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TABLE OF CONTENTS

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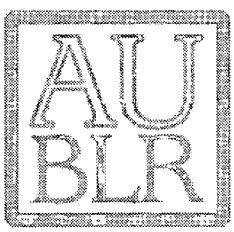
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SYMPOSIUM ARTICLES: TRANSACTIONAL LAW PEDAGOGY

GOING BEYOND THE FOUR CORNERS: REFLECTIONS ON TEACHING LETTERS OF CREDIT AS A SUBSET OF INTERNATIONAL BANKING LAW

JAMES E. BYRNE*

The subject of letters of credit affords an ideal introduction to advanced commercial law studies. Rather than being taught as a traditional case-oriented course, it is best taught by conducting students through discrete problem-oriented experiences that focus on transaction and

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litigation skills rather than theory. Otherwise, the basic principles underlying letter of credit law and practice are only superficially grasped. A practice-oriented approach will enable students to discover, interiorize, and apply letter of credit principles in a manner that leads to an appreciation of sound letter of credit law and practice. Such a setting readily reveals the degree to which vocabulary, legal obligations, relevant practice rules, laws, and related issues have been acquired and mastered.[1]

1. This Article was originally presented to the Transnational Commercial Law Teacher's Conference at the University of Washington School of Law in Seattle, Washington on 19–20 November 2012. It was subsequently presented in modified form at the "Transactional Lawyering: Theory, Practice & Pedagogy" symposium panel discussion entitled "Business Planning and Legal Drafting Pedagogy" at American University on April 5, 2013 in Washington, D.C. This Article represents a revision of these presentations.

INTRODUCTION

This Article addresses teaching letters of credit ("LC") in the context of teaching international commercial law as a two credit hour semester course in light of 30 years of experience teaching commercial law classes of various sizes and experience ranging from undergraduate to skilled bank professionals and attorneys in multiple countries (with and without translation). Part I is a survey of the inadequacies of the conceptual framework for teaching commercial law subjects and of current instruction methods. Part II presents proposals for an alternative method of teaching commercial law and specifically letters of credit through a transactional approach. Finally, Part III discusses several lessons used to teach all grade levels are included to make concrete the abstract points made here.

The goal of the courses envisioned here is to enable the student to appreciate and begin to formulate sound letter of credit law and practice with respect to discrete international issues and indirectly to build a transactional basis towards approaching commercial law.[2]

Because this Article discusses the effective teaching of commercial law from the perspective of teaching a course on LC law and practice, it is helpful to begin with an introduction to LCs.[3]

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2. Because the utility and purpose of this Article relates to its efficacy as a teaching tool, the author will keep much of the substantive legal instruction on letter of credit law and practice confined to the footnotes. The idea is to keep the reader focused on the teaching lessons by not getting bogged down with LC details. However, these details are in the footnotes for those who are interested.

3. In the United States, letters of credit are governed by U.C.C. Article 5. U.C.C. Article 5 (Letters of Credit) was contained in the original Model U.C.C. that was

The term "letter of credit"[4] and its variations such as "LC" in the context of this paper signifies the family of independent undertakings, (so-called

approved in 1952. In 1957, Model U.C.C. Article 5 was revised extensively as a result of comments by the New York Law Revision Commission. *See* N.Y. LAW REV. COMM'N REP. 11, 46 (1956); *see also* Robert Braucher, *The 1956 Revision of the Uniform Commercial Code*, 2 VILL. L. REV. 3, 4–6, 11–12 (1956). This version was eventually adopted by all 50 states. A non-conforming amendment, styled Section 5-102(4), however, was adopted by Alabama, Arizona, Missouri and New York that displaced U.C.C. Article 5 where the letter of credit was determined to be subject to the Uniform Customs and Practices for Documentary Credits (UCP) published by the International Chamber of Commerce (ICC). *See* ALA. CODE § 7-5-102 (1966); ARIZ. REV. STAT. ANN. § 47-5102 (1984); MO. REV. STAT. § 400.5-102 (1965); N.Y. U.C.C. LAW § 5-102 (McKinney 1962); U.C.C. § 5-102(4) (1995). A joint American Bar Association/Banking Industry Task Force recommended the revision of original U.C.C. Article 5 in 1990. *See* Stanley F. Farrar et al., *An Examination of U.C.C. Article 5 (Letters of Credit)*, 45 BUS. LAW 1521, 1536–37 (1990). The revision of U.C.C. Article 5, completed in October 1995, has been adopted by all 50 states, the District of Columbia, and Puerto Rico. *See* INST. OF INT'L BANKING LAW & PRACTICE, LC RULES & LAWS: CRITICAL TEXTS FOR INDEPENDENT UNDERTAKINGS (James E. Byrne ed., 6th ed. 2014) [hereinafter LC RULES & LAWS] (offering a table of dates of adoption, effective dates, and state citations). For a summary of revised U.C.C., see generally JAMES G. BARNES, JAMES E. BYRNE & AMELIA H. BOSS, THE ABCS OF THE UCC, ARTICLE 5, LETTERS OF CREDIT (Am. Bar Ass'n ed., 1998); James G. Barnes & James E. Byrne, *Letters of Credit: 1995 Cases*, 51 BUS. LAW. 1417 (1996). This Article refers to the 1957 version of the Model Code as "Prior U.C.C. Article 5" and the 1995 version (including Article 9 amendments) as "Revised U.C.C. Article 5."

4. UCP600 defines "Credit" as "means any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation." INT'L CHAMBER OF COMMERCE, PUBL'N NO. 600, THE UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS art. 2 (2007) [hereinafter UCP600] (Definitions). Revised U.C.C. Article 5 defines "letter of credit" as "a definite undertaking that satisfies the requirements of Section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value. Revised U.C.C. § 5-102(a) (1995). ISP98 defines "standby letter of credit" as "an irrevocable, independent, documentary, and binding undertaking when issued and need not so state." INT'L CHAMBER OF COMMERCE, PUBL'N NO. 590, INTERNATIONAL STANDBY PRACTICES R. 1.06(a) (1998) [hereinafter ISP98] (Nature of Standbys). The UN LC Convention defines "undertaking" as "an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person." Convention on Independent Guarantees and Stand-by Letters of Credit, art. 2(1), Dec. 11, 1995, 2169 U.N.T.S. 190, 35 I.L.M. 735 [hereinafter UN LC Convention] (Undertaking). URDG 758 defines "Demand guarantee" as "means any signed undertaking, however named or described,

"documentary"[5] letters of credit) including commercial letters of credit,[6] standby letters of credit,[7] independent (bank, first demand) demand

providing for payment on presentation of a complying demand. INT'L CHAMBER OF COMMERCE, PUBL'N NO. 758, UNIFORM RULES FOR DEMAND GUARANTEES art. 2 (2010) [hereinafter URDG 758] (Definitions).

5. The term "documentary" applied to the species instead of the genus is a misnomer since all types of letters of credit are documentary in the sense that they are conditioned on the presentation of a required document. The use of the term "letter of credit" embroils one in a problem of classification because in one sense, "letter of credit" is a name of an independent undertaking, where letters of credit are the best known species of this genus of independent undertakings. However, in a more limited sense, the term is associated with commercial or documentary credits or can include independent guarantees and standbys. Revised U.C.C. § 5-103(a) states that it applies to "letters of credit and to certain rights and obligations arising out of transactions involving letters of credit." Revised U.C.C. § 5-103(a). This definition includes standby letters of credit, independent guarantees, transferred credits, pre-advices, and reimbursement undertakings under the ICC Uniform Rules for Reimbursement Article 2(g) (Definitions), and an irrevocable undertaking to purchase documents by a nominated bank. Included within the scope of Revised U.C.C. Article 5, but different from "letters of credit," are obligations such as advices, actions of nominated banks, to an extent the agreement with the applicant, and other undertakings that are not issued by the issuer or do not otherwise fall within the definition of "letter of credit." There is no formal definition of "commercial letter of credit," "standby," or "Independent Demand Guarantee" that distinguishes one undertaking from another. *See* James E. Byrne, *Revised Article 5: Letters of Credit*, *in* 6B HAWKLAND UNIFORM COMMERCIAL CODE SERIES 5-1, 5-200 to -201 (2010) [hereinafter HAWKLAND].

6. A commercial letter of credit is a definite documentary undertaking given by the issuer to a beneficiary that undertakes to honor a presentation of "live" commercial documents as a means of payment for the recent sale of goods or services. It is also sometimes misnamed a "documentary credit," used to represent the contemporaneous delivery of goods. Historically, "documentary credit" signified an undertaking to pay only against documents of title, but since the acceptance of standbys by the UCP system, this term has come to signify any undertaking to pay against documents, regardless of whether or not they are commercial documents. The definition of "letter of credit" in Revised U.C.C. § 5-102(a)(10) does include a commercial letter of credit. *See* Revised U.C.C. § 5-102(a)(10); HAWKLAND, *supra* note 5, at 5-200.

7. Standby letters of credit are definite documentary undertakings by an issuer to honor the presentation of documents that do not represent a demand for immediate payment for a transaction in goods or services. Standbys are not necessarily default undertakings, and are seen with a variety of different terms such as a direct pay element that may be seen in a financial standby, or a standby that functions to ensure payment under a contract for the sale of goods in the event that the buyer fails to pay, distinguishing them from a commercial letter of credit. Under the ISP98, the term "standby" encompasses even "clean" (i.e. demand only) letters of credit, and the Revised U.C.C. Article 5 definition includes standby letters of credit. *See* ISP98, *supra* note 4; Revised U.C.C. § 5-102. There is no legal distinction between standby letters of credit and any other type of letter of credit. More colloquial classifications are made between "commercial standbys," "insurance (or reinsurance) standbys," "bid/tender bond" standbys or (independent) guarantees, "performance bond" standbys or (independent) guarantees, "supersedeas bond" standbys, and "advance payment" standbys or (independent) guarantees. In the United States, banks are required by

guarantees,[8] confirmations,[9] reimbursement undertakings,[10] and pre-advices.[11] The term excludes other undertakings with similar functions

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regulators to maintain capital based on risk weighting aligned with categorization as a commercial letter of credit, a performance standby, or a financial standby under the Basel I and Basel II risk rating system. HAWKLAND, *supra* note 5, at 5-202 to -203. Under this system, the risk of a commercial letter of credit involving goods and assumed to be self-liquidating is perceived to be less than the risk of a standby assuring performance. Moreover, a standby assuring performance is perceived to be less risky than a financial letter of credit in which the obligation is simply the payment of money. While it is possible to distinguish performance and financial standbys predicated on the demand for payment being the trigger, i.e. payment of money or something else, these distinctions are theoretically unsatisfactory and not truly distinguishable in application. *See id.*

8. "Independent guarantees are definite documentary undertakings by a guarantor to honor the presentation of documents that do not represent immediate payment for a transaction in goods or services." HAWKLAND, *supra* note 5, at 5-203. Like standbys, independent guarantees can be issued under the ISP98, and do not necessarily fall into the category of default undertakings since they can have direct pay elements, although they rarely do. Abstractly, if an independent guarantee is subject only to local law or rules like URDG 758, the independent guarantee is functionally equivalent to a standby LC with some possible differences in practice and party expectations; however, if the independent guarantee is fully independent, there is no difference between the guarantee and a standby. Since the Revised U.C.C. definition of "letter of credit" includes independent guarantees, there is no legal distinction under the U.C.C. between independent guarantees and any other type of letter of credit. *See* Revised U.C.C. § 5-102(a)(10); HAWKLAND, *supra* note 5, at 5-203 to -204.

9. UCP600 defines "confirmation" as "a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honour or negotiate a complying presentation." UCP600, *supra* note 4, art. 2 (Definitions). ISP98 defines "confirmer" as "a person who, upon an issuer's nomination to do so, adds to the issuer's undertaking its own undertaking to honor a standby." ISP98, *supra* note 4, art. 1.09(a) (Definitions). A bank that is nominated as confirmer is not a confirmer until it adds its confirmation, that is to say, when it acts on the nomination. The definition of "confirmer" in Revised U.C.C. indicates that only when a confirmer so acts does it become a confirmer. Revised U.C.C. § 5-102(a)(4). A confirmer adds its undertaking to that of the issuer and is obligated on the letter of credit to the extent of its confirmation. Its obligation, therefore, must be understood from the perspective of the obligation to the beneficiary and its rights against the issuer. Without confirmation, a beneficiary assumes the risk that the issuer will be solvent when a complying presentation is made, that the issuer will respect letter of credit practice, will not seek to avoid its obligations by raising technical arguments, and that the country where the issuer is located will not interfere with payment. Usually an issuer nominates a bank to confirm in the credit itself, an amendment, or some other communication by authorizing or requesting the bank to do so as a way for a beneficiary to mitigate risks by requiring that a letter of credit be confirmed by a bank that is local to the beneficiary and, presumably, subject to jurisdiction in a place that is accessible to or comfortable to the beneficiary. While risks can also be set off by insurance, confirmation is often a simpler way for a beneficiary to make sure its presentation will be honored. Nomination is usually contained in a credit or amendment; it can be contained in another communication or a combination of them.

While a confirmation is similar to the undertaking of an issuer, however, it is

such as accessory or suretyship undertakings (dependent undertakings), indemnities, insurance, or bilateral contracts.[12]

I. THE INADEQUACIES OF THE CURRENT CONCEPTUAL FRAMEWORK AND METHODOLOGICAL FOR TEACHING COMMERCIAL LAW

To begin this discussion of effective teaching of commercial law on a transactional basis, it is important to discuss current teaching practices and approaches to material and why they are not effective. Several points need to be made.

A. It is Not Contract Law

In my experience, contract law is inapt for the effective study of LC law.[13] An LC is only a contract in the sense that it does not fall within the

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not necessarily identical, an aspect of confirmations that is not made explicit and which must be determined from the terms and conditions of the confirmation itself. In addition, a confirmation, while similar to the undertaking of and for the account of the issuer, differs in that the beneficiary must present documents to the confirmer in order to trigger its undertaking unless the confirmation or applicable practice rules provide otherwise. Confirmation in standbys involves different issues than in Commercial LCs. *See* ISP98, *supra* note 4, Model Forms 7, 8, (allowing for the beneficiary, effectively, to look only to the confirmer); HAWKLAND, *supra* note 5, at 5-379 to -380; INT'L CHAMBER OF COMMERCE, PUBL'N NO. 680, COMMENTARY ON UCP 600, ARTICLE-BY-ARTICLE ANALYSIS OF THE UCP 600 DRAFTING GROUP 91–92 (2007) [hereinafter COMMENTARY ON UCP600]; JAMES E. BYRNE, ISP98 & UCP500 COMPARED 42 (2000).

10. *See infra* note 25.

11. *See infra* note 30.

12. The Restatement (Third) of Suretyship and Guaranty specifically states that while "suretyship law is a potential source of generally appropriate analogies[,]" the Restatement does not apply to letters of credit of any type. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 4 cmt. c (1996). The practical reason for this exclusion is that the law and practice rules governing letters of credit are well-developed, and "[n]o good purpose would be served by disturbing [this] state of affairs." *Id.* Section 4(d) makes it clear that "instruments analogous to letters of credit[,]" like independent guarantees, are also "beyond the scope" of the restatement. *Id.* § 4 cmt. d. The basic difference between a suretyship guarantee and a letter of credit is that in a suretyship, any defenses asserted by the primary obligor, even in the underlying transaction may be asserted by the guarantor. In letters of credit, the applicant cannot prevent or assert defenses against the beneficiary in order to prevent the issuer from honoring a complying presentation. The independence principle, that the undertaking by the issuer to pay against a complying presentation is a separate undertaking independent of any underlying contract, is unique to letter of credit practice. *See* U.C.C. § 5-101 official cmt. ("The objects of the original and revised Article 5 are best achieved by defining the peculiar characteristics of a letter of credit that distinguish it and the legal consequences of its use from other forms of assurance such as secondary guarantees, performance bonds and insurance policies, and from ordinary contracts, fiduciary engagements, and escrow arrangements . . . .").

13. "As is the case with much of letter of credit law, it is futile to look to general

other branch of the law of obligations, namely tort.[14] There is no bilateral promise, the beneficiary has no obligation to the issuer/guarantor and

principles of contract or commercial law for antecedents to the law of letter of credit fraud. Its origin lies as much in the mercantile character of the letter of credit as it does in law. It is sui generis." HAWKLAND, *supra* note 5, at 5-494. Letters of credit developed not out of contract law per se, but rather as a mercantile specialty. Early English cases have had little impact on the development of letters of credit in business. "[English] [c]ase law proved a particularly inapt method to address the fundamental doctrinal questions and challenges that letters of credit presented to the relatively primitive doctrines of bilateral contracts applied to questions such as consideration, characterization, enforceability, mutuality, offer and acceptance, what constitutes a confirmation, and the like." *Id.* at 5-23. Letters of credit do not create fiduciary relationships, and the issuer only takes on an obligation to pay according to the terms of the credit. It is up to the applicant to set for the terms of the agreement, what practice rules govern the undertaking, and no terms are truly "bargained for." If the letter of credit were subjected to traditional bilateral contracts, it is unlikely that such promises made by the applicant/issuer would be enforceable because the traditional law of bilateral contracts has its own formality requirements and also would require that the contract be supported by consideration. Furthermore, letters of credit do not have a requirement that the beneficiary "accept" in the traditional sense of contract formation for the LC to become operative. Some legal systems feel the need to create a fiction of "beneficiary acceptance" because they erroneously believe that the LC is a traditional bilateral contract; however, no such fiction is necessary under Revised U.C.C. Article 5, Prior U.C.C. Article 5, or U.S. common law. HAWKLAND, *supra* note 5, at 5-23, 5-43, 5-152, 5-298, 5-494; *see, e.g.*, Eastland Bank v. Massbank for Sav., 749 F. Supp. 433 (D.R.I. 1990) (determining whether court could exercise personal jurisdiction over out-of-state LC beneficiary; judge opining that it was inappropriate to compare the relationship between beneficiary and issuing bank with that of two parties in contract).

14. The Official Comment to the Revised U.C.C. § 5-101 (Short Title) describes a letter of credit as an "idiosyncratic form of undertaking that supports performance of an obligation" and seeks to define "the peculiar characteristics . . . that distinguish it and the legal consequences of its use from other forms of assurance . . . ." Revised U.C.C. § 5-101 official cmt. What distinguishes letters of credit is that it is a voluntary obligation, and as such is distinguished from other types of obligations that are imposed by the law like torts. Also, because of a letter of credit's tripartite nature and the independence of an issuer's undertaking, it does not fit well within the framework of traditional bilateral contract or any other category of law. The issuer deals "at arm's length" and is obligated to pay only according to the terms of the letter of credit. The issuer is not a fiduciary for either the beneficiary or the applicant. The relationship is governed by rules of practice and local law, like Revised U.C.C. Article 5. The responsibility to the applicant is set forth in the parties' agreement, which is how the relationship and terms of payment will be determined. "Because letters of credit are not well understood by lawyers or judges, it is common for judicial opinions to provide a brief introduction to the transaction and the law, often as a preface to explaining the doctrine of independence." HAWKLAND, *supra* note 5, at 5-43; *see also* Confeccoes Texteis De Vouzela, LDA v. Riggs Nat'l Bank of Washington, D.C., 994 F.2d 851 (D.C. Cir. 1993) (confirming bank in letter of credit transaction cannot be sued in tort by account party); *In re* B.C. Rogers Poultry, Inc., 455 B.R. 524, 564–65 (Bankr. S.D. Miss. 2009) (describing an LC as a three party arrangement); Caroline Apartments v. M&I Bank, 334 Wis. 2d 808 (Wis. Ct. App. 2011) (unpublished) (finding that LCs

perhaps to the applicant (who is, in any event, not a party to the LC undertaking) to perform (draw on the LC), and there is no bargained for agreement between the issuer/guarantor and the beneficiary.

An example is transfer. In contract law, "transfer is used in parallel with 'assignment'"[15] whereas in LC law and practice, they are very different phenomena. An LC transfer is of the right to draw, namely, the transferee is a new beneficiary. LCs are not transferable undertakings unless they expressly so provide.[16] An "assignment" in LC law and practice is of any proceeds that may result from a drawing on a LC. If an assignment of proceeds by the beneficiary is not acknowledged by the issuer, then the issuer has no obligation to pay proceeds to the assignee.[17]

B. Letters of Credit Are Neither Commercial Law Nor Sales Law

While LCs are a part of commercial law in a broad sense, they are more like pre-modern law in that they are a promise that runs to a unique person that is not freely transferable and calls for a performance that is more precise than substantial.[18] Many, if not most, of the instincts of a modern commercial lawyer or jurist are inapt in the application of LC law.

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form a unique legal relationship among the parties, without consideration and mutual obligation, and citing Bank of Cochin, Ltd. v. Mfrs. Hanover Trust Co., 612 F. Supp. 1533, 1537 (S.D.N.Y. 1985), which was decided under Prior U.C.C. Article 5, for the proposition that an LC is a relationship with no perfect analogies but nevertheless a well-defined set of rights and obligations); *see also* Alhadeff v. Meridian on Bainbridge Island, LLC, 220 P.3d 1214, 1217–23 (Wash. 2009) (applying Washington U.C.C. Art. 5 [Rev] and providing a diagram of a four party LC).

15. As indicated in Chapter 15 of the Restatement 2d of the Law: Contracts, Chapter 15 (Assignment and Delegation), transfer of contractual rights is distinguished between "assignment" of rights and "delegation" of duties. RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981). Both of these actions can be loosely referred to as a "transfer." The Introductory Note to the Chapter explains that the two topics are "part of the larger subject of the transfer of intangible property." *Id.* ch.15.

16. *See* URDG 758, *supra* note 4, art. 33 (Transfer of Guarantees and Assignment of Proceeds); UCP600, *supra* note 4, art. 38 (Transferable Credits); ISP98, *supra* note 4, R. 6 (Transfer, Assignment, and Transfer by Operation of Law); UN LC Convention *supra* note 4, art. 9 (Transfer of Beneficiary's Right to Demand Payment); Revised U.C.C. § 5-112.

17. *See* URDG 758, *supra* note 4, art. 33 (Transfer of Guarantee and Assignment of Proceeds); UCP600, *supra* note 4, art. 39 (Assignment of Proceeds); ISP98, *supra* note 4, R. 6 (Transfer, Assignment, and Transfer by Operation of Law); UN LC Convention, *supra* note 4, art. 10 (Assignment of Proceeds); *see also* Revised U.C.C. § 5-114 (Assignment of Proceeds) (generally following the approach with a limited exception where the assignee holds the original LC).

18. At common law, choses in action, including contract rights were not transferrable because debts were believed to be personal to the party that incurred it. If a contract were to be assigned, it was seen as "maintenance-as tending to encourage

One telling example is the LC preclusion rule, a doctrine that operates quite differently than estoppel, to which it is sometimes incorrectly equated.[19] An issuer/guarantor that fails to give adequate and timely notice

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litigation" much like the modern view of assignment of tort. E. A. FARNSWORTH, CONTRACTS § 11.2 (4th ed. 2004). In the words of Lord Coke, assignment of rights "would be the occasion of multiplying contentions and suits." *Id.* Contracts were based on the mutual agreement of both parties and consent to create a contract based on free choice. The sanctity of the contract would be broken if one party could pass its obligation onto another. Later modifications at common law still viewed assignment as giving the assignee just power of attorney as an agent of the assignor, but only to pay the debts of the assignor. In the 1800s, with the advent of code pleading, individuals who could prove that they were a "real party in interest" could sue on the contract, starting the new trend of free assignability.

Likewise, there is no room in letters of credit for a substantial performance. Substantial performance standards are most often applied in construction and land transfer contracts, and while these transactions may underlie a letter of credit transaction, the independence principle separates the two transactions. Given the development of the UCP of what is required for a transport document, it is difficult to imagine where "idiosyncratic differences" of the parties would ever become an issue. Either a party submits the required documents under a credit or it does not. Either the issuer examines the documents for compliance or is precluded. To include a substantial performance standard in letter of credit practice would remove the element of certainty that makes letters of credit attractive payment methods in the first place. *See* P. S. ATIYAH, INTRODUCTION TO THE LAW OF CONTRACT 1–36 (5th ed. 1995); FARNSWORTH, *supra* note 18, §§ 8.12, 11.2.

19. The ISP98, UCP600, and UCC all include preclusion rules. URDG 758, *supra* note 4, art. 24(d)–(f) (Non Complying Demand, Waiver and Notice); UCP600, *supra* note 4, art. 16(c), (f) (Discrepant Documents, Waiver and Notice); ISP98, *supra* note 4, R. 5.03 (Failure to Give Timely Notice of Dishonour); Revised U.C.C. § 5-108(c) (Issuer's Rights and Obligations). Preclusion operates as a way to provide certainty and finality with letter of credit practice, and also as a way to ensure rigor and instill confidence. It operates to assure a beneficiary that an issuer will not be complacent with the applicant, and will give the beneficiary "prompt notice of refusal detailing discrepancies and that the [issuer will not wait for] market movements that might be more favorable before taking a position on the presentation." *See* HAWKLAND, *supra* note 5, at 5-440. Preclusion applies both to the failure to examine the documents within a reasonable time, as well as failure to give timely notice of refusal. A bank is not expected to give notice instantaneously, but it may not deliberately delay. The practice rules largely dictate what an issuer must do to give timely notice of dishonor, from calculation of the time to dishonor, with what specificity a notice must contain of discrepancies, and in what medium the notice must come in. At a minimum, the notice must not be ambiguous as to why the presentation is being refused, or provide information on how to cure it. Deference is also given to practice as to what is considered timely and reasonable standards. The practice rules and laws operate without regard to the curability of the discrepancies; however, the notice has at least some relevance to the beneficiary's ability to cure discrepancies. Failure to state a reason for dishonor will preclude the issuer from asserting the defect at a later date. One of the reasons that the concept has proven difficult for lawyers and courts is that it appears to be contrary to the banks' interest in that it holds them to their first expression of their response within a relatively narrow time frame and visits on them

of refusal is precluded from asserting that the documents presented are not in compliance with the terms and conditions of the undertaking regardless of whether the discrepancy was curable or there was reliance. The point of this rule is not to give the beneficiary a "free ride", but to assure the integrity of the LC institution and to require issuers/guarantors to make a timely and complete examination and to give timely notice of the results. While curability is a factor, it is a secondary one.[20]

In a Sales course, there are other differences with respect to payment terms. The focus in a letter of credit course regarding payment terms should be on the LC terms to be inserted into a contract for payment against the recent shipment of goods or extrapolated from it and inserted into a LC and their interpretation and application. In a Sales-oriented course, the focus would be on the provisions for payment by LC in the sales contract. Most of the materials on Sales that deal with LCs overlook this point and attempt to provide a mini-treatise on letters of credit. Such an approach is inadequate to teach LCs and does not attempt to focus students' attention on drafting an adequate payments clause or interpreting the inadequate ones that are often drafted. This failure may offer one explanation for the relative lack of sophistication in contract clauses related to payment or assurance of payment by LCs. An example would be whether a standby LC providing for payment 60 days after the date of

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what appear to be draconian penalties even in situations where any omission or deficiency on the bank's part could not cause harm because the discrepancy could not be cured. It is also important to note that for public policy reasons both the failure to notify of the expiry of the credit or of letter of credit fraud are outside of the preclusion rule. *See id.*; JAMES E. BYRNE, VINCENT M. MAULELLA, SOH CHEE SENG & ALEXANDER ZELENOV, UCP600: AN ANALYTICAL COMMENTARY 597–600, 752–56 (2010) [hereinafter UCP600 COMMENTARY].

20. The notion of curability is linked to the concept of separateness of presentation. ISP98 Rule 3.07 (Separateness of Presentation), and URDG Article 18(a) (Separateness of Each Demand) both contain provisions stating that unless the undertaking expressly states, a beneficiary may make multiple presentations under a letter of credit so long as it has not expired. URDG 758, *supra* note 4, art. 18(a); ISP98, *supra* note 4, R. 3.07. In theory, a beneficiary could attempt to cure any discrepancies that were the basis for the original dishonor by the bank, and still receive the amount available under the credit. The UCP does not expressly so state, but the ability to cure has been recognized by the ICC. *See* INT'L CHAMBER OF COMMERCE, PUBL'N NO. 371, DECISIONS (1975–1979) OF THE ICC BANKING COMMISSION R. 13 (1980). Preclusion, however, is not based primarily on the right to cure discrepancies but on the importance of forcing an issuer or confirmer to make a timely and complete statement of the grounds for refusal so as to prevent it from raising discrepancies in a piecemeal fashion or from delaying refusal pending shifts in the market price of goods. *See* JAMES E. BYRNE, THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES 113–14 (James G. Barnes ed., 1998) [hereinafter THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES].

delivery on a required copy of a transport document meets a sales contract required of "payment by LC issued by an acceptable bank[;]" i.e., is a "standby" a "letter of credit" in the sense intended?[21] This question is one for Sales law and not LC law.

C. *The Study of Letters of Credit Is a Useful Basis for Understanding Commercial Transactions*

The study of LCs is an ideal platform from which to describe and discuss commercial transactions because it is highly challenging for even the brightest student at the highest level, but also understandable in a basic, but meaningful way even for students at the beginning of higher education. The study of LCs also brings together all of the aspects of a commercial transaction including sales or service contracts, payment, delivery, terms, obligations of third party intermediaries regarding delivery and inspection, the correspondent banking system, the differences between dependent and independent undertakings, the use of commercial documents in a representational capacity, mechanisms for third party assurance of performance, and mechanisms for assurances of repayment. These observations would also apply to differences with other forms of financial assurance ranging from the performance of obligations to the repayment of funds, whether from simple loans or supporting the bond market

Furthermore, the study of LCs is a significant instance of workable self-regulation in commercial law. Why it works is another, and charged, question. In my opinion it is because the LC banking community, which has evolved the rule making apparatus, has grasped the essential need for neutral rules as a basis for the credibility of the product and of specific banks. It helps that the banks themselves are often the beneficiary or nominated banks as well as issuers and confirmers and that the applicants are often good customers, thus feeding the desire for neutral rules.

D. *Methodologies for Teaching Letters of Credit: The Problem of Using Reported Judicial Decisions*

In my opinion, an approach that emphasizes retention and reporting of facts, rules, and data embedded in judicial decisions should be avoided. The result of such an approach is a superficial understanding of LC law and

21. *See, e.g.*, Torco Oil Co. v. Innovative Thermal Corp., 763 F. Supp. 1445, 1445–46 (N.D. Ill. 1991) (denying motions for judgment notwithstanding verdict or new trial and overlooking the significance of UCC Section 2-325 ("Letter of Credit" Term; "Confirmed Credit") for the significance of the term "Letter of Credit" in a contract).

often a misunderstanding of LC practice. To a considerable extent, this approach explains why lawyers and judicial decisions have tended to fail to grasp and apply the principles behind LC law. It is also why, in the opinion of experts, more than half of reported decisions are wrong; and, of those that are correct, more than half are correct for the wrong reason.[22]

U.S. law schools can place too much emphasis in their teaching methodology in advanced courses on the use of reported cases as a mechanism for teaching students the "black letter law." This approach is not optimal if the goal of the course is to elicit critical faculties regarding the subject matter. The tendency of casebook editors is to fill their books with the leading decisions coupled with detailed notes and explanations of the principles contained in the cases.

Instead, casebooks should simply be "bare," that is, platforms for the classroom experience, and should not be treatises of the subject involved. That function should be left to treatises themselves and students should be left to their own devices in learning how to master and utilize them in understanding the field as they will in practice. Thus, the texts should be excerpts from reported cases or the text of various undertakings that are appropriate platforms for discussion.[23] In my opinion, at least one-third of the cases in the materials should be wrong, misguided, or problematic. Otherwise, students are reinforced in the notion that they should take the printed word too seriously, a serious mistake for a lawyer. The notes should pose dilemmas that are not solved in the text, forcing students to grapple with the problem.

Needless to say, students hate this approach. They simply want to write down the answer and move along to "learning" more "things" with as little

22. The author has spent more than 15 years writing summaries of international letter of credit cases in the Annual Survey of Letter of Credit Law & Practice (IIBLP) (1996–2009), the International Review of International Banking Law (2010–present), and as co-author of the American Bar Association's Business Law Section's Business Lawyer UCC Survey. This opinion of judicial decisions involving letters of credit derives from that experience and from working with bankers and lawyers around the world in annual sessions in the Americas, Europe, the Middle East, and Asia under the auspices of the Institute of International Banking Law & Practice. It should be noted, however, that under a well-drafted and explained statutory scheme, these estimates improve considerably, based on the experience of courts in the US before a statutory scheme (pre U.C.C. Article 5 – pre 1956), under a skeletal and premature scheme (Prior U.C.C. Article 5 – 1956 to 1998), and under a modern, sophisticated, systematic statute with commentary (Revised U.C.C. Article 5 – post 1998). *See generally* James E. Byrne, *The Revision of U.C.C. Article 5: A Strategy for Success*, 56 BROOK. L. REV. 13, 13 (1991).

23. *See, e.g.*, JAMES E. BYRNE, INTRODUCTION TO DEMAND GUARANTEES & STANDBYS (2012).

intellectual strain or work as possible. This negative student reaction is a positive indication of the merits of the method, based on the reasons behind it. Another positive indicator is that more mature students tend not to react in this manner.

The problem remains as to where students can look for the resolution of the problems and issues. Subtle hints should be given. In addition, the ready availability of the texts of practice rules, statutory provisions, and model forms helps considerably. The library should also have ample resources. Above all, however, students must learn to find sources themselves, a skill that they will need to do in the real world so it is essential not to spoon-feed them.

E. What Are Letter of Credit Law and Letter of Credit Practice?

Since it has been asserted that LCs are not to be understood from the perspective of contracts or sales, it is necessary to consider what constitutes LC law and practice.

1. A Starting Place Is Classification

There has been considerable debate about how to classify LCs. This debate was undertaken at the beginning of the 20th Century and the best resolution was that it should be understood as *sui generis*, a manifestation of the *lex mercatoria*.[24] That conclusion, in any event, coincides with my opinion.

Excluded from an LC course in most instances are the following related LC subjects: bank-to-bank reimbursements,[25] collections,[26] SWIFT,[27] and

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24. *See* E.P. Ellinger, *The Doctrine of Strict Compliance: Its Development and Current Construction* (2000), *reprinted in* INST. OF INT'L BANKING LAW & PRACTICE, ANNUAL SURVEY OF LETTER OF CREDIT LAW & PRACTICE 64 (2001).

25. Bank-to-bank reimbursement is a mechanism by which an issuer can encourage a nominated bank to act on a nomination by indicating a bank to which it can turn for reimbursement. UCP600, *supra* note 4, art. 13 (Bank-to-Bank Reimbursement Arrangements) (providing basic rules for such reimbursements). The Uniform Rules for Bank-to-Bank Reimbursements Under Documentary Credits (URR725) provide comprehensive rules for bank-to-bank reimbursements. INT'L CHAMBER OF COMMERCE, PUBL'N NO. 725, ICC UNIFORM RULES FOR BANK-TO-BANK REIMBURSEMENTS (2008). URR725 Article 2(g) (Definitions) defines "reimbursement undertaking" as "a separate irrevocable undertaking of the reimbursing bank, issued upon the authorization or request of the issuing bank, to the claiming bank named in the reimbursement authorization, to honour that bank's reimbursement claim, provided the terms and conditions of the reimbursement undertaking have been complied with." *Id.* art. 2(g). Revised U.C.C. § 5-108(i)(1) and (2) set forth the rights of an issuer or confirmer to obtain reimbursement after honoring a complying presentation. Revised U.C.C. § 5-108(i)(1), (2) (1995). ISP98 Rule 8.04 (Bank-to-Bank Reimbursement) incorporates the current version of the URR by reference. Most often, these obligations

authentication.[28] These topics are usually not addressed except in training professionals because they clutter discussions without adding light to basic

arise when the issuing or corresponding bank does not have a correspondent relationship with a bank that acts in according to terms of the LC. ISP98, *supra* note 4, R. 8.04. Reimbursement undertakings are important to letter of credit practice because they provide the "necessary lubricant in correspondent banking relationships permitting banks which do not have an account relationship to act on behalf of other banks with the knowledge that they can claim reimbursement from a local bank with which they have a relationship." BYRNE, *supra* note 20, at 289; *see generally* DAN TAYLOR, ICC GUIDE TO BANK TO BANK REIMBURSEMENTS UNDER DOCUMENTARY CREDITS (1997).

26. The 1995 revision of the Uniform Rules for Collections ("URC522") is a revision of the URC322, published in 1978. INT'L CHAMBER OF COMMERCE, PUBL'N NO. 522, ICC UNIFORM RULES FOR COLLECTIONS (1995); INT'L CHAMBER OF COMMERCE, PUBL'N NO. 322, UNIFORM RULES FOR COLLECTIONS (1978). These rules guide the practice of handling of collections (sometimes referred to as "documentary collections" and "clean collections"), and they are completely different from handling of presentations under an LC, even when waiver of discrepancies is sought. Bank collections are handled under U.C.C. Article 4.

27. SWIFT/S.W.I.F.T. stands for "Society for Worldwide Interbank Financial Telecommunication." After the completion of Revised U.C.C. Article 5, the periods between the letters were dropped and the name is now "SWIFT." SWIFT is a financial industry owned, cooperative network that supplies secure, standardized messaging services and interface software, servicing more than 10.000 financial institutions in more than 212 countries. SWIFT, http://www.swift.com/about_swift/index (last visited Nov. 12, 2013). SWIFT's worldwide community is made up of banks, broker/dealers, investment managers, and market infrastructures in payments, securities, treasury and trade. *Id.* at http://www.swift.com/about_swift/community/swift_user_categories. It is estimated that more than 90 percent of their commercial LCs by major LC banks are issued via SWIFT MT 700. André Casterman, *ICC Survey 2012, Swift Trade Traffic-2011 Statistics*, ICC BANKING COMMISSION 20 (Mar. 27, 2012), *available at* http://www.iccwbo.org/Data/Documents/Banking/SWIFT-Trade-Traffic-Stats_Andre-Casterman/. Information about SWIFT can be obtained at www.swift.com.

