of loitering in this ordinance is "to remain in any one place with no apparent purpose" and asking how a person was to know if he or she had an "apparent purpose").

114. *Id.*

115. *Id.*

116. *Id.* at 61, 71 (Breyer, J., concurring) ("The ordinance is unconstitutional, not because a policeman applied this discretion wisely or poorly in a particular case, but rather because the policeman enjoys too much discretion in every case. And if every application of the ordinance represents an exercise of unlimited discretion, then the ordinance is invalid in all its applications."); *see also* Hunt v. City of L.A., 638 F.3d 703, 712 (9th Cir. 2011) (holding the statute impermissibly vague when it lacked clear guidance and left determinations to the subject judgment of police officers).

117. *See* United States v. Gaudreau, 860 F.2d 357, 360 (10th Cir. 1988).

118. 712 F.2d 174, 178 (5th Cir. 1983) (finding Texas Harassment Statute, Tex. Penal Code Ann. § 42.07 to be impermissibly vague because it did not construe the terms "annoy" and "alarm" in a manner that lessened those words' inherent vagueness).

119. *Id.* at 178 (holding that whatever the petitioner's intent may have been, if she was unable to determine the underlying conduct proscribed by the statute, the statute was impermissibly vague).

120. 682 F.2d 672 (7th Cir. 1982).

121. *Id.* at 678.

122. *Id.* at 677.

clear.[123]

ii. The Rule of Lenity

When a criminal statute is ambiguous, the rule of lenity requires courts to resolve the ambiguity in favor of the defendant.[124] It is a tool of statutory construction, which means that it "is to be used [only] to choose between possible meanings if a statute is ambiguous, not to determine whether the statute is ambiguous in the first place."[125] The rule of lenity provides that (1) fair warning shall be given to the public about what constitutes a crime and (2) legislatures, and not courts, should define criminal activity.[126]

The touchstone of the rule of lenity is "statutory ambiguity."[127] Under this rule, a statute is not ambiguous merely because it is possible to articulate a construction narrower than the articulation the government urges.[128] Rather, courts reserve lenity "for those situations in which a reasonable doubt persists about a statute's intended scope even *after* resorting to" an analysis of the "language and structure, legislative history, and motivating policies of that statute."[129]

In *United States v. Thompson/Center Arms Co.*,[130] the court applied the rule of lenity to resolve an ambiguity in the term "making" a firearm.[131] The National Firearms Act ("NFA") provided that the term "make" included manufacturing, putting together, altering, or otherwise producing a firearm.[132] However, the provision did not expressly address the question of whether a rifle could be made by the aggregation of finished parts that

123. *Id.*

124. Whitman v. United States, 135 S. Ct. 352, 353 (2014); Elliot Greenfield, *A Lenity Exception to Chevron Deference*, 58 BAYLOR L. REV. 1, 10 (2006) ("The rule of lenity complements the vagueness doctrine by providing that when a criminal statute is ambiguous, rather than vague, courts should resolve the ambiguity in the favor of the narrower scope of criminal liability.").

125. Greenfield, *supra* note 124, at 14.

126. United States v. Bass, 404 U.S. 336, 348 (1971); *see also id.*, at 12 ("It is the legislature, not the Court, which is to define a crime, and ordain its punishment.").

127. Moskal v. United States, 498 U.S. 103, 109 (1990) (internal quotations and citations omitted).

128. *Id.* at 103; *see also* Greenfield, *supra* note 124, at 15 (stating the rule of lenity is only applicable if there is "grievous ambiguity or uncertainty") (internal quotations and citations omitted).

129. *Moskal*, 498 U.S. at 109 (internal quotations omitted) (quoting Bifulco v. United States, 447 U.S. 381, 387 (1980)); *see also* United States v. Granderson, 511 U.S. 39, 54 (1994) (applying the rule of lenity when the "text, structure, and history" failed to establish that the government's position was unambiguously correct).

130. 504 U.S. 505 (1992).

131. *Id.* at 518.

132. *Id.* at 509.

one could readily assemble into a rifle.[133] The court rejected the government's interpretation—that assembly is not necessary—in favor of the defendant's construction that assembly was required.[134] In reaching this decision, the court examined the language and structure of the statute, congressional intent, and legislative history.[135]

In the context of spoofing, if the anti-spoofing statute is found to be impermissibly vague, courts will most likely apply the rule of lenity.[136] Otherwise, the broad anti- spoofing statute would not provide the defendant notice of the charges against him or her.[137] To reduce the error, courts would adopt a narrower definition of spoofing to the benefit of the defendant.[138]

iii. Void for Vagueness Doctrine, the Rule of Lenity, and Coscia

In determining whether the anti-spoofing statute was impermissibly vague, the court in *Coscia* undertook a similar analysis to those described above.[139] Because the anti-spoofing statute includes a definition of spoofing, the court easily distinguished this case from *Stoller*.[140] The court attempted to prove that the anti-spoofing statute does not encompass other activities by distinguishing spoofing from FOK orders and partial fill orders.[141]

The court, however, did not consider the issue of whether the statute provided a clear standard for enforcement.[142] The court bypassed this step because, in its view, it was clear that Coscia entered the orders with intent

133. *Id.*

134. *Id.* at 510–18.

135. *See id.* at 513–17.

136. *But see The New Rule of Lenity*, 119 HARV. L. REV. 2420, 2420 (2006) (explaining that the rule of lenity has been applied inconsistently, randomly, or not at all).

137. *See* ELLEN S. PODGOR ET AL., WHITE COLLAR CRIME HORNBOOK SERIES: THE RULE OF LENITY 17 (1st ed. 2013) ("A rationale for using the rule of lenity is that a defendant should be provided with due process (notice) of the charges against him or her.").

138. *Id.*

139. *See* United States v. Coscia, 100 F. Supp. 3d 653, 656–59 (N.D. Ill. 2015) (determining whether the anti-spoofing statute was vague as applied to Coscia).

140. *Compare id.* at 658–59 (anti-spoofing statute contained a definition of spoofing), *with* Stoller v. CFTC, 834 F.2d 262, 265 (2d Cir. 1987) (noting that the CEA does not contain a definition of "wash sale").

141. *Compare Coscia*, 100 F. Supp. 3d at 658 (ruling that spoofing does not encompass other trading activities), *with* Balthazar v. Superior Court of Mass., 573 F.2d 698 (1st Cir. 1978) (holding that the law was impermissibly vague because it was not defined well enough that it could be interpreted to encompass other acts).

142. *See Coscia*, 100 F. Supp. 3d at 658.

to cancel.[143] This intent was apparent because Coscia frequently entered and cancelled large-volume orders in a matter of milliseconds.[144] Furthermore, Coscia enlisted the help of a computer programmer to design two computer programs, which helped him detect the conditions in which his strategy would work best.[145] The court inferred from these trading patterns and computer programs that Coscia placed orders with the intent to cancel.[146] The court, therefore, did not have to consider the issue of enforcement because "[a] plaintiff who engages in some conduct that is clearly proscribed cannot complain of the vagueness of the law as applied to the conduct of others."[147]

The court also did not apply the rule of lenity.[148] However, this non-application is not clearly erroneous as courts often inconsistently or randomly apply the rule of lenity, if they apply it at all.[149] Furthermore, the rule of lenity applies only when a statute is ambiguous and, in *Coscia*, the court found the statute to be unambiguous.[150]

Assuming that the court in this instance was correct, are there other instances in which courts may find the anti-spoofing statute impermissibly vague? To answer this question, the following section will consider situations of the "hypothetical legitimate trader[s]" referenced in *Coscia*.[151] As demonstrated below, there are many instances in which courts may find this anti-spoofing statute impermissibly vague.

B. How the Anti-Spoofing Statute is Impermissibly Vague

The anti-spoofing statute is problematic for four reasons. First, it makes illegal any conduct that "is, is of the character of, or is commonly known to

143. *Id.* at 659.

144. *Id.* at 655; *see also* Panther Energy Trading LLC, CFTC No. 13-26, 2013 WL 3817473, at *2 (July 22, 2013) ("In some instances, [Coscia] utilized the spoofing algorithm hundreds of times in an individual futures contract in a single day.").

145. The two programs were "Flash Trader" and "Quote Trader." *Coscia*, 100 F. Supp. 3d at 655.

146. *See id.* at 658.

147. *Id.* (quoting Vill. Of Hoffman Estates v. Flipside, 455 U.S. 489, 495 (1982)).

148. *See id.* at 655 (finding that the anti-spoofing statute was not vague in the first place).

149. *See The New Rule of Lenity*, *supra* note 136, at 2420 (explaining that courts apply lenity inconsistently, randomly, or not at all).

150. *See Coscia*, 100 F. Supp. 3d at 659 (holding that the anti-spoofing statute is not vague); Moskal v. United States, 498 U.S. 103, 108 (1990) (declining to apply the rule of lenity when the statute unambiguously applied to the petitioner's conduct); *see also* McElroy v. United States, 455 U.S. 642, 658 (1982) (refusing to apply the rule of lenity when the present case did not raise significant questions of ambiguity).

151. *Coscia*, 100 F. Supp. 3d at 658.

the trade as 'spoofing'."[152] However, the statute itself does not state exactly what is "of the character of" spoofing.[153] As a result, this statutory silence could arguably indicate that many legal trading activities could fall under the ambit of the anti-spoofing statute or that enforcers would have the broad discretion of determining which conduct constitutes spoofing.[154]

Second, the definition of spoofing itself is vague.[155] There is no accepted meaning of spoofing in the futures markets.[156] As a result, regulators can give the term any meaning.[157] Without a clear definition, there cannot be a "clear line between lawful and unlawful activity[,]" which means that an innocent trader cannot know exactly what conduct actually constitutes spoofing.[158]

Additionally, the statute does not specify whether the intent to cancel is required to be present at the time the original order was placed.[159] The anti-spoofing statute merely states that there must be "intent to cancel the bid or offer *before* execution."[160] In *Coscia*, the intent to cancel was present at the

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152. 7 U.S.C. § 6c(a)(5)(C) (2014).

153. *See id.*

154. *See* Ronald Filler & Jerry W. Markham, *The Flash Crash Case Against Sarao-Will the CFTC Prevail?*, FUTURES & DERIVATIVES L. REP. Winter 2015, at 48 ("[S]poofing in the context of cancelling orders conflicts with other permitted market practices.").

155. Coscia Mot. to Dismiss Mem., *supra* note 13, at 10–11 (citing the CFTC Open Meeting on the Twelfth Series of Proposed Rulemakings Under the Dodd-Frank Act 12 (Feb. 24, 2011)) (quoting former-Commissioner Jill Sommers stating, "[w]hen the draft language of [the provision] was first discussed among Commission staff, it was my view and the view of others [at the CFTC] that *the language was too vague*" and former Commissioner Scott O'Malia referring to the statutory prohibitions as "admittedly vague").

156. Kenneth W. McCracken & Christine Schleppegrell, *The CFTC's Manipulative and Disruptive Trading Authority in an Algorithmic World*, FUTURES & DERIVATIVES L. REP. Winter 2015, at 8 (Apr. 2015).