28. Authentication is the method by which a document may be signed, and also confirming the identities of an issuer, beneficiary or confirmer. The authentication must show who made the authentication and include that party's signature or initials. If the authentication appears to have been made by a party other than the issuer of the document, the authentication must clearly show what capacity that party had to authenticate the correction or alteration. Under UCP600 Article 3 (Interpretations), it can be understood as an alternative to a "signed" document as long as it proves that the document is legitimately verified. *See* UCP600, *supra* note 4, art. 3. Under UCP600 Article 9(b), (c), & (f) (Advising of Credits and Amendments), in the process of advising a credit with respect to the sender and the integrity of the transmission, a certain level of formality is implicit. *Id.* art. 9(b), (c), (f). Revised U.C.C. § 5-104 requires that a credit or similar undertaking be "authenticated." Revised U.C.C. § 5-104. While this term is not defined in U.C.C. Article 1, Official Comment 2 to Revised U.C.C. § 5-104 states that it refers to the "authentication only of the identity of the issuer, confirmer, or adviser." *Id.* § 5-104 cmt. 2. "The statute indicates two means by which the record may be authenticated, namely: (1) signature or (2) 'in accordance with the agreement of the parties or the standard practice referred to in Section 5-108.'" HAWKLAND, *supra* note 5, at 5-306. Where a signature is not authentic, the bank or person purportedly having signed it is not obligated but the person actually signing it

issues. Also excluded are negotiation,[29] transfer, assignment, and pre-advice.[30] These topics are too difficult for students to readily grasp and, in my opinion, the time is better spent on more basic topics.[31]

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would be liable. The reference to standard LC practice is to the practice of "financial institutions that regularly issue letters of credit." Revised U.C.C. § 5-108(e). "In effect, this provision defers to the practices of bankers with respect to authentication, recognizing the high degree of sophistication that has evolved in providing secured means of authentication." HAWKLAND, *supra* note 5, at 5-306 to -307. It is important to note, however, that authentication is not used to determine whether the documents or signatures are indeed genuine. Issuers take the documents on their face value. *See id.*; INST. OF INT'L BANKING LAW & PRACTICE, 2007 ANNUAL SURVEY OF LETTER OF CREDIT LAW & PRACTICE 183–84 (James E. Byrne & Christopher S. Byrnes eds., 2007) (discussing Hilton Grp., PLC v. Branch Banking & Trust Co. of S.C., No. 2:05-937-DCN, 2007 WL 2022183 (D.S.C. July 11, 2007)), a rare case of an LC where the signature of the issuer is forged). In recent times, the systems of authentication are sufficiently effective that the problem of a forged LC rarely arises. The use of banks as advisers and the widespread use of the SWIFT system have effectively eliminated these issues. *See* UCP600 COMMENTARY, *supra* note 19, at 221–23, 1275, 1440.

29. LCs are not negotiable instruments. However, there are some credits under which negotiation, i.e. the transfer from one bank to another, occur. *See* James E. Byrne, *Negotiation in Letter of Credit Practice and Law: The Evolution of the Doctrine*, 42 TEX. INT'L L.J. 561 (2007).

30. Pre-advice is provided for in UCP600 Article 11 (Teletransmitted and Pre-Advised Credits and Amendments). UCP600, *supra* note 4, art. 11. The need for pre-advice arises in a commercial transaction where the beneficiary requires an LC for financing to produce the product but the details of transportation are not available. Were the credit issued without these details, the issuer would have to consent to any amendment; a pre-advice is an obligation of the issuer to issuer a similar credit which is not inconsistent, permitting omitted details to be inserted. UCP600 Article 11 (Teletransmitted and Pre-Advised Credits and Amendments) defines "pre-advice," which is a practice in commercial LCs where a bank will issue an advice, indicating that it will, under certain indicated terms, issue a credit on certain indicated terms. *Id.* While the definition of "credit" in UCP600 Article 2 does not expressly refer to a pre-advice, if read with Article 11, Article 2's definition certainly does encompass a pre-advice. *Id.* arts. 2, 11. Under the UCP, this advice is effectively equated to an LC because the issuer is irrevocably obligated to issue a credit under its specified terms without "delay." These types of undertakings are vulnerable to misuse. The definition of "credit" in Revised U.C.C. § 5-102(a)(10) raises a question about whether a pre-advice is truly an LC because the pre-advice is not the operative credit instrument. Revised U.C.C. § 5-102(a)(10). Nevertheless, this type of obligation is the functional equivalent of an LC and should be regarded as such. *See* HAWKLAND, *supra* note 5, at 5-204 to -205; UCP600 COMMENTARY, *supra* note 19, at 119; *see also* Bouzo v. Citibank, N.A., 96 F.3d 51 (2d Cir. 1996) (making summary judgment in favor of alleged issuer who promised in writing to "issue an unconditional, irrevocable bank pay order" reversed because terms were ambiguous; purported beneficiary had argued, *inter alia*, that the undertaking was a pre-advice although this theory was not mentioned in the appellate decision).

31. Occasionally, such topics can be addressed in required graded papers, assignments, or with each student reporting to the class on his or her assigned topic.

2. *Deference of LC Law to LC Practice*

The fundamental principle in the field of LC law is the deference of law to sound rules of practice. The corollary of this principle is that in order to understand LC law, it is necessary to understand LC practice. There are, of course, exceptions to this principle, but they are rather limited.[32] There are also important policy questions in addition to the matters indicated above, namely the importance of insisting on the soundness and neutrality of the practices to which deference is given.

3. *Encouraging Sound LC Practice*

The primary mission of LC law is to encourage sound LC practice. On the whole, soundness is manifested in the neutrality of a given rule which does not favor any particular party and which is manifested in making the LC workable and not in multiplying excuses to payment. This rule often equates to *contra proferentium,* that is, construing ambiguity against the issuer/guarantor but which can also involve public policy issues where LC fraud, protected persons, perpetual undertakings, or similar issues are involved.

4. *Letter of Credit Law*

To the extent that there is a letter of credit law, it is either statutory or case-inspired law. There are chiefly three statutory schemes available, the United Nations Convention on Independent Guarantees and Standby Letters of Credit,[33] Revised U.S. U.C.C. Article 5 (Letters of Credit),[34] and

32. The exceptions include LC fraud or abuse (although there are practice issues grounded in the correspondent banking network that give rise to exceptions for protected persons or the equivalent of good-faith purchasers with qualifications), formality, and the power to issue LC-type undertakings. *See, e.g.*, Consol. Aluminum Corp. v. Bank of Va., 704 F.2d 136 (4th Cir. 1983) (discussing the power to issue undertakings and issues regarding formality).

33. The UN LC Convention opened for signature in December 1995 by the U.N. General Assembly; it was adopted by resolution on 26 January 1996 at its fiftieth session; and it was signed by seven nations, including the United States, which signed on 11 December 1997. UN LC Convention, *supra* note 4. It went into effect on 1 January 2000 and has been adopted by Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama, and Tunisia. The Convention has been signed but not ratified by the United States of America as of 1 January 2014. The UN LC Convention was drafted by the United Nations Commission on International Trade Law (UNCITRAL) in the six official languages of the UN. For the text of the UN LC Convention and a list of the countries which have ratified the Convention, see www.uncitral.org. The text and explanatory note are also reprinted in LC RULES & LAWS, *supra* note 3.

34. *See* Revised U.C.C. § 5; LC RULES & LAWS, *supra* note 3.

the Chinese Supreme Court rules regarding letters of credit.[35] These statutes or rules were formulated in light of letter of credit practice and compliment it.

Apart from these rules, however, LC law consists of judge-made pronouncements, which are non-systematic at best. Although the common law recognized at an early point in time the importance of a statutory formulation for a subject as complex as commercial paper in the UK Bills of Exchange Act in 1882, many common law jurisdictions (including England) have failed to do so for a subject far more complex—namely, LCs. Even less understandably, the civil law jurisdictions have no statutes for LCs. The result is a series of decisions both in common and civil law jurisdictions, which are of mixed value at best. As indicated, even where the result is proper, the rationale explaining it may not be.

5. *Letter of Credit Practice*

What constitutes sound LC practice is a fairly complex question. There are, of course, articulated rules of practice; namely, the Uniform Customs and Practice for Documentary Credits (UCP600),[36] the International

35. *See* Fa Shi No. 13 [Provisions of the Supreme People's Court on Certain Issues Concerning Trial of Cases Involving Letter of Credit Disputes] (promulgated by the Sup. People's Ct., Nov. 14, 2005, effective Jan. 1, 2006) (China), *translated in* LC RULES & LAWS, *supra* note 3, at 305; *see also* Fa Shi No. 22 [Provisions of the Supreme People's Court Concerning Jurisdiction over Foreign-Related Civil and Commercial Coases] (promulgated by the Sup. People's Ct., Feb. 25, 2002, effective Mar. 1, 2002), *translated in* LC RULES AND LAWS, *supra* note 3, at 236.

36. The current version of the UCP600 became effective 1 July 2007 and was promulgated by the Commission on Banking Technique & Practice of the International Chamber of Commerce (ICC Banking Commission). *See generally* UCP600, *supra* note 4. For studies of the UCP600, see UCP600 COMMENTARY, *supra* note 19; James BYRNE, THE COMPARISON OF UCP600 & UCP500 (2007); COMMENTARY ON UCP600, *supra* note 9. Useful articles include James Byrne & Lee H. Davis, *New Rules for Commercial Letters of Credit Under UCP600*, 39 UCC L.J. 3 (2007); E.P. Ellinger, *The UCP-500: Considering A New Revision*, 2004 LLOYD'S MAR. & COM. L. Q. 30 (2004). Prior versions were issued in 1933 (UCP82), 1951 (UCP151), 1962 (UCP222), 1974 (UCP290), 1983 (UCP400), and 1993 (UCP500). The official text is the English text. UCP600, *reprinted in* LC RULES & LAWS, *supra* note 3, at 1. Although UCP600 has been or will be translated into virtually every language in which international commerce is conducted, the only official translation is French. *Id.* Therefore, care must be taken with translations of the official English version as they are only as good as the person or persons translating them and the review process instituted by the various ICC national committees. *Id.* For studies in the evolution of the UCP, see James E. Byrne, *Ten Major Stages In The Evolution of Letter of Credit Practice*, DOCUMENTARY CREDIT WORLD 28 (Nov./Dec. 2003); Dan Taylor, *The History of the UCP*, DOCUMENTARY CREDIT WORLD 11 (Dec. 1999). Mr. Taylor has usefully collected all prior versions of the UCP into one volume. DAN TAYLOR, THE COMPLETE UCP: UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS: TEXTS, RULES

Standby Practices (ISP98),[37] and the Uniform Rules for Demand Guarantees (URDG 758).[38] In addition, there are a host of subsidiary articulations of practice including most notably the International Standard Banking Practices (ISBP 2013).[39] These attempts to articulate standard international LC practice largely emanate from the Commission on Banking Technique and Practice of the International Chamber of Commerce. They are not written by lawyers or for lawyers and have

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AND HISTORY 1920–2007 (2008).

37. The International Standby Practices (ISP98) was completed in 1998. The text was endorsed by BAFT/IFSA (formerly the U.S. Council on International Banking), the United Nations Commission on International Trade Law, and by the International Chamber of Commerce in 1998, and became effective on 1 January 1999. ISP98 is published as ICC Publication No. 590 and is generally cited as ISP98 (ICC No. 590). ISP98, *supra* note 4. The rules are explained in THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY PRACTICES, *supra* note 20. The ISP98 has been supplemented by the ISP98 Model Forms. The ISP98 Model Forms are attached as Appendix C. They may also be found online at www.iiblp.org/ISPForms. Additional information on the text of the ISP98 and educational tools may be obtained from the Institute of International Banking Law & Practice, Inc., P.O. Box 2235, Montgomery Village, MD 20886 or at http://www.iiblp.org. The full text of ISP98 has been reprinted in LC RULES & LAWS, *supra* note 3.

38. URDG 758, *supra* note 4; *see generally* DR. GEORGES AFFAKI & SIR ROY GOODE, GUIDE TO ICC RULES FOR DEMAND GUARANTEES URDG 758 (2011); "The URDG 758 Compared with ISP98 and UCP600: Part Three of the CSGP Training Program" (Institute of International Banking Law & Practice CD-ROM rel. 2013).

39. At its May 2000 meeting the Commission on Banking Technique and Practice of the International Chamber of Commerce (ICC Banking Commission) established a task force to document international standard banking practice for the examination of documents presented under documentary credits issued subject to the UCP. The ICC's International Standard Banking Practice (ISBP) for the Examination of Documents under Documentary Credits complements the UCP500, filling in gaps and explaining the practices that underline UCP500. INTERNATIONAL CHAMBER OF COMMERCE, INTERNATIONAL STANDARD BANKING PRACTICE FOR THE EXAMINATION OF DOCUMENTS UNDER DOCUMENTARY CREDITS (2003); *see Uniform Customs & Practice for Documentary Credits*, Int'l Chamber of Comm., Publ'n No. 500 art. 2 (Jan 1, 1994) [hereinafter UCP500]. It is a statement of "standard banking practice" referenced in UCP500 Article 13(a) Sentence 2. The ISBP is based on ICC Banking Commission Opinions and Decisions, and its understanding of the practices reflected in them. To complete it, practices were compiled from some 39 ICC national committees and a substantial number of individual banks. It was an attempt to provide an international formulation to various national statements of practice, most notably the Standard Practice for the Examination of Documents promulgated by IFSA with the American Bankers Association. This ISBP was aligned with the UCP600 in 2007 (ISBP 2007) and extensively updated as ISBP 2013. *See* INTERNATIONAL CHAMBER OF COMMERCE, INTERNATIONAL STANDARD BANKING PRACTICE FOR THE EXAMINATION OF DOCUMENTS UNDER DOCUMENTARY CREDITS (2007), *reprinted in* LC RULES AND LAWS, *supra* note 3, at 161; INTERNATIONAL CHAMBER OF COMMERCE, INTERNATIONAL STANDARD BANKING PRACTICE FOR THE EXAMINATION OF DOCUMENTS UNDER UCP 600 (2013), *reprinted in* LC RULES AND LAWS, *supra* note 3, at 101.

occasioned considerable difficulty when courts have attempted to interpret them as statutes.[40]

F. Approach to Teaching

In the absence of a sophisticated conceptual model of teaching methodology for law schools, this paper distinguishes (i) a lecture-based approach, with or without tutorial session; (ii) a casebook approach; (iii) a litigation problem-oriented approach; and (iv) a transactional approach. For clarification purposes and understanding these following teaching approaches are understood and classified as:

Lecture-Based Approach. Lecture is understood to consist of a monoline presentation by the instructor with or without the possibility of questions that attempts to set forth a systematic exposition of the subject matter. It is my experience that pure lecture has very limited effect because it is difficult to determine the level of comprehension and is only effective as a means of summarizing material once it is apparent that the students have mastered it.

Casebook Approach. A casebook approach is understood to consist of using reported legal decisions as a platform on which to teach involving a series of oral questions designed to elicit an understanding of the decision and its theoretical underpinnings. It is my experience that this method is of limited value with non common law jurisdictions and that its focus for common law students is too narrow, in part because of the lack of a transactional appreciation of the underlying transactions.

Litigation Problem-Oriented Approach. A litigation problem-oriented approach is understood to consist of designed problems intended to systematically lead the students to resolve legal issues related to ligation through a series of situations that will require them to master the terminology and legal obligations involved and to apply them in a practical setting to resolve problems in a principled manner.

Transactional Approach. A transaction-oriented approach is understood to consist of problems related to resolving client needs by suggesting various solutions and drafting to implement them.

Both the litigation and transactional approaches require considerable instructional engineering and flexibility in execution depending on the

40. The ICC Banking Commission regularly issues opinions interpreting the UCP and addressing questions raised by its regional committees. They are collected regularly by ICC Publishing. *See, e.g.*, INTERNATIONAL CHAMBER OF COMMERCE, ICC BANKING COMMISSION COLLECTED OPINIONS 1995–2001 (Gary Collyer & Ron Katz eds., 2002).

circumstances in the classroom. Typically, both approaches involve having students attempt to resolve the various problems, often in a context in which they must justify their position against those held by parties reflecting divergent interests.

II. METHODOLOGY FOR TEACHING LETTERS OF CREDIT: A TRANSACTIONAL APPROACH

Given that other more traditional studies of transactional law are inappropriate for the teaching of transactional law for the reasons discussed above, a better alternative is possible.

A. Preferred Approach

The preferred approach for teaching this material is a combination of the three forms identified here with primary emphasis on the problem-oriented approach. A modified version of what is described here as the casebook approach (based on thorough questioning) is used to assure student familiarity with essential definitions and terms of art (but, generally, not using assigned case reports). The problem-oriented approach is used for the bulk of the class sessions, ideally in settings in which students explain their positions, interact with opposing positions in a litigation setting or seek accommodation in a transactional setting with other parties. Lecture is used to summarize material at the conclusion of a session where it is apparent that the students have grasped the principles intended to be identified in order to reinforce the lesson. A modified version is interspersed throughout the class session where it is essential to redirect fruitless discussions or misdirection.

B. Discussions

Permitting students to discuss the issues among themselves during the class has proven helpful. Taking a break during a difficult point for the students to engage in side conversations can be useful for them to regroup and then raise more focused questions. This method is especially helpful where the students' first language is not English. In this case, it can be helpful for the students to engage in discussions among themselves in their own language. The discussions can either clarify points that are not fully grasped or to enable one of the students whose English is better to formulate questions in English for those not able to do so. These comments would not exclude online discussions using vehicles such as TWEN but live interaction in a monitored setting has considerable advantages.

C. Two Cautionary Observations for Instructors

It is a challenge for instructors to refrain from intervening in problem solving exercises. However, if the students are to learn to apply their understanding to the resolution of problems, they must be allowed room to make mistakes and the freedom to conclude that they have made a mistake either by following their mistake to its ultimate consequence or with the assistance of classmates. Therefore, the instructor's best contribution to these exercises is not to speak or merely to ensure that the discussion flows evenly with all students involved.

There are times when silence can be golden. There is nothing wrong with silence in response to a question. Let the students work through the question. Many instructors fear silence and believe that they must fill any such void. Doing so, however, will teach the students that they need not think since the answer will be forthcoming if they only remain silent.

D. Assessment

The focus of the assessment of students used in these courses is not to determine whether basic terminology has been mastered or whether basic principles can be repeated. Mastery of these basics is assumed. What is intended to be tested is the understanding of these principles at a deeper level. This understanding is measured by testing the ability of the student to take basic principles and apply them to situations not discussed in class or the readings. All questions are in the context of a factual problem.

An example of such a question would be a factual setting in which the beneficiary has committed letter of credit fraud, but the transferable credit has been duly transferred to a transferee beneficiary who has drawn on the LC. The issue is whether the doctrine of independence applies to the due transfer of a transferable credit and whether the transferee is a protected person, thus constituting an exception to the LC fraud and abuse exception to the independence principle. Of course, the problem set forth in the examination would not be described in a conclusory manner as it was here but the various facts would have been explained, leaving the student to determine the issues, identify and express them, and to resolve them.

E. Forum and Governing Law

Careful thought must be given to the applicable law and forum for any problem. This decision will affect the significance of judge-made law in resolving the problem. Of course, a decision about judge-made law will be affected by the location where the course is being taught. However, students should be given the opportunity to explore at least one of the statutory schemes even where there is no applicable statutory scheme. The

UN LC Convention provides a useful platform for such an exercise.

III. SUGGESTED COURSE OUTLINES, METHODOLOGY, STRUCTURE, AND EXAMPLES[41]

The principles discussed here would also apply to treatment of LCs in the context of other traditional commercial law courses such as sales or commercial paper/negotiable instruments, in one or two classes. In such a setting, the temptation is to focus on transmitting information to be recalled rather than on interiorization of principles necessary for problem solving due in large part to time limitations. This condensing manifests itself on two levels: by cramming facts and data in a written discourse in the text and by pure lecture in the classroom.

A. Prerequisites and Limited Coverage

The essential starting point for substantive areas of LC law is student understanding of the terms being used and an appreciation of the transactional or litigation context in which they unfold. Considerable work must be done to develop the contexts for these problems. Sample problems are explored further in following text.

While it is valuable for students to have some real world background in business, there are no essential prerequisite courses for this course, except that it is assumed that the course would not be offered to students in their initial year of legal or business studies. Contracts, or the law of volitional obligations, would be useful if the students understood third party debt obligations (suretyship or accessory undertakings), but this topic is rarely covered adequately in such courses. A course in the sale of goods may provide insights into the legal background for sales transactions, but it is my experience that any treatment of the payment obligation by means of letters of credit often causes more difficulties than benefits.

It also is assumed that no law school course will enable the student to obtain mastery of the entire field. The choice is between seeking a superficial mastery of large quantities of information and focusing on selected areas of concentration in which the student can be expected to gain some insight and understanding. The approach taken in this paper and the courses that it reflects is the latter choice. Therefore, it is necessary to identify discrete areas that can be grasped in the time available and that will yield significant insights into the subject. Even for these areas, however, it

41. These reflections assume that at least one semester hour (approximately 15 class hours) is devoted chiefly to letters of credit either as the only topic being taught or as a unit in a commercial transactional law course.

is necessary to select discrete problems that are typical and afford a useful insight.

B. Factors in Selecting the Areas Around Which the Problems Are Focused

The selected areas should be: (i) transaction—matters which involve the type of work that is done on a regular basis for clients with respect to drafting contracts, forms and other matters; (ii) litigation—issues that arise regularly and offer arguments from various perspectives; (iii) drafting of practice rules and related policy issues—issues that require in-depth appreciation of the various perspectives involved; and (iv) regulatory issues—questions of safety and soundness.

C. Materials

The most significant problem in creating a course is providing materials for the students. The problems include obtaining access to practice rules, statutes and similar materials, reported cases, and practical problems. I have developed materials for these courses.[42] My students are required to have: (i) the texts of the practice rules and laws; (ii) a textbook containing problems, excerpts of texts of selected cases, and an outline of the course; and (iii) the ISP98 Model Forms. As indicated, it is not possible to understand LC law without thorough familiarity with the practice rules, meaning that the students must have their text. Because of the predatory copyright and pricing practices of the ICC, the Institute of International Banking Law & Practice (IIBLP) has collected the important texts into *LC Rules & Laws: Critical Texts* and made them currently available at USD 59.00, a price which is one quarter of what it would cost to purchase them individually, and more than half of the price of this book consists of royalties.[43] The textbooks differ in that one is focused on LCs generally while the other focuses on standbys and demand guarantees. In addition, the students should have resources available to them in the school library.[44]

D. Examples of Practice Problems

The following areas have been selected for development of practice problems: (1) independence principle versus dependent undertakings; (2)

42. The list is set forth in Appendix A.

43. IIBLP, which owns the copyright to ISP98, was forced to charge for its rules in order to obtain ICC endorsement but licenses the text to teachers without charge or provides pamphlets of ISP98 at cost.

44. An annotated bibliography of these materials is contained in Appendix A.

rules and laws; (3) obligations; (4) compliance with the terms and conditions of the undertaking; (5) drafting a clause in an independent undertaking; (6) counter-standby or counter-guarantee practice and issues which arise with respect to it; (7) LC fraud or abuse; and (8) an example of an assessment (test) based on the application of the material to public policy. The rationale behind the choice of each area is explained with respect to each area below.

The selected areas represent examples that have been used previously. They are changed in the courses from time to time, based on developments in the field. Whenever possible, I try to draw on current issues being debated in the evolution of doctrine in LC law and practice. For example, currently there is considerable interest in automatic extension of the expiry date of a LC-type undertaking and the automatic reduction of the amount available, which is reflected in two of the exercises below. Fifteen years ago, the issue would have been originality of documents and applicable rules and case law.[45] That problem is now basically resolved and the issue is only of historical interest. An issue attracting attention and that is likely to be reflected in the next iteration of the course is how to handle the reinstatement of a LC that has expired, an issue on which there is no consensus.

Example 1: Independent Undertakings. Analysis of LC practice: the independence of an undertaking.

The Assignment. Classifying the text of an undertaking drawn from a reported case and redrafting it to ensure that it will be classified as an independent undertaking.

Significance of the Topic. Apart from the general importance of independence, a not insignificant number of cases are reported annually involving sophisticated parties and large sums in which it is not clear whether the undertaking is dependent or independent. Most of these cases relate to demand guarantees whose distinction from dependent (true) guarantees is often blurred. Considering these cases forces the student to decide what independence signifies, when it is present, and why.

The Platform. The materials contain the text of several undertakings from notable cases. The decisions are not linked to the texts, and some of the decisions appear later in the materials. Valid arguments can be made for concluding that the texts are either dependent or independent. There is no obviously correct answer based on the texts.

45. *See* JAMES E. BYRNE, THE ORIGINAL DOCUMENTS CONTROVERSY: FROM GLENCORE TO THE ICC DECISION 1–33 (Christopher S. Byrnes et al. eds., 1st ed. 1999).

Classroom Approach. Students are asked to determine whether or not a particular text is dependent or independent and justify their choice. They are then asked to compare their evaluation with that of the courts. They are then asked to revise the undertaking to make it unambiguously independent (or dependent) and, only after doing so, to compare the text with ISP98 Model Form 1 (Model Standby Incorporating Annexed Form of Payment Demand with Standby). The attempt to fix the text can alternatively be assigned before class.

Instructional Goals. It is hoped that the students will come to appreciate the importance of independence, the difference between it and suretyship, of drafting (good and bad and comparing the two), of classification, of using and relying on practice rules for independent undertakings, of presumptions in ambiguous situations, the problem of non documentary conditions, of clarity regarding the intention of a client, and of the elements of independence. They are also invited to consider whether independence is a question of drafting or status.

Appendices. Appendix B contains an undertaking from an English case, Marubeni Hong Kong and South China Ltd v. Government of Mongolia [2005] EWCA (Civ) 395, 2005 All E.R. 117, and Appendix C contains ISP98 Model Form 1.

Example 2: Law & Practice. Drafting a Practice Rule.

The Assignment. Formulating a practice rule for automatic extension clauses.

Significance of the Topic. Practice rules are critical to the understanding of letter of credit practice and letter of credit law. However, their quality is uneven. ISP98 represents the most tightly drafted set of practice rules and UCP600 the most porous. It is essential that students appreciate the difficulty of interpreting and applying practice rules.

The Platform. One of the areas not codified in detail in current practice rules is the automatic extension clause. Such clauses have considerable advantages in that they permit regular reevaluation of the credit decision for long-term undertakings, usually on an annual basis. There are, however, considerable challenges coupled with such clauses. Forcing students to attempt to draft a rule forces them to confront their own inadequacies as drafters. For convenience, I ask students to draft a new rule for ISP98 because it already deals with one preliminary issue—namely, that such a provision is not an "amendment" requiring the consent of the beneficiary—and so that they can concentrate on other more important doctrinal and technical issues.

A variation on this approach would be to start by asking the students to

draft a revision of *The Official Commentary on the International Standby Practices* on ISP98 Rule 2.06 (When an Amendment is Authorised and Binding), which contains the provisions explaining the effect of an automatic amendment, and to require them to draft a new rule in a second class.

An alternative approach would be to take a specific rule and require students to critique it. One obvious example is the inadequate definition of "Negotiation" in UCP600 Article 2 (Definitions), which incorrectly links the definition to the presentation being complying. This problem surfaced in a recent Hong Kong decision, *China New Era Int'l Ltd. v. Bank of China (Hong Kong) Ltd.*, [2009] HKCU 2012 (C.F.I.). My approach has been to provide the facts of the case but not the decision and require the students to analyze the problem.

Classroom Approach. It is expected that students will circulate their clauses prior to class, and specific students are assigned to critique specific clauses.

Instructional Goals. The goal is to introduce an element of humility before the reality of LC practice and business needs. The students have no basis for drafting a practice rule without understanding the practice and the problems it entails. In my experience, they do not understand that practice rules must proceed from the comprehension of the practices being ordered. Only by taking what is typically a technically sound draft rule can this point be brought home to them forcefully.

Appendices. Appendix D contains a recent assignment reflecting a two part exercise that involves revising *The Official Commentary on the International Standby Practices* and then revising ISP98 itself.

Example 3: Obligations.

The Assignment. Students are given a problem drawn from LC practice with ramifications for the obligation of various players and asked to sort it out with a view to pending litigation.

Significance of the Topic. A necessary prerequisite to understanding LCs is understanding the undertakings made by various entities.

The Platform. Here, the platform is a problem based on practice. Depending on the focus of the course, the problem could be drawn from so-called silent confirmations, the obligation of negotiating banks that negotiate but seek to recover the proceeds from the beneficiary when the issuer refuses on the basis of alleged discrepancies, or the obligation of a confirming bank when the beneficiary bypasses the confirmer and presents documents directly to the issuer.

An alternative exercise could be based on the role of an advising bank to

which documents are presented on the expiration date and forwarded to the issuer or confirmer on that date but received after the expiration date.

Classroom Approach. Students are given the problem in advance and required to prepare and circulate brief memos to a senior partner assessing the problem and courses of action. They are given different clients, typically an applicant, issuer, nominated bank, and beneficiary. In class, they are required to discuss their positions.

Instructional Goals. The goal is to provide students with an appreciation of the obligations of the various players and their role in practice, the relative practice rules and their differences, and statutory provisions that might affect these obligations.

Example 4: Compliance.

The Assignment. Students are provided with the text of a letter of credit-type undertaking, documents presented under it, and a notice of refusal. They are given various persons as clients, namely an issuer, applicant, beneficiary, and possibly a nominated bank. The discrepancy is technical, that is: (i) omitting the number of the letter of credit or missing a number or letter in it; (ii) omitting or misstating some detail from the description of the goods that is not germane to the description of the goods and extraneous to the particular document (such as shipping information or addresses) and its role in the LC transaction; or (iii) omitting required information such as the LC number or inserting incorrect extraneous information on a document that has no bearing on its role in the LC. Applicable rules may have bearing on this problem and they will be indicated in the undertaking.

Significance of the Topic. A significant number of reported decisions deal with problems regarding the compliance of presented documents with the terms and conditions of the undertaking. Misunderstanding the notion of "strict compliance" (which is a legal term and not one contained in any of the practice rules), courts and attorneys often resort to the mindless notion of literal replication which neither reflects actual LC practice, the practice rules, or common sense.

The Platform. The problem and legal memos addressing it can proceed from the different perspectives of various clients. The problem could involve stages, starting with the course of action of the confirmer or negotiating bank (if there is one) and addressing the problems that arise when a notion of refusal is given for the issuer, the beneficiary, and the applicant. The notice of refusal is deliberately drafted inadequately but students' attention is not drawn to this point until the classroom exercise is well underway.

Classroom Approach. Start with a discussion of the merits of the presentation, namely does it comply and why, and then to move on to the question of whether the notice of refusal is adequate and, if not, the consequences of its inadequacy.

Instructional Goals. One goal is to help students deal with problems caused by pending litigation or that arise transactionally. Also, the problem forces students to see a problem from the perspective of various parties. It forces the students to face the inadequacy of the so-called "strict compliance" approach and to take a more nuanced approach to the problems caused by minor typographical errors that are extraneous to the role of an otherwise complying document in a letter of credit transaction. The problem also forces students to appreciate the importance of provisions in an agreement between the issuer/guarantor and the applicant dealing with such issues.

Example 5: Drafting an Automatic Extension Clause.

The Assignment. Students are given a factual problem and asked to draft an automatic extension clause for a letter of credit which is to be circulated before class.

Significance of the Topic. The topic focuses on the significance of the processes involved in drafting and the need for interaction between the parties to reach a consensus. Automatic extension clauses are essential to modern letter of credit practice since it is neither safe nor sound for banks to make long term commitments without regular reassessment of the credit standing of the applicant. Such clauses are also highly problematic, however. To name only one issue, should a notice of non-extension be effective when sent to the beneficiary or received?

The Platform. Here, the platform is a factual problem in which a construction company requires a performance standby or demand guarantee for 10 years related to a USD 50 million hydroelectric project in another country for a government-controlled entity. The focus on the issue is whether the bank will or can issue such an undertaking for that length of time and the alternatives.

Classroom Approach. First, the students are invited to comment on the various draft clauses which are projected on a screen.

Second, students are required to take the role of the applicant, the beneficiary, and the applicant's bank with respect to a transaction for a period of ten years. They are required to consider the various issues involved in such an undertaking and how it is that the relative risks can be mitigated. The optimal solution in such a context apparently is a limited duration of an expiration date with an automatic extension clause coupled

with notice of non-extension and the ability to draw in the event that notice is given. The students are forced to discuss, negotiate and consider the various alternatives as well as the issues involved in the formulation of such a clause such as to whom notice is given, addresses, whether it is to be sent or received, and similar issues.

Instructional Goals. This exercise should be linked with the exercises on drafting rule for automatic extension clauses but need not immediately follow it. The exercise should demonstrate the inadequacy of practice rules to solve certain problems. At some point, the students' attention should be directed to ISP98 Model Form 2 (Model Standby Providing for Extension and Incorporating Annexed Form of Payment Demand with Alternative Non-Extension Statement) whose provisions and endnotes detail many of these issues. The dramatization forces students to identify with the various perspectives of their clients and to come to a resolution with which the various parties can live or to face the consequences of failure to do so. Any solution must provide adequate protection to the issuer/guarantor and to the beneficiary.

Note: Three of these exercises involve automatic extension clauses, namely (and in this order) drafting a comment in the official commentary on a practice rule, drafting a proposed revision of the rule, drafting a clause for a standby letter of credit, and negotiating the terms of the clause. These exercises are deliberately structured to be backwards. It is absurd to attempt to draft rules without understanding the issues that arise in practice and difficult to draft a clause for a standby without having a sense of what is possible. In addition, the exercises are designed to illustrate the limitations of rulemaking. Some things are better handled by drafting or model clauses than rules.

Example 6: Counter Undertakings and related issues and problems.

The Assignment. Students utilize the exercise involving drafting an automatic extension clause (Example 5), requiring issuance of a counter undertaking requesting issuance of a local bank undertaking in favor of the government agency ordering construction of the hydro-electric plant. The facts will be drawn from the problem in Exercise 5.

Significance of the Topic. Counter undertakings have assumed considerable importance in letter of credit practice.

The Platform. Students are requested to deal with the consequences of closure of the local bank on a business day which is also the expiration day of the local bank undertaking on the counter undertaking.

Alternatively, or in conjunction with this exercise, they can be asked to deal with forwarding documents presented under the local undertaking in

the context of an otherwise complying presentation under the counter undertaking.

Classroom Approach. Students are assigned roles in advance and asked (separately or together as a group) to draft a counter undertaking containing the text of the requested local undertaking or to draft a reply to the request on the part of the local bank. The class is used to discuss the issues.

Instructional Goals. To acquaint students with counter undertakings and the different problems and issues that arise under them.

Appendices. Appendix E contains a recent example of an assignment.

Example 7: Letter of Credit Fraud or Abuse.

The Assignment. Students are given a factual problem involving delivery of goods that had little or no economic value. The students are given various scenarios involving the beneficiary and involving nominated banks and a counter undertaking.

Significance of the Topic. An example is used in the context of counter-standbys or counter-guarantees coupled with several cases which speak to these issues. The focus of the exercise is the litigation postures of the various parties. Students are assigned to represent the local beneficiary, the local bank, the issuer of the counter-standby or counter-guarantee, and the applicant. They are required to indicate in a memo their approach to various issues including jurisdiction, law, and the substantive issues involved with respect to fraud and the role of protected persons. In the hypothetical that is set for them, it is likely that the local beneficiary has committed fraud and the question is whether or not a demand by the local bank which is the beneficiary of the counter-undertaking is to be honored where the local bank has honored its local obligation.

The Platform. The factual problem with various scenarios calling for memos on behalf of various clients.

Alternative: Use the problem from Example 6 and indicate a drawing without basis by the local beneficiary coupled with a complying drawing by the local bank on the counter standby. This problem would force the students to address whether the local undertaking was separately independent from the counter undertaking.

Classroom Approach. Require the students to submit to mediation on behalf of their clients and permit them to interact with each other's arguments.

Instructional Goals. Understanding the various degrees of conduct that constitute Letter of Credit Fraud or Abuse and exceptions in favor or protected persons.

Appendices. Appendix F contains a recent assignment.

Example 8: Assessment based on application of principles to a public policy question.

The Assignment. Students are given a take-home examination limited by a time deadline and the number of words permitted. The examination asks students to address the following question: "The Peoples' Supreme Court is drafting rules [under Chinese organic law, legally binding on all Chinese courts] for standby letters of credit. Assume that you are asked for advice. What suggestions do you have?"

Significance of the Topic. Questions of public policy and statutory drafting. In a course to Chinese graduate students, they were required for the final examination to draft a memo directed to the People's Supreme Court indicating issues to be considered in drafting rules for standby letters of credit. It should be noted that the People's Supreme Court has drafted rules applicable to commercial letters of credit and is bogged down in theoretical and substantive questions with respect to demand guarantees which are confused with dependent guarantees for which there is legislation in China (as in many countries). The question is in the minds of the drafters whether standbys should be linked with commercial letters of credit or with demand guarantees which are (mistakenly) classified with dependent guarantees. The exercise tests the ability of the student to grasp substantive issues as well as to provide a sound resolution of the problem.

Basis for the Assessment. Whether the students able to provide a coherent and principled resolution to the various issues including classification.

APPENDIX A

Bibliography:

Student Materials:

JAMES E. BYRNE ed., *LC RULES & LAWS: CRITICAL TEXTS FOR INDEPENDENT UNDERTAKINGS* (6th ed. 2013) (377 pages/paperback) (IIBLP). ISBN 978-1-888870-63-3. [Contains the texts of all relevant practice rules, the UN LC Convention & Secretariat's Explanatory Note, US Revised UCC Article 5, translations of the Chinese Peoples' Supreme Court rules, the ISBP (2007), and other important resources. Ability to access these texts is essential for the study of letters of credit.]

ISP98 MODEL FORMS (2012) (IIBLP). URL: www.iiblp.org/ISP98Forms. Also available in UBS with comments and index: [IIBLB]. [Eight forms developed for use with ISP98, including explanatory endnotes containing alternative clauses intended as a starting point for applicants and beneficiaries to draft ISP98 standbys.]

JAMES E. BYRNE, *INTRODUCTION TO DEMAND GUARANTEES & STANDBYS* (2012) (IIBLP) (174 pages/paperback). ISBN 1-888870-44-3 [Platform for classes on demand guarantees and standbys, containing problems, excerpts from opinions, texts from actual standbys and guarantees, and the text of select court decisions that provide a basis for problem solving.]

JAMES E. BYRNE, *INTRODUCTION TO LETTER OF CREDIT LAW & PRACTICE* (6th ed. 2011) (IIBLP) (232 pages/paperback). ISBN 1-888870-44-3 [Platform for course on commercial letters of credit, containing problems, excerpts from judicial opinions, actual texts from letters of credit, and the text of select court decisions that provide a basis for a problem solving approach to the subject.]

Resources that Should be Available to Students in an Academic Library:

1. Commercial LCs & UCP:

JAMES E. BYRNE, *THE ORIGINAL DOCUMENTS CONTROVERSY: FROM GLENCORE TO THE ICC DECISION* (1999) (160 pages/paperback) (IIBLP). ISBN 1-888870-21-4 [Analysis of the dangers inherent in judicial misinterpretation of practice rules based on a series of English cases that

distorted UCP provisions regarding original, detailing the response of the letter of credit community and its effect on courts.]

JAMES E. BYRNE ET AL., *UCP600: AN ANALYTICAL COMMENTARY* (2010) (1462 pages/hardback) (IIBLP). ISBN 978-1-888870-47-3 [Definitive analysis of the UCP, organized on an article by article basis but tracing the genesis of each article to the original UCP82 (1933), referencing all relevant ICC Banking Commission opinions, the ISBP, and relevant judicial decisions. Essential for any serious study of the UCP and commercial letter of credit practice.]