157. Filler & Markham, *supra* note 154 (explaining the history of the definition of "spoofing").

158. *Id.*

159. Stacie R. Hartman et. al., *Navigating the Thicket of Disruptive Trading Prohibitions in the Commodity Exchange Act and Exchanges' Disciplinary Rules*, BANKING & FIN. SERVICES POL'Y REP. Apr. 2015, at 7–8. *But see* Bradley Hope & Aruna Viswanatha, *CFTC Charges 3Red with 'Spoofing' Scheme*, WALL ST. J. (Oct. 19, 2015, 7:39 PM), http://www.wsj.com/articles/cftc-charges-3red-with-spoofing-scheme-1445275381 (quoting David Miller, a former New York federal prosecutor who handled securities and commodities fraud cases, as saying, "[y]ou need to demonstrate the intent to cancel those bids and offers *immediately*") (emphasis added); Sohair Aguirre, et al., *New CME Rule on Disruptive Trading Practices Summary Chart*, JD SUPRA BUS. ADVISOR (Sept. 11, 2014), http://www.jdsupra.com/legalnews/new-cme-rule-on-disruptive-trading-pract-21883/ (noting that The Chicago Mercantile Exchange ("CME"), the world's leading derivatives marketplace, interprets spoofing to mean that the intent to cancel is present at the time the order is entered).

160. 7 U.S.C. § 6c(a)(5)(C) (2014) (emphasis added).

time the defendant placed his orders.[161] However, because the statute does not explicitly state that intent must be present when the order was initially placed, traders may be liable for spoofing if they initially place orders with the intent to execute, but in a matter of seconds, change their minds and decide to cancel the order.[162]

For example, consider a trader who places a sell order of 500 shares but then quickly changes his mind and decides to cancel the order. In this situation, the trader is not attempting to manipulate the market, but such a large order will inadvertently impact the market, causing prices to either increase or decrease. The trader may not have intended to at first cancel the orders, but after he placed the offer, he then intended to cancel the offer before execution for no outwardly apparent reason. So, while the trader has the necessary intent, does such conduct fall under the anti-spoofing statute? The answer is unclear. No other cases have addressed this issue. This vagueness indicates that a legitimate trader may not understand exactly what conduct falls under the anti-spoofing statute.

Third, the anti-spoofing statute is problematic because of the way that regulators prove spoofing has occurred. In all previous spoofing cases, the CFTC has heavily relied on circumstantial evidence of trading patterns to establish an intent to cancel.[163] This practice exists because there is rarely any other evidence that the government can use to demonstrate the necessary intent.[164] For example, in *Panther Energy Trading LLC*,[165] the CFTC relied on the fact that Panther frequently placed small sell orders at or near the best price and then placed large buy orders at progressively

161. *See* United States v. Coscia, 100 F. Supp. 3d 653, 658 (N.D. Ill. 2015) (holding that Coscia entered large-volume orders that he immediately cancelled before they could be filled by other traders).

162. *See* Matt Levine, *Regulators Not Happy with Guy Whose Algorithm Tricked Some Other Algorithms*, DEALBREAKER (July 22, 2013, 3:41 PM), http://dealbreaker.com/2013/07/regulators-not-happy-with-guy-whose-algorithm-tricked-other-algorithms/ ("If you put an order knowing there is a 98% chance that you'll cancel it before execution, do you *intend* to cancel it before execution?").

163. Stacie R. Hartman et al., *Disruptive Trading and the Search for Wrongful Intent*, 48 R. OF SEC. & COMMODITIES REG. 191, 200 (Sept. 9, 2015) (listing factors that regulators consider, which include: exposure of time of canceled orders, frequency of cancelations, and the imbalance created through the orders between the volume on the bid and offer). *See generally* CFTC v. Moncada, 31 F. Supp. 3d 614 (S.D.N.Y. 2014); Panther Energy Trading LLC, CFTC No. 13-26, 2013 WL 3817473 (July 22, 2013).

164. *See* Gregory Scopino, *The (Questionable) Legality of High-Speed "Pinging" and "Front Running" in the Futures Markets*, 47 CONN. L. REV. 607, 666–67 (2015) ("Most individuals don't write an e-mail . . . saying they intend to manipulate prices, but that is currently what the law requires the [CFTC] to prove: 'specific intent' to manipulate."); *see also* Hartman, *supra* note 163, at 201 (suggesting that traders document the purpose of particular trading strategies to combat a spoofing charge if one is brought in the future).

165. CFTC No. 13-26, 2013 WL 3817473 (July 22, 2013).

higher prices that were ultimately cancelled to increase the likelihood that market participants would buy the original small sell order as proof of Panther's intent to cancel the orders before execution.[166] However, there was no other indication that the government used other means to establish the requisite intent.[167] Similarly, in *CFTC v. Moncada*,[168] the court held that "the most compelling inference one might draw from the trading records is that Moncada was indeed trying to manipulate the market."[169]

This reliance on trading patterns to demonstrate intent could result in seriously discriminatory enforcement.[170] Many instances in which traders frequently place and then cancel large orders may be mistaken for spoofing.[171] In fact, such behavior is quite commonplace.[172] High-speed traders cancel an estimated ninety-five to ninety-eight percent of their trades.[173] Relying on trading patterns alone cannot distinguish between these normal trading activities and spoofing.

The vagueness of the anti-spoofing statute along with its discriminatory enforcement generally indicates that the anti-spoofing statute may be impermissibly vague. The following examples look at specific trading activities to further demonstrate how the current anti-spoofing statute remains problematic.

i. Fill or Kill Orders

An FOK order instructs a brokerage to either (1) execute a transaction immediately and completely or (2) not execute it at all.[174] The purpose of

166. *Id.* at *2–3.

167. *See* McCracken & Schleppegrell, *supra* note 156, at 8.

168. 31 F. Supp. 3d 614 (S.D.N.Y. 2014).

169. *Id.* at 616.

170. Lockwood, *supra* note 92, at 257.

171. *See* Ivy Schmerken, *Spoofing and the Flash Crash – Six Things You Need to Know*, FLEXADVANTAGE BLOG (May 12, 2015), http://flextrade.com/spoofing-and-the-flash-crash-six-things-you-need-to-know/ ("If you cancel repetitively, it could be considered that you are manipulating the market . . . ."); Hartman, *supra* note 159, at 8 (suggesting market participants that anticipate frequently cancelling orders carefully consider how regulators will view their cancellations and assess how strong an argument they can present to show they did not have the requisite intent to cancel orders before execution); *see also* Levine, *supra* note 79 (explaining that frequently canceling orders is not necessarily spoofing because if a trader is "frantically clicking his mouse all day," then cancelling is not necessarily a pattern but could just be evidence that he changes his mind a lot).

172. *See* Hope, *supra* note 76 (quoting an alleged spoofer saying, "we are clicking in response to what we are seeing . . . [i]f we click quicker than most, it is a skill").

173. Levine, *supra* note 162.

174. Patricia Chelley-Steeley, *Noise and the Trading Mechanism: the Case of SETS*, 11 EUROPEAN FIN. MGMT. 387, 391 n.6 (2005); *see also* David M. Weiss, III-B-7-g *Fill or Kill (FOK Order)*, AFTER THE TRADE IS MADE: PROCESSING SEC.

this type of order is "to ensure that a position is entered at a desired price."[175] On an average day, 1.56 percent of all orders entered in the market are FOK orders.[176]

Coscia distinguished FOK orders from spoofing because according to the court, traders place FOK orders with the intent that the trades be consummated.[177] However, when a trader places these types of orders, he or she intends the orders to be cancelled if the order cannot be executed at the desired price. In other words, the intent the trade be carried out is conditional. Thus, at the time the trader places an order, both the intent to execute the trade and the intent to cancel the trade are present. Therefore, under the anti-spoofing statute, these types of orders can qualify as spoofing.

While the court in *Coscia* distinguished FOK orders from spoofing, such a distinction may not be as clear in the real world.[178] As mentioned, enforcement actions have tended to rely on trading patterns as proof of spoofing.[179] Based on trading patterns alone, one could easily mistake this activity for spoofing as both strategies usually involve large quantities of stock. Additionally, the purpose of entering FOK orders is essentially the same reason that traders spoof; traders want to ensure that they enter a position at a desired price. Such a difference in the court's definition and real world application could result in confusion among traders. While it may be clear to a trader that he or she is entering a FOK order, to others it may not appear to be so clear. As a result, traders could be left wondering if they will be held liable for spoofing each and every time they enter this type of order. Therefore, in this respect, the anti-spoofing statute is impermissibly vague.

ii. Pinging

Pinging is defined as placing "small test orders at various price levels

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TRANSACTIONS 153 (2006) (providing an example of FOK orders).

175. *Fill Or Kill – FOK*, INVESTOPEDIA, http://www.investopedia.com/terms/f/fok.asp (last visited Jan. 20, 2016).

176. Elvis Jarnecic & Mark Snape, *The Provision of Liquidity by High-Frequency Participants*, 49 FIN. REV. 371, 376 (2014); *see also* Rakesh Shah, *Shares: Order Types and Trading Dynamics*, INV. CHRON. (Apr. 24, 2008), http://www.investorschronicle.co.uk/2011/12/06/your-money/shares-order-types-and-trading-dynamics-6gu3bWPGZxzcVDVCE34cxK/article.html (stating that, in practice, FOK orders are rarely ever used).

177. United States v. Coscia, 100 F. Supp. 3d 653, 657 (N.D. Ill. 2015).

178. *See id.* at 659 (stating that FOK orders are not entered with the intent to cancel).

179. *See e.g.*, *id.*; CFTC v. Moncada, 31 F. Supp. 3d 614, 618 (S.D.N.Y. 2014). *See generally* Panther Energy Trading LLC, CFTC No. 13-26, 2013 WL 3817473 (July 22, 2013).

[and] immediately cancelling those orders that are not instantly filled."[180] Pinging is akin to using underwater sonar, "which involves the use of sound waves—'pings'—to detect objects underwater."[181] In pinging, a trader will issue an order extremely fast, and if nothing happens, he or she will cancel the order.[182] However, if something does happen, the trader learns hidden information that the trader can use to his or her advantage.[183] As with FOK orders, this type of trading behavior is permissible because there is a chance that the order will execute before cancellation.[184] However, traders immediately cancel the majority of these orders both before and after the trade has been detected.[185]

As a result, it is unclear whether a trader that is pinging the market may be liable for spoofing under the anti-spoofing statute.[186] Based off trading patterns alone, pinging can easily resemble spoofing. In both pinging and spoofing, traders quickly place and then quickly cancel orders.[187] Additionally, both trading practices may occur very frequently. Therefore, based off trading patterns alone, it would be extremely difficult to distinguish pinging from spoofing.

Once the government can establish pinging is "of the character of" spoofing, it will then all come down to proving intent. Based on a *Coscia*-type argument, one can distinguish pinging from spoofing because, like FOK orders, pinging orders are entered with an intent to be consummated and are only cancelled if no one bites.[188] But, traders cancel a majority of pinging orders before the trade executes.[189] This scenario raises the following question: if you place an order that you are almost positive that you will cancel, are you placing this order with the intention of cancelling

180. Scopino, *supra* note 164, at 613; *see also* Elvis Picardo, *You'd Better Know Your High-Frequency Trading Terminology*, INVESTOPEDIA, http://www.investopedia.com/articles/active-trading/042414/youd-better-know-your-highfrequency-trading-terminology.asp (last viewed Apr. 11, 2016) (explaining that pinging is like baiting because its sole purpose is to lure institutions with large orders to reveal their hand).

181. Scopino, *supra* note 164, at 613–14.

182. *Id.* at 622.

183. *Id.* at 612, 622; *see also* Filler & Markham, *supra* note 154, at 48–49 (noting that pinging is used to determine if there is a trader on the sidelines seeking "a better than existing market price").

184. Filler & Markham, *supra* note 154, at 49.

185. Scopino, *supra* note 164, at 616; *id.* (highlighting that more than ninety percent of pinging orders are estimated to be canceled).

186. Filler, *supra* note 154, at 49 (asserting that there is a fine line between pinging and illegal conduct).

187. *See* Scopino, *supra* note 164, at 616 (emphasizing that a majority of pinging orders are cancelled).

188. *See* United States v. Coscia, 100 F. Supp. 3d 653, 659 (N.D. Ill. 2015).

189. Scopino, *supra* note 164, at 617.

it before execution? Again, the answer is unclear. Therefore, in the context of "pinging," the anti-spoofing statute is again arguably impermissibly vague.

IV. HOW TO RESOLVE THE ISSUE OF VAGUENESS

*A. Eliminate the "*is of the character of*" Part of the Anti-Spoofing Statute*

By its very nature, the anti-spoofing statute encompasses activities other than just spoofing.[190] The anti-spoofing statute makes it illegal to engage in any conduct that "is, is of the character of, or is commonly known to the trade as 'spoofing'."[191] As a result, this statute explicitly allows for liability for those trading practices that are similar to spoofing. However, this statute and CFTC interpretations do nothing to clarify which activities are "of the character of" spoofing.[192] As explained above, a statute is impermissibly vague when it encompasses a broad range of activities so imprecise that it specifies no standard of conduct.[193] This part of the anti-spoofing statute is therefore impermissibly vague.

Removing this part of the statute would limit the activities that this statute proscribes. This removal would therefore make it more clear exactly which activities fall under this category. The practice of pinging, which shares many characteristics of spoofing, would no longer be under threat of being illegal under this statute.[194] Similarly, FOK orders would clearly fall out of the parameters of the statute. As a result, this anti-spoofing statute would no longer encompass as broad a range of activities as it does today. Rather, it would only impose liability for activities that are in fact spoofing.

B. A Better Definition of Spoofing

The definition of spoofing itself is impermissibly vague.[195] Therefore, a

190. *See* Meyer, *supra* note 7 (quoting 3Red Trading's chief compliance officer saying in light of spoofing accusations that "[t]he CFTC has oversimplified complex trading and is now trying to classify legitimate trading and risk management as a market infraction. We stand behind the trading at issue as it does not contradict available guidance nor violate the law.").

191. 7 U.S.C. § 6c(a)(5)(C) (2014).

192. *See* Antidisruptive Practices Authority, 78 Fed. Reg. 31890, 31896 (May 28, 2013) for the CFTC's interpretations.

193. Coates v. City of Cincinnati, 402 U.S. 611, 614 (1971).

194. *See generally* Scopino, *supra* note 164, at 648–50.

195. Coscia Mot. to Dismiss Mem., *supra* note 13, at 10–11 (citing CFTC Open Meeting on the Twelfth Series of Proposed Rulemakings Under the Dodd-Frank Act 12 (Feb. 24, 2011)) (quoting former Commissioner Jill Sommers as saying "[w]hen the draft language of [the provision] was first discussed among Commission staff, it was my view and the view of others [at the CFTC] that *the language was too vague*" and

new definition of spoofing could help resolve all issues of ambiguity. In an attempt to propose a better definition, this Comment will briefly explore how other financial institutions define spoofing.

The Chicago Mercantile Exchange ("CME"), in its new Rule 575, provides regulatory guidance on various types of prohibited disruptive trading practices, including spoofing.[196] Rule 575 prohibits the type of activity CFTC identifies as spoofing, but it provides additional guidance.[197] Rule 575 states that "[a]ll orders must be entered for the purpose of executing bona fide transactions" and that "[n]o person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution."[198] Among other things, the CME intends to consider the following: (1) the market participant's intent to create misleading market conditions, (2) the effect on other market participants, (3) the market participant's order entry and cancellation activity, and (4) the changes in prices that result from the entry of the order.[199]

However, the Financial Industry Regulatory Authority ("FINRA")[200] takes a different approach.[201] FINRA Rule 5210 states the following:

> No member shall publish or circulate, or cause to be published or circulated, any notice, circular, advertisement, newspaper article, investment service, or communication of any kind which purports to report any transaction as a purchase or sale of any security unless such member believes that such transaction was a bona fide purchase or sale of such security; or which purports to quote the bid price or asked price for any security, unless such member believes that such quotation

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former Commissioner Scott O'Malia referring to the statutory prohibitions as "admittedly vague"); McCracken & Schleppegrell, *supra* note 156 (noting that there is no accepted meaning of spoofing in the futures markets).

196. The CME is the world's leading and most diverse derivatives marketplace that is comprised of four exchanges: the Chicago Mercantile Exchange, Inc. ("CME"), the Chicago Board of Trade ("CBOT"), the New York Mercantile Exchange ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX"). *About CME Group*, CME GROUP, http://www.cmegroup.com/company/ (last visited Oct. 22, 2015); *see also* Aguirre, *supra* note 159.

197. *See* CME Market Regulation Advisory Notice, Rule 575, http://www.cmegroup.com/rulebook/files/mran-ra1516-5.pdf (last visited Apr. 10, 2016) [hereinafter "CME MRAN Rule 575"].

198. *Id.*

199. *Id.*

200. FINRA is "an independent, not-for-profit organization authorized by Congress to protect America's investors by making sure the securities industry operates fairly and honestly." *About FINRA*, FINRA, http://www.finra.org/about (last visited Oct. 22, 2015).

201. *See* FINRA Manual Rule 5210, Publication of Transactions and Quotations, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=8726 (last visited Apr. 10, 2016) [hereinafter "FINRA Manual Rule 5210"].

represents a bona fide bid for, or offer of, such security.[202]

Even though it is not explicitly stated, FINRA's rule essentially prohibits activities such as fictitious quoting, spoofing, and layering quotes.[203]

Both CME and FINRA place an emphasis on whether the trader placed the order for the purpose of executing a bona fide transaction.[204] Because the CFTC stated essentially the same thing in its guidance, it seems that a part of spoofing is to enter into an order with intent to not execute a bona fide transaction.[205] Therefore, it would make sense to amend the anti-spoofing statute to include this aspect. Additionally, it would also help to clarify at what point the intent to cancel must arise. For this reason, this Comment recommends that the anti-spoofing statute be amended to adopt the CME's requirement that the intent arises at the time the time the trader enters his or her order.

This Comment recommends that Congress should redefine spoofing as the following: the act of placing a bid or order that, at the time of entry, was not intended to be executed as a bona fide transaction.

This definition would solve all of the problems listed above with the current definition of spoofing and help increase investor confidence.[206] Namely, because the recommended definition requires that the trader did not intend to complete a bona fide transaction, it requires that the trader entered the orders with the intent to manipulate the market in some way rather than just intending to cancel the order.[207] This newly defined mens rea requirement would reflect that there was some type of bad intent rather than merely an intent to cancel.[208] As a result, occasions when traders innocently cancel orders would fall outside of the scope of this definition,

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202. *Id.*

203. *Equity Trading Initiatives: Supervision and Control Practices for Algorithmic Trading Strategies*, Regulatory Notice 15-09, at 2 (Mar. 2015), http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-09.pdf.

204. *See* CME MRAN Rule 575, *supra* note 197; FINRA Manual Rule 5210, *supra* note 201.

205. *See* Antidisruptive Practices Authority, 78 Fed. Reg. 31890, 31896 (May 28, 2013) (emphasizing that legitimate, good-faith cancellation or modification of orders would not constitute spoofing).

206. *See* Susan Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 194–95 (2006) (explaining that investor confidence increases with strong rules); David J. Franklyn, *Toward a Coherent Theory of Strict Tort Liability For Trademark Licensors*, 72 S. CAL. L. REV. 1, 35 (1998).

207. *See Bona Fide*, THE 'LECTRIC L. LIBR., http://www.lectlaw.com/def/b045.htm (last visited Nov. 15, 2015) (defining bona fide as "[i]n good faith; without fraud or deceit").

208. Peter J. Henning, *Conviction Offers Guide to Future 'Spoofing' Cases*, N.Y. TIMES (Nov. 9, 2015), http://www.nytimes.com/2015/11/10/business/dealbook/conviction-offers-guide-to-future-spoofing-cases.html.

absent proof that the traders are attempting to manipulate the market.

While this new definition of spoofing would help to clarify what spoofing is and thereby eliminate the issue of vagueness, some difficulties may still arise with this new definition. Most importantly, it still may be difficult to prove that a trader intended to enter into a bona fide transaction. However, it would be much easier to prove a bona fide transaction than an intent to cancel.

C. What this Narrower Definition of Spoofing Would Mean for Business

When it is clear precisely what conduct is proscribed by the anti-spoofing statute, traders can once again go about their normal trading activities without fear that they will accidently break the law.[209] As a result, the markets will function as they are supposed to. Once again, the futures markets will be able to serve their purposes of risk-shifting and price discovery.[210] Price discovery will be more accurate as there will be no artificial prices to prevent accurate prediction of future prices, which will facilitate speculation and, therefore, make it easier to make managerial predictions.[211]

Additionally, a clear anti-spoofing provision could actually encourage market participation by increasing confidence in the markets.[212] A recent Goldman Sachs Group study found that only eighteen percent of young adults trusted the stock market and that sixteen percent said that stocks are either too volatile or that the market is not fair.[213] Such distrust is worrisome as these young adults are entering their prime saving years and they will soon become "the most important financial generation in America."[214] It is therefore important to rebuild confidence in these markets in order to encourage these young adults to invest in U.S.

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209. *See* Sec. of Labor v. Lauritzen, 835 F.2d 1529, 1539 (7th Cir. 1987) ("People are entitled to know the legal rules before they act, and only the most compelling reason should lead a court to announce an approach under which no one can know where he stands until litigation has been completed. Litigation is costly and introduces risk into any endeavor; we should struggle to eliminate the risk and help people save the costs. Unless some obstacle such as inexperience with the subject, a dearth of facts, or a vacuum in the statute books intervenes, we should be able to attach legal consequences to recurrent factual patterns.").

210. *See* Edwards & Edwards, *supra* note 63, at 335–36.

211. *See* Yang, *supra* note 68, at 280; *id.* at 345.

212. Susan Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 194–95 (2006) (stating that investor confidence increases with strong rules).

213. Callie Bost, *Millennials Don't Trust Stock Market, Goldman Sachs Poll Shows*, BLOOMBERG BUS. (June 24, 2015, 2:49 PM), http://www.bloomberg.com/news/articles/2015-06-24/millennials-don-t-trust-the-stock-market-says-goldman-sachs-poll.