KIM SINDBERG, *UCP 600 TRANSPORT DOCUMENTS* (2012) (152 pages/ paperback) (IIBLP). ISBN 978-1-888870-54-1 [Detailed analysis of transport documents under UCP600 and the ISBP by leading banker, taking into account opinions by the ICC Banking Commission and actual practice]

DAN TAYLOR, *THE COMPLETE UCP* (2008) (249 pages/paperback) (ICC). ISBN 978-92-842-0032-0 [Contains the text of all versions of the Uniform Customs and Practice for Documentary Credits, including versions prior to its adoption by the ICC.]

2. Standby Letters of Credit Practice:

JAMES E. BYRNE, *THE OFFICIAL COMMENTARY ON THE INTERNATIONAL STANDBY* PRACTICES (1998) (IIBLP) (353 pages/hardback and paperback). ISBN 1-888870-17-6 [The official commentary issued by the IIBLP interpreting ISP98. Organized on an article by article basis and containing comparisons with UCP500, relevant statutes, and regulations.]

3. Demand Guarantee Problem:

GEORGES AFFAKI & ROY GOODE, *GUIDE TO ICC UNIFORM RULES FOR DEMAND Guarantees URDG* 758 (2011) (511 pages/hardback) (ICC). ISBN 978-92-842-0078-8 [Comments organized on article by article basis on URDG 758.]

4. LC Law:

JAMES E. BYRNE & CHRISTOPHER BYRNES EDS., 2009 – PRESENT: ANNUAL REVIEW OF INTERNATIONAL BANKING LAW & PRACTICE; 1996-2008 THE ANNUAL SURVEY OF LETTER OF CREDIT LAW & PRACTICE: (IIBLP) (Available in print and electronically) (2012) (IIBLP). [Annual yearbooks containing all significant literature in English or translated,

summaries of all reported cases and texts of non-reported or translated cases, practice and other developments. Cumulatively indexed.]

JAMES E. BYRNE, HAWKLAND UNIFORM COMMERCIAL CODE SERIES, VOLUME 6B, [REV.] ARTICLE 5 LETTERS OF CREDIT (Frederick H. Miller ed.) (unit of multi-volume treatise on Uniform Commercial Code/750 pages/hardback) (West Group Pub. 2009) [Article by article analysis of US Revised UCC Article 5 (Letters of Credit) containing the text of the statute, prior statutory versions, an analysis of the issues inherent in each section drawing on all case law and select case law under prior version, and comparing UN LC Convention, Chinese LC Rules, and relevant practice rules.]

JAMES E. BYRNE, *INTERNATIONAL LETTER OF CREDIT LAW AND PRACTICE* (2012) (1443 pages/paperback) (West). ISBN 978-0-314-60768-3 [International study of letter of credit law topically divided with statement of principles, problems, and rules and annotated case summaries following by country or region.]

JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT* (4th ed. 2007) (2 Vols./ hardback looseleaf) (A.S. Pratt & Sons). ISBN 1-55827-716-1 [Oft cited and exhaustive treatise of letter of credit law, focusing on US cases but covering many international cases, as well. Organized on the basis of a systematic outline of the topic.]

APPENDIX B

Marubeni Hong Kong and South China Ltd v Government of Mongolia

[2005] EWCA Civ 395, [2005] All ER (D) 117 (Apr)

Abstracted by James G. BARNES[46]

Topics: Guaranty; Independent Guarantee; Surety; Independent, Dependent;

Type of Lawsuit: Beneficiary sued issuing bank for wrongful dishonor

Parties: Claimant/Beneficiary/Seller– Marubeni Hong Kong and South China Ltd
Applicant/Buyer– Buyan Holding Co Ltd
Defendant/Issuer– Mongolian Government

Underlying Transaction: Purchase of equipment for cashmere processing plant.

Undertaking: The text of the undertaking issued by the Finance Ministry of Mongolia is reproduced below.

Decision: The Court of Appeals (Civil Division), Waler, Carnwath, LJJ, and Sir Martin Nourse, J.J., dismissed an appeal and approved the decision of Creswell, J., that an undertaking issued by the Finance Ministry of Mongolia was binding on the issuer as a secondary obligation and not as an independent obligation

Rationale: An undertaking issued by a non-bank is presumed not to be independent.

Factual Summary: The beneficiary sold equipment and materials for a cashmere processing plant in Mongolia under a deferred payment contract for US$18,511,670. Disputes between the seller and buyer resulted in several reschedulings of the payment obligations of the buyer. Following non payment of most of the rescheduled amounts, seller demanded

46. James G. BARNES practices law with Baker & McKenzie in Chicago, Illinois.

payment of US$13,796,556 plus interest under the undertaking issued by the Finance Ministry of Mongolia, reproduced below. The defendant issuer refused to pay on the grounds that the reschedulings materially changed the underlying obligation with the effect of discharging its obligations under its undertaking. The claimant beneficiary sought to eliminate that defense by characterizing the undertaking as "independent".

Legal Analysis: The English Court of Appeal held that the undertaking issued by the Finance Ministry of Mongolia, reproduced below, was not an independent undertaking. The court emphasized that the issuer was not a bank and held that only bank undertakings to pay on demand enjoy a presumption of independence, such that they are enforceable as first demand guarantees or performance bonds that are analogous to letters of credit. The court then determined that neither the text of the undertaking nor any other factor overcame the presumption of non-independence of the non-bank undertaking in this case.

For procedural reasons the court did not consider any other grounds for treating the undertaking as unaffected by reschedulings of the underlying payment obligations.

Comment by James G. BARNES:

1. Determining which undertakings qualify as independent and which do not can be difficult, particularly if there is no clear statutory or case law definition of independence.

2. US law provides a clear framework for identifying undertakings that qualify as independent. The Restatement Third, Suretyship and Guaranty, broadly defines guarantee and suretyship relationships and expressly excludes letters of credit from the definition. The Uniform Commercial Code defines letters of credit, essentially as undertakings to pay against the presentation of documents, so as to exclude from suretyship law commercial letters of credit, standby letters of credit, and independent guarantees, notably undertakings issued subject to UCP500, ISP98, and URDG, as well as Article 5 of the UCC itself. A feature of the law and practice applicable to such undertakings is that nondocumentary conditions, if any are included in the undertaking, must be disregarded. A consequence of this interpretive rule, as well as the statutory definition of "letter of credit", is that an undertaking containing nondocumentary

conditions that are essential to the undertaking may not qualify as a letter of credit, in which case they would not be excluded from the definition of suretyship. Fortunately, the divide between independent and non-independent undertakings is not frequently tested in the US, and US case law applying UCC Article 5 in this regard is generally good.

3. Outside the US there is much more testing of the divide between independent and non-independent undertakings both in practice and in the courts. There is more inclination to draft undertakings that are intended to be independent and then to add recitals and waivers appropriate for suretyship undertakings but not for independent undertakings. There is an understandable desire on the part of courts, and the banking industry generally, to enforce bank undertakings to pay without regard to the facts of performance or default in the underlying transaction. Accordingly, there is considerable case law outside the US treating bank undertakings as independent that are riddled with nondocumentary conditions and otherwise in a form that would not be issued by a US bank. In this case, the English court rather struggled to decide that the undertaking before it was not independent, because, had it been issued by a bank, it might have qualified under English case law precedent as independent, even though it is indefinite as to the form and substance of the demand required to be presented, its duration and amount are expressed only in terms of a defaulted underlying obligation, and it does not incorporate rules that might signify its independence and provide for disregard of nondocumentary conditions.

4. US law recognizes that ordinary guarantors may effectively waive defenses otherwise available to a secondary obligor, notably by providing in the guarantee that the beneficiary may change the underlying obligation, or release collateral, or otherwise agree to pay as if a primary obligor. It appears that English law is similar, but for procedural reasons the Court of Appeal did not address the possibility that this particular undertaking should be unaffected by a rescheduling of the underlying debt even though it did not qualify as independent.

TEXTUAL APPENDIX

The following text appeared in the report of the decision:

"To: Marubeni Hong Kong Ltd

"In consideration of your entering into the deferred payment sales contract No 258500 (hereinafter called the 'agreement') with Buyan Holding Co Ltd, a corporation duly organised and existing under the laws of Mongolia, with its principal office at I-40000-68-4 Ulaanbaatar, Mongolia (hereinafter called the 'buyer') for sales and purchase of a textile plant the contract price of which is United States dollars eighteen million eight hundred eleven thousand six hundred seventy (US$18,811,670), the undersigned Ministry of Finance of Mongolia unconditionally pledges to pay to you upon your simple demand all amounts payable under the agreement if not paid when the same becomes due (whether at stated maturity, by acceleration or otherwise) and further pledges the full and timely performance and observance by the buyer of all the terms and conditions of the agreement. Further Ministry of Finance undertakes to hold indemnify and hold you harmless from and against any cost and damage which may be incurred by or asserted against you in connection with any obligations of the buyer to pay any amount under the agreement when the same becomes due and payable (whether at stated maturity, by acceleration or otherwise) or to perform *2501 or observe any term or condition of the agreement, or in connection with any invalidity or unenforceability of or impossibility of performance of any such obligations of the buyer.

"This covenant shall come to force from the date of implementation of this agreement and remain in full force and effect until all amounts due to you by the buyer under the agreement have been paid in full and all the terms and conditions of the agreement have been fully performed and observed by the buyer.

"The Ministry of Finance hereby waives any right to require you to proceed against the buyer or against any security received from the buyer or any third party or to pursue any other remedy available to you."

The letter also provided that: "All disputes related to this pledge shall correlate in accordance with the jurisdiction courts of England."

APPENDIX C

ISP98 Form 1
Model Standby Incorporating Annexed Form of Payment Demand with Statement*

[name and address of beneficiary] **[date of issuance]**

Issuance. At the request and for the account of **[name and address of applicant]** ("Applicant"),[1] we **[name and address of issuer at place of issuance]** ("Issuer") issue[2] this irrevocable[3] standby letter of credit number **[reference number]** ("Standby")[4] in favour of **[name and address of beneficiary]** ("Beneficiary")[5] in the maximum aggregate amount[6] of **[currency/amount]**.

Undertaking. Issuer undertakes to Beneficiary[7] to pay[8] Beneficiary's demand for payment in the currency and for an amount available under this Standby[9] and in the form of the Annexed Payment Demand completed as indicated[10] and presented[11] to Issuer at the following place for presentation: **[address of place for presentation]**,[12] on or before the expiration date.[13]

Expiration. The expiration date of this Standby is **[date]**.[14]

[*Payment. Payment against a complying presentation shall be made within 3 business days*[15] *after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary. An advice of such payment shall be sent to Beneficiary's above-stated address.*][16]

[*Drawing. Partial and multiple drawings are permitted.*][17]

[*Reduction. Any payment made under this Standby shall reduce the amount available under it.*][18]

ISP98. This Standby is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).[19]

[*Communications. Communications other than demands may be made to*

Issuer by telephone, telefax, or SWIFT message, to the following: ***[numbers/addresses]****. Beneficiary requests for amendment of this Standby, including amendment to reflect a change in Beneficiary's address, should be made to Applicant, who may then request Issuer to issue the desired amendment.*][20]

[Issuer's name]

[signature]
Authorized Signature

Annexed Payment Demand

[INSERT DATE][21]

[name and address of Issuer or other addressee at place of presentation as stated in standby][22]

Re: Standby Letter of Credit No. **[reference number]**, dated **[date]**, issued by **[Issuer's name]** ("Standby")[23]

The undersigned Beneficiary demands payment of [INSERT CURRENCY/ AMOUNT] under the Standby.[24]

Beneficiary states[25] that Applicant[26] is obligated[27] to pay to Beneficiary the amount demanded[, *which amount is due and unpaid*[28]] under [*or in connection with*] the agreement[29] between Beneficiary and Applicant[30] titled **[agreement title]** and dated **[date]**.

[*Beneficiary further states that the proceeds*[31] *from this demand will be used to satisfy*[32] *the above-identified obligations and that Beneficiary will account to Applicant*[33] *for any proceeds that are not so used.*]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY'S BANK, AND NAME AND NUMBER OF BENEFICIARY'S ACCOUNT].[34]

[Beneficiary's name and address][35]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE][36]
[INSERT TYPED/PRINTED NAME AND TITLE]

[Before the standby is issued, all text in **[bold]** should be completed, and optional text in [*italics*] should be included or deleted (or redrafted). Text in the annexed demand form preceded by "INSERT" (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the beneficiary prepares and presents a demand.]

****

This ISP98 Form 1 model standby includes terms that ISP98 indicates should be included in a standby. It includes terms that restate other ISP98 rules for the avoidance of doubt, e.g., that the standby is irrevocable and permits partial demands. It uses words, phrases, and spellings that are used in ISP98. It also includes optional terms that are specific about when and how payment will be made.

This ISP98 Form 1 incorporates an annexed model form of payment demand that includes terms that ISP98 indicates should be included when making a presentation. This demand form also includes beneficiary statements of a type the applicant or beneficiary may desire in order to identify the underlying obligation(s) to be supported by the standby (and to be satisfied upon honour of the standby).

The annexed demand form may also be used as a precedent by a beneficiary preparing a demand to be presented under an ISP98 standby that does not specify the entire form of demand to be presented. See ISP98 Form 5 (Simplified Demand Only Standby).

This ISP98 Form 1 is intended to be self-contained and, absent special

circumstances, useable without extended reference to the text of ISP98.

The endnotes to this form include alternative and other optional terms, as well as references to relevant ISP98 rules. Other ISP98 model standby forms vary this form, e.g., by adding text and annexes (with relevant endnotes) that focus on expiration, reduction, transfer, confirmation, and counter standby support.

This form is published for educational purposes and not as legal or professional advice. Potential users should consult with their own advisers in the drafting or use of a standby letter of credit. ISP98 and letter of credit educational and training materials, including *The Official Commentary on the International Standby Practices* containing official interpretations of ISP98, are available from IIBLP at www.iiblp.org.

Endnotes

1. Applicant. As noted in ISP98 Rule 1.09(a) (Definitions), the "applicant" is the person who applies for issuance or for whose account the standby is issued. Typically, the applicant stated in the standby is the person whose underlying obligation is supported by the standby. The standby's terms should be appropriate to support those underlying obligations, and the underlying documentation should appropriately provide for the standby and for the use of funds paid under the standby.

Where a standby is issued on the application of a correspondent bank from whom the issuer expects reimbursement, consideration should be given to an alternative clause: "At the request and for the account of **[name of correspondent bank]**, ("Applicant") acting at the request and for the account of its customer, **[XYZ]**. . .". Similarly, where a standby is issued on the application of a parent company, consideration should be given to an alternative clause: "At the request and for the account of **[Parent]** ("Applicant") acting at the request and for the account of its subsidiary **[name]**. . .".

This standby form adds "("Applicant")" after the name of the applicant, and that defined term is used in the annexed model demand form. If this parenthetical definition (or the parenthetical definition for the issuer or the beneficiary) is not wanted, appropriate adjustments should be made in the standby, including in any statement required to be included with any beneficiary demand. If an adjustment is made because the applicant is not also the underlying obligor (or the beneficiary is not also the underlying obligee), then the adjustments should be made in the standby and also in

the documentation underlying the standby. See endnote 30.

Except for endnotes 1 and 30, these endnotes do not address issues that may arise where the applicant is not the underlying obligor or where there are multiple applicants.

2. Issuance. The name of the issuer and the place(s) of issuance and presentation should be indicated in the standby. The indicated place of issuance is significant in determining what law governs the issuer's obligations. Absent an indication of the place of issuance in the standby, it may prove difficult to determine a single place of issuance, even with full knowledge of the process resulting in sending the standby to the beneficiary. This form, including endnotes, does not address the possibility, briefly addressed in ISP98 Rule 10 (Syndication/Participation), of multiple issuers or of participating interests in a single issuer's standby facility.

Rule 2.03 (Conditions to Issuance) provides generally that a standby is issued when it leaves the issuer's control, and Rule 3.05 (When Timely Presentation Made) allows presentation any time after issuance (and before expiry) It is customary for a standby to recite the issuance date either at the top of the undertaking or in the first paragraph of the text (or both).

3. Irrevocability. It is unnecessary to state that an ISP98 standby is irrevocable. See ISP98 Rule 1.06(a) and (b) (Nature of Standbys). However, because of the contrary rule in UCP82 (1933) until UCP500 (1993), some letter of credit users expect or require inclusion of the word "irrevocable".

4. Name of undertaking. While this form of undertaking is named a "standby letter of credit", the name is not determinative of its character as an undertaking within the scope of ISP98 or as an independent undertaking under applicable law. As provided in ISP98 Rule 1.01(b) (Scope and Application), it could be called an independent guarantee, bank guarantee, bond, or any other name.

5. Beneficiary. The beneficiary named in a standby is the person to whom the issuer's obligation is owed. Typically, there is one named beneficiary of the issuer's undertaking, who is also the obligee of the applicant's obligation that is supported by the standby. This standby form, including endnotes, does not address issues that may arise where the named

beneficiary is not the underlying obligee or where there are multiple beneficiaries.

6. Amount available. A standby should expressly state the amount available under the standby. Standbys commonly add that the stated amount of a standby is the "maximum" (or "full" or "not to exceed") "aggregate" amount. These are unnecessary additions because ISP98 Rule 3.08 (Partial Drawings & Multiple Presentations; Amount of Drawings) permits presentations for less, but not more, than the amount available under a standby.

Under ISP98 Rule 3.08(e) (Partial Drawings & Multiple Presentations; Amount of Drawings), a drawing that exceeds the amount available under the standby is discrepant. To override that rule and require the issuer to pay the full amount available under the standby against a presentation that would comply but for the "credit overdrawn" discrepancy, the following clause may be added: "If a demand exceeds the amount available, but the presentation otherwise complies, Issuer undertakes to pay the amount available."

7. Undertaking to the beneficiary only. It is unnecessary to state that an issuer's payment obligation is made "to Beneficiary". Except as otherwise stated in the standby or mandated by applicable law, a standby that names a beneficiary and does not identify any other person as having rights under the standby obligates the issuer solely to the named beneficiary. ISP98 Rule 2.04 (Nomination) provides for the possibility that a standby nominates another person to confirm the issuer's undertaking or otherwise to give value against the named beneficiary's complying demand. ISP98 Rule 6 (Transfer, Assignment, and Transfer by Operation of Law) provides for the possibility that an issuer is requested to acknowledge a person claiming to be a transferee beneficiary or an assignee of standby proceeds or a successor beneficiary. ISP98 Form 4 (Model Standby Providing for Transfer and Incorporating Annexed Form of Transfer Demand) focuses on transfer of drawing rights by beneficiary demand and other standby terms affecting a claimed transferee beneficiary, assignee of standby proceeds, or successor beneficiary.

8. Honour by payment. An issuer may undertake to honour a letter of credit other than by sight payment. Under ISP98 Rule 2.01 (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) an issuer may undertake to honour by non-recourse negotiation (purchase) of the

documents presented or by acceptance of a time draft or incurrence of a deferred payment undertaking, followed by payment at maturity. Also, an issuer may undertake to honour by the delivery of an item of value, such as gold, in which case the issuer must be able to deliver the specified item. These other forms of honour are not covered in this form because they are much less common for standbys than honour by sight payment.

9. Presentation of standby. An issuer's obligation is not dependent on the beneficiary's holding or presenting the standby, unless the standby so provides. See ISP98 Rule 2.03 (Conditions to Issuance). This form, like most standbys, does not require presentation of the standby with a payment demand. Any such requirement exposes the beneficiary to the risk that a demand may be rightfully refused if the standby is lost or otherwise cannot be timely presented. It also exposes the issuer to disputes over the issuer's receipt, handling, or return of the standby. There are other ways to avoid payment against a forged demand, e.g., by providing in the standby that payment must be made to a specified beneficiary account.

Under ISP98 Rule 3.12 (Original Standby Lost, Stolen, Mutilated, or Destroyed), an issuer is entitled to enforce a requirement that the standby be presented with a demand. However, the rule also gives an issuer considerable discretion to excuse or remedy a beneficiary's failure to present the standby. If greater certainty is desired, then the standby could add the following or a variation: "Issuer undertakes to exercise its discretion under ISP98 Rule 3.12 to waive the requirement to present this Standby (or to replace it) against Beneficiary's representations and indemnities (including third party indemnities deemed appropriate by Issuer) in favor of Issuer and Applicant that are reasonably satisfactory to Issuer." The representations and indemnities should run to the applicant as well as the issuer. Although the issuer would determine what is reasonable at the time of taking any representations or indemnities, the applicant would bear the ultimate risk of payment against a forged demand.

The term "this Standby" in this ISP98 Form 1, like the term "original standby" in ISP98 Rule 3.12 (and Rule 6.03 (Conditions to Transfer)), refers to the originally signed/authenticated undertaking that evidences the issuer's obligation. Unless the issuer sends a signed/authenticated undertaking directly to the beneficiary, it may be desirable to clarify in the standby what must or may be presented as, or in lieu of, the issuer's undertaking in the form it left the issuer's control. If the standby was sent by an authenticated SWIFT message from an issuing bank to an advisor,

the document to be presented would be the advisor's signed/authenticated message to the beneficiary annexing, or reproducing the text of, the SWIFT message sent by the issuer. There may be no unique undertaking for the beneficiary to present. If, for example, a standby was sent to a beneficiary in an electronic medium, its presentation to the issuer in an electronic medium or as a paper printout would serve merely to identify the standby to be transferred.

The terms "this standby" and "original standby" do not necessarily refer also to amendments. Some standbys state that all amendments must also be presented, and some also require a statement from the beneficiary as to whether it has consented (or not) to each amendment issued by the issuer. Neither should be necessary. An issuer should be able to determine from its own records whether amendments are binding on the issuer and the beneficiary, but it may nonetheless be desirable to address the status of amendments in any standby term requiring presentation of the standby.

10. Form of payment demand. This ISP98 Form 1 standby incorporates an annexed model form of payment demand to be completed and presented by the beneficiary. Annexing the desired form of payment demand (with any desired beneficiary statement) to a standby is unnecessary but promotes the efficient use of standbys. Requiring a "draft" (or bill of exchange) drawn at sight by the beneficiary on the issuer is neither necessary nor efficient under a standby that undertakes to pay at sight.

A standby that specifies wording in an annexed form of demand is subject to ISP98 Rule 4.09(b) (Identical Wording and Quotation Marks). That subsection requires or permits the beneficiary to complete blank lines or spaces and to correct apparent typographical errors and the like. It is intended to cover practically all circumstances in which a form of beneficiary demand and statement is annexed to the standby.

If more flexibility is desired, Rule 4.09(a) should be consulted, but flexibility is better introduced by adding alternative wording to the annexed form of demand or otherwise indicating in the annexed form of demand how blank spaces may be completed. If no flexibility whatsoever is desired (e.g., because the demand or statement must be delivered to a third person in a precisely specified form), then Rule 4.09(c) should be consulted, with the understanding that it should be invoked rarely, that it requires use of the word "exact" or "identical" in the standby, and that its use may lead to unintended consequences for the issuer, applicant, or beneficiary.

The phrase "completed as indicated" assumes that the annexed form of demand adequately indicates how it is to be completed (e.g., by the inclusion of instructions and blank lines) and that it is to be dated and signed by the beneficiary. It does not add that the demand be "apparently" signed by the beneficiary or the beneficiary's "purported" representative, because such additions are more likely to confuse than clarify the allocation of risks under ISP98 and applicable law of payment or non-payment of a forged demand.

ISP98 Rule 4.08 (Demand Document Implied) requires presentation of a documentary demand for payment. ISP98 itself does not require the named beneficiary to present any beneficiary statement.

Some standbys state that they are available by "one or more demands" or by "demand(s)", rather than by "demand" in the singular. This is unnecessary for the reasons indicated in endnote 17.

11. Manner of presentation. This standby form is based on the usual practice of sending original documents, sometimes including the original standby, in a package by courier to the issuer's indicated place of presentation. Presentations by telefax and the like are prohibited unless expressly permitted in the standby or unless the beneficiary is a SWIFT participant or bank sending a demand using SWIFT or other similar authenticated means. See ISP98 Rule 3.06 (Complying Medium of Presentation). ISP98 Rule 1.09(c) (Electronic Presentations) includes defined terms that may be used in a standby that permits electronic presentation.

12. Place of Presentation. ISP98 Rule 3.01 (Complying Presentation under a Standby) provides that a standby should indicate the place, the location within that place, and the person to whom presentation should be made. ISP98 Rule 3.04 (Where and to Whom Complying Presentation Made) provides default rules. The indicated place of presentation is significant in determining whether a complying demand is timely presented.

Standbys frequently include a requirement that the presentation be addressed to the attention of the Standby Letter of Credit Department or the like, which may prove critical on a last minute presentation. Some standbys also include in the address for presentation a specific floor or

office, which, if it is not accessible to the beneficiary, may prove contentious in the case of a last minute presentation. Beneficiaries and issuers both should avoid testing the limits of such requirements.

A standby may require presentation to the issuer to be made at a place that is not the place of issuance, e.g., to and at the address of a processing agent for the issuer (which could be an affiliate or another bank). A standby may also nominate another branch or bank to receive a presentation and act on that nomination. This standby form does not include any nomination or address issues which arise from a nomination. See ISP98 Rule 2.04 (Nomination).

13. Time of presentation. ISP98 Rule 3.05 (When Timely Presentation Made) provides that presentation must be made before expiry on the expiration date and that a presentation after business hours is treated as made the next business day. Rule 9.04 (Time of Day of Expiration) provides that expiry occurs at the close of business at the place of presentation.

14. Expiration. Standbys must contain an expiration date under ISP98 Rule 9.01 (Duration of Standby) and likely also under applicable commercial law and banking regulations. This standby form is based on the common practice of stating a specific calendar date. The stated date should be set sufficiently after the underlying obligation becomes due to allow for drawing after refusal of an initial drawing. If payment of the underlying obligation may be made outside of the standby, the stated date should be set to allow also for drawing after any possible rescission of an outside payment made by an insolvent payor.

Many issuers are subject to laws, regulations, or internal policies that limit their incurrence of obligations that are indefinite or long term. A common response is to set a one year expiration date and allow for automatic annual extensions unless the issuer sends or the beneficiary receives advance notice of non-extension. ISP98 Rule 2.06(a) (When an Amendment is Authorized and Binding) makes "automatic amendments", including extensions of the expiration date, effective without further notification or consent, if the automatic amendment is expressly stated in a standby. ISP98 Form 2 (Model Standby Providing for Extension) focuses on annual automatic extension and other alternatives to a single fixed expiration date.

The expiration date stated in a standby is not necessarily the last day on

which a complying presentation may be made under the standby. ISP98 Rules 3.13 (Expiration Date on a Non-Business Day) and 3.14 (Closure on a Business Day and Authorization of Another Reasonable Place for Presentation) extend the expiration date where it falls on a non-business day or on a day the bank is closed for any other reason.

15. Three days to examine and pay a presentation. ISP98 Rules 2.01(c) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) and 5.01 (Timely Notice of Dishonour) provide for the time an issuer has to honour or dishonour and include a safe-harbor of three business days after presentation. The three day period begins on the business day following the business day of presentation. This optional standby text converts that 3-day safe harbor period in ISP98 into a timing requirement for payment of a complying presentation.

Many so-called financial standbys state a shorter period within which a complying presentation must be paid, and some also state that the shortened period also applies to the time allowed for the issuer to avoid preclusion by giving a notice of dishonour. For example, a standby payable against a simple demand to be presented by a bank beneficiary might state: "Payment of a complying presentation shall be made[, or in the case of a non-complying presentation a notice of dishonour shall be given,] on the first banking day following the banking day on which Issuer receives a presentation from Beneficiary[, if received before noon,][by SWIFT/telefax message at Issuer's following SWIFT address/telefax number]. . ."

Some standbys permit a longer period for payment, e.g., 30 days after presentation or 10 days after a presentation is determined to comply. Lengthening the time for honour would not, without more, lengthen the timing requirements of ISP98 Rule 5.01 (Timely Notice of Dishonour) for giving a notice of dishonour or for precluding defenses under ISP98 Rule 5.03 (Failure to Give Timely Notice of Dishonour).

16. Place and method of payment. If a standby, including an annexed form of demand, does not state the method of payment, then an issuer may voluntarily follow the presenter's request. ISP98 Rule 5.08 (Cover Instructions/Transmittal Letter) permits an issuer to deal with the presenter and to follow instructions accompanying a presentation. Similarly, ISP98 Rule 6.10 (Reimbursement for Payment Based on an Assignment) protects an issuer's reimbursement rights in cases of payment to an acknowledged

assignee of standby proceeds. ISP98 Rule 2.01(e) (Undertaking to Honour by Issuer and Any Confirmer to Beneficiary) provides that honour by payment is to be made in immediately available funds. This optional standby text facilitates payment by wire transfer in response to a request duly made by the beneficiary.

Unless the standby otherwise states, an issuer is not required to pay anyone other than a beneficiary, a nominated person, or an acknowledged assignee of standby proceeds and is not required to pay anywhere other than at the place of presentation. See ISP98 Rule 6 (Transfer, Assignment, and Transfer by Operation of Law). Payment may be made at the place of presentation by sending a bank check to the order of the beneficiary or by initiating a wire transfer.

If payment by check is the sole desired method of honour, the following may be substituted: "Payment shall be made by Issuer's check payable to Beneficiary sent to Beneficiary's above-stated address by registered mail or [*inter*]nationally recognized courier or other means of receipted delivery to Beneficiary."

If payment by wire transfer is the sole desired method of honour, the following standby text may be substituted: "Payment shall be made by wire transfer to an account of Beneficiary as follows: **[name, address, and routing number of Beneficiary's bank, and name and number of Beneficiary's account]** or to such other bank account of Beneficiary as Beneficiary may duly request of Issuer". An issuer's response to a beneficiary request may be affected by regulatory requirements limiting payment to a permissible account at a permissible financial institution located in a permissible country. The annexed form of demand and statement incorporated into this ISP98 Form 1 standby contains model wording for a beneficiary's request for payment by wire transfer. Including a detailed method of payment in a standby may deter forged beneficiary demands, as well as avoid delays resulting from the issuer's receipt of an inadequate request as to the method of payment.

No matter what a standby, demand form, or separate request for routing payment may state, applicable law, e.g., a court or government agency order, may block payment. Applicable law may also allocate the risks of loss in case of payment to the wrong person.

17. More than one drawing. It is unnecessary to state that a beneficiary

may make multiple drawings or drawings for less than the full amount available. A standby that undertakes to honour "a demand" (in the singular) does not affect the beneficiary's right to present more than one demand under standard practice applicable to standby (and commercial) letters of credit. ISP98 Rule 3.08 (Partial Drawings & Multiple Presentations; Amount of Drawings) permits both partial and multiple drawings unless prohibited in the standby. If a standby is to be honoured once only, then the standby should state that affirmatively or, as indicated in ISP98 Rule 3.08(d), state "multiple drawings prohibited".

18. Reduction by honour. It is unnecessary to state that the amount available under a standby is reduced by the amount of any drawing that is honoured. This is because honour discharges (rather than amends or cancels) the issuer's obligations and because ISP98 Rule 1.10(c)(ii) (Redundant or Otherwise Undesirable Terms) presumes that reinstatement is not intended. ISP98 Form 3 (Model Standby Providing for Reduction and Incorporating Annexed Form of Reduction Demand) focuses on reduction, including reduction to zero, by beneficiary demand and by other optional terms permitting or requiring reductions in the amount available under a standby.

19. Incorporation of ISP98; law, court, arbitration, and sanctions. Incorporation of ISP98 into an undertaking that is payable against the presentation of documents should qualify the undertaking as independent under applicable law. ISP98 invokes letter of credit law by emphasizing the letter of credit aspects of a standby and its independence in ISP98 Rules 1.06(c) (Nature of Standbys) and 1.07 (Independence of the Issuer-Beneficiary Relationship). See *Team Telecom Int'l v. Hutchison 3G UK Ltd*, 2003 EWHC 762 (Q.B. Div'l Ct.) [England], abstracted at *2004 Annual Survey of Letter of Credit Law & Practice* 335 (bond subject to ISP98 is an independent undertaking).

It is unnecessary for a standby to recite that it is independent or that it is enforceable without regard to the validity of any claim of performance or non-performance in the underlying transaction. It is unnecessary for a standby to add a recital (including an "integration" or "merger" clause) that would deny or limit the effect of any document or other matter mentioned in the standby or of any negotiations leading up to or following standby issuance. Such clauses and recitals risk limiting the various ISP98 rules that provide for the standby's independence.

Where a choice-of-law clause is included in a standby, most courts will give effect to it. Otherwise, a court will likely apply its own conflict-of-laws' rules. Conflict-of-laws' rules affect the legal standards for compliance of any presentation, for the scope of any fraud/abuse exception, for the availability of any excuse based on government sanctions, etc. Under many legal systems, the conflict-of-laws' rules provide that the law at the place of issuance of the standby (or confirmation) should govern the issuer's (or confirmer's) obligations. See, e.g., the UN Convention on Independent Guarantees and Standby Letters of Credit, Articles 21 (Choice of applicable law) and 22 (Determination of applicable law). However, courts may hear a wrongful dishonour claim filed other than where the issuer (or confirmer) is located, may apply different conflict-of-laws' rules, and may determine, e.g., that the law of the place where the beneficiary is located should govern.

As indicated, most courts will respect a choice-of-law clause and a choice-of-exclusive-forum clause in a standby (or confirmation of a standby). Including a choice of law clause or an exclusive forum clause or both fosters certainty. E.g.: "Issuer's obligations under this Standby are governed by the laws of **[State]**. The courts located in **[State]** shall have exclusive jurisdiction over any action to enforce Issuer's obligations under this Standby."

The Preface to ISP98 includes a suggested arbitration clause: "This Standby [*undertaking*] is issued subject to ISP98, and all disputes arising out of it or related to it are subject to arbitration under ICLOCA Rules (1996)." (The ICLOCA Rules, which are based on the UNCITRAL Rules of Arbitration, are available at www.icloca.org. The International Center for Letter of Credit Arbitration is located in metropolitan Washington, D.C., at 20405 Ryecroft Court, Montgomery Village, MD 20886 USA.)

Particularly if the standby does not choose applicable law, the issuer may wish to consider including a "sanctions" clause covering sovereign compulsion excusing the issuer, e.g.: "Issuer disclaims liability for delay, non-return of documents, non-payment, or other action or inaction compelled by a judicial order or government regulation applicable to Issuer."

A standby consists of obligations of the issuer limited by its terms and conditions. Accordingly, a choice of law or forum or both in a standby

applies to those issuer obligations and not to the obligations of any confirmer or other person. There is no problem under a straight standby that states that "this standby is governed" by the chosen law or that any litigation under it is limited to the chosen court, but this same wording might prove confusing when included in a standby that nominates another person to advise, confirm, or otherwise act on the standby.

20. Communications. This optional clause or a variation of it is particularly apt for a standby that is long term or that provides for communications from or to the beneficiary (apart from payment demands). If a beneficiary requires greater certainty that its request to amend its address will be given effect, then the standby should expressly provide for automatic amendment against presentation of a complying beneficiary demand for an address change. Standby language with a demand form for this purpose may be adapted from ISP98 Forms 3 and 4 providing for reduction and transfer on demand by the beneficiary.

21. Demand Date. ISP98 Rule 4.16(b)(ii) (Demand for Payment) provides that a demand must contain an issuance date, and ISP98 Rule 4.06 (Date of Documents) provides that its issuance date may not be later than the date of its presentation. To override that rule, e.g., to permit post-dated documents, the following clause may be added to the Standby text: "The issuance date or any other date on any document, including the required demand, may be a date on, before, or after the date the document is presented under this Standby."

22. Addressee. The information in the text of the standby indicating where, how, and to whom a presentation is to be made under the standby should be repeated in the demand form. See ISP98 Rules 3.01 (Complying Presentation under a Standby), 3.04 (Where and to Whom Complying Presentation Made), and 3.06 (Complying Medium of Presentation). Particular attention should be given to the possibility that a standby may require presentation at an address that differs from the issuer's letterhead address.

23. Standby identification. A demand form should identify the standby by including the information in the standby text that identifies it, particularly the issuer's reference number. See ISP98 Rules 3.01 (Complying Presentation under a Standby) and 3.03 (Identification of Standby)

24. Demand. This model form of annexed demand should satisfy the

requirements of ISP98 Rules 4.16 (Demand for Payment) and 4.17 (Statement of Default or other Drawing Event), so that, when the beneficiary completes it as indicated, it will include a demand for payment of a stated amount, be dated and signed, and contain any required beneficiary statements.

25. Beneficiary statements. Standbys commonly require presentation of beneficiary statements and commonly combine them with the required form of demand for payment. Words other than "states", such as "certifies", "represents", "warrants", "promises", or a combination of those words, are also used and may be preferable in the context of the underlying transaction. Any such word of assurance, when required to be included in a document presented under a standby, may give rise to a claim against the beneficiary who obtains payment under the standby. The nature and sufficiency of such claim may depend on the precise wording included in the demand, the identity of the claimant, and the status of any related claims based on the obligations intended to be supported by the standby.

The applicant or issuer or both may prefer a combination of specific representations and undertakings from the beneficiary. The beneficiary may prefer no such wording or only conclusory wording qualified by the beneficiary's reference to "good faith" belief or the like. The applicant or issuer or both may prefer that the beneficiary make its statements expressly to the applicant or issuer or both.

ISP98 Rule 4.12 (Formality of Statements in Documents) provides guidance on standby requirements for statements that are to be "sworn to", "witnessed", "legalized", or the like.

It should be unnecessary to include in a demand form that the amount demanded is available under the standby, because that amount should be determinable without dependence on any such statement.

26. "Applicant" as underlying obligor. This demand form uses "Applicant", which is a defined term in the text of the standby, and assumes that the applicant and beneficiary are parties to an underlying agreement that establishes the obligations to be supported by the standby. See endnotes 1 and 30.

27. Obligated/in default. This statement indicates that the applicant is "obligated to pay" the amount demanded, not that there is a "default". A

default statement is inapt where the amount demanded is payable on the date demanded without regard to the occurrence or continuance of a default or where "default" is not adequately defined in the documentation for the underlying obligations or where "default" may require that an action be taken that may be prohibited under laws triggered by the insolvency of the applicant or other party.

28. Unpaid. The term "unpaid" in the optional "due and unpaid" recital may raise a question where the applicant has made a direct payment to the beneficiary but the funds paid are subject to recapture by an insolvency representative of the applicant. It should be possible for a beneficiary in that context to state, without running afoul of a fraud or abuse exception under applicable letter of credit law, that the underlying obligation remains unpaid where a direct payment has been received subject to a credible claim that the direct payment is voidable and must be returned.

29. Underlying obligation. Although some standbys are payable on simple demand, the applicant, beneficiary, or issuer may insist that a demand under a standby identify the underlying obligation, obligor, and obligee, particularly where there may be no single underlying agreement between the applicant and beneficiary that establishes the underlying obligations and provides that those obligations be supported by a standby.