214. *Id.*

markets.[215] Otherwise, the United States could face a severe "confidence crisis," which could result in consumers delaying their spending.[216] This decreased spending and business investment could force the economy to sink into another recession.[217] Therefore, it is vital that Congress quickly restore investor confidence by refurbishing the anti-spoofing statute.[218]

One way of fostering confidence in markets is to make clear definitions of prohibited behaviors so that all people who want to be involved understand the rules.[219] Clear rules also mean that the average person looking to become involved in financial markets would no longer fear being liable for a rule that he or she did not even understand in the first place.[220] Clear rules would create targeted, specific enforcement. In plain terms, not only would the average person looking to become involved in the markets be able to understand the rules, but he or she would also not have to be in constant fear of accidently breaking an unclear rule. According to Christopher Hehmeyer, the Chief Executive Officer of HTG Capital Partners LLC, "[t]he market's desperate for clarity . . . the fact that there's doubt creates confusion."[221] A clear and unambiguous anti-spoofing statute would be a step in the right direction to providing clearer rules and rebuilding confidence in the markets.

More confidence in the futures markets would also mean that "farmers, ranchers, producers, commercial companies, municipalities, pension funds and others" could continue to use the futures markets to "lock in a price or a rate and focus on what they do best- innovating, producing goods and

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215. *See* Ripken, *supra* note 212, at 194–95 (explaining that without a "broad-based investor perception of legitimacy, people will not invest in the market" and will instead put their money somewhere else, perhaps even just "under their mattress"); Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 712 (stating that when investor confidence in the capital markets was at record lows, the average trading volume dropped by fifty-four percent).

216. Kenneth A. Kim & John R. Nofsinger, *The Importance of Investor Confidence*, FIN. TIMES PRESS (July 4, 2003), http://www.ftpress.com/articles/article.aspx?p=98127&seqNum=4.

217. *Id.*

218. *Id.*; *see also* Mike Larson, *Crisis of Confidence Latest Market Challenge*, MONEY AND MKTS. (Sept. 18, 2015, 4:30 PM), http://www.moneyandmarkets.com/crisis-confidence-latest-market-challenge-73405#.ViRYetbsVAI ("[C]onfidence is a precious commodity. Once you lose it, it can be the biggest market killer of all.").

219. Franklyn, *supra* note 206, at 35 ("[I]t is generally recognized that clear rules enable more efficient business planning which, in turn, should inure to the benefit of society.").

220. *See* William Grayson Lambert, *Focusing on Fulfilling the Goals: Rethinking How Choice-of-Law Regimes Approach Statutes of Limitations*, 65 SYRACUSE L. REV. 491, 534 n.216 (2015) (noting that clear rules improve "the perception of the judicial system as a fair arbiter of disputes"); *see also id.* ("The clearer the rule, the better one can avoid it.").

221. Harris, *supra* note 11.

services for the economy, and creating jobs," resulting in a better GDP and therefore a better economy.[222]

D. Change is Hard; Reform Is Unlikely

Unfortunately, there is little political will to change the anti-spoofing statute. Recently, the government has dramatically increased the number of cases it has brought against alleged spoofers.[223] This increase in spoofing actions demonstrates that the government is confident that it can succeed on spoofing charges with the anti-spoofing statute as it currently stands. The *Coscia* case's guilty verdict—which came only one hour of deliberation—furthered bolstered the government's confidence.[224] With one successful conviction, regulators are confident that there are no problems with the anti-spoofing statute as it stands.[225] Absent a political will for change, it is unlikely that legislatures will undertake the arduous task of redefining spoofing.

However, the lack of political will does not mean that there is no hope for reform. In light of the first criminal conviction and the clear vagueness of the statute, market participants could start to become more invested and push for a clearer definition.[226] Additionally, in the course of spoofing cases, the judicial process could serve to clarify what actually constitutes spoofing.[227] These two forces could effectively work together to clarify what spoofing is. However, until there is a clarification on the definition of spoofing, government attorneys should practice prosecutorial discretion.[228]

CONCLUSION

Recently, commodities trading activity, which may fall under the

222. *Mission & Responsibilities*, CFTC, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Apr. 10, 2016); *see also* Ott, *supra* note 85.

223. *See generally* CFTC v. Oystacher, No. 15-CV-9196 (N.D. Ill. Dec. 18, 2015).

224. *See* Louis, *supra* note 50 (explaining the jury only deliberated for about an hour before finding Coscia guilty of spoofing).

225. Lynne Marek, *Three Reactions to Yesterday's Spoofing Conviction*, CRAIN'S CHI. BUS. (Nov. 4, 2015), http://www.chicagobusiness.com/article/20151104/NEWS01/151109918/three-reactions-to-yesterdays-spoofing-conviction.

226. *Id.* (quoting the President of the Futures Industry Association, Walter Lukken, asking for more clarification about what spoofing actually is in light of the first criminal spoofing conviction).

227. *But see id.* (quoting the Mr. Lukken as saying that clarification by enforcement is not the best way to clarify a regulation).

228. *See* WAYNE R. LAFAYE ET AL., CRIM. PROC. § 13.2(a): THE PROSECUTOR'S DISCRETION (3d ed. 2014) (stating that prosecutors can exercise their discretion when (1) there is not sufficient evidence, (2) the costs of prosecution would be excessive, (3) prosecution would cause undue harm to the offender, and (4) when the harm done by the offender can be corrected without prosecution).

classification of spoofing, has dramatically increased. As technology continues to evolve and traders are able to place ever larger orders even faster, there is a possibility that spoofing practices will increase even more. However, the current ambiguity and vagueness of the anti-spoofing statute could result in confusion as to what trading activities actually constitute spoofing. Even worse, the government could prosecute legal trading activities as spoofing. This over-prosecution could lead to confusion among traders and could cause traders to stop trading altogether or move to markets outside of the United States. For these reasons, Congress and the associated regulatory agencies must clarify the current anti-spoofing statute to resolve this problem of vagueness.

NOTE

IMPROVING GREEN BUILDING: COMPARING LEED CERTIFICATION TO THE FDA AND ITS PRIVATE, THIRD-PARTY RATINGS APPROACH

PATRICK KAIN*

Recognizing global warming and other environmental concerns as potentially hazardous to life on earth, many environmentalists have targeted the building industry as a specific area with enormous room for improvement in sustainability. This effort has led to the development of new, green building practices in the building industry in the United States. The green building movement has been met with such positive feedback that it has essentially become the standard in the building industry today. The building industry is one of the most significant and lucrative businesses in the world, and any substantial changes to the system have vast business implications.

While the green building movement has certainly had many positive impacts on the environment, the swift enactment of measures to incorporate green building practices—largely based on private, third-party organizations—has received significant criticism. Many critics have expressed dissatisfaction with the government's reliance on these third-party organizations in legislative actions. Specifically, critics argue that the third-party organizations are unconstitutional because they are not valid government authorities and lack meaningful government review. Additionally, the potential conflicts of interest that arise in the current process have led to increased skepticism surrounding the green building movement as a whole.

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INTRODUCTION

"LEED will not be a novelty in the future. In today's market if you are building without LEED, you are building in obsolescence."[1] Beginning with the earliest recognition of climate change concerns, there has been an increasingly predominant effort in the United States to "go green." As President Barack Obama stated in his 2014 State of the Union address, "[t]he shift to a cleaner energy economy won't happen overnight, and it will require tough choices along the way. But the debate is settled. Climate change is a fact."[2]

Through the "go green" initiative, early environmentalists identified the

1. Eileen D. Millett, *Green Building for Dummies: What is a LEED Certification?*, 25 PRAC. REAL EST. LAW. 41, 41 (2009).

2. President Barack Obama, 2014 State of the Union Address (Jan. 28, 2014) (transcript available at https://www.whitehouse.gov/the-press-office/2014/01/28/president-barack-obamas-state-union-address) [hereinafter "2014 State of the Union Address"].

building industry as an area with significant room for improvement in sustainability and came up with the idea of green building. Generally, green building is defined as "the practice of creating structures and processes that are environmentally responsible and resource-efficient throughout a building's life-cycle . . . ."[3] More specifically, green building is "the practice of increasing the efficiency of buildings and their use of energy, water, and minerals, and reducing building impacts on human health and the environment through improved siting, design, construction, operation, maintenance, and removal."[4] In sum, green building is a dynamic, rapidly growing and evolving field, which is driven by a convergence of increasing public awareness about global climate change, cost and availability of energy sources, and the impact of the built environment on human health and performance.

The building industry has a massive impact on the natural environment, human health, and the economy.[5] In fact, research estimates that architects use up to ninety percent of all materials ever extracted from the environment in the construction of buildings and infrastructure worldwide.[6] Environmentalists, therefore, identify green building practices as an essential component of reducing energy consumption in the United States.

This Comment will argue that the development and integration of green building practices, as they exist today, has been done rashly and without consideration of legal implications. As the "go green" movement has continued to gain momentum, federal, state, and local governments have concurrently implemented policies to encourage, and in some cases require, green building. However, the governments endorsing these policies have generally failed to evaluate the constitutional and other legal implications

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3. *Basic Information – Definition of Green Building*, U.S. ENVT'L PROT. AGENCY, http://archive.epa.gov/greenbuilding/web/html/about.html (last updated Feb. 20, 2016).

4. *See* Kaleb Keller, Note, *LEEDing in the Wrong Direction: Addressing Concerns with Today's Green Building Policy*, 85 S. CAL. L. REV. 1377, 1378 (2012) (quoting MARK J. BENNETT, ET AL., CURRENT CRITICAL ISSUES IN ENVIRONMENTAL LAW: GREEN BUILDINGS AND SUSTAINABLE DEVELOPMENT § 1.04[1] (2008)) (identifying the central foremost considerations of green building as energy use, water use, indoor environmental quality, material selection, and the building's effects on its site).

5. *See* U.S. GREEN BLDG. COUNCIL, NATIONAL GREEN BUILDING RESEARCH AGENDA 4 (2008), http://www.usgbc.org/Docs/Archive/General/Docs3402.pdf (stating that buildings and structures in the United States are responsible for approximately thirty-eight percent of greenhouse gas emissions, seventy-one percent of electricity consumption, thirty-nine percent of total energy consumption, twelve percent of water consumption, and forty percent of non-industrial waste in the United States).

6. *See* Sarah B. Schindler, *Following Industry's LEED(R): Municipal Adoption of Private Green Building Standards*, 62 FLA. L. REV. 285, 288 (2010) (explaining that buildings in the United States consume nearly forty percent of all primary energy).

of such policies, leading to the deferral of decision-making and standard-setting responsibilities to independent third parties.

II. "GOING GREEN" IN THE BUILDING INDUSTRY MEANS OBTAINING LEED CERTIFICATION

The current system for recognizing green building is based almost entirely on the Leadership in Energy and Environmental Design ("LEED") certification program, which the private nonprofit U.S. Green Building Council ("USGBC") developed.[7] While LEED has received credit for developing a standard for determining if a building is "green," it has also been the subject of much criticism.[8] This Section will discuss the intricacies of the USGBC and the LEED certification ratings system and compare it with the U.S. Food & Drug Administration ("FDA") and the United States Pharmacopeia ("USP") ratings system, one of the oldest and most well respected third-party ratings systems used in food and drug law.