30. Applicant-beneficiary relationship. This model form of annexed demand assumes that the standby supports one or more obligations of the applicant to the beneficiary. Under commercial and regulatory laws, the issuer, any nominated bank, the applicant and beneficiary, and, where different, the underlying obligor and obligee may need to identify the underlying obligations intended to be supported by the standby and to be satisfied or secured by the proceeds of a drawing under the standby. Accordingly, this form of demand should be redrafted if, e.g., the applicant is a surety for the underlying obligor or the beneficiary is a creditor of the underlying obligee. Additionally, the underlying documentation should be drafted to provide for the pre- and post-honour obligations of the applicant and beneficiary (and, where different, of the underlying obligor and obligee) to each other, particularly if the named applicant has or intends to claim the rights of an ordinary guarantor or surety. In this regard, it may be desirable for the beneficiary's statement to refer expressly to the underlying obligations, as they may be amended by the obligor and obligee, without (or with) the further consent of the applicant.

31. Use of proceeds. This optional beneficiary statement is unnecessary if the underlying agreement adequately provides for the use of all proceeds from a drawing under the standby and if the applicant reimburses the issuer. Otherwise, some mention in the form of demand of the relationship of any standby proceeds to the underlying obligation is helpful in answering post-honour questions about the disposition of any excess standby proceeds. Absent such a provision, the "independence" of the standby obligation may hinder appropriate post-honour accounting for the use of funds received under a standby.

32. Proceeds as cash collateral. Where the proceeds cannot or might not be used to "satisfy" the applicant's obligations, the demand form should indicate that the proceeds will be used to "secure" them. This consideration is important under standbys that are intended to be used, at least in some circumstances, to fund the applicant's underlying obligation to provide cash collateral. The most common circumstance involves standbys that may expire before the underlying obligations become fully due and payable.

33. Accounting to issuer for unused proceeds. The issuer may want to take a security interest in the applicant's rights to unused proceeds and/or require the beneficiary to state, e.g.,: ". . .and that Beneficiary will account to Issuer or Applicant, as their interests may appear, for any proceeds that are not so used."

34. Request for wire transfer to beneficiary's account. This term in the demand form is unnecessary if the text of the standby includes satisfactory wire transfer information for payment to the beneficiary. See endnote 16.

Issuers are not required to pay wherever, however, or whomever the beneficiary requests, unless the standby so states. Under ISP98 Rule 5.08 (Cover Instructions/Transmittal Letter), issuers are permitted to follow a request to pay by wire transfer to the beneficiary's account, subject to timely receipt of customary account information and deduction of customary wire transfer charges and due consideration of any regulations or bank policies affecting wire transfer of funds to the requested country, bank, and account.

A request to pay to another's account is a request for acknowledgement of an assignment of proceeds, which is subject to the special rules in ISP98

Rules 6.06-6.10 (Acknowledgement of Assignment of Proceeds), as well as laws protecting issuers and applicants and other laws regulating money laundering, etc.

To deter forged demands, and to address anti-money-laundering concerns, this model form of request for payment by wire transfer states that payment is to be made to the named beneficiary at a specified beneficiary account at a specified bank location.

35. Signer authentication. This demand form requires the signer to indicate in the signature line that the demand and statement are made by the named beneficiary located at the address stated in the standby. Accordingly, the beneficiary's name and address should be stated in this demand form when the standby incorporating it is issued.

36. Original signature. What is an original signature depends on the mode of communication. See ISP98 Rules 1.09(a) (Defined Terms) ("Signature") and 3.06(d) (Complying Medium of Presentation)[*IIBLP as of 10 May 2012]*

APPENDIX D

ICT Fall 2012

Assignments for Monday 24 September and 1 October 2012

The readings focus on automatic extension and reduction clauses. There are no rules, as such, that address automatic extension with the minor exception of ISP98 Rule 2.06(a).

The assignment for Monday 24 September is to revise the portion of *The Official Commentary on the International Standby Practices* for ISP98 Rule 2.06 that deals with automatic extension clauses. A PDF of that chapter accompanies this message. Email your revision to the entire class via the TWEN email list before the beginning of class. Include a brief explanatory paragraph describing your methodology.

The assignment for the class on Monday 1 October is to draft a revision of Rule 2.06's treatment of automatic extension, explaining in endnotes the provisions. The new rule should be entitled Rule 2.06B Automatic Extension Clauses address automatic extension clauses exclusively, leaving to Rule 2.06A the treatment of amendments. Its content will be current ISP98 Rule 2.06(b), (c), and (d). Email your revision to the entire class by 9:00 PM on Sunday 30 September via the TWEN email list.

You should understand the effect of Revised UCC Article 5 on amendments, the rules and practices regarding amendment, the reasons for automatic extension provisions, how they operate (read ISP98 Form 2), and the problems inherent in them (see the cases and notes in the text).

The purpose of this exercise is to enable you to understand the role and process of rulemaking in commercial law.

APPENDIX E

International Commercial Transactions Fall 2012

Assignment for 15 October 2012

1. Read Chapter 4 Confirmation, Counter Standbys, and Counter Guarantees).
2. Prepare the following exercise and submit by Friday 12 October via TWEN drafts for discussion in class.
3. Exercise: The sovereign principality of Bifurcated wishes to purchase jet fighter parts from Atlas Air Corp. for US$ 500 million. It is prepared to pay via commercial letter of credit. It requires, however, assurance of performance and warranty amounting to 10% of the contract amount. It will accept cash to be held in escrow or a demand guarantee in its favor. Its regulations require that the obligation be from a local bank. Atlas Air does not have accounts with any banks in Bifurcated; its bank is Global International Bank. Global International has a correspondent banking relationship with Commercial Bank of Bifurcated (CBB).

    a. Student A will arrange a drawing in class on 1 October to determine who will represent whom. There will be two representatives of the banks and one each of the buyer and seller. The bankers will be further divided in that one will propose a counter guarantee/local bank undertaking relationship and the other will propose an issuance/ confirmation relationship.
    b. Each party will draw up and submit to one another proposals for terms of the undertakings to be issued by the banks (on the part of buyer and seller) or what the banks are prepared to do (on the part of the banks). In addition to proposing the terms, the bankers should prepare a draft undertaking using the ISP98 Model Forms. The buyer and seller should be prepared to react to these proposed forms in class.
    c. The class on 22 October will be devoted to negotiations between the parties regarding what their clients are prepared to accept. Note: everyone wants this deal to work.

[30 September 2012]

APPENDIX F

International Commercial Transactions

Assignment for Class Scheduled for Monday 29 October 2012

Problem A:

Antoine Ltd, a producer of USB drives located in Bulgaria, agreed to sell 10 million USB drives to Sampson, Inc., located in Virginia, for USD 4 million. The contract provided for commercially usable USB drives. Payment was to be by commercial letter of credit issued by Sampson's bank, Virginia Credit Bank, and, pursuant to the agreement, confirmed by Antoine's bank, ABC, also located in Bulgaria. Required documents included a certificate of inspection issued by SGS stating that the drives meet the contract specifications. The commercial LC was payable 60 days after presentation of the required documents.

On 1 March 2012, Antoine presented complying documents to ABC which forwarded them to Virginia Credit. Neither bank sent a notice of refusal. Thirty days later, the goods arrived and were not compatible with any computers except those produced in the former Soviet Union, utilizing a technology that was so outdated and unique as to make them unusable for most computers in the world.

Assignment Part A1: Prepare a 2 page Memo outlining whether Buyer should seek to enjoin payment on the LC and against whom the suit should be brought in what jurisdiction and under what law.

Assignment Part A2: Prepare a 2 page Memo outlining options available to Seller in opposition to an action for an injunction.

Assignment Part A3: Prepare a 2 page Memo on behalf of the Confirmer.

Assignment Part A4: Prepare a 2 page Memo on behalf of the Issuer.

Problem B:

To support its warranty obligations under the contract, Antoine caused its bank, ABC, to issue a counter standby in favor of Sampson's bank, Virginia Credit, asking Virginia Credit to issue its local bank undertaking in favor of Sampson. When the USB drives would not work because they

were not compatible, Sampson drew on the local undertaking whereupon Virginia Credit drew on the ABC Counter Standby.

Contending that it shipped good goods to Sampson, Antoine objects and threatens to sue for an injunction. Prepare a 2 page Memo on behalf of

Assignment B1: Antoine

Assignment B2: Virginia Credit.

Assignment B3: ABC.

Assignment B4: Sampson.

The Memos.

The Memos should be directed to your Senior Partner and indicate possible strategies, risks, and make a recommendation. They should also note any factual questions, which must be clarified.

The Memos should be sent to everyone in the class on the TWEN email list by the end of the day on Friday 26 October 2012.

DOING THE NUMBERS: THE NUMERATE LAWYER AND TRANSACTIONAL LAW

THERESA A. GABALDON*

> Dear Professor,
>
> I am responding to your request for comments regarding the course in Corporations. I was one of those who could profess no prior experience with business at the outset of the course. I am most challenged by "Balance Sheet." These are the dark magic words that bring forth the demons of chaos. Once you incant these words you begin to speak in tongues and you write strange symbols that cloud the mind. You take those numbers, which seem like so many orphans on the street and you move them about finding them homes. You scribble on the board for a bit and then turn about with that "whole face, about to chuckle I am so pleased, isn't this mountains of fun" smile, and I want to bang my head on the table till the bad woman goes away. Still, it is not your fault that the course is so dreadfully horrible. Math is a thing so terrible that it defies description. Poets, who can grasp the terrors of war and death, pain and suffering, have never been able to capture that dark aspect. It is the incarnation of evil, it comes in many forms and guises, and in your class it calls itself "Balance Sheet."
>
> Anon.[1]

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* Lyle T. Alverson Professor of Law, The George Washington University School of Law; B.S. University of Arizona; J.D. Harvard University Law School. The author expresses thanks for the research assistance of Kevin McNiff and for the efforts and insights of Robert and William Palmer.

1. Letter from anonymous to author (on file with author) (omitting text and grammatical corrections).

INTRODUCTION

Over the years, I have received thousands of responses to my mid-semester request for anonymous comments about my Corporations class. Although few are so eloquent as the note set out above, no small number share its message. More succinctly, one student put it, "If I could do math I would have gone to medical school." My plaintive correspondents modestly tend to phrase their laments in strictly individual terms, but others do not. Notably, First Lady Michelle Obama has said of her own experience with math and science, "I know for me, I'm a lawyer because I was bad at these subjects."[2] She then generalized with, "All lawyers in the room, you know it's true. We can't add and subtract, so we argue."[3]

This Article begs to differ. As Part I discusses, not only is it possible for lawyers to add and subtract, but they even can multiply and divide. As Part II describes, it also is necessary for them to do so, and not just when they are billing their clients and figuring out whether their partners are cheating them. They frequently are called upon to give legal advice that requires the

2. Michelle Obama, *Remarks of the First Lady at the National Science Foundation Family-Friendly Policy Rollout*, WHITE HOUSE (Sept. 26, 2011), http://www.whitehouse.gov/the-press-office/2011/09/26/remarks-first-lady-national-science-foundation-family-friendly-policy-ro [hereinafter *Remarks of the First Lady*].

3. *Id.*

derivation and interpretation of – pardon the expression – numbers. This is particularly, although not uniquely, true in the context of transactional lawyering. Part III discusses the impediments to enhancing numeracy through legal education, and Part IV advances proposals for overcoming those impediments.

I. THE QUESTION OF CAPACITY: ARE LAWYERS AND LAW STUDENTS INNUMERATE?

"Innumeracy" is a fancy word for "bad at math." Its converse, "numeracy," does not mean "good at math." It simply is the numbers-referent equivalent of literacy, but more specifically has been defined as "includ[ing] an understanding of subjects such as basic numbers, orders of magnitude, algebra, and probability and statistics."[4] To either elucidate or complicate matters, "innumeracy" is sometimes characterized as the result of either an "objective" lack of math competence or a "subjective" lack of math confidence.[5]

A. Objective Innumeracy

Michelle Obama is part of a far larger cohort that appears to take the position that lawyers are objectively innumerate (although, to be fair, some of her remarks accompanying those quoted above might be taken as a reflection on subjective innumeracy).[6] This position is not without reason: in a recent article, an author suggests that objective numeracy may be "produced either by cognitive disability [a condition known as "dyscalculia"] or by a persistent failure to engage with numbers and calculations."[7] She logically goes on to observe, "Because of the widespread perception that lawyers are not – and need not be – good at math, it seems likely that dyscalculiac individuals are overrepresented in the law [compared to other professional fields]."[8] Still, when law students

4. Joan MacLeod Heminway, Michael A. Woronoff & Lyman P.Q. Johnson, *Innovative Transactional Pedagogies*, 12 TRANSACTIONS: TENN. J. BUS. L. 243, 252 (2011).

5. Lisa Milot, *Illuminating Innumeracy,* 63 CASE W. RES. L. REV. 769, 772 (2013).

6. *See Remarks of the First Lady*, *supra* note 2 ("And so encouraging girls early not to lose heart in those fields, and encouraging them through high school is important."). The quoted language suggests that girls can do better with encouragement, thus establishing they are not believed to be objectively incapable of doing so.

7. *See* Milot, *supra* note 5, at 800 nn.148–49 (taking pains to distinguish objective and subjective innumeracy). Dyscalculia is suffered by 5–7% of the general population. *Id.*

8. Milot, *supra* note 5, at 801; *see also id.* at 801–02 n.158 (providing statistics to illustrate the large number of students entering law school without a mathematical

actually were studied, good news emerged. No matter how lawyers and law students think about themselves, they probably are not, as a group, objectively innumerate. This was determined using a standard, three-question test for numeracy which, given the irresistible allure of do-it-yourself testing, is set out below (with answers in the accompanying footnote):

> (1) Imagine that you flip a fair coin 1,000 times. What is your best guess about how many times the coin will come up heads?
> (2) In the Big Bucks Lottery, the chance of winning a $10 prize is 1%. What is your best guess about how many people would win a $10 prize if 1,000 people each buy a single lottery ticket?
> (3) In Acme Publishing Sweepstakes, the chance of winning a car is 1 in 1,000. What percent of tickets to the sweepstakes win a car?[9]

When this test was first administered to takers who might be described as "the general public," about fifty percent of the respondents correctly answered the first two questions; only twenty percent were able to correctly answer the third.[10] Thirty percent were unable to answer a single question correctly and only sixteen percent got all three right. By contrast, when the same test was administered to University of Illinois law students,[11] slightly over eighty-five percent answered the first two questions correctly; that happy result fell to sixty-nine percent for the third question.[12] Fifty-seven percent got all three right and slightly under three percent got all the questions wrong.[13] The law student outcomes did not significantly deviate from those achieved by a test population comprised of highly-educated non-lawyers, leading the authors of the 2012 study to conclude that education level is correlated with numeracy, whereas the choice to pursue a legal career is not.[14]

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background).

9. The test was developed by Lisa Schwartz, Steven Woloshin, William Black & Gilbert Welch, *The Role of Numeracy in Understanding the Benefit of Screening Mammography*, 127 ANNALS INTERNAL MED. 966, 1038 (1997). The answers are, respectively, 500; 10; and .1%.

10. *Id.* at 969.

11. *See* Arden Rowell & Jessica Bregant, *Numeracy and Legal Decision-Making*, 46 ARIZ. ST. L.J. 1, 14–19 (forthcoming 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2163645## (describing method, which also included administration of other numeracy measures to samples of the students studied).

12. *Id.* at 16–17.

13. *Id.*

14. *Id.* at 43–44.

B. Subjective Innumeracy

Lack of confidence in one's ability to do math may be the result of math anxiety, an identified biological phenomenon that causes tension or fear in those who are objectively numerate.[15] A second asserted cause is a self-perception of relative incompetence: someone who is highly skilled at verbal tasks and somewhat less strong in math may simply perceive him- or herself as "bad" in the latter category.[16] For instance, students who perform better on the verbal parts of the Scholastic Aptitude Test ("SAT") may tend to give up on math – and ultimately wind up in law school.[17]

It certainly is possible to disaggregate math competence and math confidence in some circumstances. Thus, people who have not been taught any new math skills but who perform better on math tests after being treated for math anxiety would not properly be regarded as objectively innumerate. Moreover, people who score in the 99th percentile on the verbal parts of the SAT and in the 95th percentile on the math portion should not be regarded as objectively innumerate, no matter what they say or think about themselves. On the other hand, if people who subjectively but incorrectly perceive themselves as bad at math subsequently "persistently fail to engage with numbers and calculations," it seems they might succeed in rendering themselves innumerate by at least some objective standards. Conversely, it would seem quite possible for someone who is objectively innumerate by reason of lack of education to achieve numeracy if not prevented from doing so by lack of confidence. In any event, it seems entirely likely that people who genuinely are bad at math – by reason of dyscalculia or lack of education – would know it and thus lack confidence as well as actual competence. Indeed, the study of numeracy in law students described above did find a very high correlation of objective innumeracy and lack of confidence.[18]

C. A More Practical Path

Rather than becoming lost in what is either an objective or subjective thicket about types of innumeracy, it ultimately may be more meaningful for law schools and individual law students to focus on the following questions:

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15. *See* Mark H. Ashcraft, *Math Anxiety: Personal, Educational, and Cognitive Consequences*, 11 CURRENT DIRECTIONS IN PSYCHOL. SCI. 181, 181 (2002).

16. *See* Milot, *supra* note 5, at 807–08 (discussing self-perception of relative incompetence).

17. *See* David A. Hyman, *Medicare Meets Mephistopheles*, 60 WASH. & LEE L. REV. 1165, 1168 n.12 (2003) (commenting that most law professors had higher scores on the verbal portion of the SAT than on the math portion).

18. Rowell & Bregnant, *supra* note 11, at 17.

(1) *Is an individual contemplating a career path requiring significant engagement with numeric tasks?* Although this question may be a difficult one, and one many law students may be reluctant to answer affirmatively, subsequent parts of this Article make the case that some types of law, including transactional law, do require such an engagement. If a path of this sort is not contemplated, however, the remainder of the questions need not be addressed.

(2) *Does the individual in question suffer from dyscalculia?* If so, he or she probably should find a different career path or devise some method of partnering with someone who can compensate for the disability. In contrast to the first question, this one should not be difficult to answer. People typically would not make it into, much less through, college without having this condition diagnosed and appropriately accommodated.

(3) *Does the individual in question suffer from math anxiety?* If so, he or she should get treatment. Math anxiety presumably is less obvious than dyscalculia, but if one has it, he or she probably did quite poorly on standardized math tests unless an appropriate accommodation was made. If treatment is not an option, or is not successful, see the suggestion made in (2).

(4) *Does the individual in question really lack basic math skills?* Come on folks! Did you or did you not graduate from high school? If the answers to (2) and (3) both are "no," and we are talking about someone in law school, the answer to question (4) should never be "yes."

D. Is "Not Bad" Good Enough?

Submerged in the questions presented in Part I.C is one question that is arguably transcendent. Assuming that most law students (and presumably lawyers) are not bad at math, and actually are better at it than the population at large, is that good enough?[19] Are they – or can they be – prepared and ready to deal with numbers as they present themselves in practice? As an analog, one might say that a determination that law students are not illiterate is reassuring. A determination that their literacy achievements are somewhat higher than those of the general population is more reassuring still. It does not, however, mean that law school has nothing to teach them about how their literacy skills should be employed. In the numeric context, this basic logic requires supplementation by an analysis of the numeracy demands actually made on transactional lawyers.

19. *See id.* at 44–45.

II. THE QUESTION OF WHAT IS REQUIRED: WHAT ARE THE NUMERIC DEMANDS OF THE TRANSACTIONAL LAWYER'S JOB?

Judge Stanley Sporkin asked, in connection with a wave of scandals that washed over the thrift and savings and loan industries in the 1980s, "Where . . . were the . . . attorneys . . . ?"[20] This question resurfaced in the wake of the collapse of Enron,[21] and sounded again in response to the financial collapse popularly believed to have started in 2008.[22] My guess is that at least some of those lawyers were exactly where I tell my students they don't want to be: off in the corner, hiding from the numbers and quaking with fear.

In transactional law, numbers have always been with us. Indeed, since transactional lawyering almost inevitably involves measured quantities of money, there has been no getting away from math – except, perhaps, in the classroom. As to the basic claim, anecdotal evidence abounds: simply ask someone who practices or has practiced in the area (the author of this Article, for instance). As a resource, Michael A. Woronoff, a practitioner and adjunct professor of law at UCLA, has offered what he refers to as a "quite obviously incomplete" list of tasks "commonly performed by transactional lawyers, each of which requires some level of numeracy."[23] The tasks he identified include (with many other examples) the negotiation and monitoring of anti-dilution provisions, earn-out conditions, purchase price adjustments, subordination provisions, exchange ratios, and financial covenants.[24] Other obvious illustrations include advising on and negotiating partnership profit-sharing arrangements,[25] consulting on the legitimacy of dividends,[26] and (especially in California, where the subject is taken particularly seriously)[27] explaining how corporate cumulative

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20. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

21. *See, e.g.*, Gary J. Agguire, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 40 TEX. J. BUS. L. 107, 108 (2004).

22. *See, e.g.*, Sarah Kellogg, *Financial Crisis 2008: Where Were All the Lawyers?*, DC B. (Jan. 2010), http://www.dcbar.org/for_lawyers/resources/publications/washington_lawyer/january_2010/financial_crisis.cfm.

23. Heminway, Woronoff & Johnson, *supra* note 4, at 253.

24. *Id.*

25. Robert S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229, 244–47 (1993).

26. *See* Robert M. Lawless, Stephen P. Ferris & Bryan Bacon, *The Influence of Legal Liability on Corporate Financial Signaling*, 23 J. CORP. L. 209, 214–16 (1998) (discussing significance of corporate dividend policy).

27. *See* CAL. CORP. CODE §§ 301.5, 708, 708.5 (West 2010) (providing for cumulative voting by the shareholders of all companies that are not listed for public trading).

voting works.[28] One really cannot, after all, just hand a client a copy of the relevant statute and head off to that corner to shiver.

A simple contemplation of familiar case law also generates sumptuous anecdotal evidence of the importance of numbers. As a single example, consider *Litwin v. Allen*, which appears in many Corporations casebooks.[29] *Litwin* involves the duty of care owed by the members of a corporate board of directors and the issue of whether the substance of a board decision should by judicially reviewed for lack of prudence. The text includes the following summary facts:

> Not being able to [take] a loan [because of debt restrictions in its charter], the way that Alleghany could raise the necessary funds was by sale of some of the securities that it held. Among them was a large block of about $23,500,000 of Missouri Pacific convertible 5 ½ debentures. These were unsecured and subordinate to other Missouri Pacific bond issues. They were convertible into common stock at the rate of ten shares for each $1,000 bond. In 1929, Guaranty Company had participated to the extent of $1,500,000 in the underwriting of these bonds at 97 ½. At one time in 1929, the bonds had sold as high as 124 and had never gone below par except in November 1929 when they sold at 97. Between October 1 and October 10, 1930 Missouri Pacific common stock had dropped from 53 to 44. There was a decline in the bonds from 113 in April 1930 to 107 on October 1, 1930, and thereafter a decline of about two more points to 105 ½ by the date of the consummation of the transaction we are considering on October 16, 1930.
>
> The Van Sweringens suggested that $10,000,000 of these bonds be sold to J.P. Morgan & Co. for cash at par, the latter to give an option to Alleghany to buy them back within six months for the price paid.[30]

The lawsuit in question challenged the decision of the board of directors of a bank to participate, along with J.P. Morgan, a related entity, in the purchase of the bonds described.[31] The punch line of the case is that the decision to participate was "so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice."[32] The underlying reasoning is summarized in the

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28. William Meade Fletcher, *Cumulative Voting*, 5 FLETCHER CYC. CORP. § 2048 (2012).

29. *See* Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).

30. *Id.* at 692.

31. *Id.*

32. *Id.* at 699.

court's observation that "any benefit of a sharp rise in the price of the securities is assured the seller and any risk of heavy loss is inevitably assumed by the bank."[33] This observation focuses only on the fact, described in the second paragraph quoted, that the seller had an option to repurchase the securities. It is more-or-less oblivious to that first nasty paragraph with all the mysterious numbers.

On inspection, however, the nasty paragraph reveals that the bonds were trading above their face value (105 ½ as opposed to a "par" value of 100), which tells us that they carried an interest rate in excess of market. Moreover, the bank bought the bonds at their face value (100) and thus was receiving something the market value of which (105 ½) exceeded the amount paid. Because everyone conceded that the transaction was simply a disguised loan (the propriety of which is admittedly more than a little questionable), the bank had made a loan secured by collateral in excess of the loan amount and was assured an interest rate that exceeded then-market. Moreover, if the loan was not repaid, the bank would be spared the cost of foreclosure, since it already held title to the collateral. It is true that the loan was not in fact repaid and the value of the collateral steeply declined, but stuff like that happens – and the court itself at one point mouths the usual party line (well-known as the "business judgment rule") that directorial decisions are not to be judged in hindsight.[34] It also is true that the borrower was not obliged to repay the loan and that the bank effectively was prevented from selling the bonds for six months, but banks are not exclusively limited to holding highly liquid investments.[35]

Litwin sometimes is cited as an indication that, notwithstanding the business judgment rule,[36] there is some minimum rationality test that the substance of directorial decisions must pass – more-or-less the equivalent of considering application of the doctrine of waste.[37] Sometimes the case is dismissed as an aberration,[38] or is taken to be an illustration that directors of financial institutions are – or were in 1940 – subject to more demanding standards than the directors of other companies.[39] It has prompted

33. *Id.* at 698.

34. *See id.* at 700 (discussing standard for reviewing directorial decisions).

35. *Id.* at 695–96.

36. *Id.* at 699.

37. *Id.* at 701.

38. *See* Alfred Dennis Mathewson, *Decisional Integrity and the Business Judgment Rule: A Theory*, 17 PEPP. L. REV. 879, 881–82 (1990) (describing view that *Litwin*'s outcome is aberrational); Patricia A. McCoy, *The Notional Business Judgment Rule in Banking*, 44 CATH. U. L. REV. 1031, 1038–40 (1995).

39. *See* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1095–97 (1968).

speculation that the court was responding to a conflict of interest that fell short of a breach of the duty of loyalty.[40] One might also read it as a public policy message to bankers who think it's a dandy idea to help borrowers evade their debt restrictions.

It is, however, a rare student who does not read *Litwin* and simply agree with the court's "tails the bank loses, heads the borrower wins" analysis. Many simply avert their eyes from "the nasty" and do not see the transaction's possible benefits to the bank (the above-market interest rate and above-loan-amount collateral). Until those benefits are understood, it really is impossible to discuss, much less appreciate, the issues that *Litwin* presents. It presumably also would be very difficult to advise a board of directors with respect to the liability that might be incurred for approving certain types of transactions, particularly those involving novel schemes.

III. THE QUESTION OF WHAT'S STOPPING US: WHAT ARE THE IMPEDIMENTS TO TEACHING NUMERACY TO LAW STUDENTS?

There are at least four easily identified impediments to teaching numeracy to would-be transactional lawyers and, perhaps, law students in general. The first three are intimately related: law student enthusiasm, if not capacity; professorial enthusiasm, if not capacity; and, the infamous message that lawyers are not and therefore do not need to be good at math. The fourth, foreshadowed faintly above, is a bit different: the methods we use to teach first-year students to "think like lawyers" are distinctly likely to disincline them from rolling up their sleeves and doing any math.

A. In Some Order: Law Student Capacity and Enthusiasm, Professorial Capacity and Enthusiasm, and the Infamous Message that Lawyers Are Not, and Therefore Do Not Need To Be, Good at Math

The discussion in Part I was intended to address, and dispose of, the argument that law students (and therefore, presumably, lawyers) cannot do math. It leaves unaddressed the question of their enthusiasm. The discussion in Part II was intended to address, and dispose of, the implicit claim that lawyers – particularly transactional lawyers – do not need to do math. It does not, however, describe how to deal with the message itself. Completely unaddressed thus far, is the idea that "[m]any law professors share the math aversion of their students, so that the numerical aspects of cases are often left unexplored in class or edited out of casebooks."[41]

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40. *See* ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS 238 (6th Ed. 2009) (discussing *Litwin* as a "safety valve" case in which the duty of care stands in for the duty of loyalty).

41. Milot, *supra* note 5, at 771.

The notion that law professors are unenthused about math seems to be untested, but is oft-repeated.[42] If it were to be true, it could be the result of objective innumeracy. This seems unlikely, given that law students do not seem to be objectively innumerate. On the other hand, law professors are generally older than law students and it is possible that our once-extant math skills simply have atrophied through disuse – although one perceives a kind-of-a-chicken-and-egg thing going on. Might it any more plausibly be the result of subjective innumeracy? Law professors generally are not known for their lack of confidence, although one could easily believe that we would prefer to exhibit our greatest, rather than our second-best, strengths in the classroom.

There may, however, be three other reasons law professors might be disinclined to do the math. One is the perception that law students do not like it, even if they arguably could do it. If one is known as teaching a math-intensive version of a class that others are teaching numbers-free, enrollments and evaluations may suffer.[43] Another is the idea that teaching law students to do math is not our job. Someone else was supposed to do that along the line, weren't they? The rebuttal to this point is that although we expect students to know how to read when they come to law school we also teach them to read – cases and statutes, that is. We should be just as willing to teach them how to do math – as it applies to legal questions.

The third, and most problematic explanation for lack of professorial enthusiasm for teaching math is the "hours in the day" (as in "there are only so many") justification. It is ever so true that the law's cup runneth over: there are more laws and legal developments every year, and very few exit either by way of revocation or desuetude. The question of coverage, however, will always be with us. Anyone who covers, or even aspires to cover, the entirety of a casebook probably would be a rarity. Many of us traditionally have salved our consciences with the idea that the law school enterprise is about teaching thinking, not content.[44] If one accepts that lawyers frequently need to apply mathematical principles, one simply must bump something else from the line-up.

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42. *See id.* (speculating about lack of professorial enthusiasm for math teaching); *see also* Daniel Keating, *Ten Myths About Law School Grading*, 76 WASH. U. L. Q. 171, 171 (1998) (characterizing law students and law professors as quite possibly math-phobic).

43. *See generally* John D. Copeland & John W. Murry, Jr., *Getting Tossed from the Ivory Tower: The Legal Implications of Evaluating Faculty Performance*, 61 MO. L. REV. 238, 239 (1996) (discussing importance of student evaluations in one's law teaching career).

44. *Cf.* Nancy B. Rapoport, *Is "Thinking Like a Lawyer" Really What We Want to Teach?*, 1 J. ASS'N LEGAL WRITING DIRECTORS 91, 96, 102–03 (2002).

B. *Thinking Like a Lawyer*

This Article is not the place to get down and dirty on exactly what "thinking like a lawyer" means or what the best method of teaching that skill might be. We presumably can agree that the process begins in the first year and indeed does involve some enhancement of the ability to distill general principles and then to apply them to differing facts.

Imagine, then, a student who is called upon to recite the facts of *Petterson v. Pattberg*,[45] a hoary old chestnut appearing in many contracts casebooks. He or she might start with something like "John Petterson, of whose last will and testament the plaintiff is the executrix, was the owner of a parcel of real estate in Brooklyn, known as 5301 Sixth Avenue."[46]

The professor, stifling an inner sigh and outer eye roll, might gently interrupt to ask some sequence of questions including "Does it matter what the address of the property is? Does it matter that the property was in Brooklyn? Does it matter what the decedent's first name is? Does it matter that the original owner of the property is dead?"

Moving on, the student might say, "The defendant was the owner of a bond executed by Petterson, which was secured by a third mortgage upon the parcel. On April 4, 1924, the unpaid principal was $5,450. This amount was payable in $250 installments on the 25th of each month."[47]

The professor then might helpfully inquire, "Does it matter that the bond was secured by a third mortgage? Would the outcome have been different if it were a second or first mortgage? Does it matter how much the installments were? Does it matter what the unpaid principal amount was?"

And so on, but you get the general idea. Eventually, the student might concede that the facts can be distilled as follows:

> The defendant owned a bond executed by Petterson.[48] He offered to accept a reduced principal amount if the next installment was paid on time and the specified amount was paid in cash by a stated date. Petterson paid the next installment on time and approached the defendant's house before the stated deadline. He knocked on the door and stated that he had come to pay off the bond. The defendant shouted through the door that the bond had been sold. Petterson then exhibited the cash but the defendant refused to accept it.[49]

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45. Petterson v. Pattburg, 161 N.E. 428, 429 (N.Y. 1928).

46. *Id.*

47. *Id.*

48. Maintaining the last name to avoid discussing the executrix, who was not the person who executed the bond.

49. This is not, of course, a direct quote; it is a hypothetical student answer summarizing the facts of *Petterson*.

This version is streamlined, numbers-free and still leaves the professor with plenty to talk about.

Obviously, the distillation process can be criticized as leading to the loss of more than just numbers. When we edit the parties' first names we often lose their gender.[50] Losing the grisly details of crimes may reduce emotive responses we actually might prefer to maintain.[51] Inevitably, when discussing efficiency in the abstract, little bits of reality tend to disappear.[52] Concern with loss of emotion and other parts of reality is something that some feminists have written about at length and has led to approaches emphasizing detail-rich experience over abstraction.[53] These approaches have, in turn, been criticized for the inevitable "essentializing" – or abstraction – of experience itself, because discussing the experience of one or a few tends to regard the essence of that experience as representative of the experience of others.[54]

As a practical matter, of course, some amount of abstraction is unavoidable. It is inherent in human thought processes and attempts to communicate. Speech is about using words as symbols.[55] Speech can also channel thinking and, to some extent, create realities that might not otherwise exist – or, at any rate, assign significance to occurrences that otherwise might be ignored. Thus, naming has a tendency to make things "real" – or, at any rate, significant. Talking about "glass ceilings" may, to at least some, make them "real," leading women to shy away from achievement of particular sorts.[56] Talking about lawyers' inability to do math will lead some lawyers to assume there is no need to try.

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50. *See* Judith Resnick, *Visible on "Women's Issues,"* 77 IOWA L. REV. 41, 53 n.58 (1991).

51. *Cf.* David J. Dempsey, *Master the Magic of Storytelling*, 29 VT. B. J. 32, 33 (2003); Jonathan K. Van Patten, *Storytelling for Lawyers*, S. D. L. REV. 239, 264–65 (2012).

52. *See* Litwin v. Allen, 25 N.Y.S.2d 667, 699 (N.Y. Sup. Ct. 1940); *see also* Theresa A. Gabaldon, *The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders*, 45 VAND. R. REV. 1387, 1410 (1992).

53. *See, e.g.*, Marion G. Crain, *Feminizing Unions: Challenging the Gendered Structure of Wage Labor*, 89 MICH. L. REV. 1155, 1187–88 (1991); Robin West, *Jurisprudence and Gender*, 55 U. CHI. L. REV. 985 (1988).

54. *See, e.g.*, ELIZABETH SPELLMAN, INESSENTIAL WOMAN: PROBLEMS OF EXCLUSION IN FEMINIST THOUGHT 179 (1988); Angela P. Harris, *Race and Essentialism in Feminist Legal Theory*, 42 STAN. L. REV. 581, 585 (1990).

55. *See* Christopher D. Stone, *From a Language Perspective*, 90 YALE L.J. 1149, 1159 (1981).

56. *See* Theresa A. Gabaldon, *Feminism, Fairness and Fiduciary Duty in Corporate and Securities Law*, 5 TEX. J. WOMEN & L. 1, 7 (1995).

One should not, of course, lose track of the fact that numbers are also symbols. It thus is worth thinking about whether the abstraction inherent in the use of numbers might sometimes obscure, rather than enhance, both reality and analysis of general principles.

C. *Thinking Like an Economist*

Perversely, one of the schools of legal analysis least averse to numeric exercise is also sometimes accused of losing sight of reality. This is the school of law and economics. Commentators have both noted and demonstrated the school's math proclivity;[57] also illustrative are approximately fifteen pages of dicta recently produced by Seventh Circuit Judge Richard Posner on the subject of the proper method of conducting a simple linear regression.[58]

With respect to the second proposition (loss of sight of reality), consider the following, composed in the context of an analysis of the importance of limited liability in corporate law:

> Recall, once again, the economists' conclusion that a rule of limited liability for shareholders simply duplicates, at a lower cost, the agreement that shareholders would reach with voluntary creditors. The larger the group of voluntary creditors . . . the greater the explanatory power of the model. . . . The range of voluntary creditors thus includes, along with traditional institutional lenders and bondholders, such classes as suppliers, customers, and employees. In terms of economic theory, then, consumers who are injured by an insolvent corporation's defective products hypothetically have bargained in advance for price concessions to reflect the possibility that both injury and insolvency would occur. Taxi cab passengers, injured by a driver's negligence, supposedly made a similar bargain. Employees of corporations, cannily contemplating the possibility of corporate bankruptcy prior to payment of wages in arrears, hypothetically demanded higher wages than they would have required had they gone to work for partnerships.[59]

The tone of the quoted material presumably conveys some amount of skepticism about the assumptions underlying the economic analysis

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57. *See generally* Ron Harris, *The Uses of History in Law and Economics*, 4 THEORETICAL INQUIRIES L. 659, 666 (2003) (noting preference of use of math over use of history during critical formative stage); Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO L.J. 237, 248 (1996) (describing math usage); Gary Minda, *The Jurisprudential Movements of the 1980s*, 50 OHIO ST. L.J. 599, 604–14 (1988).

58. *See generally* ATA Airlines, Inc. v. Fed. Express Corp., 665 F.3d 882 (7th Cir. 2011).

59. Gabaldon, *supra* note 52, at 1411–12.

described. If those or similar assumptions are reduced to mathematical symbols and presented as part of an equation, or otherwise made the basis of a complicated math exercise, they are made no more valid.[60] In other words, a pig with lipstick is still a pig, and unrealistic assumptions under a layer of math are just as porcine.

IV. THE QUESTION OF WHAT TO DO: HOW SHOULD MATH SKILLS BE TAUGHT IN LAW SCHOOL?

A number of years ago, the question of whether legal ethics should be taught was resolved in the affirmative by the American Bar Association's Committee on Law School Accreditation.[61] How best to teach the subject was a matter of what passed, in law school circles, for hot debate.[62] A threshold question was whether professional responsibility should have a class of its own or whether it should be integrated into courses on other subject matters.[63] Most law schools opted for a separate course,[64] which perhaps registers a composite opinion with respect to the relative effectiveness of the instructional methods considered. That said, many, if not most, law teachers do make some effort to integrate some amount of ethical instruction into their courses on other subjects.[65]

We obviously stand at a different juncture *vis–à–vis* math instruction, which has not been mandated. Still, if one is inclined to reason by result (or to obtain proof by tasting pudding), the experience of law schools with the professional responsibility mini-brouhaha suggests a collective conclusion with respect to the efficacy of the separate course and integration approaches: a combination probably is best. Happily, as described below, in the case of math skills, the combination approach is something that can be relatively easily achieved in individual courses. Implementation may, however, take both will power and persuasion since students lacking math confidence may vote with their feet.

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60. *See* Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. 107 (2005) (providing an interesting economic examination of limited liability that tests different assumptions than those criticized in the text).

61. *See* Steven H. Hobbs, *Symposium Introduction: Sharing Stories About Our Commitment to Legal Ethics*, 26 J. LEGAL PROF. 101, 106–07 (2002).

62. Panel I, Symposium, *Legal Education and the Role of Law Schools in Defining and Training Lawyers for Public Interest Practice in the Twenty-First Century*, 3 N.Y. CITY L. REV. 139 (2000).

63. *See* Deborah L. Rhode, *Ethics by the Pervasive Method*, 42 J. LEGAL EDUC. 31, 50–56 (1992).

64. *See* Deborah L. Rhode, *Teaching Legal Ethics*, 51 ST. LOUIS. U. L. J. 1043, 1047 (2007).

65. *See* Rhode, *supra*, note 63, at 50–56.

1. Step One: Speak the Truth

If there will be math instruction of any kind, there will be students in class on the first day who are sitting on the fence – word will have spread even if the syllabus hasn't been posted. They should be clearly informed of expectations but also reassured that they not only are fully up to the task but also are in good company with respect to their lack of confidence. Most importantly, they should be assured that although math is a necessary component, it is not the entire focus of the class.

2. Step Two: Back to Basics

It probably is a good idea to set at least one class hour aside, quite early in the semester (but emphatically not on the first day), for separate math coverage. The content would differ depending on the class, but a course like Corporations seldom will involve more than a review of what virtually every student learned in high school or middle school.[66] Indeed, virtually every student did at one time know how to add, subtract, multiply, and divide – and with decimals, no less! In fact, he or she even once knew how to "solve for x." It definitely is worth the time both to review basic calculations with decimals and to work several problems of the "solve for x" variety, because it is handy for working cumulative voting problems and critical in understanding the role of return in determining value. The review should segue into preview by explaining a couple of simplified "real" problems. These might include something like:[67] "Assume you paid $100 for a bond with an interest rate of 10%. Prevailing interest rates are now 5%. How much would someone pay for your bond?"[68]

Speaking of basics, not only is math a throwback to high school or earlier, it lends itself to throwback teaching methods. It is very easy to give math problems for homework and/or to administer quizzes on the subject. If the problems and/or quizzes count toward their grades, students will be inclined to take them more seriously (going out on a limb, perhaps, but a pretty sturdy one). In any event, law students crave feedback and generally will appreciate even self-checked exercises.

3. Step Three: Use It or Lose It

Once the basics have been reviewed, it is a good idea to make sure that numbers are actively employed on a regular basis. In a course like

66. *See generally* Heminway, Woronoff & Johnson, *supra* note 4.

67. This is, of course, in the spirit of Litwin v. Allen, 25 N.Y.S.2d 667, 699 (N.Y. Sup. Ct. 1940), discussed *supra* at notes 29–37.

68. Assuming the equivalence of risk, the relevant calculation is 10 = .05x, or $200.

Corporations, they do not have to be the focus of every class session, much less every case, but having a close encounter with math on at least a weekly basis will help the students maintain their refreshed abilities and, hopefully, build their confidence.

4. Step Four: Logic vs. Math

It is worth recurrently noting for students that sometimes when they think they do not understand some major math mystery, they actually are confused about logic. This is particularly the case when there is discussion about basic accounting principles. For instance, understanding the dreaded balance sheet (as surely any competent transactional lawyer must) requires remarkably little in the way of math skill. At an introductory level, the basic equation of Assets = Liabilities + Equity can pretty easily be described as "A company has a pie as its only asset. Where did the pie come from? Some ingredients were contributed by shareholders. Some were loaned by creditors.[69] Who gets to eat the pie? The creditors get their promised share first. What's left belongs to the shareholders." That means, of course, if you want to figure out what belongs to the shareholders you subtract liabilities from assets. How hard is that?

5. Step Five: The Final Step

As suggested above, it is likely that students will embrace mathematic instruction a bit more thoroughly if their mastery affects their grades. Even if math is not made the subject of graded homework or quizzes, if class time is spent on it there is absolutely nothing unfair about embedding it in the final exam – assuming only that true dyscalculiacs and those with true math anxiety receive counseling and appropriate accommodation. From the professorial perspective, the benefits of testing the ability to apply mathematic concepts in legal contexts include relative grading ease.

CONCLUSION: BALANCE IS BEST IN ALL THINGS[70]

This Article started with a letter submitted to me anonymously. When I first received it, I immediately read it to the class, the members of which howled with laughter. Every year, about half-way through the course, I read it out loud with the same result. I frequently have students come up after class to say, "That's right! That's just how I feel!"

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69. Some the company may have grown itself, making use of what the shareholders and/or creditors made available, but that's a later hypothetical, as is the possibility that the pie is more valuable than its raw ingredients.

70. HOMER, THE ODYSSEY, Book 7, Line 355 (Robert Fagles trans., Penguin Books 1996).

Several years after beginning this tradition, I attended an alumni event. A young man whom I recognized as a former student diffidently approached me. He said, "Professor Gabaldon, it was me. I wrote the letter about balance sheets. I heard from one of our new associates that you still read it." After thanking him and complimenting him extravagantly, I asked him where his legal career had taken him. With an enormous but slightly embarrassed grin, he replied that he was working for a firm in Silicon Valley specializing in representing venture capitalists – and that he had, indeed, learned to read balance sheets.

This story seems too good to be true, but it is. It also provides a moral too obvious to require stating. Instead, I will conclude with an observation. Outside of dedicated courses such as Quantitative Methods for Lawyers and Law and Accounting, incorporating math in legal education is a balancing act. Issues relating to coverage and student enthusiasm are very real. Some teachers might prefer having a reputation that does not involve being "the bad woman" who enjoys math a little too much. Those of us who choose, however, to believe in a literal interpretation of the motto "there is strength in numbers" will be undeterred. We should also take to heart the more mainstream interpretation of the aphorism and do what we can to enlist colleagues throughout the curriculum in the effort to embrace and enhance the numeracy of the profession.

DEAL DECONSTRUCTIONS, CASE STUDIES, AND CASE SIMULATIONS: TOWARD PRACTICE READINESS WITH NEW PEDAGOGIES IN TEACHING BUSINESS AND TRANSACTIONAL LAW

MICHELLE M. HARNER* AND ROBERT J. RHEE**

INTRODUCTION

Striking an appropriate pedagogical balance in business law is challenging. The discipline is rich in doctrine and theory, and at the same time has incredibly significant practical application. In a traditional business associations, mergers and acquisitions, or securities law course, the professor barely has sufficient time to cover the basics. With such limited time, how do we help students better connect theory and practice to facilitate their development into practice-aware new lawyers?

In this short commentary, we explore the use of two interrelated pedagogical methods for teaching transactional and business law. The first method is deal deconstruction, which analyzes the set of final deal documents and outcomes. This method is backward-looking, conducting a post-mortem on business transactions and analyzing the parties' choices

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memorialized in the agreement against the legal and financial alternatives. The second method involves case studies and simulations, which are commonly seen in business schools. This method is forward-looking, exposing students to the uncertainties and situational contexts of doing deals and deal-related litigation. Together, these complementary methods help students understand the tradeoffs and dynamics of transactions and deal negotiations. They provide pedagogical alternatives to the traditional Langdellian method, which relies heavily on the study of edited appellate opinions. By presenting problems in different packages and from different temporal perspectives, these methods hone analytical, deal structuring, problem-solving, and decision-making skills.

I. THE NEED FOR NEW PEDAGOGY

Law schools today face enormous challenges. These challenges are well-known: fewer jobs for new graduates due to overcapacity in the legal market, high student debt levels due to high tuition costs, client demands for rationalization of professional services, high cost structure of law schools, and increased demand by the profession for "practice ready" graduates. These factors have prompted criticism of law schools, including criticisms of their curriculum.[1]

In response to these challenges, most law schools are considering, at least, programs and curricula that better bridge the training gap. We do not believe that better training in school is a silver bullet to the crisis as a whole, but we do believe that producing more "practice ready" graduates is helpful. Anecdotal evidence suggests that corporate clients are no longer willing to pay the fees for junior attorneys, which has historically been the way law firms trained their young lawyers.[2] Law firms would have to bear this cost unless training can be further pushed down to law schools. As a result there is a heightened sense of responsibility on the part of most law schools to answer the call for greater "practice ready" graduates.

In the history of modern law schools, the bedrock pedagogical method—indeed the predominant method—in law schools has been the Langdellian case method.[3] For many generations, law students learned the law (and presumably how to practice law) by reading edited appellate cases and engaging in an intellectual discussion through the Socratic method. This

1. *See generally* BRIAN Z. TAMANAHA, FAILING LAW SCHOOLS (2012) (providing a general criticism of law schools).

2. *See, e.g.*, Robert J. Rhee, *On Legal Education and Reform: One View Formed from Diverse Perspectives*, 70 MD. L. REV. 310, 320–21 (2011).

3. *See generally* Todd D. Rakoff & Martha Minow, *A Case for Another Case Method*, 60 VAND. L. REV. 597 (2007) (arguing that the business school case method should be incorporated more into the law school curriculum and pedagogy).

process trains students to "think like a lawyer" within the scale of large classrooms typically comprising 1L courses. Students read appellate cases in the common law tradition and other sources of law, such as statutes and regulations, decipher and distill the rule of law, and conceive the legal framework to analyze a particular legal issue.

The Langdellian method is a limited means of teaching problem-solving and transactional skills.[4] To be clear, we are not suggesting that it ought to be displaced. It has and will have a prominent role in the training of law students, particularly in the 1L curriculum. The first step in becoming a lawyer is thinking like a lawyer, and this means that students must be able to analyze case law and statutes.[5] In most business law classes that cover doctrine, reading appellate cases and statutes must be standard fare. However, beyond the 1L curriculum, there are diminishing pedagogical returns in terms of skills training through the Langdellian method. What else is offered in the upper-level curriculum in terms of skills development?

A major weakness of the Langdellian method is that it does not provide the necessary context in which legal problems exist. Appellate judges distill facts and procedure to their relevant essence, and casebook authors further distill them for the purpose of casebook design. The end of this process is nothing remotely resembling actual litigation—something that might have taken years and many thousands of hours of professional work. Even when the litigation is a deal gone wrong, it is rarely the case that we see the full contract in the case opinion, which will usually only provide the most relevant facts surrounding how the contested provisions were written or interpreted at the time. Furthermore, by focusing on the analysis and disposition of appellate opinions, the Langdellian method has a litigation bent, which is certainly useful, but at the same time appellate cases are necessarily studies of what went wrong resulting in a trial court outcome and an appeal. Litigation frequently reduces to a zero sum dynamic[6] with discrete determinatives (for example, is there a right or not, is there a breach or not, is there an injury or not, and, ultimately, is there liability or

4. *See id.* at 598–600 (describing the Langdellian method and arguing that it is limited to a pedagogy focusing on appellate litigation, fixed facts, and retroactive viewpoint).

5. *See, e.g.*, Michelle M. Harner, *The Value of "Thinking Like a Lawyer,"* 70 MD. L. REV. 390, 417–18 (2011) (discussing the value of "thinking like a lawyer" in the context of transactional law).

6. *See* Robert J. Rhee, *A Price Theory of Legal Bargaining: An Inquiry Into the Selection of Settlement and Litigation Under Uncertainty*, 56 EMORY L.J. 619, 663 (2006) (explaining that litigation can result in mutual surplus in the light of transaction costs).

not). This type of problem solving promotes adversarial positioning and typically closed-form solutions on ultimate questions.[7]

Professors Todd Rakoff and Martha Minow aptly critiqued the Langdellian method as follows:

> Remarkable as such endurance may be, survival is not the only or even the best test of an educational curriculum, especially given the pull of the status quo on teachers and administrators. The fact is, Langdell's case method is good for some things, but not good for others. We are not talking about fancy goals here; we are talking about teaching students "how to think like a lawyer." Langdell's case method fails in this mission. It fails because lawyers increasingly need to think in and across more settings, with more degrees of freedom, than appear in the universe established by appellate decisions and the traditional questions arising from them. The Langdellian approach treats too many dimensions as already fixed. When what is at issue is whether an appellate bench correctly decided a case, or how its decision fits into the general fabric of appellate decisions, self-evidently we have already decided that the paradigmatic institutional setting for thinking about a legal problem is the appellate court.[8]

In the study of business law specifically, students should appreciate the context of business practice and transactions. A large part of transactions concerns contracting for terms. Transactional lawyers must advise clients on what the positive law is, while creating the private ordering of participants in a myriad of configurations as memorialized in the transaction documents.

Business lawyers do not operate within a litigation framework (of course, always keeping in mind that a large part of their work is to prevent litigation). Business transactions must be more contextualized than the Langdellian method can provide. Contextualized to what? Our answer is to the business situation, the choices of parties, the risk and reward calculations and allocations, the transactional documents, the varied possibilities of contractual solutions to difficult problems, and the possibilities of economic value creation.[9] This is quite a lot of "context," and the Langdellian method falls short in creating it.

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7. We speak here in broad generalities, and we do not mean to dismiss or diminish the enormous volume of meaningful scholarship on litigation dispute resolution. Our suggestion is only that the dynamics seen in litigation and in business transactions have important differences.

8. Rakoff & Minow, *supra* note 3, at 600.

9. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 246 (1984) (discussing the potential value an attorney

Students should, instead, learn transactions through deal deconstructions, case studies, and simulations. Each of these methods provides greater contextualization and teaches students more deal-related skills than the Langdellian method of reading appellate cases. The skills developed are: (1) understanding and appreciation of transactional documents, (2) contract drafting skills, (3) understanding and appreciation of deal economics and business issues, (4) decision-making under uncertainty, and (5) negotiation skills in a non-litigation context.

II. DEAL DECONSTRUCTIONS

"Deal deconstruction" is the post-mortem analysis of real transactions with a focus on analyzing transactional documents such as merger agreements, proxy statements, and summary judgment pleadings.[10] We use the term "deconstruction" in its more generic sense to mean the "analytical examination of something."[11] Although the approach may draw on and benefit from aspects of traditional deconstruction theory, that is not the focus of this article.[12] Rather, we want students to dissect, analyze, and question the components of a deal so that, when they are practicing attorneys, they will build the next one even better and more efficiently.

Deal deconstruction is not necessarily a novel concept. Professors are experimenting with simulations and deal analysis in a variety of business law courses.[13] For example, Professors Victor Goldberg and Ronald Mann

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adds to the context of a business transaction).

10. *See infra* note 12 (using a "deconstruction" concept in various settings and explaining how, practitioners, business executives, and institutions often use a "deconstruction" approach to perform a post-mordem analysis of a deal or project); *see generally* Mary Ann Jones, Derek Marshall & Sharon A. Purtee, *"Big Deal" Deconstruction*, 65 SERIALS LIBR. 137 (2013) (analyzing certain subscription packages in the University library setting). The authors create and use the term "deal deconstruction" here to represent a distinct pedagogical method for analyzing deals in the classroom setting.

11. MERRIAM-WEBSTER DICTIONARY, http://www.merriam-webster.com/dictionary/deconstruction (last visited Sept. 2, 2013).

12. *See, e.g.*, Jack M. Balkin, *Deconstruction's Legal Career*, 27 CARDOZO L. REV. 719, 719, 723 (2005) (explaining the history of deconstruction theory and its application in the legal context).

13. *See, e.g.*, Eric J. Gouvin, *Teaching Business Lawyering in Law Schools: A Candid Assessment of the Challenges and Some Suggestions for Moving Ahead*, 78 UMKC L. REV. 429, 441–44 (2009) (discussing, among other things, use of case files, simulations, and deal courses); *see also* Daniel D. Bradlow & Jay Gary Finkelstein, *Training Law Students to be International Transactional Lawyers—Using an Extended Simulation to Educate Law Students About Business Transactions*, 1 BUS. ENTREPRENEURSHIP & L. 67, 71–72 (2007) (explaining negotiation simulation in the international transactional law context); W. David East, Douglas Wm. Godfrey & Carol D. Newman, *Teaching Transactional Skills and Tasks Other than Contract Drafting*, 12 TRANSACTIONS: TENN. J. BUS. L. 217, 231–32 (2011) (discussing the Deals Skills

offer a Deals course at Columbia Law School that allows students to analyze documents from completed transactions and then discuss those transactions with the lawyers who worked on them.[14] This course offers students an opportunity to start honing their analytical and strategic skills through real-life deal situations. The deal lawyers' participation enhances the experience. We see potential in greater use of transactional documents and collaboration with the bar, both of which we want to push further through this Article.

Transactional documents are valuable teaching tools. We can use them to explain deal structures and to explore the dynamics of business relationships, agreements, and litigation. To that end, we suggest deconstructing the deal, agreement, or litigation through deep dives into the relevant transactional documents. We want students to understand not only the how and why of a particular transaction, but also the role of applicable law and theory in shaping transactions—both the deal that has been completed and future deals in that space.

Consider a lawyer whose client has been asked to serve as a director of a corporation. The lawyer can review the corporation's articles of incorporation and bylaws and then explain her client's indemnification rights as a director of that company. The lawyer who understands the applicable corporate indemnification statute, how courts interpret that statute, and how insolvency law impacts indemnification rights, however, can also suggest and draft an indemnification agreement that better protects and achieves her client's objectives.

We certainly can teach these concepts in the abstract. We can, for example, review Section 145 of Delaware General Corporation Law, discuss case law applying the section, and explain that bankruptcy law

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course offered at Emory University); Victor Fleischer, *Deals: Bringing Corporate Transactions Into the Law School Classroom*, 2002 COLUM. BUS. L. REV. 475, 477–78 (2002) (discussing the value of incorporating transactional skills training into the law school curriculum). At University of Maryland Carey Law School, we strive to integrate these approaches not only in our traditional business law courses, but also in new offerings such as Business Law Boot Camp and Business 101. For a description of these courses, see *The Business Law Track*, U. MD. FRANCIS KING CAREY SCH. L., http://www.law.umaryland.edu/programs/business/academics/track.html (last visited Sept. 2, 2013). Moreover, several law schools, including Harvard, Michigan and University of Virginia, have started transactional law clinics. *See, e.g.*, *Entrepreneurship Clinic*, U. MICH. L. SCH., http://www.law.umich.edu/clinical/entrepreneurshipclinic/; *The Transactional Law Clinics*, HARV. L. SCH., http://www.law.harvard.edu/academics/clinical/tlc/ (last updated Dec. 17, 2013); *Transactional Law Clinic*, VA. L. SCH., http://www.law.virginia.edu/html/academics/practical/transactional.htm (last visited Jan. 30, 2014).

14. *See* Charles E. Gerber, *Deals Course at Columbia Law School*, COLUM. L. SCH., http://www.law.columbia.edu/courses/L6107-deals (last visited Mar. 24, 2013) (describing the basic structure and content of the course).

generally prevents debtors from honoring in full their pre-bankruptcy obligations.[15] But will those concepts connect for the student when she is asked to review the relevant corporate governance documents? Will the new lawyer see the potential need to address vesting of the indemnification rights, clarify ambiguous coverage terms, and protect in the event of the corporation's insolvency?[16] Although we cannot teach law students how to connect the dots in every situation, we can use deconstruction to help them develop this skill while gaining a more thorough understanding of the underlying theory and doctrine and how lawyers use that knowledge in practice.[17]

Another example of how deconstruction might work in the classroom is focusing on merger or acquisition agreements that end up in litigation. These transactions resemble the traditional business school case study method and have the benefit of providing a blueprint for the professor's and ultimately the students' benefit. The provisions below are taken from the Agreement and Plan of Merger among RAM Holdings, Inc., RAM Acquisition Corp. and United Rentals, Inc., dated July 22, 2007, and they represent just two of the useful and interesting discussion points in the agreement:

> SECTION 8.2 Effect of Termination . . . . (e) *Notwithstanding anything to the contrary in this Agreement, including with respect to Sections 7.4 and 9.10,* (i) the Company's right to terminate this Agreement in compliance with the provisions of Sections 8.1(d)(i) and (ii) and its right to receive the Parent Termination Fee pursuant to Section 8.2(c) or the guarantee thereof pursuant to the Guarantee, and (ii) Parent's right to terminate this Agreement pursuant to Section 8.1(e)(i) and (ii) and its right to receive the Company Termination Fee pursuant to Section 8.2(b) *shall, in each case, be the sole and exclusive remedy*, including on account of punitive damages, of (in the case of clause (i)) the Company

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15. DEL. CODE. ANN. tit. 8, § 145 (2011); *see also* Marla H. Kanemitsu, *Under Siege: The Effect of Bankruptcy on D&O Protections*, CORP. COUNS. BLOOMBERG L. REP. (Feb. 23, 2012), http://www.dicksteinshapiro.com/files/Publication/1c8b85d1-92c4-4f18-885e-29f276185a17/Presentation/PublicationAttachment/83a26c5e-4bd1-453d-a145-34056a3f889b/Bankruptcy_DO_Protections.pdf (explaining the potential impact of corporate bankruptcy on directors' indemnification rights).

16. *See, e.g.*, Kevin LaCroix, *Taking a Look at the Limits of Indemnification*, THE D&O DIARY (Feb. 22, 2012, 3:46 AM), http://www.dandodiary.com/2012/02/articles/shareholders-derivative-litiga/taking-a-look-at-the-limits-of-indemnification/ (explaining potential issues for directors under Delaware law, including tensions in objectives that lawyers need to consider in drafting indemnification agreements).

17. *See generally* Joan MacLeod Heminway, *Corporate Finance as Advanced Contract Drafting*, 12 TRANSACTIONS: TENN. J. BUS. L. 243 (2011) (stressing the importance of connecting theory and practice and explaining tools for doing so in the context of Corporate Finance course).

and its subsidiaries against Parent, Merger Sub, the Guarantor or any of their respective affiliates, stockholders, general partners, limited partners, members, managers, directors, officers, employees or agents (collectively "Parent Related Parties") and (in the case of clause (ii)) Parent and Merger Sub against the Company or its subsidiaries, affiliates, stockholders, directors, officers, employees or agents (collectively "Company Related Parties"), for any and all loss or damage suffered as a result thereof, and upon any termination specified in clause (i) or (ii) of this Section 8.2(e) and payment of the Parent Termination Fee or Company Termination Fee, as the case may be, none of Parent, Merger Sub, Guarantor or any of their respective Parent Related Parties or the Company or any of the Company Related Parties shall have any further liability or obligation of any kind or nature relating to or arising out of this Agreement or the transactions contemplated by this Agreement as a result of such termination. The parties acknowledge and agree that the Parent Termination Fee and the Company Termination Fee constitute liquidated damages and are not a penalty and shall be the sole and exclusive remedy for recovery by the Company and its subsidiaries or Parent and Merger Sub, as the case may be, in the event of the termination of this Agreement by the Company in compliance with the provisions of Section 8.1(d)(i) or (ii) or Parent pursuant to Section 8.1(e)(i) and (ii), including on account of punitive damages. *In no event, whether or not this Agreement has been terminated pursuant to any provision hereof, shall Parent, Merger Sub, Guarantor or the Parent Related Parties, either individually or in the aggregate, be subject to any liability in excess of the Parent Termination Fee for any or all losses or damages relating to or arising out of this Agreement or the transactions contemplated by this Agreement, including breaches by Parent or Merger Sub of any representations, warranties, covenants or agreements contained in this Agreement, and in no event shall the Company seek equitable relief or seek to recover any money damages in excess of such amount from Parent, Merger Sub, Guarantor or any Parent Related Party or any of their respective Representatives.*

SECTION 9.10 Specific Performance. The parties agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. Accordingly, (a) Parent and Merger Sub shall be entitled to seek an injunction or injunctions to prevent breaches of this Agreement by the Company and to enforce specifically the terms and provisions of this Agreement, in addition to any other remedy to which such party is entitled at law or in equity and (b) the Company shall be entitled to seek an injunction or injunctions to prevent breaches of this Agreement by Parent or Merger Sub or to enforce specifically the terms and provisions of this Agreement and the Guarantee to prevent breaches of or enforce compliance with those covenants of Parent or Merger Sub

> that require Parent or Merger Sub to (i) use its reasonable best efforts to obtain the Financing and satisfy the conditions to closing set forth in Section 7.1 and Section 7.3, including the covenants set forth in Section 6.8 and Section 6.10 and (ii) consummate the transactions contemplated by this Agreement, if in the case of this clause (ii), the Financing (or Alternative Financing obtained in accordance with Section 6.10(b)) is available to be drawn down by Parent pursuant to the terms of the applicable agreements but is not so drawn down solely as a result of Parent or Merger Sub refusing to do so in breach of this Agreement. *The provisions of this Section 9.10 shall be subject in all respects to Section 8.2(e) hereof, which Section shall govern the rights and obligations of the parties hereto (and of the Guarantor, the Parent Related Parties, and the Company Related Parties) under the circumstances provided therein.*[18]

The details of the failed United Rentals/Cerberus merger are well known among business law professors and practitioners.[19] The Delaware Chancery court's decision and the related commentary on the drafting inconsistencies (some of which are provided in the quoted material above), contractual interpretation principles and case law, and substantive issues concerning veil piercing, reverse breakup fees, and material adverse change clauses, among others, offer at least a semester's worth of materials for an advanced business law course.[20] Moreover, most law students are not

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18. United Rentals, Inc., Form 8K, dated July 22, 2007, Exhibit 2.1 (emphasis added).

19. *See generally* United Rentals, Inc., Form 8K, dated Nov. 16, 2007, Exhibit 99.3 (complaint filed by United Rentals, Inc. in the Court of Chancery of the State of Delaware, County of New Castle); STEVEN M. DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION (2009) (examining the United Rentals/Cerberus merger and related litigation); Dealbook, *Diagramming the United Rentals Lawsuit*, N.Y. TIMES (Nov. 30, 2007, 3:09 PM), http://dealbook.nytimes.com/2007/11/30/diagramming-the-united-rentals-lawsuit/.

20. *See* United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007); *see also, e.g.*, Gregory M. Duhl, *Conscious Ambiguity: Slaying Cerberus in the Interpretation of Contractual Inconsistencies*, 71 PITT. L. REV. 71 (2009); Ken Adams, *Costly Drafting Errors, Part 3—United Rentals Versus Cerberus*, ADAMS ON CONT. DRAFTING (Dec. 23, 2007), http://www.adamsdrafting.com/uri-versus-cerberus/; Jeffrey Lipshaw, *The Cerberus Case and Lessons in Law, Society, and Language*, CONCURRING OPINIONS (Dec. 22, 2007, 9:57 AM), http://www.concurringopinions .com/archives/2007/12/ the_cerberus_ca.html; Edward B. Micheletti, *Chancery Declines to Require Specific Performance in a Case of Buyer's Remorse*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 4, 2008, 8:52 PM), http://blogs.law.harvard.edu/corpgov/tag/united-rentals-v-ram/. The Merger Agreement also offers a variety of one-off drafting and critical analysis teaching opportunities. For example, the Solvency provision of the acquirer's Representations provides, "the Surviving Corporation and each of its subsidiaries will not: (i) be insolvent (either because its financial condition is such that the sum of its debts, including contingent and other liabilities, is greater than the fair market value of its

sufficiently familiar with the facts or transactional documents to recognize the deal if the parties' names are removed. A professor thus can start with the relevant transactional documents—that is, the merger agreement, equity commitment letter, and the limited guarantee—and guide the students' critical analysis of the various components.[21]

By starting with the final set of deal documents, students are forced to consider why the parties agreed to the stated terms. What aspects of the law or possible client objectives might have been in play? Through this process, students also should consider what potential issues might lie ahead for the parties based on their assessment of the documents.[22] The professor can then supplement the discussion with, for example, the parent's decision to terminate the merger prior to closing and what that might mean for the parties. The initial exercise of working backwards through the documents with little information concerning the parties or their real-life objectives and then confronting potential factual twists will help students better appreciate how the law shapes and reshapes deal negotiations and structures.

As part of deconstructing the deal, students should draft at least one memorandum critiquing the transactional documents.[23] This part of the

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assets or because the fair saleable value of its assets is less than the amount required to pay its probable liability on its existing debts, including contingent and other liabilities, as they mature); (ii) have unreasonably small capital for the operation of the businesses in which it is engaged or proposed to be engaged; or (iii) have incurred debts, or be expected to incur debts, including contingent and other liabilities, beyond its ability to pay them as they become due." United Rentals, Inc., Form 8K, dated July 22, 2007, Exhibit 2.1 § 4.13, p. 30 (merger agreement). A professor can use this provision to explore potential fraudulent conveyance and related legal issues, including in the context of leveraged buyouts, as well as the underlying drafting and negotiation techniques.

21. *See* Steven M. Davidoff, *URI's Argument*, M&A L. PROF BLOG (Nov. 29, 2007), http://lawprofessors.typepad.com/mergers/2007/11/uris-argument.html (providing a thoughtful analysis of the United Rentals/Cerberus dispute and links to copies of the relevant documents); *see also* United Rentals, Inc., Form 8K, dated Nov. 19, 2007, Exhibit 99.3 (equity commitment agreement); United Rentals, Inc., Schedule 13D/A, dated Nov. 14, 2007, Exhibit 2 (limited guarantee); United Rentals, Inc., Form 8K, dated July 22, 2007, Exhibit 2.1 (merger agreement).

22. This exercise can include sensitizing future deal lawyers to the importance of appreciating what the deal and related documents will look like in any subsequent litigation. *See, e.g.*, Erik J. Olson et al., *The Wheels Are Falling Off the Privilege Bus: What Deal Lawyers Need to Know to Avoid the Crash*, 66 BUS. LAW. 901, 915–17 (2011).

23. To be effective transactional lawyers, law students need strong basic writing skills *and* exposure to drafting transactional documents. *See, e.g.*, Lisa Penland, *What a Transactional Lawyer Needs to Know: Identifying and Implementing Competencies for Transactional Lawyers*, 5 J. ASSOC. LEGAL WRITING DIRS. 118, 123–26 (2008) (explaining transactional competencies necessary to be an effective transactional lawyer); Wayne Schiess et al., *Teaching Transactional Skills in First-Year Writing*

exercise forces students to be active participants in the critical analysis process. In the memorandum, students should, at a minimum, identify provisions in the transactional documents that work well and those that might pose issues; explain why they have reached those conclusions based on applicable law and other considerations; and, if relevant, redraft or draft provisions to address the issues. Using this annotated drafting approach allows students to work on two types of related but different writing skills, both of which are important to business (and most all) lawyers.

As we continue to talk with our colleagues who practice in the business law community, we are identifying different ways in which law schools might better prepare soon-to-be business lawyers. Notably, many of these colleagues emphasize the need for law students to grasp the import of case and statutory law on business clients, that deals and business are not done in a vacuum, and that little substitutes for a strong work ethic. Although some are skeptical about what law schools can or should teach law students about practical business law skills, most appear to believe that law schools are really well suited to hone critical thinking, writing and drafting skills, and substantive knowledge.

Our concept of deal deconstruction capitalizes on what law schools already do well. The approach is based in critical analysis and doctrine. It subtly introduces writing and drafting exercises in a way that allows law students to practice those skills and start to develop confidence and style. Yet, it is not focused on specific forms or drafting techniques that law firms would need to "unteach" after graduation. Moreover, it provides a safe environment in which students can start exercising judgment about clients' needs, objectives, and strategies—a skill that many argue you cannot teach but that typically improves with practice.

Overall, deal deconstruction offers a meaningful way to structure advanced business law courses and better prepares law students for practice. It is not a complete solution, and it is not the only way to integrate theory and practice concepts in the classroom. It also may pose resource challenges to law schools that generally do not generate transactional documents. Nevertheless, we believe that such potential challenges can be overcome, and we encourage professors to consider its value in the business law curriculum.

III. CASE STUDIES AND CASE SIMULATIONS

Deal deconstruction sharpens analytical skills through forensic study of deals. Complementing this method are case studies and case simulations.

Courses, 9 TRANSACTIONS: TENN. J. BUS. L. 53, 54–57 (2009) (examining the value of teaching transactional drafting skills in law school).

Through these methods, students learn how to analyze business problems and legal issues, and then how to form judgments and to make decisions. Unlike deal deconstruction, which is backward-looking in time, case studies and case simulations are forward-looking—that is, students are placed in situations where the problem is situated at a point in time at which the deal or transaction is anticipated and participants are expected to move forward toward resolution.

Case studies are standard fare in business school pedagogy. The differences between the Langdellian case method and the business school case method are stark. In the business school case method, there is no starting point analysis done by an expert, such as a lawyer or a judge, to criticize, deconstruct, or evaluate. There are only facts and data, and often the problem or issue is not even explicitly stated. Business school professors write case studies on actual situations or transactions with the cooperation of the participants involved. They place the students in the position of the manager or executive, and the teaching method asks students to identify the problem, propose a solution from many potential options, and defend the decision based on facts and data. In any problem, in business or in law, a set of facts constitutes the context and the specific nature of the problem.

Professors Todd Rakoff and Martha Minow aptly describe the business school case as follows:

> The archetypical "case" at a business school consists of much more information, and a much more open-ended situation, than the appellate cases used in law schools. They are taught by teachers asking different questions, often in classes as large as law school classes. A careful study by a Harvard Business School professor comparing the methods used in several of Harvard's professional schools found that alternative "case methods" do indeed develop different skills. Business school students, for example, generate alternative solutions and choose among them more ably than the typical law student; medical school students more successfully learn to identify what they do not know and how to find it out.[24]

In the analysis of appellate opinions, the emphasis is situating the decision in a framework of policy and theory, a type of thinking that lawyers must learn (of course). However, much of law practice is more complex than just desktop legal analysis. Lawyers develop facts and construct the case theories, deal with uncertainties, calculate risk and reward, make decisions, and solve problems. Business school case studies

24. Rakoff & Minow, *supra* note 3, at 603–04.

present contextualization that is frequently lost during the appellate litigation and casebook production processes. Problems are presented and analyzed from an ex ante framework; students are expected to look forward toward an answer. Frequently, business students are not told ahead of time the outcome of the case, and they are sensitized to the fact that uncertainty pervades the real world and that business problems require decisions at the end of the day and not just intellectualized analysis.

A variant of the business school case study is a case simulation. In our vision of this method, "case simulation" has two attributes that distinguish it from a case study: (1) the problem is fictional as opposed to a case study, which is based on a real situation, and (2) the problem is conducive to role-playing, negotiations, or some other form of simulated situation involving active participation of students.

Professor Rhee has taught case studies in his law school and business school courses on corporate ethics. These case studies include, among others, the collapse of Enron, Hewlett-Packard's board spying scandal, Walmart's efforts and challenges in environmental sustainability, Credit Suisse's changes in executive compensation after the financial crisis of 2008-2009, and IKEA's efforts to combat child labor.[25] These case studies are factually very dense, most comprising more than 25 pages of factual information. The density and complexity of the facts and problem do not perfectly mimic real practice, but this form of presentation gets students closer to practice and situational awareness than the study of edited appellate cases.

Consider, for example, the Hewlett-Packard ("HP") board spying scandal, which illustrates the point. If we teach this case in the classroom, then, in addition to the fine contributions of academic analysis,[26] the HP case can be taught through a case study of the facts and circumstances of

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25. *See* Christopher A. Bartlett, Vincent Dessain & Anders Sjoman, *IKEA's Global Sourcing Challenge: Indian Rugs and Child Labor (A) & (B)*, Harvard Business School Case # 906414-PDF-ENG and # 906415-PDF-ENG (May 3, 2006) (30 pages); Krishna G. Palepu et al., *Hewlett-Packard Co.: The War Within*, Harvard Business School Case # 107030-HCB-ENG (Nov. 1, 2006) (35 pages); Erica Plambeck & Lyn Denend, *Walmart's Sustainability Strategy*, Stanford Business School Case # OIT71-PDF-ENG (Apr. 17, 2007) (36 pages); Clayton Rose & Aldo Sesia, *Post-Crisis Compensation at Credit Suisse (A)*, Harvard Business School Case # 311005-PDF-ENG (July 7, 2010) (28 pages); Malcolm S. Salter, *Innovation Corrupted: The Rise and Fall of Enron (A) & (B)*, Harvard Business School Case # 905048-PDF-ENG & # 905049-PDF-ENG (Oct. 11 and 17, 2005) (73 pages). These case studies are available from the Harvard Business Publishing at http://hbsp.harvard.edu/.

26. *See, e.g.*, Miriam Hechler Baer, *Corporate Policing and Corporate Governance: What Can We Learn from Hewlett-Packard's Pretexting Scandal?*, 77 U. CIN. L. REV. 523, 524 (2008) (analyzing the conflict between the board's competing obligations of overseeing internal corporate monitors and implementing norms and structures of good corporate governance).

the company at that point in time.[27] Students learn to assimilate a complex set of facts and data that are relevant to the growing dysfunction of the board, among other things: the introduction of a new CEO, the bursting of the technology bubble in 2000, the role of corporate culture, the effect of a languishing stock price on strategy, the internal conflict over the proposed merger with Compaq, the post-merger execution, the role of unique personalities within a social structure, the rapidly changing board compositions post-merger, the failure of leadership, the breakdown of trust, and the erosion of a sense of obligation toward the corporate enterprise. These are not conclusions of a preexisting analysis, but rather students must tease out this analysis from facts and data, which mimics imperfectly what occurs in "the thick of things." This kind of holistic analysis associated with business school case studies promotes judgment, analysis, and problem-solving skills that are inadequately developed through the Langdellian method.

Case studies are not entirely new to the legal academy. Jonathan Zittrain and Jennifer Harrison have written a case study published as a book entitled, *The Torts Game: Defending Mean Joe Greene*.[28] This book excerpts material from a real case involving a lawsuit against "Mean" Joe Greene (the Hall of Fame defensive lineman for the 1970s Pittsburgh Steelers) and the Arizona Cardinals arising from an incident in which Greene struck the plaintiff. Among other things, the book contains portions of the complaint; answer; deposition testimonies of key witnesses; several insurance policies; attorney letters, including settlement offers; and edited appellate opinions.[29] The book is really a condensed litigation file, and students can develop many skills by analyzing the case studies. These skills include gathering facts, assessing testimony, learning directly from reading insurance policies the implications of insurance on a tort action, and reading appellate cases in this context.[30]

Another benefit of case studies and case simulations is that students can work in groups or simulated transaction teams. Case studies are conducive to formal and informal presentations performed by groups of students. Team production and business communication skills are learned. Furthermore, simulation is one form of experiential learning as it requires a

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27. Krishna G. Palepu et al., *supra* note 25.

28. JONATHAN ZITTRAIN & JENNIFER K. HARRISON, THE TORTS GAME: DEFENDING MEAN JOE GREENE (2004).

29. *Id.* at 1–65 (providing in chapters 1 and 2 various sources of facts such as a newspaper article, deposition testimonies, the law of torts, an attorney demand letter, and a legal memo).