A. The USGBC and the Rise of the LEED Ratings System

Three building industry professionals established the USGBC as a nonprofit trade group in 1993 in response to growing concerns about environmental sustainability in the building industry.[9] During its first year, the USGBC consulted industry experts including architects, real estate agents, building owners, lawyers, and environmentalists to develop a green building certification system and create a uniform system of green building standards.[10] The resulting system—called Standard Version 1.0—was unveiled in 1999, and it immediately gained popularity and notoriety throughout the building industry.[11] The USGBC advertises the LEED

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7. *See generally* U.S. GREEN BLDG. COUNCIL, www.usgbc.org (last visited Feb. 9, 2016).

8. *See* Luke Rosiak, *EXography: LEED certification doesn't guarantee energy efficiency, analysis shows*, WASH. EXAMINER, (Oct. 29, 2013, 12:00 AM), http://www.washingtonexaminer.com/exography-leed-certification-doesnt-guarantee-energy-efficiency-analysis-shows/article/2538046. *See generally* Thomas Frank, *In U.S. Building Industry, Is It Too Easy to Be Green?*, USA TODAY (June 13, 2013, 11:52 AM), http://www.usatoday.com/story/news/nation/2012/10/24/green-building-leed-certification/1650517/ (critiquing the USGBC and LEED's lack of environmental benefits).

9. *See* U.S. GREEN BLDG. COUNCIL, *supra* note 7 (stating the USGBC's mission is "to promote sustainability in the building and construction industry").

10. *See* Keller, *supra* note 4, at 1380–81 (explaining that the LEED creators sought to bring uniformity to the American green building movement by developing consensus-based national standards for use in constructing high-performance, sustainable buildings).

11. MARK J. BENNETT, ET AL., CURRENT CRITICAL ISSUES IN ENVIRONMENTAL LAW: GREEN BUILDINGS AND SUSTAINABLE DEVELOPMENT § 1.04[1] (2008)

rating system as an innovative system that provides a method of standardization and oversight for environmental performance in the building industry.[12]

According to the USGBC's website, "LEED is green building[,]" and the organization is largely correct in making this assertion.[13] Today, the USGBC has over 13,000 members in all fifty states and in more than 150 countries and territories around the world.[14] Since the establishment of LEED, not only has the ratings system grown to be the most widely-used green building rating system in the United States, but it has also become the "globally recognized symbol of excellence in green building."[15] Additionally, many states and localities have passed green building legislation based solely on LEED.[16] LEED has essentially created its own new, extremely valuable and lucrative green building industry.[17]

i. How Does LEED Work?

LEED certification is an instrument utilized by builders to offer independent, third-party authentication that a building project implemented strategies to achieve high performance in key areas of environmental health and sustainability throughout design and construction.[18] The LEED certification process allows owners and developers to earn points for a specific project by meeting technical requirements in nine different

(emphasizing the vast support accrued by LEED following its inception).

12. *See What is LEED?* U.S. GREEN BLDG. COUNCIL, http://leed.usgbc.org/leed.html (last visited Mar. 26, 2016) ("LEED certification provides independent verification of a building or neighborhood's green features, allowing for the design, construction, operations and maintenance of resource-efficient, high-performing, healthy, cost-effective buildings.").

13. Jacob Kriss, *What is Green Building?* U.S. GREEN BLDG. COUNCIL, http://www.usgbc.org/articles/what-green-building.

14. *See What is LEED?*, *supra* note 12 (referencing the dramatic rise in participation in the USGBC from both the public and private sectors at the global, regional, and local levels).

15. *See About LEED*, U.S. GREEN BLDG. COUNCIL, http://www.usgbc.org/articles/about-leed (last visited Mar. 26, 2016) ("With 13.8 billion square feet of building space participating in the suite of rating systems and 1.85 million feet certifying per day around the world, LEED is transforming the way built environments are designed, constructed, and operated.").

16. *See What is LEED?*, *supra* note 12 ("More than 72,000 projects are participating in LEED across 150+ countries and territories, comprising over 13.8 billion square feet."); *see also* Keller, *supra* note 4, at 1388–90 (listing the many states and localities with LEED-based policies).

17. Kriss, *supra* note 13 ("LEED has also spawned an entire green building industry, expected to be worth up to $248 billion in the U.S. by 2016.").

18. *See About LEED*, *supra* note 15 (describing the basics of how LEED works).

categories designed to promote sustainability.[19]

Under the LEED ratings system, "[a] building project earns one or more points toward certification by meeting or exceeding the technical requirements for each topic area."[20] The point allocation for technical requirements follows a broad system, but each system varies based on the specific type of project.[21] There are four LEED certification levels that a project may achieve based on the number of points it earns.[22] As mentioned, LEED certification is a globally recognized symbol and achieving certification can provide many benefits to building owners.[23]

Moreover, building ratings systems, including LEED, are designed to be adaptable and inclusive of many different types of projects.[24] As such, each category consists of common prerequisites and credits to accommodate each individual project.[25] Over the past decade, LEED has enjoyed outstanding popularity, success, and growth.[26] Since the inception of its first ratings system, the USGBC has developed LEED into many distinct

19. *See What is LEED?*, *supra* note 12 (describing the nine key categories: (1) integrative process; (2) location and transportation: (3) sustainable site development; (4) water efficiency; (5) energy and atmosphere; (6) materials and resources; (7) indoor environmental quality; and (8) innovation; and (9) regional priority).

20. Nancy J. King & Brian J. King, *Creating Incentives for Sustainable Buildings: A Comparative Law Approach Featuring the United States and the European Union*, 23 VA. ENVTL. L.J. 397, 407 (2005).

21. *See About LEED*, *supra* note 15 ("LEED rating systems generally have 100 base points six Innovation in Design points and four Regional Priority points, for a total of 110 points . . . .").

22. *Id.* (outlining the four levels of certification: Certified (40–49 points); Silver (50–59 points); Gold (60–79 points); Platinum (80+ points)).

23. *See* King & King, *supra* note 22, at 408 (specifying that "benefits include: reduced or equivalent initial costs for sustainable design; reduced annual operating costs that reflect the incorporation of energy-efficient and renewable energy systems; water-saving design features; increased durability of the facility; and reduced maintenance costs").

24. *See* Stephanie Vierra, *Green Building Standards and Certification Systems*, WHOLE BLDG. DESIGN GUIDE, http://www.wbdg.org/resources/gbs.php (last updated Oct. 27, 2014) (noting that the integration of a building ratings system is at the heart of the design and begins at the earliest planning stages).

25. *See About LEED*, *supra* note 15 (explaining that prerequisites are the "required elements, or green building strategies that must be included in any LEED certified project," whereas credits are the "optional elements, or strategies that projects can elect to pursue to gain points toward LEED certification").

26. Jennie Richards, *GREEN BUILDING: A Retrospective on the History of LEED Certification*, INST. FOR ENVTL. ENTREPRENUERSHIP (Nov. 2012), http://enviroinstitute.org/wp-content/uploads/2012/09/GREEN-BUILDING-A-Retrospective-History-of-LEED-Certification-November-2012.pdf (referencing the timeline illustrating the growth of LEED).

ratings systems that accommodate specific sectors of the market.[27] The USGBC, in an effort to seek continued progress and improvement, regularly conducts research to improve its rating systems by creating new versions for various sectors of the built environment utilizing new technology as they become available.[28]

ii. Who Sets the USGBC's Standards?

While the USGBC emphasizes its diversity, a small sector of the USGBC called the LEED Steering Committee—comprised entirely of members of private industry—sets the specifics of the LEED ratings systems.[29] According to the USGBC, the USGBC member-based volunteer committees, and the USGBC staff, put forth the LEED ratings system on a consensus basis.[30] However, the LEED Steering Committee, which has final review and approval rights for all decisions, is not representative of this diversity with "its volunteer voting members all hail[ing] from private architecture, technology, and consulting firms."[31] Additionally, the USGBC's Executive Committee members and Board of Directors have backgrounds in "building, manufacturing, consulting, finance, real estate, and related private industries."[32] In fact, the vast majority of USGBC members represent private industry with very few representing the public sector or government entities.[33] The idea of adopting a structure of predominantly private individuals setting government-adopted LEED standards has received negative treatment in the past and creates many disincentives that may lead to market failures in the future.[34]

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27. *See generally LEED v4 Ratings System Guidance*, U.S. GREEN BLDG. COUNCIL, http://www.usgbc.org/articles/rating-system-selection-guidance (identifying the many different rating systems that may currently be utilized to register a project with the USGBC).

28. *See About LEED, supra* note 15.

29. *See USGBC LEED Committees*, U.S. GREEN BLDG. COUNCIL, http://www.usgbc.org/committees/leed (last visited Feb. 9, 2016) (identifying all of the members of the various USGBC committees).

30. *See About USGBC*, U.S. GREEN BLDG. COUNCIL, http://www.usgbc.org/articles/about-usgbc-0 (last visited Mar. 26, 2016) ("Membership includes building owners and end-users, real estate developers, facility managers, architects, designers, engineers, general contractors, subcontractors, product and building system manufacturers, government agencies, and nonprofits.").

31. Keller, *supra* note 4, at 1381.

32. *Id.*

33. *Id.* (emphasizing the potential conflicts of interest that arise given this type of situation and the need for monitoring them).

34. *See LEED Certification: Where Energy Efficiency Collides with Human Health*, E.H.H.I. REPORT 49 (2010), http://www.ehhi.org/reports/leed/LEED_report_0510.pdf [hereinafter "E.H.H.I. REPORT"] ("The number of jurisdictions

To be eligible to receive LEED certification, a building owner must register the project with an affiliate organization called the Green Building Certification Institute ("GBCI").[35] The GBCI was established in 2008 to "administer[] project certifications and professional credentials and certificates within the framework of the [USGBC]'s [LEED] green building ratings systems."[36] While the GBCI appears on its face to be an independent organization, it is closely tied to the USGBC and remains a trade association for the building industry with nearly all members having potential conflicts of interest.[37]

Once a builder has applied for LEED certification, registered, and paid the requisite fee, the project undergoes a very subjective and extensive review process to determine what, if any, level of certification it has achieved.[38] Notably, the USGBC does not publish or disclose any information regarding the points awarded to a project, and therefore, the process lacks transparency.[39] The USGBC has enormous discretion in deciding whether to award a project with LEED certification.

iv. The Use of the USGBC in Legislation

LEED has been integrated into policy through a wide range of legislative actions at all levels of government in the United States in an effort to "go green."[40] The "go green" movement created a wave of public policy action that led to more than 400 local jurisdictions, thirty-five state governments, and fourteen federal agencies or departments adopting LEED as a benchmark for monitoring green building practices.[41] Additionally, the possibility of requiring LEED Certification in building codes, rather than simply using it as a benchmark, is gaining momentum.[42]

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adopting these standards as law is growing, which will make them difficult if not impossible to change, unless federal law and regulation supersedes the 'green' standards . . . .").

35. GREEN BLDG. CERTIFICATION INST., www.gbci.org (last visited Feb. 21, 2016) (identifying the GBCI as "the only certification and credentialing body within the green business and sustainability industry to exclusively administer project certifications and professional credentials and certificates of LEED").

36. *About,* GREEN BLDG. CERTIFICATION INST., www.gbci.org/about (last visited Fed. 21, 2016).

37. *See* E.H.H.I. REPORT, *supra* note 34.

38. *Guide to LEED Certification: Commercial,* U.S. GREEN BLDG. COUNCIL, http://www.usgbc.org/cert-guide/volume (last visited Feb. 20, 2016).