30. *Id.* at 88, 97, 112, 118–31 (providing opportunities for written exercises and analysis of insurance policies in the context of a tort).

student to experience a hypothetical situation in the context of an assigned role.

Case studies and case simulations can enhance the teaching of business law and transactional skills in important ways. They more effectively capture the complexity of real transactions and professional settings. They present fewer sharper divisions between "business problems" and "legal issues," in contrast to appellate cases where discrete legal issues are the foci. They provide opportunities to work with whole transactional and governance documents rather than snippets of the relevant provisions at issue. They promote a greater degree of personification of the problem—that is, the sense that you are a part of the transaction or litigation involved rather than a legal analyst examining the events from a detached point of view. Lastly, they promote what Professors Rakoff and Minow have called "'legal imagination[,]' . . . the ability to generate the multiple characterizations, multiple versions, multiple pathways, and multiple solutions, to which they could apply their very well honed analytic skills."[31]

IV. BARRIERS AND OPPORTUNITIES

Although we believe that deal deconstruction, case studies, and case simulations are effective methods to teach business law and transactional skills, there are three significant barriers to using them.[32]

First, the most significant barrier is that course materials must be developed, oftentimes from scratch, as there is a dearth of prepackaged, published teaching materials. Casebooks are popular not only because professors are familiar with the Langdellian method, but also, and equally importantly, because the casebook authors have nicely packaged the teaching materials. Deal deconstruction, case studies, and case simulations require a significant upfront investment of time to prepare the course materials if there are no other available sources.

Second, even if a professor were inclined to create the teaching materials, she would need the raw materials: the suitable deal to analyze, the case study to write up, and the hypothetical scenario for the simulation. Research must be done. Cases must be found. The imagination must be unleashed. In addition to time, the source materials are another resource constraint.

Third, while teaching from appellate cases is the standard pedagogy in law schools, many law professors, who were themselves educated in the

31. Rakoff & Minow, *supra* note 3, at 602.

32. *See id.* at 604–06 (discussing the barriers to introducing case studies in legal curricula).

Langdellian method, may be unfamiliar with these relatively new pedagogical methods. In addition to an apprehension of the unfamiliar, class preparation may consume more time. Managing classroom participation for the experienced teacher is comfortably done. But managing group work, class presentation, and simulations may be more difficult. Participation in the context of case studies and case simulations is not always the transitory conversations between the teacher and a single student that is typical of the Socratic method.

We do not believe that these impediments are insurmountable. Law schools would benefit from the publication, either through traditional print media or open source networks, of more deal files, case studies, and case simulations. Certainly, the Harvard Business School has gained fame and fortune from publishing a huge repository of business school case studies. Recently, the Stanford Law School published case studies on environmental law for open use.[33] The effort to manufacture deal files, case studies and simulations requires a dedicated group of law professors who believe in the methods and are willing to write teaching materials. We believe that there are teachers who would be willing to write case studies for fun, service, personal profit, or a combination of these legitimate reasons.

Although law professors are certainly capable of putting together deal files and case studies from publicly available sources, a better and more efficient way to manufacture deal files and case studies is through a partnership with lawyers who actually participated in the deals and cases. Writing materials present excellent opportunities for law professors to collaborate with the professional bar. We are mindful of confidentiality and client issues, but they are not insurmountable barriers. On big public deals, most of the documentation is publicly filed, and these transactions are of such significance and open with respect to information that clients may be willing to talk about them on some detailed, helpful level that does not disclose vital secrets (these kinds of conversations are essential fodder for business school case studies). On many smaller deals, the client's need for strict confidentiality of business information may be lessened, and thus clients and attorneys may be able to talk about the deal or action in significant detail. These types of conversations could advance the educational mission, and the profession could provide a vital service. As well, there could be significant benefit for the clients and attorneys in the form of marketing benefits associated with law schools and law students studying *their* deals or actions. We see potential value in drawing on the

33. *Stanford Law School Case Study Collection*, STAN. L. SCH., http://www.law.stanford.edu/node/175680/ (last visited Sept. 2, 2013) (providing an array of factually dense and legally complex case studies available for teaching use).

vast expertise and diverse experiences of the transactional bar to help better prepare our transactional law students.

CONCLUSION

The traditional Langdellian method does not fully develop transactional and deal skills. Analysis of appellate cases provides one facet of transactions—that is, deals gone so wrong that they resulted in lawsuits that were then presented in an edited appellate case opinion. By examining deals gone bad, we gain insight into how to do them properly, as well as the doctrinal developments gotten from appellate cases. However, as discussed, the Langdellian method falls short in important ways. We suggest that case studies, simulations, and deal deconstructions simulate experience, provide contextualization, promote problem-solving skills, and hone decision-making skills and judgment. Although actual experience can never be perfectly replicated, these methods bridge the gap between the classroom and actual transactional practice.

We do not discount the hurdles required to employ these pedagogical methods on a sustained basis. The Langdellian method has been supported over many decades by law professors writing casebooks in the service of the educational mission. Like the production of casebooks, the development of a case study, a case simulation, or a deal file requires a significant investment of time. We believe that if a broad enough segment of the professoriate sees the benefits of alternative pedagogical methods in teaching business and transactional law, many law professors, like authors of casebooks, will make similar investments in the service of the educational mission.

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M&A AS ONE COMPONENT OF A BUSINESS PLANNING COURSE

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INTRODUCTION

This Article describes how law schools can teach mergers and acquisitions ("M&A") as one component of a business planning course that also addresses other stages of a business's development, such as the start-up and financing of growth stages. This approach to covering M&A is in contrast to a curricular offering that focuses solely on M&A for an entire semester. The benefits and costs of such an M&A module approach are identified, and the key pedagogical features of the M&A segment are explained. One critical factor for successful pedagogy is for the professor to collaborate with both an experienced transactional lawyer and a seasoned transactional business person. Effective partnering in this way requires the professor to articulate clearly to those cohorts the importance of transmitting practical knowledge and experience, to be sure, but doing so while being especially mindful of the teaching/learning process itself. For those lawyers and business persons who can successfully combine deep sophistication with attentiveness to the teaching function—a challenge in one or two-day "cameo" appearances—the pedagogical payoff is immense. This Article pays special attention to the crucial role of the business "deal person" in this approach to M&A.

We begin this Article by describing how such an offering fits into, and enhances, current efforts to improve legal education by making it more experiential, specifically in an advanced transactional offering where significant attention, but not an entire semester, is devoted to M&A. We then describe the way in which, as a professor and a business person, we collaborate to structure and conduct such an M&A component.

I. THE CASE FOR AN EXPERIENTIAL, TRANSACTIONAL M&A COURSE MODULE

Professor Johnson's Business Planning Practicum is an intensive, five-credit simulation with enrollment limited to 15-20 second-semester 3L students. These students have completed at least the basic business associations class and the introductory income tax course at Washington & Lee ("W&L").[1] Many students, however, also have taken an additional corporations course,[2] and offerings such as securities regulation, business tax, bankruptcy, and other business-related offerings. All 3L students at

1. The "basic" business associations course at Washington & Lee (W&L) is called Close Business Arrangements. It covers all common forms of business arrangements in the closely held business setting.

2. The next corporations course in the business law sequence at W&L is called Publicly Held Businesses. It covers the range of issues pertaining specifically to public corporations.

W&L, moreover, must take a demanding two-week Immersion course at the beginning of the second semester that focuses on transactional work.

The Business Planning Practicum is just one offering in W&L's pioneering 3L curriculum, which in 2008, was made entirely experiential.[3] This major reform was in the works already when the influential Carnegie Report was released in early 2007.[4] The Carnegie Report famously leveled criticisms at law schools for failing to better equip their graduates for practice. Since publication of the Carnegie Report and W&L's adoption of dramatic curricular changes, a large number of law schools have been moving toward adopting more practice-ready approaches to legal education.[5]

A. Experiential Learning

By "experiential," at W&L we mean situating students in *lawyer-like* settings where they engage in *lawyer-like* tasks and produce *lawyer-like* work product. The learning process is student-centered, not professor-centered. Students plan and manage the workflow, but—given the university setting—they are provided with very close supervision by, and access to, a senior lawyer-professor. The relationship is similar to a tutorial and is designed to forge a strong mentor-protégé relationship. Much of this learning takes place in our numerous Practicums—which are simulations—but clinics and externships also play a central role.

B. Transactional Offering As Experiential

Because transactional offerings are well-suited for experiential learning, there has been a proliferation of a variety of such courses that focus exclusively on M&A or related transactional work. At W&L, for example, we offer such deal-only offerings as: Cross-Border Transactions Practicum; Mergers & Acquisitions Practicum; "Deals" Practicum; and Real Estate Transactions Practicum.[6]

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3. W&L's entire reform project is fully described in LYMAN P. Q. JOHNSON, ROBERT T. DANFORTH & DAVID K. MILLON, *Reforming the Third Year of Law School*, *in* REFORMING LEGAL EDUCATION 11, 11–45 (2012), *available at* http://ssrn.com/abstract=2139789.

4. WILLIAM M. SULLIVAN ET AL., EDUCATING LAWYERS; PREPARATION FOR THE PROFESSION OF LAW (2007).

5. To cite just one recent example, in 2013, the University of Denver adopted an initiative to bring a greater experiential learning emphasis to its curriculum. *See Denver Law to Launch Experiential Advantage Curriculum this Fall*, U. OF DENVER, STURM C. OF L. (June 5, 2012), http://www.law.du.edu/documents/news/Experiential-Advantage-Release_FINAL0605.pdf.

6. *See 2012–2013 School of Law Catalogue*, WASH. & LEE UNIV. SCH. OF L., http://law.wlu.edu/thirdyear/page.asp?pageid=1105 (last visited Dec. 24, 2013).

These offerings, and others like them at many law schools across the country, can play a key role in providing a more realistic, sophisticated, and practice-oriented curriculum in business law. At the same time, law students can also gain a great deal in a more holistic Business Planning offering that examines a business at different stages in its life cycle—that is, the start-up/formation stage, the early to mid-stage financing/growth phase; and the exit (sale or divestiture) stage. In other words, in an offering where the M&A module fits into a larger, but still entirely business law and business-oriented, planning course. In a 13 or 14-week semester, such an M&A segment would comprise about three to four weeks.

C. Costs of A Module Approach

There are certain costs to approaching M&A—a notoriously complex area—in this compressed manner, rather than in a full-blown, semester-long course.[7] The most obvious drawback of the module approach is the inability to examine technical, high level, deal-only issues in depth and with a sustained opportunity for feedback and redrafting. At the same time, perhaps some (maybe much) of that nuance and sophistication—old hat to a lawyer with ten or more years of experience—is simply lost on novice law students anyway. In addition, a real pedagogical challenge, particularly for especially experienced professors (and lawyers), is to recall that they have moved far away from students in both depth of understanding and experience. Thus, the perennial temptation to explore overly subtle concepts and intriguing alleyways must be firmly resisted in favor of pitching the course to a savvy, but still inexperienced, group of law students.

D. Benefits Of A Module Approach

There are several benefits of having an M&A component within a larger transactional planning course. First, it contextualizes M&A work by situating it into a larger business life-cycle framework. Second, such an approach can counter somewhat the cyclical nature of M&A work, which can ebb and flow. By addressing other business planning transactions as well, a down cycle in deal flow in any given year still leaves much to talk about—for instance, start-ups and the "how-to's" of financing existing businesses. This serves to usefully diversify the knowledge base of law students, which in itself makes them more practice-ready and employable.

Third, an M&A module provides exposure to M&A work for students who will do some—maybe a great deal of—M&A work but who will also

7. Some students, it should be noted, take both the Business Planning Practicum and another M&A-only offering, but not many.

do other types of legal work. Relatedly, such a course component offers insights into M&A work to those students who will work in small or medium-sized law firms—or other practice settings—where deal work is just one of several practice areas they will see.

Notwithstanding decided benefits to such an approach, such a compressed treatment of M&A requires careful collaboration with both a very experienced deal lawyer and a business person actively engaged in deal-making. Here too, there are several benefits of such partnering. Students gain multiple and varied perspectives on a subject. Students also come to appreciate how different participants in M&A transactions have different roles, priorities, protocols, and expectations. Furthermore, students observe different styles used by senior persons in communicating and interacting with novices in a deal setting, a crucial element in their professional training.

Another benefit of our collaborative approach is that students have more opportunities to learn (and use) "the lingo." It is easy for M&A veterans to forget that the rich and colorful M&A idiom is not a native tongue but, like any foreign language, must be learned. Finally, because sophisticated M&A work tends to change with the economy, market conditions, and evolving deal practices (themselves often a result of evolving legal clarification or uncertainty), students gain an important and valuable sense of being au courant and up to date from savvy guest speakers.

II. THE THREE PARTS OF THE M&A MODULE

Believing that there are numerous benefits to addressing M&A within a larger business planning course and to collaborating in this endeavor, Professor Johnson for many years has partnered with others in teaching this segment. The M&A segment itself has three aspects: Professor Johnson's involvement; participation by an experienced business person actively engaged in buying and/or selling businesses; and the involvement of an experienced and sophisticated deal lawyer.[8]

Professor Johnson spends approximately six hours, spread over three class sessions, introducing M&A work. Briefly, because this portion of the course is not the focus of this Article, a host of issues are addressed during this phase of the course.[9] These include: an overview of a deal; various

8. W&L is extremely fortunate to have devoted, loyal alumni who help in our teaching efforts. This has been gratifyingly true in Professor Johnson's course. He has benefitted in recent years from the substantial assistance of the following W&L graduates: Bill Boardman, Jim Seevers, Brian Hagee, Wyatt Deal, David Freed, Hugh Wellons, Sean Leuba, and Rob Ricca.

9. For one example of what Professor Johnson does, see LYMAN P. Q. JOHNSON, WASH. & LEE PUB. LEGAL STUDIES RESEARCH PAPER NO. 2011-6 & ST. THOMAS LEGAL

forms of and reasons for structuring transactions in different ways; motives of sellers and buyers (including strategic versus financial buyers); tax considerations; deal protection and walk rights; due diligence concerns; privilege issues; the young lawyer's role; and other foundational, stage-setting issues. Necessarily, given the vast amount of information, very extensive pre-class readings are assigned and class sessions themselves are lectures affording students numerous opportunities to ask questions. One critical goal for the future, consistent with the experiential quality of the Practicum, is to find more and better ways for students to engage in active learning in this module. Students draft and redraft letters of intent in a prior course component and they are again exposed to those here,[10] but more "hands on" opportunities are needed.

As to the savvy deal lawyer's role, this too is not the focus of the current Article,[11] but, in brief, the goal here is simple. This lawyer, given approximately three or four hours in one class session, must selectively address key practical issues in the M&A area. In particular, this lawyer should really hone in on what a more senior lawyer—whether a partner or senior associate—desires and expects a junior lawyer to know about M&A when that junior lawyer shows up on a deal. This session is always productive, but it seems to go especially well when a senior associate or new partner handles it. This is because students relate quite well to someone not all that farther along than them in career terms, at least compared to a senior partner, and because framing the session as "what you need to know to work on my deal" is a real attention grabber for students. It also goes well because that younger lawyer likely still remembers being a law student, and so he or she can more readily and empathetically place himself or herself on the other side of the lectern.

As to the business person, as noted, the key requirements are ongoing experience in deal-making and a strong ability to relate to law students. In recent years, Sean Leuba has partnered with Professor Johnson. Mr. Leuba has both a law degree from W&L and an MBA from the University of Chicago. He practiced at Arnold & Porter before joining Caterpillar, where initially he did law work and now leads acquisitions for Caterpillar. Obviously, Sean approaches this responsibility as a strategic buyer, not a financial (private equity) buyer, and it is helpful for students to understand the different goals and techniques of these two types of buyers. The next

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STUDIES RESEARCH PAPER NO. 11-13, TECHNIQUES TO TEACH SUBSTANCE AND SKILL IN CONTRACT DRAFTING: IN-OFFICE MEETINGS AND ANALYTICAL MEMOS 1–15 (2011), *available at* http://ssrn.com/abstract=1816862.

10. *See infra* Part III.

11. Rob Ricca, now at the Wilson Sonsini law firm in Palo Alto, is currently preparing such an article.

part of this Article describes what Mr. Leuba does for his part in the M&A module.

III. THE DEAL PERSON'S ROLE IN CLASS

A. Introduction

There are several overarching goals for this part, which is ideally four hours in length. First, it seeks to disabuse law students of their faulty lawyer-centric vision of the business world, including the deal world. Second, it is designed to help students see how/where/when the lawyer's role fits into a larger transaction and how a transaction itself is designed to advance a larger corporate strategy. Third, this part aims to assist students in forming a more grounded and informed professional identity of themselves as lawyers, including the need to meet client expectations, the ways in which they add business value, and the reality that they will face recurrent ethical challenges.

To provide context for Mr. Leuba's remarks, he opens his presentation to students with a short biography and brief explanation as to why he is speaking to them. What follows now is Mr. Leuba's description of his presentation.

I graduated from Washington and Lee University School of Law in 1997 and started my practice in the Corporate group of Arnold & Porter LLP, a Washington D.C. based international law firm. After two years, I moved in-house to Caterpillar Inc., a large, American industrial corporation as a transactional lawyer. While practicing in-house, I attended the University of Chicago Graduate School of Business and earned my MBA in Finance in 2003. I left the practice of law and joined the Strategy & Business Development ("S&BD") Division at Caterpillar in 2004. I have made a few moves since that time, but for the most part, have been focusing on mergers and acquisitions, joint ventures and alliances, on the business side, for the past nine years.

My presentation in Professor Johnson's Practicum is always given in April, toward the end of the spring semester. We do this because I act as a bridge between the three years of law school and the practicing, client-paying world that the 3Ls will soon be entering. In my current role as an executive in the S&BD Division, I am constantly interacting with lawyers of all types such as transactional, tax, environmental, labor and employment, and others. In presenting to the Business Planning class, I give my perspective on two main topics: (a) a brief overview of an acquisition from strategy to closing; and, (b) my view of what characteristics are demonstrated by the most effective deal lawyers.

1. Overview of M&A Market

I typically begin with an overview of the current state of the M&A market. In 2013, for example, the mergers and acquisitions market is healthy. In 2012, acquirers completed $2.7 trillion of announced global M&A transaction volume.[12] This is down from a high of $4.7 trillion in 2007, the height of the most recent leveraged buyout boom, but is up substantially from the low of $2.3 trillion in 2009.[13] Of deals closed in 2012, there was a fairly even split around the globe with the Americas comprising about 44 percent, EMEA (Europe, Middle East and Africa) at about 37 percent, and Asia at about 19 percent.[14] There are several reasons that contribute to the strength of the current market. Cash on corporate balance sheets is at a historical high with over $3 trillion of excess cash.[15] Financing costs are very low with central banks around the globe continuing to fight the 2008–2009 recession with high liquidity. Valuations appear reasonable with relatively low forward P/E ratios. And private equity funds must use the cash that they raised prior to the 2008–2009 recession or risk having to return it to the limited partners.

I emphasize to students that these transactions are not just occurring in New York, London, or Beijing. M&A deals of all sizes occur in all regions of the United States and around the world. The overwhelming majority of these deals are less than $1 billion in consideration. This helps students see the importance of M&A work in small and mid-size markets, and that there are excellent opportunities for M&A work in all markets.

2. The Lawyer's Key Role

For any given deal that I am involved in, there are several attorneys participating on behalf of each of the buyer and the seller. The M&A generalist lawyer leads a team in completing all of the due diligence of a target across multiple areas. This attorney also leads a team in drafting and negotiating the numerous definitive agreements for a transaction. M&A

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12. *See Global M&A Review—Full Year 2012*, DEALOGIC 3 (Jan. 2013), http://www.institutionalinvestorchina.com/arfy/uploads/soft/130108/32320_0902282321.pdf.

13. *See Global M&A Review—Full Year 2011*, DEALOGIC 1 (Dec. 2011), http://www.institutionalinvestorchina.com/arfy/uploads/soft/111227/1_0909591611.pdf.

14. *See Global M&A Review—Full Year 2012*, DEALOGIC 7–12 (Jan. 2013), http://www.institutionalinvestorchina.com/arfy/uploads/soft/130108/32320_0902282321.pdf.

15. Joe Weisenthal, *JPMorgan's Tom Lee Explains What Will Happen With The $3.6 Trillion in Cash On Corporate Balance Sheets*, BUS. INSIDER (Mar. 25, 2012, 8:07 AM), http://www.businessinsider.com/jpmorgans-tom-lee-explains-what-will-happen-with-the-36-trillion-in-cash-on-corporate-balance-sheets-2012-3.

transactions, of course, not only require the generalist team, but frequently there are specialists involved from tax, environmental, labor and employment, intellectual property, and other areas. If a transaction requires lenders, then there are additional lawyers involved to obtain and provide the credit facility. If a deal is public (or the debt will be public), then there are also securities lawyers involved.

3. Corporate Organizational Structure

At the next stage of my four-hour presentation, I review the organizational structure of a typical large American industrial company. A typical American industrial company will have its divisions split into one of three functions. The first are the operating divisions, in which reside product research and development, design, manufacturing, and operations. The second group is the sales and marketing divisions. The operating divisions "sell" the products via a transfer price to the sales and marketing divisions who then market and sell the products to the company's customer base. The third group is composed of the service divisions. These divisions include: Legal, Accounting, Human Resources, Tax, Treasury, and Information Technology.

4. The Law School Role

It is my view that law schools can play a role in aiding the M&A business world and the law firms serving that world. They can do so by better exposing those graduating students interested in commercial work to the issues arising in mergers and acquisitions. With sixteen years of experience on both the legal and business side of deal-making, I have concluded that a critical element of that M&A exposure is for law students to have a better, more complete and holistic perspective on acquisitions. Clients today want many characteristics in their lawyers, but foremost, clients desire a lawyer who is a complete advisor. The most valuable M&A lawyers are the ones who not only give excellent legal advice, but also have an understanding of their client's broader business goals and at least a cursory understanding of how to achieve those goals. For example: What is the client's short and long term strategy? How do acquisitions fit within and advance that strategy? What are the key business drivers that must be achieved to ensure success? Which particular acquisition targets can best enable a client to execute on its strategy? What are the specific risks of a target as it is integrated into an acquirer? What mitigation plans can be developed? If a lawyer has a working understanding of these broader points, the lawyer can become invaluable to the client. The lawyer can move from just being a legal technician hired for a specific matter, to one who is a valued member of the business team and who, in doing so,

becomes a complete counselor and trusted advisor. This will then lead to a deeper, longer and ultimately more satisfying client relationship.

B. Strategy Development and Target Identification

After explaining that there is abundant M&A activity occurring across all deal sizes and geographies and that, in my view, the best lawyers are the ones that understand more than just the law, I take the students through a high-level discussion of corporate strategy development. Why do companies undertake acquisitions? Acquisitions are an arduous process, fraught with risk, they can be very expensive, and they frequently fail. The primary driver of acquisitions is growth. The overwhelming majority of companies, whether it be small community banks or a Fortune 500 behemoth, want to grow. This can be growth in sales, profit, or market share. Growth generally leads to more profits, a higher share price (if public), more money to invest in facilities and people, greater engagement among the employees, more confidence with customers, and many other positive benefits. Growth typically drives corporate behavior.

There are many ways companies can grow. They may invest in the sales and marketing team in an attempt to gain incremental customers. They may have strong R&D budgets, improve existing products, and innovate and develop new technologies or products. They may invest in new geographic locations with facilities and a heightened sales presence. Or, they may acquire other companies and use the acquisition to launch growth.

A well-developed corporate strategy will guide management in the best manner to execute growth plans. At its essence, the growth strategy attempts to answer three basic questions: (1) What industries or segments do we wish to grow in; (2) why do we want to undertake those actions; and, (3) how are we going execute those plans (i.e., new products, new facilities, supply agreements, joint ventures, acquisitions)?

The new industries, products, markets, or customers a company wishes to pursue will flow directly from the fundamental mission and purpose of an organization. For a company's management to properly set the course of growth, they must fully understand their goals for the business. Companies that are viewed as best-in-class acquirers develop a set of filters through which they run all growth initiatives. Management derives these filters from the vision, the mission, and the long-term strategy of the organization. These filters apply even before a company decides which method is the best manner to grow; it is at the earlier stage of evaluating whether a company should even enter this market segment. Some examples of filters include the following questions. What is the addressable market size of an industry? What is the aggregate growth rate

for the industry? Are the customers in a particular industry profitable and what is their margin? What do the customers in the industry value? Are the customers price buyers or premium buyers? Does the industry value differentiated technology or is it more of a commodity-type industry? Is it a global industry or a regional one? What are the barriers of entry into a particular industry? To answer the first two questions above, "What markets and why?" a company identifies particular industries, the "what." and applies its filters to determine the "why."

Once a company elects to enter a particular market, then it turns to the execution alternatives, or the "How are we going to enter?" There are many different execution alternatives including the following: (a) internal development, (b) supply agreement, (c) co-development with a supply agreement, (d) greenfield facility (if new factories are required), (e) equity joint venture, and (f) acquisition. In deciding the best method to grow into an industry, companies develop a set of Critical Success Factors ("CSFs"). These CSFs are similar to the filters described above, but instead of relating *to* a particular industry, the CSFs relate to goals *within* a particular industry. Examples of CSFs include: What is the speed to market? What are the financial metrics, such as sales, operating profit, internal rate of return ("IRR"), net present value ("NPV"), cash flow, and return on invested capital ("ROIC"), of each of the options (e.g., internal development v. supply agreement v. acquisition)? Does the company have available capacity at any of the existing facilities? Is there protected IP that would prevent the company from undertaking a new product program? Are there multiple, competent suppliers to choose from for a product sourcing? After evaluating the alternatives against the CSFs, a company will develop a prioritized list of growth alternatives.

Assuming the company determines an acquisition is the best option to pursue, the process of target identification begins. Acquiring companies will begin an examination of existing companies in the targeted industry. A third set of filters is established to prioritize the potential targets. These filters may include, among others: (a) what is the financial performance of the targeted companies; (b) where are the companies located, including management centers, engineering centers, manufacturing footprint, and distribution centers; (c) who are the customers and what type of customers are they; (d) what is the distribution channel, i.e., direct or through dealers; (e) what is the competitive position and market share of each company within the industry; and (f) what is the culture of the company and will it fit within the acquiring company. At the end of this exercise, the acquiring company should have a list of potential targets prioritized by desirability.

A significant amount of time and effort goes into developing a corporate growth strategy, determining the best manner in which to execute on that growth, and if an acquisition is involved, deciding on the priority ranking

of potential targets. Law students, like many lawyers, generally do not appreciate this business reality. The best-in-class companies with sophisticated business development teams are constantly evaluating industries, markets, and the key players in those markets.

At this point in my presentation, I attempt to clearly relate the corporate strategy back to the attorney's role in an organization. The best attorneys understand growth strategy development and execution process and how their clients approach it. They understand the corporate strategy, understand the risk appetite of their clients, and provide constructive and insightful advice to their clients as they develop and execute on their growth strategies. It is critical in today's environment that corporate counselors go beyond the provision of mere legal advice and become a proactive, comprehensive advisor. To do that, lawyers must possess a solid understanding of strategy and execution alternatives. It is best that law students learn this lesson early in their careers.

C. Transaction Execution

After I provide an overview of corporate strategy development and execution alternatives, I then move to the more tactical discussion of transaction mechanics. This is intended to provide 3Ls with my perspective on the flow of an M&A deal and some of the key legal and business items that frequently arise. If in their first year of practice they work on an acquisition, they will have had some brief exposure to the issue because I have touched on it.

Once the acquirer determines that an acquisition is the best method to achieve growth, and it has developed the list of prioritized target candidates, it begins the process of contacting those targets. This is typically done via a communication from the acquirer's Business Development Department ("BD") to the Target's CFO or BD group, but other methods such as CEO to CEO or business unit to the BD group are common. It can be as simple as stating that the acquirer is interested in exploring ways that the two companies can cooperate or create value together.

1. The NDA

At this point, Non-Disclosure Agreements ("NDAs") may be exchanged and executed. I will hand out to students a sample NDA and discuss the key points in the document. Lawyers are very much involved at this point in the process. They will take the lead on negotiating the NDAs, as well as, on the buyer's side, starting preliminary due diligence on the potential target.

The initial meeting will typically be small and include between four and eight representatives combined. Topics will range from general business discussions, macroeconomic views, each other's business outlook, and effective ways that the two companies can increase shareholder value by working together. The important element, whether at this meeting or at a subsequent follow up call, is to explore whether the potential target is truly interested in being acquired.

2. The Deal Team

If a target is willing to explore selling, the teams from each party will expand. The acquiring company will form a Deal Team with an M&A expert from BD in the lead, a business unit operational person, the business unit controller, and the M&A lawyer assigned to the project. Lawyers will take an increasingly large role from this point until the transaction closes. Having a lawyer who understands the corporate strategy, the business unit strategy, the industry in general, and a working knowledge of the potential target helps the acquiring company tremendously. These types of lawyers are much better able to provide constructive counseling and advice to the Deal Team because they have a working understanding of how a company is seeking to achieve its overall strategy through this particular acquisition.

The Deal Team then prepares a Preliminary Information Request List and delivers it to the target. This is one-page document with two main requests: (1) a description of the business; and, (2) financial information. I have a sample that I hand out to the students and we review the key points. Under the first category, the acquirer seeks information related to products, customers, competitors, real estate footprint, capacity expansion plans, human resources, material litigation, and other material risks. Under the second category, the acquirer seeks the current business plan, the historical financial statements, and a list of planned financial projects for at least the next few years.

The purpose of this information request is to enable the acquiring company to confirm its view of strategic fit, begin building a financial model (including positive and negative synergies), and start its work on risk assessment. The acquiring company also starts to develop a preliminary valuation of the target and to build its internal business case for making an acquisition of the target.

As the acquirer is reviewing this initial information, it is common for the target to invite the acquirer for a site visit and management presentation. The team of people for both parties involved in the transaction grows larger to include operational personnel, human resources, information technology, additional lawyers around specific areas, and additional personnel from the accounting group.

The management meeting will typically include a three to four hour presentation and a facility visit to one of the target's operations. It can be an all day affair if the target wishes to provide fulsome information. Attendees will usually include the expanded team described above and external advisors hired by the acquirer and target. The materials presented in the management meeting will follow an outline similar to this: (1) Company Overview, (2) Investment Highlights, (3) Industry Overview, (4) Business Overview (products & end-markets, business segments, technology, sales & marketing and operations), (5) Growth Opportunities, (6) Financial Review, and (7) Conclusion. Upon completing review of this information, the acquirer should be in position to make a determination whether to go forward and, if so, to formulate a conditional valuation offer and transactional structure to the target.

When the preliminary valuation is complete and the acquirer has the necessary internal approvals, it launches price and structure negotiations with the target. This process can take many rounds and usually culminates with an in-person meeting between senior members of each company. At the conclusion of this process, a handshake understanding is reached and parties move to the Letter of Intent.

3. The Letter of Intent; Valuation

A Letter of Intent ("LOI") within the M&A context is mostly a non-binding agreement on certain key elements of a deal. The document can vary in length from a few pages to more than a dozen depending on the complexity of the deal and how many key terms the parties wish to negotiate prior to the definitive agreements. I distribute a sample LOI to the class and review key terms with them. There may be binding sections such as confidentiality and exclusivity provisions. The most important elements contained in the LOI are the purchase price and other deal terms, which typically are non-binding.

The primary technique for developing a valuation of a target is to use the Discounted Cash Flow ("DCF") method and to then use trading comparables and earnings multiples as a check. The DCF method derives a cash flow amount for each year of the model (usually a five-year or ten-year model), assigns a terminal value for the years beyond the initial model period, and then discounts those cash flows to present value by using an appropriate discount rate. This model will produce a discrete stand-alone valuation, the NPV based on the discounted yearly cash flows and the discounted terminal value. The NPV is then checked against comparable recent transaction prices and current public company trading multiples.

During my presentation, I show a sample DCF model and walk the class through the major elements. While I do not expect the students to become

valuation experts in the twenty minutes that I review it, it is very helpful for them to have an understanding of the primary method by which acquirers value targets. Valuation is so fundamental to a business person's view of acquisitions that I believe it critical that an M&A lawyer at least have some familiarity with how acquirers place a value on targets. This topic will come up for students in their first actual acquisition transaction.

There is tremendous "art" in the supposed science of DCF modeling given the numerous assumptions that must be made. There are assumptions around all aspects of the forecasted income statement, including annual revenues, material costs, indirect costs, overhead costs, the industry growth rates, future recessions, etc. Additionally, small changes in the chosen discount rate can significantly impact the NPV. Generally, the riskier a particular transaction, the higher the discount rate, and the lower the risk, the lower the discount rate. In today's current climate of very inexpensive debt, discount rates of nine- to twelve-percent are common.

Acquirers will develop at least two DCF valuations. The first is the standalone value model. This model views the target company on an independent, standalone basis. What is the value of the company if it were an independent business? The second valuation model is the synergistic valuation. This model examines the target company and derives a valuation as if the target company were a part of the acquirer. All of the synergies, both positive and negative, are included in the synergistic value. Examples of positive synergies include cost synergies such as lower material cost, reductions in head-count due to a combined business, manufacturing process efficiency improvements, and revenue synergies, such as a stronger distribution network that the acquirer can bring to the target's products. Examples of negative synergies include additional costs related to benefit plans, start-up and integration costs, and customer flight.

Lawyers are deeply involved, and frequently take the lead, in the negotiation and drafting of the LOI. As the most important element of the LOI, the valuation is a critical element that excellent transactional lawyers should understand. The best advisors are the ones who understand the value-drivers of a transaction and are able to appropriately structure and document a transaction around those value-drivers, in addition to the more typical risk mitigation provisions well-known to deal lawyers.

4. Due Diligence; Definitive Agreements; Closing; Post-Closing

After the signing of the LOI, both parties are in full-blown deal mode. The number of personnel involved in the transaction increases significantly as the acquirer launches extensive due diligence. This is a comprehensive investigation of the target. The acquirer is attempting to validate its DCF

model and is searching for all appropriate risk items and then developing a mitigation plan. Additionally, the acquirer has launched its post-closing integration team and uses due diligence to begin mapping out the integration plan and prioritizing areas of focus on Day 1 post-closing.

At the conclusion of due diligence,[16] the parties move to the negotiation and drafting of definitive agreements. Lawyers are very much in the lead at this point and the deal team is focused on obtaining all of the necessary internal approvals, supporting the legal team, and negotiating the final documents.

At this point in the presentation to students, I shift to a much more legally focused discussion. I distribute a sample stock purchase agreement and review key elements such as reps and warranties, indemnities, MAC clauses, and conditions to closing. I flag important areas of risk and negotiation that the students are likely to come across in their first year of practice. I also discuss the differences in deals where the target is a public company compared to private. I briefly cover auctions as well, which are inherently different than negotiated acquisitions where the acquirer approaches the target. Lastly, I touch on acquisitions by financial buyers and how they are different from transactions where there is a strategic buyer.

The aim of this portion of my presentation is not only to build on Professor Johnson's prior discussion of M&A and to set up the ensuing more lawyer-centered presentation to be given the following week by a deal lawyer, but also to supply what frequently is lacking in the legal education of business law students. In brief, such students—in M&A classes and all business law courses—must understand what their future clients' goals are in any particular setting. Only by doing so can a lawyer serve as the knowledgeable, trusted advisor that all companies desire.

CONCLUSION

Experiential learning is here to stay in legal education. Business law courses are ideally suited to this form of pedagogy, and professors in this field have designed a wide variety of offerings. For those who seek a business life-cycle approach to experiential learning, business planning courses give students an opportunity to work on different stages of a company's growth. M&A can be one component of such a holistic offering. We have described what we have discovered to be an effective approach in the M&A area, the key to which is a collaboration that draws on the business person's and the professor's respective strengths.

16. Some due diligence, of course, continues post-signing.

SYMPOSIUM ARTICLES: TRANSACTIONAL LAW PRACTICE

THE STATE OF LAWYER KNOWLEDGE UNDER THE MODEL RULES OF PROFESSIONAL CONDUCT

GEORGE M. COHEN*

INTRODUCTION

The state of lawyers' ethical "knowledge" is poor. By that, I mean that the Model Rules of Professional Conduct and the authorities interpreting it do a poor job of defining "knowledge"; of explaining or justifying the use of the knowledge standard in the rules; and of relating the knowledge

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requirement to, and reconciling it with, other ethical and legal requirements. As a result, many lawyers have less "knowledge" of their ethical and legal obligations than they ought to have. Moreover, lawyers who understand the knowledge problem, such as drafters of ethics codes, are apparently unwilling to do anything about it. The reason is that lawyers often view the knowledge standard as an important means of limiting lawyer responsibility. That view, however, is misleading.

The terms "knowingly," "known," and "knows" appear in almost every category of ethical rules: those dealing with the lawyer-client relationship,[1] the lawyer's role as advocate and duties to the court,[2] the lawyer's obligations to third parties,[3] the lawyer's responsibilities within law firms,[4] the lawyer's duties concerning public service,[5] and the lawyer's obligations to the profession.[6] The Terminology section of the Model Rules defines these terms to mean "actual knowledge of the fact in question," and then adds: "A person's knowledge may be inferred from circumstances."[7] There is no comment explaining this definition.

The problem starts with the meaning of this definition. Its two sentences are in some tension. If actual knowledge may be inferred from circumstances, a lawyer can violate an ethical rule requiring "knowledge" even if the lawyer does not "actually know." A common resolution is that the two sentences establish an objective rather than a subjective standard of proof for actual knowledge.[8] Thus, as a practical matter, the rules allow a disciplinary authority to prove actual knowledge by circumstantial evidence, rather than solely by a lawyer's admission of knowledge as part of the disciplinary proceeding, or by the testimony of some third party to whom the lawyer had earlier stated his or her intentions.[9] Moreover, an

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1. *See* MODEL RULES OF PROF'L CONDUCT RR. 1.2(d), 1.4(a)(5), 1.8(a), 1.9(b), 1.10(a), 1.11(b), 1.11(c), 1.12(c), 1.13(b), 1.18(c) (2013).

2. *See id.* RR. 3.3, 3.4(c), 3.8(a), (d), (g), (h).

3. *See id.* RR. 4.1, 4.2.

4. *See id.* RR. 5.1(c), 5.3(c).

5. *See id.* RR. 6.3, 6.4, 6.5(a).

6. *See id.* RR. 8.1, 8.3(b), (c), 8.4(a), (f).

7. *Id.* R. 1.0(f).

8. Another way to resolve the tension is to say that "all conclusions about someone else's state of mind must be derived from circumstantial evidence," even under a subjective standard. GEOFFREY C. HAZARD, JR., W. WILLIAM HODES, & PETER R. JARVIS, THE LAW OF LAWYERING §§ 1-23, 1-50 (3d ed. Supp. 2012). Under this interpretation, the "inferred from circumstances" sentence is a superfluous truism.

9. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 5 cmt. d (2000) (stating that "a finding of knowledge does not require that the lawyer confess or to otherwise admit the state of mind required for the offense"); Rebecca Roiphe, *The Ethics of Willful Ignorance*, 24 GEO. J. LEGAL ETHICS 187, 196 (2011) (arguing that "inferred from circumstances . . . prescribes an objective standard of proof but does not

objective standard of knowledge means that a lawyer cannot disprove knowledge simply by sincerely contending that the lawyer did not believe[10] that some fact was true or that some legal rule existed or would be interpreted in a certain way. This explanation does not completely eliminate the tension. The question remains: what circumstantial evidence is sufficient to find actual knowledge? Put another way, what does the actual knowledge standard intend to exclude?

The most accepted answer is that the actual knowledge standard aims to exclude a duty to inquire. In particular, the Terminology section defines "reasonably should know," which appears in a number of ethics rules,[11] as denoting "that a lawyer of reasonable prudence and competence would ascertain the matter in question."[12] The distinction between an actual knowledge standard, which includes no duty of inquiry, and a reasonably should know standard, which includes such a duty, raises a number of questions. First, does the knowledge standard include recklessness or willful blindness, which lies between "know" and "reasonably should know?" Second, how does the knowledge standard apply if a lawyer otherwise has a legal or ethical duty to inquire and fails to satisfy it? Third, how does the knowledge requirement interact with rules of imputation?[13]

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change the substantive rule").

10. "Belief" under the Model Rules means "that the person involved actually supposed the fact in question to be true." MODEL RULES OF PROF'L CONDUCT R. 1.0(a). Belief may also "be inferred from circumstances."

11. *See id.* RR. 1.13(f), 2.3(b), 2.4(b), 3.6(a), 4.3, 4.4(b). Interestingly, the phrase also appears in several comments not accompanying or interpreting a rule in which the phrase appears. *See id.* R. 1.0 cmt. 10 (stating that "screening measures must be implemented as soon as practical after a lawyer or law firm knows or reasonably should know that there is a need for screening"); *id.* R. 1.2 cmt. 13 (stating that "[i]f a lawyer comes to know or reasonably should know that a client expects assistance not permitted by the Rules of Professional Conduct or other law . . . , the lawyer must consult with the client regarding the limitations on the lawyer's conduct," and citing Rule 1.4(a)(5)). The "reasonably should know" standard in comment 13 to Rule 1.2 is inconsistent with the rule to which it refers, Rule 1.4(a)(5), which requires a lawyer to "consult with the client about any relevant limitation on the lawyer's conduct" only when the lawyer "*knows* that the client expects" unlawful or unethical assistance. A rule's text trumps any inconsistent comment, *id.* scope 21, but the comment's existence creates uncertainty.

12. MODEL RULES OF PROF'L CONDUCT R. 1.0(j). One might also distinguish "know" from "reasonably believes," R. 1.0(i), but "reasonable belief" is generally used to discourage lawyers from actions they might otherwise be inclined to take based on their subjective belief, *see id.* RR. 1.6(b), 1.7(b)(1), 1.13(c), 1.14(b), 1.16(b)(2), 2.3(a), 3.4(e), 3.4(f)(2), 3.6(c), 3.8(e), 8.5(b)(2), whereas "reasonably should know" is generally used to encourage lawyers to investigate when they might otherwise be inclined not to do so.

13. This Article will not consider a fourth key question about knowledge: in situations of factual or legal uncertainty, what quantum of knowledge is necessary to

I will argue in this Article that the Model Rules should be revised to answer these three related questions and thereby provide clearer guidance to lawyers. First, the Model Rules should expressly incorporate recklessness into the definition of "knowledge" or at least should expressly incorporate this standard whenever a duty to inquire or a duty to communicate otherwise exists under the rules or other law. Second, one way to show recklessness or willful blindness is through a deliberate breach of an otherwise existing duty to inquire. The knowledge requirement should not be interpreted to negate or limit duties of inquiry that otherwise exist.[14] Third, like inquiry, communication is an important means by which lawyers acquire knowledge, and just as lawyers in many situations have duties to inquire, they also often have duties to communicate. The duty to communicate is the basis for rules of imputation. Thus, just as the knowledge standard should not be used to negate otherwise existing duties to investigate, neither should it be used to negate otherwise existing duties to communicate, and thereby defeat imputation.

I. RECKLESSNESS OR WILLFUL BLINDNESS

Recklessness is a common scienter standard in the law of intentional torts, as well as criminal law, especially in the law of fraud.[15] Transactional lawyers in particular are familiar with the recklessness standard because it plays an important role in securities fraud and other business crimes and torts. Although authorities define recklessness in various ways, a commonly cited definition is Judge Friendly's in *United States v. Benjamin*,[16] an important securities fraud precedent. *Benjamin*

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satisfy the knowledge standard? This aspect of knowledge is particularly important for addressing issues such as client perjury.

14. Around the time the Model Rules were drafted, one group proposed the following definition of "knowledge":

> A lawyer knows certain facts, or acts knowingly or with knowledge of facts, when a person with that lawyer's professional training and experience would be reasonably certain of those facts in view of all the circumstances of which the lawyer is aware. A duty to investigate or inquire is not implied by the use of these words, but may be explicitly required under particular rules. Even in the absence of a duty to investigate, however, a studied rejection of reasonable inferences is inadequate to avoid ethical responsibility.

THE ROSCOE POUND-AMERICAN TRIAL LAWYERS FOUNDATION, THE AMERICAN LAWYER'S CODE OF CONDUCT 12 (1982).

15. *See generally* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 98 cmt. c (2000) ("For purposes of common-law damage recovery, reckless as well as knowing misrepresentation by a lawyer may be actionable.").

16. United States v. Benjamin, 328 F.2d 854, 862 (2d Cir. 1964).

holds that a lawyer has the requisite intent for securities fraud if the lawyer "deliberately closed his eyes to facts he had a duty to see . . . or recklessly stated as facts things of which he was ignorant."[17] Moreover, a corporate lawyer's "special situation and continuity of conduct" may create an inference that the lawyer "*did* know the untruth of what he said or wrote."[18]

Whether recklessness satisfies the knowledge standard under the Model Rules is unsettled.[19] Model Rule 1.0 and its comments do not say. Under a textualist or structuralist approach, the answer is straightforward. Recklessness makes an appearance in just one rule, Model Rule 8.2(a).[20] Thus, the fact that the drafters use "recklessness" in this rule while using the actual knowledge standard elsewhere (and even in Model Rule 8.2(a) itself) suggests that "actual knowledge" does not incorporate the recklessness standard.[21]

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17. *Id.*

18. *Id.* at 861–62 (quoting Bentel v. United States, 13 F.2d 327, 329 (2d. Cir. 1926)) (emphasis in original).

19. *Compare* Roiphe, *supra* note 9, at 190, 196 (arguing that "[d]eliberately turning a blind eye to relevant facts . . . would not meet" the knowledge requirement under the ethics rules and advocating for a change in the definition of knowledge, but acknowledging a "less persuasive interpretation" that "willful ignorance" could be viewed as incorporated in the definition of "knowledge"), *and* Carl A. Pierce, *Client Misconduct in the 21st Century*, 35 U. MEM. L. REV. 731, 801 (2005) (arguing that "it appears as if the Kutak Commission [which drafted the original version of the Model Rules] did not want lawyers to be subject to discipline for making statements of fact or law with reckless disregard for the truth or falsity of the statement except as specifically provided in the rules" but then advocating for a recklessness standard), *with* Nancy J. Moore, *Mens Rea Standards in Lawyer Disciplinary Codes*, 23 GEO. J. LEGAL ETHICS 11, 24 (2010) (arguing that the "willful blindness" doctrine "is available in disciplinary actions"), *and* Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 756 n.137 (2004) (arguing that the Model Rules "appear to adopt the 'willful blindness' standard" based on the comments to Rules 1.13 and 4.2), *and* HAZARD, JR., HODES, & JARVIS, *supra* note 8, §§ 1-23, 1-50, 1-51 (stating that disciplinary authorities will "infer" actual knowledge from "circumstances" when they conclude that a lawyer "*must* have known" and stating that "it will sometimes be impossible to believe that a lawyer lacked the requisite knowledge, unless he deliberately tried to evade it," but in that case the lawyer "already knows too much") (citing *Benjamin*, 328 F.2d at 854), *and* CHARLES W. WOLFRAM, MODERN LEGAL ETHICS 696 (1987) (stating that a lawyer "may not avoid the bright light of a clear fact by averting [his or her] eyes or turning [his or her] back").

20. MODEL RULES OF PROF'L CONDUCT R. 8.2(a) (2013) (stating that a lawyer "shall not make a statement that the lawyer knows to be false or with reckless disregard as to its truth or falsity concerning the qualifications or integrity of a judge, adjudicatory or public legal officer, or of a candidate for election or appointment to judicial or legal office").

21. Of course, the justification for giving more priority to deterring a lawyer from lying about the qualifications or integrity of judges, *see id.* R. 8.2(a), than to, say, deterring a lawyer from assisting a client in committing fraud against ordinary people, *see, e.g.*, *id.* R. 1.2(d) (using an actual knowledge standard) is not immediately obvious.

On the other hand, the comments to several Model Rules seem to support a version of the recklessness standard. For example, the comment to Model Rule 3.3, Candor Toward the Tribunal, states that "although a lawyer should resolve doubts about the veracity of testimony or other evidence in favor of the client, the lawyer cannot ignore an obvious falsehood."[22] Reliance on these comments raises several difficulties, however.

First, the comments are not authoritative,[23] and not all states adopt them. Second, the comments do not clearly endorse the *Benjamin* standard of recklessness or willful blindness. Ignoring an "obvious falsehood" is arguably not quite the same as closing one's eyes to "*facts* [one] ha[s] a duty to see."[24] The "obvious falsehood" standard in the comment to Model Rule 3.3. may simply mean that a lawyer may not ignore information that appears to be false on its face, as opposed to meaning that a lawyer may not ignore suspicious and readily available facts that might reveal or lead to discovery of falsity if examined.[25] Third, not every Model Rule including a knowledge standard has an accompanying comment admonishing lawyers not to ignore the obvious. This difference might suggest that the drafters intended their version of the recklessness standard to apply only to those knowledge-based rules with a specific comment endorsing that standard.[26]

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22. *See* MODEL RULES OF PROF'L CONDUCT R. 3.3 cmt. 8. The Model Rules include similar comments accompanying two other rules. *See id.* R. 1.13 cmt. 3 (stating that "knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious."); *id.* R. 4.2 cmt. 8 (stating that a lawyer "cannot evade the requirement of obtaining the consent of counsel by closing eyes to the obvious"). It is not clear what to make of the fact that the comments have slightly different wording. In particular, the comments to Rule 1.13 and 4.2 simply refer to ignoring or closing eyes to the "obvious," whereas the comment to Rule 3.3 adds the qualifier "falsehood." Notably, the ABA adopted the three comments at different times: the comment to Rule 4.2 in 1995 (following the publication of ABA Op. 95-396, which used similar language), the comment to Rule 3.3 in 2002, and the comment to Rule 1.13 in 2003 (following the recommendations of the ABA Task Force on Corporate Responsibility). *See generally* A.B.A., A LEGISLATIVE HISTORY: THE DEVELOPMENT OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT, 1982–2005 (2006).

23. MODEL RULES OF PROF'L CONDUCT scope 21 ("The Comments are intended as guides to interpretation, but the text of each Rule is authoritative."). Somewhat ironically, that statement itself is a comment (though not one accompanying a rule), and so arguably is itself not authoritative.

24. *Benjamin*, 328 F.2d at 862.

25. *See* William Wernz, An Attorney's Ethics Duty to Ascertain and Other State of Mind Issues – Thoughts and Cases (draft on file with author) (emphasis added) (arguing that the comments "do not impose a duty to 'ascertain' even that which could be known with small effort").

26. The "lawyer cannot ignore the obvious" comment to Model Rule 3.3 does not even clearly apply to all parts of the rule; the comment is directed only to the Rule 3.3(a)(3), which prohibits a lawyer from "offer[ing] evidence the lawyer knows to be false," or rectifying the previous submission of evidence when the lawyer "comes to

Otherwise, one would have expected the drafters to add a recklessness comment to the definition of knowledge in Model Rule 1.0. But there is none. In particular, if the recklessness standard applies only to those rules for which there is a comment referencing that standard, the primary ethics rules dealing with transactional fraud, Model Rules 1.2(d) and 4.1, would not incorporate the recklessness standard.[27] That interpretation would raise important issues of inconsistency among ethical obligations. For example, fraud on the court would be governed by the recklessness standard (Model Rule 3.3), but not fraud in transactions, unless Model Rule 1.13 (which includes a recklessness comment) applied. That interpretation also would mean that the recklessness standard is conspicuously absent from the ethics rules dealing with an area of law—transactional fraud—in which recklessness is the generally accepted standard.

Drawing on the general legal standard, reported cases in several jurisdictions have held that "a reckless state of mind, constituting scienter, [is] equivalent to 'knowing' for disciplinary purposes."[28] Similarly, other

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know of its falsity." *See* MODEL RULES OF PROF'L CONDUCT R. 3.3 cmt. 8. Does that mean that the comment is inapplicable to Rules 3.3(a)(1) (prohibiting a lawyer from "knowingly" making a false statement of fact or law to a tribunal), 3.3(a)(2) (prohibiting a lawyer from "knowingly" failing to disclose legal authority "known" to be adverse), 3.3(b) (requiring a lawyer who "knows" that a person commits fraud on a tribunal to take remedial action), and 3.3(d) (requiring a lawyer in an ex parte proceeding to reveal material facts "known" to the lawyer)? The comment to the parallel provision in the Restatement, § 120, endorses the willful blindness standard. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 120 cmt. c (2000) (stating that under the actual knowledge requirement of the rule "a lawyer may not ignore what is plainly apparent, for example, by refusing to read a document").

27. Rule 1.2(d) says that a "lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent." MODEL RULES OF PROF'L CONDUNCT R. 1.2(d). Rule 4.1 says that a lawyer representing a client "shall not knowingly: (a) make a false statement of fact or law to a third person; or (b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6." *Id.* R. 1.6 A Reporter's Note and comment to the parallel provisions in the Restatement endorse the recklessness standard. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 94 & reporter's note to cmt. g (stating the Reporter's view that "the preferable rule is that proof of a lawyer's conscious disregard of facts is relevant evidence, which, together with other evidence bearing on the question, may warrant a finding of actual knowledge"); *id.* § 98 & cmt. c ("For purposes of professional discipline, the lawyer codes generally incorporate the definition of misrepresentation employed in the civil law of tort damage liability for knowing misrepresentation, including the element[] of . . . scienter . . . ."); *see also* ILL. RULES OF PROF'L CONDUCT R. 4.1(a) (2010) (adopting "reasonably should know" standard); KY. RULES OF PROF'L CONDUCT R. 4.1(b) (1989) (omitting knowledge requirement); Nebraska *ex. Rel.* Neb. State Bar Ass'n v. Holscher, 230 N.W.2d 75, 84 (Neb. 1975) (finding predecessor to Rule 4.1 violated by conduct that is "careless and recklessly negligent").

28. People v. Small, 962 P.2d 258, 260 (Colo. 1998) (citing cases from several jurisdictions where courts equated a reckless state of mind with 'knowing' in a

jurisdictions have interpreted actual knowledge to incorporate "willful blindness," in some cases distinguishing that standard from recklessness (and thereby avoiding the textualist conflict with Model Rule 8.2).[29]

The uncertain status of Model Rule 8.4(c) adds to the confusion. Model Rule 8.4(c), which has no express knowledge requirement, makes it unethical for a lawyer to "engage in conduct . . . involving fraud,"[30] and Model Rule 1.0(d) specifically incorporates the substantive and procedural law of fraud into the term "fraud" under the Model Rules.[31] Because the law of fraud generally uses a recklessness standard of intent, Model Rule 8.4(c) may thus incorporate recklessness via other law. A number of jurisdictions have taken this approach and applied the recklessness standard

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disciplinary context). *Small* recognizes an exception to the recklessness standard for the misappropriation of client funds on the ground that the usual discipline for violating that rule is disbarment and so a stricter standard of knowledge is appropriate. *Id.* For other cases adopting a recklessness standard in disciplinary matters, see Office of Disciplinary Counsel v. Wrona, 908 A.2d 1281, 1288 (Pa. 2006) (approving recommendation of disciplinary board applying recklessness standard to find violations of several rules, including Model Rule 3.3(a)(1), which includes a "knowing" requirement) and Fla. Bar v. Calvo, 630 So.2d 548, 550 n.3 (Fla. 1993) (disbarring lawyer for knowingly assisting in a client's securities fraud and finding that his "acts or omissions at a minimum constituted reckless misconduct").

29. *See In re* Goldstone, 839 N.E.2d 825, 830 (Mass. 2005) (finding that even if lawyer "did not have actual knowledge that the billings he sent [to the client] were false and that he was not entitled to the fees and costs claimed, he consciously avoided obtaining readily available information that would have put him on actual notice, and thus his actions constituted wilful blindness and intentional misconduct"); *In re* Skevin, 517 A.2d 852, 857 (N.J. 1986) (upholding discipline of a lawyer for misappropriation of client funds under knowledge standard, and holding that knowledge can be established by demonstrating "willful blindness," defined as a "situation where the party is aware of the highly probable existence of a material fact but does not satisfy himself that it does not in fact exist"); Ga. Formal Advisory Op. 05-10 (2006) (applying "willful blindness" standard to Model Rule 5.1(c)); *cf. In re* Wines, 370 S.W.2d 328, 334 (Mo. 1963) (stating that even though the lawyer had "no specific intent to deceive . . ., there was nevertheless an independent representation [of facts] by [the lawyer] . . . when he knew no such facts and had made no effort whatever to investigate," and concluding that even if the lawyer was not 'knowingly a party to an attempted fraud,' . . . his acts in so carelessly dealing with the truth did not constitute that 'candor and fairness' required of lawyers, and that such conduct was also contrary to 'honesty' in its true sense").

30. MODEL RULES OF PROF'L CONDUCT R. 8.4(c) (stating that it is professional misconduct for a lawyer to "engage in conduct involving dishonesty, fraud, deceit or misrepresentation").

31. *Id.* R. 1.0(d) (defining "fraud" or "fraudulent" to mean "conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive"). An accompanying comment clarifies that the "purpose to deceive" language is meant to exclude negligent misrepresentation or negligent failure to apprise a person of relevant information, but makes no mention of recklessness. *Id.* R. 1.0 cmt. 5. Note that the reference to "procedural law" means that Model Rule 8.4(c) governs fraud on the court as well as transactional fraud.

to Model Rule 8.4(c).[32] Does that indirect incorporation of recklessness unreasonably conflict with the expressly stated actual knowledge standard in Model Rules 1.2(d) and 4.1?[33]

One might try to resolve the Model Rule 8.4(c) problem by suggesting that Model Rule 8.4(c) is limited in application to situations in which a lawyer is not representing a client.[34] Nothing, however, in the text or comments of the rule so limits it, and a number of authorities apply it more broadly.[35] Moreover, if Model Rule 8.4(c) is limited only to lawyer conduct apart from the representation of clients and the recklessness standard is not included as part of the actual knowledge standard contained in other rules, that creates an embarrassing possibility: the Model Rules, by adopting a stricter standard of knowledge, endorse a more lenient standard for fraud than do tort and criminal law. Model Rule 8.4(b) addresses this problem with respect to criminal law by making it unethical for a lawyer to "commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects." On the other hand, at least in theory, a lawyer could face liability in tort for fraud under a

32. *See* Romero-Barcelo v. Acevedo-Vila, 275 F. Supp. 2d 177, 206 (D.P.R. 2003) (holding that a violation of Rule 8.4(c) can be found if a lawyer makes a statement "with reckless ignorance of the truth or falsity thereof"); Office of Disciplinary Counsel v. Anonymous, 714 A.2d 402, 407 (Pa. 1998) (applying a standard of "reckless disregard to the truth or falsity" of a statement to discipline of a lawyer for knowingly making a false statement); Comm. on Prof'l Ethics & Conduct of the Iowa State Bar Ass'n v. Ramey, 512 N.W.2d 569, 569 (Iowa 1994) (applying to predecessor to Rule 8.4(c) a "reckless disregard of the true facts" standard to suspend lawyer for knowingly making a false statement); Att'y Grievance Comm'n v. Sliffman, 625 A.2d 314, 321 (Md. 1993) (applying predecessor to Rule 8.4(c) and upholding a finding that lawyer "must have known" of client fraud even though there was not "clear and convincing evidence" that he actually knew); *In re* Dobson, 427 S.E.2d 166, 168 (S.C. 1993) (finding that lawyer violated predecessor to Rule 8.4(c) by "deliberately evad[ing] knowledge of facts which tended to implicate him in a fraudulent scheme"); People v. Rader, 822 P.2d 950, 953 (Colo. 1992) (holding that lawyer violated predecessor to Rule 8.4(c) by engaging in conduct "so careless or reckless that it must be deemed to be knowing").

33. In one case in which federal prosecutors were disqualified because of violations of Rule 4.1(a), the Government unsuccessfully raised the discrepancy between the "knowledge" standard of Rule 4.1(a) and the absence of a knowledge standard in Rule 8.4(c) to argue that precedent finding recklessness sufficient scienter under Rule 8.4(c) could not apply to Rule 4.1(a). United States v. Whittaker, 201 F.R.D. 363, 366–67 (E.D. Pa. 2001). The court rejected that argument and instead applied the recklessness standard to both rules. *Id.*

34. *See* MODEL RULES OF PROF'L CONDUCT R. 4.1 cmt. 1 ("For dishonest conduct that does not amount to a false statement or for misrepresentations by a lawyer other than in the course of representation a client, see Rule 8.4.").

35. *See, e.g.*, N.Y. State Bar Ass'n Comm. on Prof'l Ethics, Op. 956 (2013); *see also* MODEL RULES OF PROF'L CONDUCT pmbl. 3 (referencing Model Rule 8.4 as an example of a rule that applies "*even when* [lawyers] are acting in a nonprofessional capacity").

recklessness standard, while escaping discipline under the actual knowledge standard, unless Model Rule 8.4(c) applied.[36]

Perhaps the response to all of this confusion is that it is much ado about nothing.[37] The combination of the "inferred from circumstances" language of Model Rule 1.0(f), the comments endorsing a willful blindness standard, Model Rule 8.4(c), and case interpretations of both the ethics rules and other law are arguably enough to make recklessness for all intents and purposes the true standard of knowledge under the Model Rules. If that is the case, however, why not clear up all ambiguity and just write recklessness or willful blindness into Model Rule 1.0, or at least its comment? The answer, in part, is that the knowledge standard is the key marker in a contentious struggle over the scope of a lawyer's duty to investigate.[38]

II. KNOWLEDGE AND THE DUTY TO INVESTIGATE

Recklessness is merely a doctrinal label. The more pragmatic question is what must a lawyer do to avoid risking discipline or other consequences when confronted with Model Rules whose duties are triggered by a

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36. The Restatement makes this disparity clear in § 94, which contains two different provisions addressing aiding and abetting by a lawyer, § 94(1) dealing with liability and § 94(2) dealing with professional discipline. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 94(1), (2) (2000). In comment a to that section, the drafters call specific attention to the fact that other law "may define scienter . . . differently from" the disciplinary rules. *Id.* cmt. a.

37. *See* Moore, *supra* note 19, at 23–24 (suggesting that once sufficient circumstantial evidence is developed, proving that a lawyer "must have known" will generally not be difficult and will be sufficient to satisfy the actual knowledge standard); *see also* Roiphe, *supra* note 9, at 212 (noting that some might argue that given Model Rule 8.4(b), "it does not really matter whether the knowledge requirement explicitly forbids [criminal] conduct" but rejecting that argument because of the "symbolic function" that the Model Rules serve).

38. Professor Roiphe sees the struggle as reflecting different conceptions of the lawyer's role. She argues:

> The bar's persistent refusal to adopt a willful ignorance standard, except when reacting to threats of more extensive external regulation, confirms that at least in this instance, the bar is acting to ward off greater regulation by making a nod toward its public function without in fact altering the zealous nature of its constituents' practice. . . . The actual knowledge standard serves to mask a fundamental disagreement. It papers over the real issues by allowing the profession to articulate and publicly espouse a devotion to communal ends while in reality encouraging lawyers to pursue the interests of their clients without regard to the consequences.

Roiphe, *supra* note 9, at 221–22; *see also* Susan Koniak, *The Law Between the Bar and the State*, 70 N.C. L. REV. 1389, 1422–23 (1992) (describing the bar's use of ethics rules to "trump other law (or qualify it or render it ambiguous)").

lawyer's "knowledge?" The lawyer might reason as follows. Model Rule 1.0(f)'s "actual knowledge" standard rejects a duty to investigate; in fact, the absence of such a duty is what distinguishes "know" from "reasonably should know" in the Model Rules. Thus, a lawyer faced with a suspicious fact that is not sufficient along with other circumstances to impart actual knowledge need not do anything further. In fact, investigating would be a bad idea because that would put the lawyer at risk of violating the knowledge-based rule.

Statements that the knowledge requirement implies the absence of a duty to investigate are common. For example, when interpreting the knowledge requirement of Rule 3.3, one court rejected a duty of inquiry even if a lawyer has clear information indicating crime or fraud by the client, stating that "the ethical rules, as written, [do not] require a lawyer to take affirmative steps to discover client fraud or future crimes," and adding that "imposing a duty to investigate the client would be incompatible with the fiduciary nature of the attorney-client relationship."[39] Similarly, several Restatement comments state that knowledge does not "assume" or "require" a duty of inquiry, even when a "reasonable" or "prudent" lawyer might have discovered certain facts.[40]

Stated that way, the proposition is too broad. A more defensible formulation is: the inclusion of a knowledge requirement in an ethics rule expresses an intention not to create a duty of inquiry *where one does not otherwise exist*. For example, Model Rule 8.3, which requires a lawyer to report the misconduct of another lawyer when the first lawyer knows of it, operates against a background in which the first lawyer has no general obligation to inquire about the behavior of other lawyers or even to follow up suspicions, unless it somehow benefits the lawyer's client.[41] By contast, Model Rules that include a "reasonably should know" standard implicitly

39. United States v. Del Carpio-Cotrina, 733 F. Supp. 95, 99–100 n.9 (S.D. Fla. 1990). Despite the quoted statement, the court found that the lawyer actually knew that his client had jumped bail and therefore had an obligation to report this fact to the court.

40. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 51 cmt. h, illus. 6 (stating that "knowledge" for purposes of that section "neither assumes nor requires a duty of inquiry"); *id.* § 94 cmt. g (stating that for purposes of § 94(2), the actual knowledge standard does not require a lawyer "to make a particular kind of investigation in order to ascertain more certainly what the facts are, although it will often be prudent for the lawyer to do so"); *id.* § 120 cmt. c ("Actual knowledge does not include unknown information, even if a reasonable lawyer would have discovered it through inquiry.").

41. *See* MODEL RULES OF PROF'L CONDUCT R. 8.3(a) cmt. 2 (2013); *see also* Ill. State Bar Ass'n on Prof'l Conduct, Advisory Op. 90-28 (1991) (stating that a lawyer who receives hearsay information about another lawyer's ethics violation has no duty to investigate further, because "Rule 8.3 does not cast the members of the legal profession in the role of investigators").

create a duty to investigate that does not otherwise exist, usually to protect some third party interest.[42]

Most duties to investigate, however, are created by substantive rules, not by the scienter standard. In many situations, the Model Rules or other regulations impose duties on a lawyer to investigate.[43] Duties of inquiry are of particular importance for business lawyers engaged in transactional practice, though similar duties exist for lawyers involved in civil litigation as well as criminal prosecutors and defense lawyers[44]. The remainder of this Section discusses a number of examples, focusing on duties imposed on business lawyers.

A. Duties to Investigate in the Model Rules

Consider first duties of inquiry in the Model rules. The very first Model Rule, stating the lawyer's fundamental duty of competence "requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation"[45] of a client, which in turn requires "inquiry into and analysis of the legal and factual elements of the problem."[46] In a recent opinion on Client Due Diligence, Money Laundering, and Terrorist Financing, the ABA reaffirmed that a lawyer's duty of competence includes an obligation to investigate:

> It would be prudent for lawyers to undertake Client Due Diligence ("CDD") in appropriate circumstances to avoid facilitating illegal activity or being drawn unwittingly into a criminal activity. This admonition is consistent with Informal Opinion 1470 (1981), where we stated that "[a] lawyer cannot escape responsibility by avoiding inquiry. A lawyer must be satisfied, on the facts before him and readily available to him, that he can perform the requested services without abetting fraudulent or criminal conduct and without relying on past client crime or fraud to achieve results the client now wants." Further in that opinion we stated that, pursuant to a lawyer's ethical obligation to act competently, a duty to inquire further may also arise.

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42. *See supra* note 11 (listing ethics rules using the "reasonably should know" standard).

43. *See, e.g.*, Roiphe, *supra* note 9, at 199–202. *But cf.* HAZARD, JR., HODES, & JARVIS, *supra* note 8, §§ 1-23, 1-52 (arguing that for many of the duties of investigation imposed on lawyers, "the inquiry is in the nature of a 'probable cause hearing' rather than an endeavor to establish personal knowledge on the lawyer's part").

44. For criminal defense lawyers, a separate set of rules promulgated by the ABA impose a much more detailed duty to investigate than that found in Model Rule 1.1. A.B.A, ABA STANDARDS FOR CRIMINAL JUSTICE: PROSECUTION FUNCTION AND DEFENSE FUNCTION 119–20 (3d ed. 1993).

45. MODEL RULES OF PROF'L CONDUCT R. 1.1.

46. *Id.* R. 1.1 cmt. 5.

> An appropriate assessment of the client and the client's objectives, and the means for obtaining those objectives, are essential prerequisites for accepting a new matter or continuing a representation as new facts unfold. Rule 1.2(d) prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud. A lawyer also is subject to federal laws prohibiting conduct that aids, abets, or commits a violation of U.S. . . . laws . . . .
>
> The level of appropriate CDD varies depending on the risk profile of the client, the country or geographic area of origin, or the legal services involved.[47]

Although the opinion does not discuss when a breach of the duty of inquiry might support a finding of "knowledge," the reference to Model Rule 1.2(d) and other law suggests some connection.

Other ethical duties that a lawyer owes to a client may also imply a duty to investigate in certain circumstances. These duties include the duty to communicate with the client,[48] to seek a client's informed consent,[49] to avoid conflicts of interest,[50] to "exercise independent judgment and render candid advice,"[51] or to determine a non-frivolous basis in fact and law for bringing or defending against a civil claim.[52] Other Model Rules and comments recognize that lawyers may voluntarily undertake duties of investigation.[53]

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47. ABA Comm. on Prof'l Ethics & Grievances, Formal Op. 13-463 (2013) (footnotes omitted).

48. *See* MODEL RULES OF PROF'L CONDUCT R. 1.4(b) ("A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.").

49. *See id.* R. 1.0(e) (defining "informed consent" as "the agreement by a person to a proposed course of action after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct"); *id.* R. 1.0(e) cmt. 6 ("The lawyer must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision.").

50. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 3 ("To determine whether a conflict of interest exists, a lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the persons and issues involved. . . . Ignorance caused by a failure to institute such procedures will not excuse a lawyer's violation of this rule.").

51. *Id.* R. 2.1.

52. *See id.* R. 3.1 & cmt. 2 ("What is required of lawyers . . . is that they inform themselves about the facts of their clients' cases and the applicable law and determine that they can make good faith arguments in support of their clients' positions.").

53. *See id.* R. 1.11(e)(1) (including "investigation" as "matter" in which government lawyer might be involved); *id.* R. 1.13(d) & cmts. 2, 7 (recognizing lawyer

It is true that any duty to investigate that the lawyer owes to the client under the Model Rules is not boundless. The duty to investigate is subject to a reasonableness requirement.[54] Thus, a lawyer must calculate whether the likely value of the investigation exceeds the costs.[55] The scope of the duty to investigate can also be limited by the nature and duration[56] of the representation, as well as by specific agreements between the client and the lawyer concerning the scope of the representation[57] or the type of advice sought.[58] Of course, these limits themselves have limits. A lawyer and client cannot define the lawyer's responsibilities so narrowly as to abrogate the lawyer's duty of competence.[59]

B. Duties to Investigate in Other Law

In addition to the Model Rules, other law may impose on lawyers a duty to investigate. Most notably, malpractice law[60] and agency law[61] mirror

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for an organization asked to investigate wrongdoing); *id.* R. 3.6 (imposing limits on public speech for a lawyer who is participating or has participated in the "investigation" of a matter; *id.* R. 4.2 cmt. 5 (discussing investigative activities of government lawyers).

54. Model Rule 1.0(h) defines "reasonable" as "the conduct of a prudent and competent lawyer." MODEL RULES OF PROF'L CONDUCT R. 1.0(h).

55. *Id.* R. 1.1 cmt. 5 (stating that the "required attention and preparation are determined in part by what is at stake").

56. *See, e.g.*, Mich. Ethics Op. RI-13 (1989) (opining that a lawyer has no duty to investigate the truth of a client's testimony once the lawyer is discharged for purposes of complying with Rule 3.3).

57. MODEL RULES OF PROF'L CONDUCT R. 1.2(c) ("A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.").

58. *Id.* R. 2.1 cmt. 5 ("A lawyer ordinarily has no duty to initiate investigation of a client's affairs or to give advice that the client has indicated is unwarranted, but a lawyer may initiate advice to a client when doing so appears to be in the client's interest.").

59. *See id.* R. 1.2(c) (noting that the limit on the representation must be "reasonable"); *id.* R. 1.2(c) cmt. 7 ("Although an agreement for a limited representation does not exempt a lawyer from the duty to provide competent representation, the limitation is a factor to be considered when determining the legal knowledge, skill, thoroughness and preparation necessary for the representation.").

60. *See, e.g.*, RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 52 cmt. c (2000) (stating that a "lawyer must perform tasks reasonably appropriate to the representation, including, where appropriate, inquiry into facts"); *see also* Tush v. Pharr, 68 P.3d 1239 (Alaska 2003) (stating that investigation into facts other lawyers would customarily investigate is a professional duty).

61. *See* RESTATEMENT (THIRD) OF AGENCY § 8.11(1) (2006) (imposing on an agent "a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know or should know when . . . the agent knows or has reason to know that the principal would wish to have the facts or the facts are material to the agent's duties to the principal"); *id.* § 8.11(1) cmt. d ("An agent's duty of care may require the agent to obtain information that is material to the principal's interests. If an agent's

the duty of inquiry noted in the comment to Model Rule 1.1.[62] Rule 11 of the Federal Rules of Civil Procedure includes a duty of inquiry parallel to that stated in the comment to Model Rule 3.1.[63] Lawyers engaged in writing tax opinions[64] and other opinions[65] often have duties to investigate the underlying facts.

Legal duties of inquiry imposed are perhaps most developed for securities lawyers. A well-known case discussing the duty of inquiry is *FDIC v. O'Melveny & Myers*, which held that securities lawyers retained to draft an offering document owe a duty "to protect the client from the liability which may flow from promulgating a false or misleading offering to investors" by conducting a "reasonable, independent investigation to detect and correct false or misleading materials."[66] An older case

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inquiry or investigation has been limited in some respect, the agent has a duty so to inform the principal."). Of particular relevance to lawyers is the agent's duty to provide information to the principal, including "information [that] may prove beneficial to third parties because it may enable the principal to take action to avoid harm that otherwise would be inflicted on third parties." *Id.* §. 8.11(1) cmt. b.

62. MODEL RULES OF PROF'L CONDUCT R. 1.1 cmt. 5.

63. *Compare* FED. R. CIV. P. 11(b) (2010) (requiring a lawyer who files a pleading in a civil case to certify to certain representations "to the best of the [lawyer's] knowledge, information, and belief, formed after an inquiry reasonable under the circumstances"), *with* MODEL RULES OF PROF'L CONDUCT R. 3.1 cmt. 2 (requiring lawyers to "inform themselves about the facts of their clients' cases and the applicable law and determine that they can make good faith arguments in support of their clients' positions").

64. 31 C.F.R. § 10.35(c)(1)(i) (2012) (Circular 230) (requiring tax practitioners who issue "covered opinions" to "use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant.); *see also* ABA Formal Op. 346 (1982) ("The lawyer who accepts as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue, also gives a false opinion.").

65. *See, e.g.*, Excalibur Oil Inc. v. Sullivan, 616 F. Supp. 458, 463 (N.D. Ill. 1985) ("Necessarily implicit in [a contract by a lawyer to prepare a title opinion] is the lawyer's duty to investigate the title with reasonable diligence and to report his findings accurately."); *cf.* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 95(3) cmt. c (stating that a lawyer giving an opinion does not usually have a duty of investigation unless the opinion "is stated to be predicated upon a factual investigation by the lawyer").

66. FDIC v. O'Melveny & Myers, 969 F.2d 744, 749 (9th Cir. 1992), *rev'd on other grounds*, 512 U.S. 79 (1994). More recently, in Facciola v. Greenberg Traurig, LLC, No. CV-10-1025-PHX-FJM, 2011 WL 2268950, at *5 (D. Ariz. June 9, 2011), the court, in rejecting a motion to dismiss a claim of violation of state securities laws by a law firm, stated that the law firm, "as the primary drafter of the language in the [private offering memoranda] had a duty to exercise reasonable care to ensure that the statements it made, or substantially participated in making, were not false or misleading." The court did not rely solely on the breach of the duty of care, but found other alleged facts supporting knowledge.

discussing what counts as a reasonable investigation is *Escott v. BarChris Constr. Corp.*, in which the court stated:

> It is claimed that a lawyer is entitled to rely on the statements of his client and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree. To require an audit would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes.[67]

A more recent example is *In re Brooke Corp.*,[68] in which a group of related entities selling financial products through franchisees retained a law firm to act as securities counsel for several stock offerings and to advise the client about the propriety of declaring dividends. After the entities went bankrupt, the trustee sued the law firm for malpractice and aiding and abetting a breach of fiduciary duty by the client's board. In rejecting the law firm's motion to dismiss the malpractice claim, the court found that as a result of information the law firm acquired during the representation, it "became aware or should have become aware that [the client] improperly recognized . . . revenue and . . . therefore . . . knew or should have known [the client] was insolvent."[69] In rejecting the motion to dismiss the aiding and abetting claim, the court relied on several allegations, including that the law firm "knew or should have known [that] improper accounting policies made [the client] appear solvent when it was not."[70]

In addition, in-house corporate counsel and outside counsel who serve as a company's "chief legal officer" for purposes of securities law compliance are subject to a duty of inquiry imposed by the Sarbanes-Oxley rules governing lawyers. That duty, triggered by the receipt of a report by another lawyer of "evidence of a material violation," requires the chief legal officer to "cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur."[71]

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67. Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968).
68. *In re* Brooke Corp., 467 B.R. 513 (D. Kan. 2012).
69. *Id.* at 521.
70. *Id.* at 523.
71. 17 C.F.R. § 205.3(b)(2) (2012).