39. *See* E.H.H.I. REPORT, *supra* note 34.

40. *See* Keller, *supra* note 4, at 1385.

41. *Greening the Codes,* U.S. GREEN BLDG. COUNCIL 4–5 (2011), http://www.usgbc.org/Docs/Archive/General/Docs7403.pdf.

42. *Id.* (graphing the progress toward sustainable building codes).

Over the past decade, different levels of government have made attempts to incorporate green building practices; energy, water, and material efficiency; and in some cases require LEED certification.[43] Responding to confusion associated with these attempts, Congress created the Department of Energy ("DOE") in 1977 to address energy use and conservation strategies.[44] Congress then passed a number of federal legislative green building policies outlining strict sustainable performance standards including a key provision requiring all federally-owned buildings to meet certain green building LEED certification standards.[45] Additionally, "in 2006, the [Environmental Protection Agency ("EPA")] and twenty other federal agencies—including the Departments of the Interior, Defense, Justice, State, and Transportation—signed the voluntary Federal Leadership in High Performance and Sustainable Buildings Memorandum of Understanding ("MOU")."[46] The MOU contains "guiding principles" for green building standards, which mimic the USGBC and the LEED third-party ratings system criteria.[47]

In 2007, President George W. Bush signed Executive Order 13423—Strengthening Federal Environmental, Energy, and Transportation, Management—which included federal standards for sustainable design and buildings and specifically required that new construction and major renovations of all federal agency buildings comply with the MOU.[48] Clearly, the current federal green building policy is largely based on the USGBC and the criteria from the LEED ratings system, without much independent work conducted by the EPA, the DOE, or any other government agency.

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43. *See* Richards, *supra* note 26, at 3.

44. Robert Cassidy, *White Paper on Sustainability*, BLDG. DESIGN AND CONSTR. 4 (2003), http://archive.epa.gov/greenbuilding/web/pdf/bdcwhitepaperr2.pdf.

45. *Energy Goals and Standards for Federal Government*, U.S. DEP'T OF ENERGY, http://energy.gov/savings/energy-goals-and-standards-federal-government (last visited Mar. 26, 2016) (referencing the requirement that all General Services Administration buildings meet at least a LEED Gold standard for all new federal buildings and major renovations).

46. Federal Leadership in High Performance and Sustainable Buildings: Memorandum of Understanding 3-5 (Jan. 24. 2006), https://www.fedcenter.gov/_kd/Items/actions.cfm?action=Show&item_id=4713&destination=ShowItem.

47. *Id.* (noting that the four categories of sustainability referenced in the MOU are all categories of sustainability under LEED).

48. Matt Gray, *High Performance and Sustainable Building: A Federal Lay of the Land*, U.S. GREEN BLDG. COUNCIL 26 (2008), http://www.usgbc.org/Docs/Archive/General/Docs4178.pdf.

B. The FDA and the United States Pharmacopeia Ratings System

The utilization of private, third-party ratings systems is not a new concept in the United States; it has been especially significant in the pharmaceutical industry. A group of eleven physicians concerned with the quality and consistency of medicines sought to "create a compendium of the best therapeutic products, give them useful names, and provide recipes for their preparation[,]" and in 1820, they published the first Pharmacopeia of the United States.[49] Medical practitioners were frustrated by the lack of uniformity in the medicines they prescribed and dispensed and the resulting inefficiencies in the pharmaceutical industry.[50] The first edition of the United States Pharmacopoeia ("USP") asserted that the main purpose of the Pharmacopoeia was to develop a system to efficiently and successfully cultivate uniform medicines for distribution.[51]

The subsequent early pharmacopeias consisted of compilations of recipes that facilitate compounding.[52] As manufacturing gained prevalence over compounding, USP changed from being primarily a compendium of recipes to becoming a compendium of public standards that support the testing of manufactured drugs to determine their legitimacy and effectiveness.[53] The USP identifies itself as an independent and practitioner-based, third-party organization committed to promulgating scientific-based public standards that help improve the quality of drugs and other articles.[54] When USP acquired another pharmacopeia called the

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49. USP PHARMACISTS' PHARMACOPEIA, – MISSION AND PREFACE § 11[, 3/3] (2d ed. 2009), http://www.usp.org/sites/default/files/usp_pdf/EN/products/usp2008p2supplement3.pdf; *see also What is a Pharmacopeia?*, U.S. PHARMACOPEIAL CONVENTION 1 (2011), http://www.usp.org/sites/default/files/usp_pdf/EN/regulator/what_is_a_pharmacopeia_dec_2011.pdf [hereinafter *"What is a Pharmacopeia?"*] (defining Pharmacopeia as "a book containing a compilation of pharmaceutical products with their formulas and methods of preparation").

50. *See About Us*, U.S. PHARMACOPEIAL CONVENTION, http://www.usp.org/about-usp (last visited Feb. 21, 2016) ("At the time, the marketplace for drugs and medicinals was chaotic: there was little assurance of consistency or quality regarding the medicines that patients were taking.").

51. *See id.*

52. U.S. FOOD AND DRUG ADMINISTRATION, *Compounding and the FDA: Questions and Answers*, http://www.fda.gov/Drugs/GuidanceComplianceRegulatoryInformation/PharmacyCompounding/ucm339764.htm#what (last visited Feb. 21, 2016) (defining "compounding [as] a practice in which a licensed pharmacist ... combines, mixes, or alters ingredients of a drug to create a medication tailored to the needs on an individual patient").

53. *See What is a Pharmacopeia?*, *supra* note 49.

54. *See Legal Recognition of USP Standards*, U.S. PHARMACOPEIAL CONVENTION, http://www.usp.org/about-usp/legal-recognition (last visited Feb. 21, 2016) ("While not a government entity, USP works closely with government agencies, ministries, and regulatory authorities around the world to help provide standards of identity, strength,

National Formulary, it established the United States Pharmacopeial Convention ("USPC") in 1975, and it remains the premiere and most respected authority for the benchmarking and compounding of medicines in the United States.[55]

i. How Does the USP Work?

The USPC sets standards for "identity, strength, and purity of drugs," through credible, science-based processes that USPC-selected medical experts established.[56] The evolving standards remain in a constant state of revision as modern scientific principles and new research and development advances occur in the field.[57] The USP develops and publishes third-party standards for drugs. If a drug is found to be in compliance with the standards, the USPS will allow it to feature the USP logo.[58]

ii. Who Sets the USPC's Standards?

The most significant aspect of the USPC is the particular policies enacted by the third-party agency to ensure its standards are developed and administered fairly and reasonably. Accordingly, the USPC utilizes strict processes that facilitate dialogue with drug manufacturers during the development of public standards, but it also enacts policies and rules to protect the system from undue influence by outside interests.[59] Notably, the USPC endorses a strict conflict of interest policy that applies to all staff

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quality, and purity that can help safeguard the global supply of medicines, dietary supplements, and food ingredients. In the U.S. and various other countries, USP standards are recognized in laws or accepted as a means of meeting certain regulatory criteria.").

55. PETER BARTON HUTT ET AL., FOOD AND DRUG LAW 90 (Robert C. Clark et al., eds., 4th ed. 2014) (explaining that the USP and National Formulary ("USP-NF") "is a compendium of standards for drug strength, quality, purity, packaging, labeling, and storage, published by the USPC, a nongovernmental organization more than a century old").

56. Ruth K. Miller et al., Article, *FDA's Dietary Supplement CGMPs: Standards without Standardization*, 63 FOOD DRUG L.J. 929, 931 (2008) (explaining that the USP Council of Experts are the heart of the USP and that they are responsible for creating and revising the standards that appear in the compendia).

57. *See id.* (describing the compendia as always adapting and changing "to stay abreast of evolving science and best measurement practices").

58. *See USP in U.S. Law*, U.S. PHARMACOPEIAL CONVENTION, http://www.usp.org/about-usp/legal-recognition/usp-us-law (last visited Feb. 21, 2016) [hereinafter "*USP in U.S. Law*"] (explaining that it remains the responsibility of the FDA and other government authorities to enforce the actual health standards and that it remains the responsibility of the FDA and other government authorities to enforce the actual health standards).

59. *See* Miller, *supra* note 56, at 932.

and volunteers.[60] The members of the Expert Committee—which is responsible for much of the standard setting within the USPC—must declare all relationships, activities, and any other related interests. Moreover, members must abstain from participating in any final discussion or vote on issues with any potential conflict of interest.[61]

iii. The USPC in Legislation

The Federal Food and Drugs Act of 1906 integrated the USPC in federal law for the first time by recognizing the USP standards as the official quality standards in the United States.[62] Today, there is an annual USP publication, and it "contains more than 4,500 monographs for prescription and over-the-counter products, dietary supplements, medical devices, and other healthcare products."[63] According to the USP, "[a]s they have been for nearly 200 years, USP standards continue to be established today by volunteer scientific experts, through an open and transparent process that includes public involvement. USP's science-based standards are used and relied on worldwide."[64] Mirroring the USPC model discussed, the USGBC could modify the current LEED system to give it more legitimacy.

III. SHOULD LEED "BE" THE GREEN BUILDING AUTHORITY?

According to the USGBC's website, "LEED is green building"[65]; however, many scholars and experts in the field argue that, for a variety of reasons, LEED should not be the sole authority on green building standards in the United States and the world.[66] This Comment asserts that the USGBC should not be a legal authority in legislative actions relating to green building standards because (1) it is not a valid government authority; and (2) there is a potential for conflicts of interest and informational gaps, which the organization has not addressed as well.

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60. *Id.* (referencing the organization's Conflict of Interest Policy, which states that "USP employees, officers, trustees, and volunteers have an obligation to ensure that they remain free of actual or perceived conflicts of interest in the performance of their duties").

61. *Id.* ("USPC staff not only maintain a record of all stated conflicts but also work closely with committee chairs and members to identify and evaluate potential conflicts of interest and to ensure that committee members excuse themselves from deliberations and votes as required by the Rules of Procedures of the Council of Experts.").

62. *See What is a Pharmacopeia?*, *supra* note 49.

63. *Id.*

64. *Id.*; *see also USP in U.S. Law*, *supra* note 58.

65. *See LEED*, U.S. GREEN BLDG. COUNCIL, www.usgbc.org/leed (last visited Feb. 15, 2016).

66. *See* Frank, *supra* note 8 (referencing the major problems associated with tax exemptions for huge developers manipulating the current system).

A. The USGBC is Not a Valid Government Authority under the U.S. Constitution

The government should not enact green building legislation based on LEED because the USGBC, a third-party, private organization, is not a valid government authority under the Constitution.[67] The Constitution specifically references the limits of legislative power and with whom the power is vested.[68] The nondelegation doctrine forbids the U.S. Congress to abdicate or to transfer to others the essential legislative functions with which it is thus vested.[69] The Supreme Court has recognized the need to adapt legislation to complex conditions involving details that the national legislature cannot deal with directly.[70] However, the Court has clearly asserted that delegating legislative authority to trade or industrial associations is never a valid exercise under the Constitution.[71] Additionally, although the Court has recognized that the Constitution does not deny Congress the "resources of flexibility and practicality" in developing legislation that contain useful and widely applicable functions, the steadfast recognition of the necessity and validity of such legislation cannot obscure the limitations of the authority to delegate.[72] Certain trade groups and industry associations may have a superior knowledge of applicable standards in a specific field or industry; however, the Supreme Court and other federal courts will not formally recognize the policies of these groups or associations as a valid legally binding authority.[73]

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67. U.S. CONST. art. I, § 8, cl. 18; *see also* A. L. A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 529–30 (1935) (referencing the nondelegation doctrine and general discussion of governmental authority).

68. *See* U.S. CONST. art. I, §§ 1, 8, cl. 18 ("All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives." Congress is further authorized "[t]o make all Laws which shall be necessary and proper for carrying into Execution [its general powers].").

69. *See A. L. A. Schechter Poultry Corp.*, 295 U.S. at 529–30 (highlighting the oversight from Congress necessary for democracy); *see also* Keller, *supra* note 4, at 1393–96 (discussing generally the nondelegation doctrine principle that Congress cannot delegate its legislative power to other agencies).

70. *See* Panama Refining Co. v. Ryan, 293 U.S. 388, 420–22 (1935) (recognizing that there are many complex situations in society and that it is difficult for Congress to always be knowledgeable about these situations to the degree necessary to draft legislation that will address all of the problems).

71. *See A. L. A. Schechter Poultry Corp.*, 295 U.S. at 537 (stating that delegation is "unknown in our law and is utterly inconsistent with the constitutional prerogatives and duties of Congress").

72. *See id.* at 530 (noting that, while it may be useful to allow Congress to delegate certain matters for policy considerations, the costs of doing this would be dramatic and detrimental to democracy).

73. *See Panama Refining Co.*, 293 U.S. at 420–22 (refusing to extend legislative authority to any third-party, private organizations without a clear oversight by Congress

Courts at the state level generally find delegation to private actors to be even more troublesome than courts at the federal level.[74] State courts regularly reference the nondelegation doctrine when considering the constitutionality of a transfer or delegation of legislative power to private or nongovernmental entities.[75] Also, state courts have not adopted a set standard to deal with regulatory delegation to private actors, and they have encountered many difficulties in attempting to use their discretion to decide when it may be appropriate.[76]

Thus, while the USGBC must not be recognized as a legally binding authority to make the laws under the Constitution, it may have legal significance and may be consulted as an authority with regard to the execution and carrying out of laws.[77] The Court has recognized the distinction between the power vested in Congress to make the laws and the ability of Congress to appoint authorities to enforce the laws.[78] Courts have consistently held that Congress may delegate to third-party entities the authority to research and monitor compliance of laws.[79] In a landmark food and drug decision, Congress authorized the Secretary of the Treasury to establish uniform standards of purity, quality, and fitness for the consumption of teas imported into the United States based a board of

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in formally passing legislation).

74. *See* Klopping v. Whittier, 8 Cal. 3d 39, 42 (1972); *see also* Keller, *supra* note 4, at 1394 (listing reasons including "(1) inability to hold private actors accountable; (2) potential for conflicts of interest between the public and the delegate; (3) the fact that the judiciary considers some powers to be purely governmental; (4) lack of transparency and legitimacy in the rulemaking process; and (5) concerns about efficacy of the standards promulgated").

75. *See* Keller, *supra* note 4 (continuing to discuss the many problems that arise from delegation to private actors including "concerns about notice and availability of information, lack of a public voice[,]" and future problems that arise with delegation generally).

76. *See id. See generally* Asmara Tekle Johnson, *Privatizing Eminent Domain: The Delegation of a Very Public Power to Private, Non-profit and Charitable Corporations*, 56 AM. U. L. REV. 455 (2007) (discussing many of the inherent problems with attempting to circumvent the nondelegation doctrine and delegating powers that are specifically vested in Congress to private entities).

77. *See A. L. A. Schechter Poultry Corp.*, 295 U.S. at 530; *see also Panama Refining Co.*, 293 U.S. at 420–22 (identifying the possible ways to reduce the burden on Congress).

78. *See Panama Refining Co.*, 293 U.S. at 426 ("'[The] delegation of power to make the law, which necessarily involves a discretion as to what it shall be, and conferring authority or discretion as to its execution, to be exercised under and in pursuance of the law.'").

79. *See id.* ("Authorizations given by Congress to selected instrumentalities for the purpose of ascertaining the existence of facts to which legislation is directed, have consistently been sustained.").

experts' recommendations.[80] The Court held that this was a valid delegation of authority because Congress had fixed the "primary standard" and subsequently committed the Secretary of the Treasury to merely monitor compliance and observance of the laws.[81] Therefore, nothing precludes Congress from authorizing the USGBC to oversee green building policy and to act as a vehicle to enforce legislation so long as Congress remains the valid legal authority to develop and enact the legislation.

B. Properly Delegating Government Decision-Making Authority

While courts have recognized that the inclusion of a product in the USP as having a recognizable legal significance, the Court does not consider the USPC to be a valid legal authority.[82] In general, food and drugs are subject to a rigorous regulatory regime largely due to the strong governmental interest in promoting a safe environment for consumers.[83] Consequently, food and drugs are subject to FDA approval before parties can market and sell them.[84] Notably, the 1906 Federal Food and Drugs Act contains a reference to the USP, where it specifically references inclusion of a substance in the USP as a consideration in determining whether the substance will meet the legal definition of a "drug."[85] However, Congress and courts are careful to consider the nondelegation doctrine in all decisions related to the vesting of legislative authority in third parties.[86]

Congress has been careful to abide by the nondelegation doctrine, and it

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80. *See* Buttfield v. Stranahan, 192 U.S. 470, 495 (1904) (representing one of the earliest cases of a delegation of standard setting authority to a private, third-party entity through the context of Food & Drug law).

81. *See id.* (explaining that Congress gave the Secretary "the mere executive duty to effectuate the legislative policy declared in the statute" and did not delegate the actual standard setting authority).

82. *A. L. A. Schechter Poultry Corp.*, 295 U.S. at 530; *see also* Nat'l Nutritional Foods Ass'n v. FDA, 504 F.2d 761, 788-89 (2d Cir. 1974).

83. *See generally* Colleen O. Davis, *Red Tape Tightrope: Regulating Financial Conflicts of Interest in FDA Advisory Committees*, 91 WASH. U. L. REV. 1591 (2014) (referencing the strong policy reasons for subjecting the FDA to close supervision by the federal government).

84. *See National Nutritional Foods Ass'n*, 504 F.2d at 788–89 (noting that the federal government felt the policy interests were so strong that it created a separate governmental body to mandate and enforce the standard setting regulations).

85. *See* Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 321(g)(1)(A) (2016) (replacing the repealed Federal Food and Drugs Act of 1906 that both included under the definition of "drug" any article "recognized in the official United States Pharmacopoeia, official Homeopathic Pharmacopoeia of the United States, or official National Formulary, or any supplement to any of them").

86. *See A. L. A. Schechter Poultry Corp.*, 295 U.S. at 530 (referencing the Supreme Court decision where the Court conducted a detailed investigation of the nondelegation doctrine that continues to be the leading authority on the issue today).

emphasized that the USPC represents an enforcement agency, not a government standard-setting authority.[87] Through the 1938 Federal Food, Drug, and Cosmetic Act, Congress revised the Food and Drug Act, specifically, to place the burden on drug manufacturers to demonstrate the safety of their new products directly to the FDA rather than by merely abiding by the specifications outlined in the USP.[88] Additionally, the FDA does not give much deference to the USP, and it generally relies on its own resources when evaluating substances and assessing the views of drug manufacturing companies.[89] In fact, the FDA is required to conduct its own, independent investigation into the qualification of a substance to be legally recognized as a "drug" and does not rely solely on its inclusion in the USP and the assertions made by drug companies.[90]

In the food and drug context, courts have usually thwarted the efforts of the FDA when it has attempted to classify products as "drugs" based solely on their inclusion in the USP.[91] In *United States v. Ova II*, a federal district court—considering the regulatory status of a pregnancy test—concluded that the official USP compendia provision of the drug definition "cannot be taken literally" because a literal interpretation would not be in accordance with the FDA's stance towards third-party ratings.[92] Similarly, in *National Nutritional Foods Ass'n v. Mathews*, the court held that the FDA may not

87. Ruth K. Miller et al., Article, *FDA's Dietary Supplement CGMPs: Standards without Standardization*, 63 FOOD DRUG L. J. 929, 936 (2008); *see also* Hutt, *supra* note 89 (discussing the FDA's treatment of section 321(g)(1)(A) as not being viewed expansively and, rather, being viewed in a very limited context).

88. Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 321(g)(1)(A).

89. *See* Hutt, *supra* note 89 ("Although [S]ection 321(g)(1)(A) appears on its face to give FDA the power to treat any item listed in these compendia as a drug, the agency generally has not viewed this provision so expansively.").

90. *See* Nat'l Nutritional Foods Ass'n v. FDA, 504 F.2d 761, 788–89 (2d Cir. 1974) (appointing the FDA as the government authority to approve a drug on the market for sale); *see also* Davis, *supra* note 83 (discussing the potential issues with delegating authority to any private agencies in regulating products in an extremely lucrative industry due to the likelihood of conflicts of interest).

91. *See Nat'l Nutritional Foods Ass'n*, 504 F.2d at 788–89 (rejecting the argument that vitamins and minerals are drugs because of their recognition in the official compendia); *see also* Nat'l Nutritional Foods Ass'n v. Mathews, 557 F.2d 329, 337–38 (2d Cir. 1977) (rejecting the argument with regard to high potency vitamins); United States v. An Article of Drug OVA II, 535 F.2d 1248 (3d Cir. 1976) (rejecting the argument with regard to pregnancy test kit); United States v. Articles of Animal Drug Etc., 528 F. Supp. 202, 204–06 (D. Neb. 1979) (accepting the argument with regard to animal euthanasia drug).

92. *See* United States v. An Article of Drug OVA II, 414 F. Supp. 660, 662 (D.N.J. 1975) *aff'd sub nom. An Article of Drug Ova II*, 535 F.2d at 1248 (emphasizing that a literal interpretation of the provision would "run afoul of the principle that a legislative body may not lawfully delegate its functions to a private citizen or organization").

regulate items as drugs based solely on their inclusion in the USP because the FDA does not recognize the USP as a valid government authority.[93] Further, in *National Nutritional Foods Ass'n v. FDA*, the court found that including all items listed in the USP under the umbrella of "drugs," which the FDA regulates, would unnecessarily burden the agency.[94] The court held that an administrator's decision under a regulatory statute, such as the Food, Drug, and Cosmetic Act, must be governed by an intelligible statutory principle and not based solely on the description of the substance in the USP.[95]

Similarly, the federal government must recognize that the USGBC is not a valid governmental authority on green building, and therefore, it must withhold authority to approve standards for green building practices.[96] Congress must address the nondelegation issue in green building as it addressed the nondelegation issue with the Food, Drug, and Cosmetic Act, and it should place the burden on the USGBC to concretely demonstrate the validity of the LEED ratings system to the federal government.[97] The government must not legally recognize buildings as "green" only for the purposes of classifying them as eligible for certain tax breaks and other government subsidies based solely on meeting the the USGBC-enacted LEED certification standards.[98]

The government may establish the USGBC as an authority for monitoring and enforcing green building standards, but it must be subject to review by a valid legal authority.[99] While the courts have held that

93. *See Mathews*, 557 F.2d at 337–38 ("To construe § 201(g)(1)(A) so as to grant the Commissioner the power to regulate as drugs every item mentioned in the USP and NF solely on the basis of such inclusion would give the FDA virtually unlimited discretion to regulate as drugs a vast range of items.").

94. *See Nat'l Nutritional Foods Ass'n*, 504 F.2d at 788–89 (highlighting that inclusion of all drugs "would prove too much[] for it would lead to the conclusion that all vitamin and mineral preparations even within the [U.S. RDA] limits are drugs – a position that would run counter to the regulations").

95. *See Mathews*, 557 F.2d at 329 ("Inclusion in the USP does not automatically establish that the classification of such an article as a drug is reasonable.").

96. *See id.* (identifying the nondelegation doctrine as a clear legal barrier that may not be overlooked preventing the third-party, independent USGBC from yielding authority to make legislative decisions).

97. *See* Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 321(g) (2016). *See generally* Hutt, *supra* note 89 (discussing the FDA's view of the USP as a helpful guideline rather than an authority on defining drugs).

98. *See* United States v. An Article of Drug OVA II, 535 F.2d 1248 (3d Cir. 1976); *Nat'l Nutritional Foods Ass'n*, 504 F.2d at 788–89; *see also Mathews*, 557 F.2d 325, 337–38 (emphasizing that there must be a valid governmental authority to enact binding legislation and that the USP does not possess this power).

99. *See Article of Drug OVA II*, 414 F. Supp. at 665 (noting that the "[l]imited delegation of legislative functions to governmental agencies within the boundaries of

inclusion of a product in the USP does have legal significance, the key distinction is that the USPC is not a valid legal authority for the federal government.[100] The federal government, through the FDA, maintains final decision-making authority as to whether a drug manufacturing company has met the requisite standards to be classified as a "drug" under the Federal Food, Drug, and Cosmetic Act of 1938.[101] Similarly, the USGBC must be subject to review by a valid legal authority when making legislative determinations regarding green building standards.[102]

C. The Problem of Potential Conflicts of Interest

One of the major concerns regarding the USGBC and the federal government's adoption of LEED building standards is the potential for conflicts of interest. In the corporate context, it is presupposed that all director-executed corporate transactions are free of any conflicts of interest.[103] Fiduciaries have a seemingly absolute duty to establish the entire fairness of any transaction that involves self-dealing.[104] The concern with LEED is that its members—industry professionals responsible for generating the standards—are in a position to profit dramatically from compliance with regulations based on the LEED ratings system.[105] While the government is responsible for enacting legislation that authorizes massive tax cuts for LEED certification, USGBC members and building owners stand to benefit considerably in the private industry from compliance measures.[106]

It should not be surprising that LEED's standards cater to developers:

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an expressed norm, standard or guide is well recognized; but a delegation to private groups, and without such boundaries, is quite another matter.").

100. *See id.* (explaining that the USP is a publication of a private, third-party organization and that it is not published pursuant to any "authority" other than the right of individuals or organizations to publish such works as they deem appropriate and useful).

101. *See id.* at 668 (emphasizing that the USPC, through the USP, is not responsible for setting standards for the FDA).

102. *See id.* at 667 (applying the FDA's approach would lead to a much better green building situation going forward).

103. *See* Lewis v. S.L. & E., Inc., 629 F.2d 764, 768–71 (2d. Cir. 1980) (applying conflict of interest laws to all corporate transactions and legislative actions is a cornerstone of corporate law).

104. *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 247–48 (Del. 2001) (referencing self-dealing transactions as subject to conflict of interest laws).

105. *See* Keller, *supra* note 4 (addressing the clear conflict of interest that arises in the current USGBC system).

106. *See* Frank, *supra* note 8 (studying the implications of a state law in Nevada, which put a "private interest group—not the government—in charge of deciding which buildings are green enough for a taxpayer subsidy").

LEED "was created as a marketing tool" for businesses to use to portray themselves and their projects as "green."[107] It is for this reason that critics of LEED deride it as "a highly lucrative regime of payouts and misinformation" and "a moral-protection racket."[108] Based on the arguments of these critics, it seems that the pecuniary interest of USGBC's primary stakeholders conflict directly with the broader social goals that the green building legislation seeks to address.[109]

The federal government should subject the USGBC to certain processes or policies to address many of the concerns surrounding the potential conflict of interest.[110] In the food and drug context, the FDA is subject to several regulations imposed by the federal government that are specifically aimed at preventing financial conflicts of interest.[111] First, under the Federal Advisory Committee Act of 1972, any "advisory committee" established by a federal agency must comply with specific conditions geared toward efficiency, record keeping, and public disclosure.[112] Second, the federally-imposed Sunshine Act,[113] which amended the Freedom of Information Act,[114] imposes specific requirements on advisory committees designed to increase transparency and limit potential conflicts of interest.[115] The FDA meets this requirement by hosting a website where it posts meeting outlines prior to meetings and meeting minutes after the meetings.[116] Third, the Ethics Reform Act of 1989[117] amended the basic criminal conflict of interest statute to subject advisory committee members

107. *See id.* (explaining that the USGBC has enabled many developers to win huge tax breaks and grants, charge higher rents, exceed local building restrictions, and receive expedited permitting by providing them with LEED Certification).

108. *See* Jacob Gershman, *Fake Green Labels: Buildings Don't Save Energy*, N.Y. POST (Sept. 21, 2009, 4:00 AM), http://www.nypost.com/p/news/opinion/opedcolumnists/fake_green_labels_aU9PWSSD4p71LigLp0z4eo.

109. *See* Frank, *supra* note 8 (emphasizing that the actual goals of lowering energy costs are not met under the LEED system).

110. *See* Davis, *supra* note 84, at 1592 (explaining that the FDA employs very specific processes in an effort to alleviate the financial conflicts of interest in the extremely lucrative pharmaceutical industry).

111. *Id.* (referencing the federal conflict of interest laws imposed directly on the FDA).

112. *See generally* The Federal Advisory Committee Act, Pub. L. No. 92-463, 86 Stat. 770 (1972) (stating that the committees are overseen by the U.S. General Services Administration pursuant to the law).

113. 5 U.S.C. § 552 (2012).

114. *Id.* § 552(b).

115. *See generally id.* § 552.

116. *See* Davis, *supra* note 84, at 1602 (emphasizing the efforts by the FDA to meet the federal requirements and the resulting positive effect on the industry as a whole).

117. Ethics Reform Act of 1989, Pub. L. No. 101-194., 104 Stat. 149 (1990).

to criminal liability for breach of the conflict of interest statute.[118] The revised statute prohibits an executive branch employee from participating in a government matter if the member, or anyone in the member's family, has a conflicting financial interest.[119] Finally, the Food and Drug Administration Amendments Act of 2007, which amended the Food, Drug, and Cosmetic Act, further addressed the issue of conflicts of interest in Title VII.[120] In a similar fashion, the federal government should intervene and require the USGBC to integrate the aforementioned FDA procedures, which would alleviate many of the conflict of interest concerns with the USGBC and LEED.

IV. LEED-ING THE WORLD INTO THE FUTURE

While the USGBC has made massive strides towards sustainability in the building industry, there are substantial changes that it should make to its procedures and processes. How can the federal, state, and local governments most effectively utilize LEED and the USGBC to actually help protect the environment in the long term? The solution most likely relates to the federal government taking a more active role in the USGBC and its processes to avoid nondelegation authority and conflict of interest concerns.

A. Federal Government Review of the LEED Rating System

A major step the government could take toward validating the USGBC and LEED certification would be to conduct a thorough review of the LEED ratings system. According to USA Today, "[g]overnors, mayors, state legislators, and federal administrators have been forceful LEED advocates who [have] helped it flourish nationwide."[121] It is very easy for a government official to simply promote sustainability and echo environmental concerns for the nation to hear; however, meaningful government review of green building standards could really make a significant impact. The federal government could potentially allocate a portion of its budget to study the impact of the building industry on the environment. Rather than taking time to conduct its own research, the

118. *See* Davis, *supra* note 84, at 1602 (expanding the scope of 18 U.S.C. § 208(a) to include "special government advisory committee members" under the umbrella of government employees subject to the statute).

119. 21 U.S.C. § 379d-1 (2012)

120. *Id.* (explaining that under Title VII, the Secretary must disclose on the FDA website the "type, nature, and magnitude" of any questionable financial interest of advisory committee members).

121. *See* Frank, *supra* note 8.

government today has deferred to the USGBC on all methods of improving sustainability. Most government officials have simply embraced LEED without understanding many of its actual benefits, trade-offs, or costs.[122]

In the food and drug context, the federal government recognized the substantial health risks associated with the public sale and marketing of consumable products and created a regulatory agency to mitigate those risks. Similarly, the federal government should recognize the substantial environmental concerns in the building industry and allocate resources to, among other things, study green building, set and enforce universal standards for green construction, and develop programs to update existing buildings. If the federal government can recognize concerns with the building environment to the degree that it is willing to dole out billions of dollars in tax breaks nationwide, it should take the initiative to actually study the built environment itself.

While it is certainly a step in the right direction to support "go green" initiatives, the government must do more than stand by while private, third-party organizations set the standards for green building in the United States, in violation of the nondelegation doctrine. The federal government should treat green building standards similarly to how it treats food and drug standards. The impacts of regulating the building industry have the potential to be massive in promoting sustainability and saving the environment. If the federal government actually seeks to make changes that will have a drastic impact on the environment, as President Obama has claimed,[123] it must take affirmative steps to address the problem.

B. Improving the USGBC's Transparency and Processes

Improving the USGBC's transparency of information and processes is another meaningful way to improve the current green building system. The USGBC could learn a lesson from observing the USP, a third-party organization that has been active for over 200 years, which collaborates with the FDA and has publicized all of its records, processes, and information.[124] The USP has learned from experience what it must do to be a successful, influential third-party ratings organization. The USGBC could incorporate many of the features employed by the USP into its standards-setting and conflict of interests processes. Also, if the USGBC were able to provide statistical information to the public and meaningful

122. *See id.*

123. *See* 2014 State of the Union Address, *supra* note 2.

124. *See Working with U.S. FDA*, U.S. PHARMACOPEIAL CONVENTION, http://www.usp.org/about-usp/legal-recognition/working-us-fda (last visited Feb. 21, 2016).

evidence about why it should enact certain standards for green building, then reliance on its ratings system would be much more acceptable and understandable. The lack of transparency and lack of statistical data supporting the views of the USGBC is a major issue. To avoid this information gap, the federal government, one of the largest supporters and users of the LEED ratings system, should enact legislation to require the USGBC to incorporate these mentioned tactics.

CONCLUSION

The USGBC and LEED have enormous potential in the building industry to make a massive impact on the future of the world. Green building practices can alleviate many environmental concerns facing the world today. However, there are constitutional and other legal implications with the current status of USGBC and its LEED ratings system; as it stands, the USGBC's current procedures improperly lead to the deferral of decision-making and standard-setting responsibilities to independent third parties. Time will tell whether the process of integrating standards—similar to the mentioned FDA rating system—will alleviate the legal issues that could potentially entangle the "go green" movement.

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