C. *Implications of Duties to Investigate for Model Rules Including a Knowledge Standard*

The duty to investigate can have several implications for lawyers trying to comply with their ethical obligations and faced with a rule including duties triggered by what a lawyers "knows." First, the failure to investigate can be an independent ethical violation of a different rule. Most broadly, such a failure would violate the duty of competence in Model Rule 1.1. Although disciplinary authorities generally do not discipline lawyers for isolated negligent acts in the absence of other rule violations, they could view more harshly intentional violations such as deliberately refraining from undertaking a required, reasonable investigation, or deliberately skewing a required investigation to avoid acquiring certain types of knowledge.[72]

Second, the breach of a duty to investigate imposed by other law could result in liability, such as legal malpractice, even for conduct covered by an ethical rule requiring actual knowledge. Less obviously, duties to investigate imposed by other law could turn the Model Rules including knowledge standards from protections to vulnerabilities. Consider, for example, a lawyer sued for malpractice for failure to investigate and uncover a client's fraud. In such a case, in my view, the Model Rules on fraud, all of which include a knowledge standard, could be relevant to establish causation for the malpractice claim, even in the absence of actual knowledge.[73] That is, the claim may be that if the lawyer had exercised due care and conducted a reasonable investigation, the lawyer would have learned of the fraud. Once the lawyer knew of the fraud, the lawyer would have certain obligations, as set out in Model Rules 1.2(d), 1.13(b), and 4.1, including obligations not to continue in the fraud,[74] to withdraw,[75] to

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72. *See* MODEL RULES OF PROF'L CONDUCT scope 19 (2013) (stating that "the Rules presuppose that whether or not discipline should be imposed for a violation, and the severity of the sanction, depend on the circumstances, such as the willfulness and seriousness of the violation, extenuating factors and whether there have been previous violations."); *cf.* ABA Formal Op. 335 n.1 (1974) (identifying a duty to investigate in the context of offering an opinion about whether securities need to be registered, but asserting that the duty is not "mandatory" and failure to adhere to the duty does not violate the predecessor to Model Rule 1.1 unless "the lawyer's conduct in furnishing his opinion involves *indifference* and a *consistent failure* to carry out the obligations he has assured to his client or a *conscious disregard* for the responsibility owed to his client") (emphasis added).

73. I have made this argument in a legal malpractice case in which I served as an expert witness.

74. MODEL RULES OF PROF'L CONDUCT R. 1.2 cmt. 10 ("A lawyer may not continue assisting a client in conduct that the lawyer originally supposes is legally proper but then discovers is criminal or fraudulent.").

75. *Id.* RR. 1.16(a), 1.2 cmt. 10, 4.1 cmt. 3.

disavow previously given opinions,[76] and even make a disclosure.[77] These knowledge-based obligations would then be relevant as evidence of the standard of care that would apply had the lawyer exercised the duty to investigate.[78] If a court is willing to assume that the lawyer who had fulfilled the duty to investigate would then have complied with the obligations in fraud rules, the plaintiff can argue that the losses from the fraud would have been avoided, thus establishing causation. As a result, a lawyer who thinks that not knowing would provide a safe harbor against liability might be in for a rude awakening. Precisely the opposite might be true.

Third, a deliberate breach of a duty to investigate, *when one otherwise exists*, could serve as circumstantial evidence supporting actual knowledge. This is one possible meaning of Judge Friendly's statement of the willful blindness rule, that a lawyer cannot close his eyes to facts he has a "duty to see." The recklessness standard does not create this duty; rather, the duty is an otherwise existing duty whose violation may be evidence of recklessness depending on the circumstances. The recklessness is the extreme unreasonableness in failing to satisfy the duty of inquiry when the facts were suspicious enough and the costs of following up low enough.

Thus, when a duty to investigate exists, viewing the knowledge requirement as negating or mitigating a duty to investigate that otherwise exists can easily lead lawyers into trouble.[79] The great risk of the knowledge requirement is that lawyers may view it as trumping an otherwise existing duty of inquiry. Instead of lawyers asking whether a

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76. *See* MODEL RULES OF PROF'L CONDUCT R. 1.2 cmt. 10 ("In some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like."); *id.* R. 4.1 cmt. 3 ("Sometimes it may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm an opinion, document, affirmation or the like."); *id.* RR. 1.13(c), 1.6(b)(2), (3).

77. MODEL RULES OF PROF'L CONDUCT R. 4.1(b) & cmt. 3 ("In extreme cases, substantive law may require a lawyer to disclose information related to the representation to avoid being deemed to have assisted the client's crime or fraud. If the lawyer can avoid assisting a client's crime or fraud only by disclosing this information, then under paragraph (b) the lawyer is required to do so, unless the disclosure is prohibited by Rule 1.6."). Model Rules 1.6(b)(2), (3) permit disclosure if a client has used or is using a lawyer's services in furtherance of the crime or fraud. *Id.* RR. 1.6(b)(2), (3).

78. *Cf.* MODEL RULES OF PROF'L CONDUCT scope 20 (stating that "since the Rules do establish standards of conduct by lawyers, a lawyer's violation of a Rule may be evidence of breach of the applicable standard of conduct").

79. As Professor Roiphe has recently argued, "it creates an odd and confusing tension to encourage investigation through the substantive standards of attorney conduct while simultaneously discouraging it indirectly through the definition of knowledge." Roiphe, *supra* note 9, at 198–99.

duty of inquiry exists in a situation, what they need to do to satisfy such a duty, and whether the failure to satisfy such a duty may support an inference of knowledge, lawyers instead tend to start with the question of knowledge and never ask the duty of inquiry questions, or view them as afterthoughts.

D. How Knowledge-Based Model Rules Can Mislead Lawyers: Model Rules 1.13(b) and 3.8 as Examples

The failure of the Model Rules to recognize and articulate the implications of duties to investigate for Model Rules including duties triggered by lawyer "knowledge" may well contribute to lawyers misunderstanding their ethical responsibilities. Perhaps the most troubling rule in this respect is Model Rule 1.13(b), the up-the-ladder reporting rule.[80] Despite the fact that both the Restatement[81] and the Sarbanes-Oxley lawyer rules[82] abandoned the knowledge requirement for corporate counsel

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80. Model Rule 1.13(b) states:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization . . . .

MODEL RULES OF PROF'L CONDUCT R. 1.13(b); *cf.* OHIO RULES OF PROF'L CONDUCT R. 1.13(b) (2013) (adopting "reasonably should know" standard); TEX. DISCIPLINARY RULES OF PROF'L CONDUCT R. 1.12(b) (2013) (duty triggered when lawyer "learns or knows" of wrongdoing).

81. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 96(2) (2000) (requiring a lawyer representing an organization to take steps to protect the organizational client if the lawyer "*knows of circumstances indicating* that a constituent of the organization has engaged in action or intends to act in a way that violates a legal obligation to the organization" under certain additional conditions) (emphasis added).

82. 17 C.F.R. § 205.3(b)(1) (2012) (requiring an attorney appearing and practicing before the SEC who "becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer," to report such evidence within the organization). Unfortunately, the SEC rules effectively undermine this lower "trigger" for lawyer action through an overly restrictive and convoluted definition of "evidence of a material violation." *Id.* § 205.2(e) (defining "evidence of a material violation" to mean "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."). For a critique of this rule, see Cramton, Cohen & Koniak, *supra* note 19, at 751–64.

faced with potential client wrongdoing, the ABA retained it in the post-Enron revisions to Model Rule 1.13(b), perhaps as a political tradeoff for adopting in those revisions the controversial permissive disclosure provisions in Model Rule 1.13(c) and Model Rule 1.6(b).[83] Read literally, Model Rule 1.13(b) says that a lawyer has no obligation to take any action, even action "reasonably necessary in the best interest of the organization," if a lawyer does not "know" of wrongdoing within the organization, though, as already discussed, the comment to Model Rule 1.13 adds a "willful blindness" interpretation of knowledge.

Moreover, although another comment to Model Rule 1.13 states that the "authority and responsibility provided in this Rule are concurrent with the authority and responsibility provided in other Rules," neither this comment nor any other comment to Model Rule 1.13 makes any express reference to Model Rule 1.1 or the lawyer's duty of competence to the organization under other law,[84] either of which may require the lawyer to act on less

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83. The revised text of Model Rule 1.13(c) provides:

> Except as provided in paragraph (d), if
> (1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and
> (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,
> then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

MODEL RULES OF PROF'L CONDUCT R. 1.13(c). The revised text of Model Rule 1.6(b) states in relevant part:

> A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
> . . . .
> (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
> (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services.
> . . . .

MODEL RULES OF PROF'L CONDUCT R. 1.6(b).

84. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 6 (referencing Rules 1.2(d), 1.6, 1.8, 1.16, 3.3, and 4.1, but not Rules 1.1, 1.4, or 2.1).

than "knowledge."[85] Nor is this omission likely accidental. The ABA Task Force Report on Corporate Responsibility, which had endorsed relaxing the "knowledge" requirement in Model Rule 1.13(b), nevertheless rejected a "reasonably should know" standard because of criticisms that "this standard may impose a duty, of uncertain extent, to investigate that could only be evaluated after the fact with the benefit of hindsight," and that "the lawyer may not be able to insist that the client pay for, or even permit, the investigation that may, in the light of hindsight, prove to have been necessary."[86] The hindsight danger is a legitimate concern, but one that exists for any lawyer subject to a duty of inquiry. It is not obvious why the Model Rules should single out lawyers for organizations for more lenient treatment than other lawyers. Similarly, the fact that a client might not want or be willing to pay for an investigation is a relevant fact, but again, that is true for many actions that might be necessary to satisfy the duty of care. Most importantly, the criticisms seem to start from the premise that a duty to investigate for corporate lawyers does not otherwise exist unless Model Rule 1.13(b) establishes it. That proposition is, in my view, incorrect.

Another Model Rule that runs the risk of misleading lawyers, in a completely different context, is Model Rule 3.8, the ethics rule for prosecutors. Of its eight subsections, four include a knowledge requirement. All of these have to do with evidence or information that would benefit the defense. The starting point for understanding the rule is stated in the first comment to Model Rule 3.8:

> A prosecutor has the responsibility of a minister of justice and not simply that of an advocate. This responsibility carries with it specific obligations to see that the defendant is accorded procedural justice, that guilt is decided upon the basis of sufficient evidence, and that special precautions are taken to prevent and to rectify the conviction of innocent persons.[87]

How does the knowledge requirement affect these obligations? Model Rule 3.8(a) requires a prosecutor to "refrain from prosecuting a charge that the prosecutor knows is not supported by probable cause." The use of the

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85. *See, e.g.*, RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 96 cmt. e (stating that the "lawyer . . . must not knowingly or negligently assist any constituent [of the organization] to breach a legal duty to the organization," and adding that a "lawyer is also required to act diligently and to exercise care by taking steps to prevent reasonably foreseeable harm to a client.").

86. *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 BUS. LAW. 145, 167 n.76 (2003).

87. MODEL RULES OF PROF'L CONDUCT R. 3.8 cmt. 1.

knowledge requirement here is odd. Model Rule 3.8(a) is the parallel to Model Rule 3.1, the rule for civil litigation, which does not include a knowledge requirement and implicitly recognizes a duty of inquiry as a necessary means of satisfying the rule. If the knowledge requirement is supposed to indicate the lack of a duty of inquiry, how does that square with the prosecutor's obligation, stated in the comment, "to see that . . . guilt is decided upon the basis of sufficient evidence," or with the prosecutor's duties under other law? Perhaps the knowledge requirement in Model Rule 3.8(a) is intended simply to identify a quantum of certainty, not to limit the duty of inquiry. But nothing in the comments provides any guidance on this question.

On the other hand, the knowledge requirement in Model Rules 3.8(g) and (h), adopted by the ABA in 2008, operates against a backdrop of no duty of investigation. Both rules have to do with the responsibility of a prosecutor after a defendant's conviction, when the prosecutor's duties to collect and examine evidence have generally ended. Model Rules 3.8(g) and (h) create exceptions to that proposition when the prosecutor "knows" of exculpatory evidence. Under Model Rule 3.8(g), if a prosecutor "knows" of "new, credible and material evidence creating a reasonable likelihood that a convicted defendant did not commit" the crime, and the conviction was obtained in the prosecutor's jurisdiction, the prosecutor has a duty to "undertake further investigation."[88]

Unlike Model Rule 3.8(a), Model Rule 3.8(g) includes the terms "credible" and "reasonable likelihood" to address the level of certainty of knowledge, and the fact that knowledge triggers an expressly stated duty to investigate suggests that one does not otherwise exist. Model Rule 3.8(h) then addresses the outcome of that investigation, requiring that if, as a result of such investigation, the prosecutor "knows of clear and convincing evidence establishing that a defendant in the prosecutor's jurisdiction was convicted of an of an offense that the defendant did not commit, the prosecutor shall seek to remedy the conviction."[89] Here, knowledge combined with a higher level of certainty (clear and convincing evidence) entails a stronger duty to take remedial action.

Lastly, Model Rule 3.8(d) requires a prosecutor to "make timely disclosure to the defense of all evidence or information known to the prosecutor that tends to negate the guilt of the accused or mitigates the offense."[90] Does the knowledge requirement here operate against a

88. *Id.* R. 3.8(g)(2)(ii).

89. *Id.* R. 3.8(h).

90. *Id.* R. 3.8(d). The rule also requires a prosecutor to "disclose to the defense and to the tribunal all unprivileged mitigating information known to the prosecutor" in

background duty of inquiry? A recent ABA opinion interpreting Model Rule 3.8(d) provides a sensible answer, but its analysis of the knowledge requirement takes an unnecessarily confusing and circuitous path to get there. The opinion's discussion begins with the technically correct, but misleading, point that "Rule 3.8(d) does not establish a duty to undertake an investigation in search of exculpatory evidence."[91] The point is misleading because it suggests, though does not explicitly say, that there is no duty to investigate *apart from* Model Rule 3.8(d). The opinion then compounds the problem by stating that the "knowledge requirement thus *limits* what might otherwise appear to be an obligation substantially more onerous than prosecutors' legal obligations under other law."[92] Although not entirely clear, this statement appears to suggest that the knowledge requirement limits any otherwise existing duty to investigate. Fortunately, the opinion goes on to list several exceptions to the supposed absence of a duty to investigate: when the prosecutor "actually knows or infers from the circumstances, or it is obvious, that the files contain favorable evidence or information," or if the prosecutor "was closing his eyes to the existence of such evidence or information." The opinion's apparent endorsement of the *Benjamin* willful blindness standard—in a rule that actually lacks a willful blindness comment—thus goes beyond what the comments to Model Rules 1.13, 3.3, and 4.2 endorse. In a footnote at the end of the same paragraph, the opinion then finally adds:

> Other law *may* require prosecutors to make efforts to seek and review information not then known to them. Moreover, Rules 1.1 and 1.3 require prosecutors to exercise competence and diligence, which would encompass complying with discovery obligations established by constitutional law, statutes, and court rules, and *may* require prosecutors to seek evidence and information not then within their knowledge and possession.[93]

The opinion's tentative and almost grudging acknowledgment of a duty of inquiry takes us almost to the opposite of where the discussion started.

Imagine if the opinion had started the other way. Generally, among their duties to their government clients, which include a public function,

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connection with sentencing. The rule includes an exception if the court relieves the prosecutor of his or her responsibilities.

91. ABA Comm. On Ethics and Prof'l Responsibility, Formal Op. 09-454 (2009). The opinion repeats this point several times in the same paragraph in case we missed it the first time.

92. *Id.* (emphasis added).

93. *Id.* n.27 (emphasis added).

prosecutors have a duty to reasonably investigate ongoing criminal matters and must at least be attuned during such investigations to the possibility of exculpatory evidence, which if discovered, must be disclosed to the defense. A deliberate and unreasonable failure to investigate may support a conclusion that the prosecutor acted recklessly or with willful blindness, and therefore "knowingly," in not disclosing exculpatory evidence.[94] The result would be essentially the same as the one in the ABA opinion, but the tone would feel very different.

The point is that when lawyers encounter a knowledge standard in the ethics rules, they should not think of it as negating or limiting a duty of inquiry, but should rather first ask whether such a duty otherwise exists in other ethics rules or law, and then, if it does, consider the scope of that duty, what failures might violate it, and whether a deliberate violation of that duty to avoid knowing certain information might serve as evidence of knowledge. If no duty of inquiry otherwise exists, the knowledge requirement does not create one in the ethics rule in which it appears, and the willful blindness standard should be interpreted in light of that fact. The duty of inquiry, or lack of one, should inform the knowledge standard, not the other way around.

III. IMPUTED KNOWLEDGE AND THE DUTY OF INTRA-FIRM COMMUNICATION

Apart from adopting an actual knowledge standard to emphasize the lack of intent to create a duty of inquiry, the Model Rule drafters also may have intended the actual knowledge standard to preclude discipline in cases in which a lawyer's knowledge is not personal, but "imputed" from the knowledge of others. Imputed knowledge is presumptive knowledge, and therefore not actual knowledge.[95] The broad statement that the knowledge standard precludes imputation is, however, as misleading as the statement that the knowledge standard precludes a duty of inquiry.

The doctrine of imputed knowledge is a well-recognized principle of the law of agency, partnership, and other business organizations. Agency law imputes to the principal facts material to the agent's duties to the principal that an agent knows or has reason to know.[96] Similarly, the law of

94. *Cf.* MODEL CODE OF PROF'L RESPONSIBILITY EC 7–13 (1980) (stating that "a prosecutor should not intentionally avoid pursuit of evidence merely because he believes it will damage the prosecutor's case or aid the accused").

95. *See, e.g.*, Va. Legal Ethics Op. 1862 (2012) (stating that Rule 3.8(d) differs from Brady v. Maryland, 373 U.S. 83 (1963) because *Brady* imputes knowledge of state actors, such as the police, to the prosecutor, whereas Rule 3.8 does not).

96. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006). The reverse is not true: agency law does not impute a principal's knowledge to the agent. *Id.* § 5.03 cmt. g. Nor does the law impute the knowledge of one agent to another.

partnership imputes to the partnership a partner's knowledge of any fact relating to the partnership.[97]

The doctrine of imputed knowledge is grounded in the agent's duty to communicate information to the principal,[98] as well as the desire to discourage the principal's own willful blindness. The doctrine is also linked to vicarious liability: when knowledge is an element of an agent's tort, a principal's liability for that tort can be understood either as vicarious or, if the knowledge is imputed to the principal, direct.[99] Imputed knowledge does not generally, however, support criminal liability.[100]

The imputed knowledge doctrine can apply to lawyers in several ways. First, lawyers are agents of their clients and so clients are bound by what their lawyers know. Second, lawyers practicing in firms are agents of those firms, and so a lawyer's knowledge may be imputed to the lawyer's firm. The remainder of this section considers the connection of these rules of imputation to a lawyer's ethical obligations, and the implications of imputation rules and the principles underlying those rules for the ethical definition of knowledge.

A. Imputation of a Lawyer's Knowledge to a Client

The law of agency imputes to a principal not only knowledge an agent actually has, but also knowledge that an agent has reason to know.[101] The

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97. REV. UNIFORM PARTNERSHIP ACT § 102(f) (1997). "Knowledge" is defined as "actual knowledge." *Id.* § 102(a). If, however, "notice" to a partnership is sufficient to bind the partnership, then "notice" to the partner of a fact is sufficient, and "notice" is defined to include a situation in which a partner "has reason to know [the fact] exists from all of the facts known to the [partner] at the time in question." *Id.* § 102(b)(3).

98. RESTATEMENT (THIRD) OF AGENCY § 8.11.

99. *See, e.g.*, FDIC v. Braemoor Assocs., 686 F.2d 550, 556 (1982) (finding a joint venture liable for a partner's fraud under either the imputed knowledge or vicarious liability sections of the partnership statute).

100. *See, e.g.*, United States v. Archer, 671 F.3d 149, 159 n.4 (2d Cir. 2011) ("In general, the law does not impute criminal liability to those who are unaware of the criminal activity."); RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. d(7) (stating that "personal knowledge may be required for some forms of criminal liability . . . and when a statute requires personal knowledge for a particular legal consequence"); RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 5 cmt. d (2000) ("A lawyer's knowledge will not be attributed to the client to establish criminal liability, although evidence of the lawyer's knowledge might be admissible to show what the client knew.").

101. RESTATEMENT (THIRD) OF AGENCY § 5.03. According to Comment b: "An agent has reason to know a fact when a reasonable person in the agent's position would infer the existence of the fact, in light of facts that the agent does know." *Id.* § 5.03 cmt. b. The Restatement (Third) of the Law Governing Lawyers accepts this imputed knowledge doctrine, but does not say whether it requires actual knowledge or whether "reason to know" is sufficient. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 28(1) ("Information imparted to a lawyer during and related to the representation of a

imputation rule thus implicitly recognizes yet another version of the duty of inquiry, though it appears to be a duty triggered by more of a recklessness standard than a negligence standard.[102] Thus, if an agent, including a lawyer, intentionally or recklessly fails to know information that could affect the principal's interests, the principal incurs the consequences of imputed knowledge and may have a cause of action against the agent for breach of fiduciary duty. As noted in the previous section, lawyers have an ethical as well as a legal duty to protect their clients from liability, and so must be wary of unreasonably failing to know material facts simply to protect themselves from the ethical consequences of having knowledge, because doing so might disadvantage their clients. In the case of imputing a lawyer's knowledge to a client, then, the actual knowledge requirements of the ethics rules do not supplant the imputed knowledge rule. Rather, the imputed knowledge doctrine of agency law qualifies the actual knowledge requirements of the ethics rules.

B. Imputation of a Lawyer's Knowledge to a Lawyer's Firm

In addition, the imputed knowledge rule applies to lawyers acting in firms. Lawyers are agents of their firms just as they are agents of their clients. Law firms are thus bound by what their lawyers know and have reason to know. The Restatement of the Law Governing Lawyers accepts this imputed knowledge rule for purposes of vicarious liability of a law firm as an entity.[103] The application of this aspect of imputed knowledge in disciplinary cases seems limited, however, because the ethics rules in most jurisdictions apply to individual lawyers, not law firms.[104] Nevertheless, the principles underlying imputed knowledge may still be relevant in several ways.

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client is attributed to the client for the purpose of determining the client's rights and liabilities in matters in which the lawyer represents the client, unless those rights or liabilities require proof of the client's personal knowledge or intentions or the lawyer's legal duties preclude disclosure of information to the client.").

102. *See, e.g.*, Southport Little League v. Vaughan, 734 N.E.2d 261, 265 (Ind. App. 2000) ("This court has long recognized that a principal is charged with the knowledge of that which his agent by ordinary care could have known where the agent has received sufficient information to awaken inquiry."). The Restatement (Third) of Agency is somewhat unclear about the duty of inquiry in this situation. Comment b to § 5.03 states that there is no imputation if "the agent's failure to know the fact is the consequence of the agent's breach of a duty owed to the principal or to a third party." RESTATEMENT (THIRD) OF AGENCY § 5.03 cmt. b. The Reporter's Note to § 5.03, however, cites *Southport* and quotes the above language from the opinion, apparently with approval. *See id.* § 5.03 & reporter's note to cmt. b.

103. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 58 & cmt. c.

104. The exceptions are New York and New Jersey. *See* N.Y. RULES OF PROF'L CONDUCT R. 5.1(a) (2009); N.J. RULES OF PROF'L CONDUCT R. 5.1(a) (2002).

First, even when the imputed knowledge doctrine is not strictly applicable, the lawyer's duty to provide information to the firm,[105] as well as the duty of competence owed to the client, may necessitate that the lawyer communicate with other firm lawyers involved in a representation. Even though the knowledge of one lawyer is not strictly "imputed" to another lawyer in the same firm, a breach of these duties of intra-firm communication may mean that a lawyer "knows." According to the Restatement:

> If the facts warrant, a finder of fact may infer that the lawyer gained information possessed by other associated lawyers, such as other lawyers in the same firm, where such an inference would be warranted due to the particular circumstances of the persons working together. Thus, for example, in particular circumstances it may be reasonable to infer that a lawyer who regularly consulted about a matter with another lawyer in the same law firm became aware of the other lawyer's information about a fact.[106]

That is, a lawyer's participation in a firm is part of the "special situation" and "continuity of conduct" Judge Friendly found relevant to the question of lawyer knowledge.

This aspect of imputed knowledge is particularly important in corporate representations involving large numbers of lawyers in a firm who work on different aspects of the representation. For example, many lawyers from Vinson & Elkins LLP represented Enron in a host of transactional matters. If these lawyers had been charged with violating Model Rule 1.2(d) for assisting in Enron's fraud (they were not), some of them would likely have tried to defend by saying they did not know about problems in transactions that they did not personally work on. In response, the disciplinary counsel would probably argue that the lawyers were likely talking to each other and coordinating their activities and that even if they were not, they should have been.[107] The point is that the actual knowledge standard in the Model Rules may provide less protection than lawyers think, even if the imputed knowledge rule does not strictly apply between lawyers in the same firm.

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105. *See* RESTATEMENT (THIRD) OF AGENCY § 8.11 cmt. b ("The principal may direct that information be furnished to another agent or another person designated by the principal.").

106. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 94 cmt. g.

107. I served as an expert witness for the bankruptcy trustee in the case against Vinson & Elkins alleging that it had violated the securities laws in its representation of Enron. In my expert declaration, I made a similar argument.

A second way the principles of imputed knowledge are potentially relevant to lawyers acting in firms appears in the Model Rules on the supervision of lawyers, Model Rule 5.1, and of nonlawyers, Model Rule 5.3. These rules have similar structures. Subsection (a) of both rules requires partners to "make *reasonable efforts* to ensure that the firm has in effect measures giving reasonable assurance that" the conduct of lawyers and nonlawyers is consistent with the ethics rules.[108] Subsection (b) of both rules requires any lawyer with direct supervisory authority over another lawyer or nonlawyer to "make *reasonable efforts* to ensure that" the conduct of the supervised person is consistent with the ethics rules.[109] Subsection (c) of both rules then describes the conditions under which any lawyer is "responsible" for conduct of another lawyer or nonlawyer who violates the ethics rules. Those conditions are that the lawyer (1) orders the conduct; (2) ratifies "specific conduct" of which he has "knowledge"; or (3) serves as a partner, manager, or supervisor and "fails to take reasonable remedial action" when the lawyer "knows of the conduct at a time when its consequences can be avoided or mitigated."[110]

Once again, the imputed knowledge doctrine would not apply to supervisory lawyers individually, only to their firms, and the ethics rules are directed at individual lawyers. But the principle underlying imputed knowledge may still apply. One of the rationales for imputed knowledge is that it deters the principal from discouraging the agent to provide the principal with harmful information. Imputation means the principal will be affected by the information whether or not the principal seeks it. The situations governed by Model Rules 5.1 and 5.3 do not involve a principal, but rather a supervisory lawyer, who is in an analogous position. An actual knowledge requirement could discourage the supervisory lawyer from asking too many questions about what the supervised lawyer or nonlawyers is doing.

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108. MODEL RULES OF PROF'L CONDUCT RR. 5.1(a), 5.3(a) (2013) (emphasis added); *see also* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 11(1) (lawyers); *id.* § 11(4)(a)(i) (nonlawyers).

109. MODEL RULES OF PROF'L CONDUCT RR. 5.1(b), 5.3(b) (emphasis added); *see also* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 11(1) (lawyers); *id.* § 11(4)(a)(i) (nonlawyers).

110. MODEL RULES OF PROF'L CONDUCT RR. 5.1(c), 5.3(c); *see also* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS §§ 11(3), 11(4)(b). Rules 5.1(c) and 5.3(c) suggest that a lawyer who is not a partner, manager, or supervisor could "order" or "ratify" conduct but it is not clear when that would be the case. In addition, although the agency law of ratification uses an actual knowledge requirement, *see* RESTATEMENT (THIRD) OF AGENCY § 4.06 & cmt. b, it also recognizes ratification when a principal "is shown to have had knowledge of facts that would have led a reasonable person to investigate further, but the principal ratified without further investigation." *Id.* § 4.06 & cmt. d.

Consider then the structure of Model Rules 5.1 and 5.3. What is the relationship between the first two subsections of both rules, which impose a "reasonableness" standard comparable to a negligent supervision standard in agency law,[111] and the last subsection, which imposes a "knowledge" standard that seems to reject not only imputation, but negligence?[112] At least with respect to a "supervisory lawyer," it cannot be that the "knowledge" requirement of Model Rules 5.1(c) and 5.3(c) in any way diminishes the duty of reasonable monitoring established by Model Rules 5.1(b) and 5.3(b).[113] That would create the same problem that the imputed knowledge doctrine is meant to solve. The point of the knowledge requirement must therefore be to *enhance* the duty that otherwise exists by effectively creating a presumption of unreasonable monitoring if a supervising lawyer actually knows of a supervised person's misconduct and does nothing. In addition, because some of the responsibilities in Model Rules 5.1(c) and 5.3(c) are not limited to supervisory lawyers, but apply to any lawyer (or to any partner), the knowledge requirement protects lawyers who do not have specific duties to monitor other lawyers in the firm.

A Connecticut ethics opinion concerning a managing partner's obligations with respect to a bookkeeper who misuses client trust funds provides a good example of the confusion that these Model Rules can create. The opinion states that "[n]egligent supervision of employees handling trust accounts is not an excuse for violations of Model Rule 5.3(b)."[114] This is a puzzling statement. Why is negligent supervision not itself a violation of Model Rule 5.3(b)? The opinion then adds:

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111. RESTATEMENT (THIRD) OF AGENCY § 7.05(1).

112. Several jurisdictions adopt a "reasonably should know" standard in their version of Rule 5.1(c). *See* D.C. RULES OF PROF'L. CONDUCT R. 5.1(c)(2) (2006); N.Y. RULES OF PROF'L CONDUCT R. 5.1(d)(2)(ii) (2009). Georgia recognizes the willful blindness doctrine in interpreting Rule 5.1(c). *See* Ga. Formal Advisory Op. 05-10 (2010) (stating that "knowledge could be imputed to local counsel if he or she, suspicious that lead counsel was engaging in or was about to engage in a violation of ethical requirements, sought to avoid acquiring actual knowledge of the conduct").

113. *See* MODEL RULES OF PROF'L CONDUCT R. 5.1 cmt. 6 ("Professional misconduct by a lawyer under supervision could reveal a violation of paragraph (b) on the part of the supervisory lawyer even though it does not entail a violation of paragraph (c) because there was no direction, ratification or knowledge of the violation."). One commentator acknowledges "that the Rule 5.1(c)(2) duty to rectify misconduct is likely to arise in the wake of Rule 5.1(a) and (b) violations," but then goes on to stress that "Model Rule 5.1(c)(2) imposes an actual knowledge requirement," not "constructive knowledge" without explaining the relationship between the rules. Douglas R. Richmond, *Law Firm Partners As Their Brothers' Keepers*, 96 KY. L.J. 231, 245–46 (2008).

114. Conn. Eth. Op. 97-38 (1997).

> Although Rule 5.3(c) appears to limit responsibility to those situations where the lawyer orders or with knowledge ratifies the employees [sic] acts, courts have been unwilling to excuse negligent supervision of employees handling trust accounts. . . . [T]he fiduciary responsibilities involved in maintaining client funds accounts impute knowledge of the state of those accounts to the lawyer. Rule 5.3(c) does not permit negligent supervision of employees handling client fund accounts.[115]

The result is sensible, but the reasoning is muddled. Although the opinion recognizes that Rule 5.3(c) neither prohibits negligent supervision nor imputes knowledge, it nevertheless struggles to find a violation of that rule based on those concepts. Instead, the opinion should have emphasized that the knowledge standard in Rule 5.3(c) does not limit the duty of supervision that otherwise exists under Rule 5.3(b). A supervisory lawyer reading the opinion, however, could be misled into thinking that the opinion creates a special exception to Rule 5.3(c) for trust accounts rather than a general approach for reconciling Rules 5.3(b) and 5.3(c), and that a lack of actual knowledge will protect that lawyer from disciplinary liability given the knowledge requirement of Rule 5.3(c).

C. Imputation of a Lawyer's Knowledge in Conflict of Interest Cases

A special case of imputed knowledge that greatly affects lawyers concerns conflicts of interest. The Model Rules include a number of imputation rules relating to conflicts of interest. The general conflict of interest imputation rule, Model Rule 1.10(a), provides that "[w]hile lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9," except in certain circumstances.[116] This rule, under which an individual lawyer's conflict gets imputed to the lawyer's firm, is related to imputed knowledge and in part based on it. A lawyer's exposure to confidential information often results in a conflict of interest, and the conflict imputation rule essentially presumes that all lawyers in the firm are exposed to the confidential information, just as the imputed knowledge rule does. Model Rule 1.10(a) is in one sense more expansive than the imputed knowledge doctrine because the imputation applies to individual lawyers, not the firm as an entity (though courts relying on Model Rule 1.10 in the context of disqualification motions treat it as if it applies to firms). On the

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115. *Id.*

116. MODEL RULES OF PROF'L CONDUCT R. 1.10(a); *see also id.* RR. 1.11(b), 1.12(c), 1.18(c). *But cf. id.* R. 1.8(k) (applying an imputation rule for lawyer-client conflict of interests, but omitting a knowledge requirement). The Restatement imputation rule, § 123, does not include a knowledge requirement.

other hand, Model Rule 1.10(a) includes a provision that seems inconsistent with imputed knowledge. Model Rule 1.10(a) imputes a conflict only if the other lawyers in the firm "knowingly" represent a client when another lawyer in the firm would be prohibited from doing so. As Professor Moore has pointed out, however, the meaning of "knowingly" in this rule is unclear.[117] It could mean that a lawyer must know that the lawyer is representing a client, or it could mean that a lawyer must know that the representation of the client would violate the conflict of interest rules.

A recently decided case demonstrates the difference between imputed conflicts and imputed knowledge, and also reveals some of the mischief that the "actual knowledge" standard can cause. In *Northam v. Virginia State Bar*,[118] a husband and wife separately contacted two different lawyers in the same law firm about representing them in a divorce action. Lewis, the lawyer contacted by the wife, interviewed her and at one point asked who her husband's lawyer was. She responded that it was Northam, another lawyer in Lewis's firm. Lewis immediately stopped the interview and the next day told Northam that he had met with the wife. Lewis subsequently told the wife he could not represent her. Northam, however, continued to represent the husband. The wife later filed a disciplinary complaint, alleging that Northam had violated Virginia's Rule 1.10. The Disciplinary Board agreed, but the Virginia Supreme Court reversed on the ground that the Board had not specifically made a factual finding that Northam "knew" that Lewis was disqualified from representing the husband.[119]

The Virginia State Bar tried to argue that Lewis's knowledge of the wife's confidential information should be imputed to his partner, Northam. Alternatively, the Bar argued that there was enough evidence to support a finding of actual knowledge because Lewis had claimed that he told Northam in their meeting that "I think we have a problem and I'm getting out."[120] Northam, however, claimed he did not recall such a statement. The court ignored the argument about imputed knowledge, probably believing it was not sufficient to satisfy the actual knowledge requirement of Rule 1.10. The court rejected the alternative holding because the Disciplinary Board did not explicitly resolve the conflict in the two partners' testimony in its factual findings, and because different conclusions could be drawn from the mere fact that Northam knew that

117. Moore, *supra* note 19, at 2; *see also id.* at 46.

118. Northam v. Va. State Bar, 737 S.E.2d 905 (2013).

119. *Id.* at 911. The court thus adopted Professor Moore's second interpretation of "knowingly." Northam certainly knew he was representing the husband.

120. *Id.* at 909.

Lewis and the wife had met.[121] A dissenting justice took issue with the sufficiency of evidence point but also ignored the Bar's imputation of knowledge argument.[122] But why should a court interpret the ethics rule on imputation of conflicts, which is based in part on the principles of imputed knowledge, to protect lawyers who fail to investigate, and therefore lack actual knowledge of, a partner's conflict?

Under the facts of the case, a court could have found that Northam had actual knowledge under Rule 1.10(a) based on the fact that Lewis had given him sufficient information (even under his version of the facts) to give rise to a duty to investigate the conflict. Unfortunately, no one raised this argument, or the possibility that Northam's deliberate failure to investigate could have violated Virginia's Rule 1.1 or Rule 1.7,[123] or breached Northam's duty of care under the law of malpractice.[124] *Northam* is thus a striking example of a court ignoring the principle I have advocated in this essay: an actual knowledge requirement does not negate or limit a duty to investigate that otherwise exists. The case sends the potentially dangerous and misleading message to Virginia lawyers that they can avoid discipline for imputed conflicts if they do not ask too many questions.

Perhaps the court's implicit message is that Lewis had the bigger responsibility to make sure that Northam knew there was a conflict problem,[125] though Lewis probably thought he had made sufficient disclosure. What Lewis did not do was take advantage of the ability to set up a screen, which Virginia's Rule 1.18 permits for prospective clients such

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121. *Id.* at 910–11.

122. *Id.* at 912–13 (Powell, J., dissenting).

123. *See supra* notes 49–50, 54. Oregon's version of the "actual knowledge" definition expressly addresses this issue. Its Rule 1.0(h) defines "knowingly" as denoting "actual knowledge of the fact in question, except that for purposes of determining a lawyer's knowledge of the existence of a conflict of interest, all facts which the lawyer knew, or by the exercise of reasonable care should have known, will be attributed to the lawyer. A person's knowledge may be inferred from circumstances." OR. RULES OF PROF'L CONDUCT R. 1.0(h) (2013).

124. RESTATEMENT (THIRD) OF LAW GOVERNING LAW § 123 cmt. a (2000) (noting that "an imputed conflict might be evidence of a negligent breach of duty by each of the lawyers"); *id.* § 121 cmt. g ("For purposes of identifying conflicts of interest, a lawyer should have reasonable procedures, appropriate to the size and type of firm and practice, to detect conflicts of interest, including procedures to determine in both litigation and nonlitigation matters the parties and interests involve in each representation.").

125. *Cf.* Moore, *supra* note 19, at 48 (arguing that "knowing" standard of Model Rule 1.10(a) should apply to "the lawyer's awareness or lack of awareness of facts that cause the associated lawyer to be disqualified under Rule 1.7 or Rule 1.9 because "a lawyer whose conflict is merely imputed . . . relies to a large extent on the associated lawyer to disclose the facts that prohibit that lawyer from undertaking the representation").

as the wife.[126] Neither the court nor the dissent makes any mention of this possibility.

Screening solutions, recognized in a number of other Model Rules,[127] create an additional "knowledge" wrinkle. Screens must be "timely" and the comment to the definition of "screened" requires that lawyers implement screens when they "reasonably should know" that screens are necessary.[128] How does this standard work with the "knowledge" requirement of Model Rule 1.10(a)? One interpretation would give priority to the knowledge requirement. That is, until the other lawyers "know" of a conflict, they need not institute a screen even if they should have known.[129] But that interpretation is troubling. Once the conflict is "known," the client could already have revealed much information to the lawyer. Moreover, if the rule did not allow screening (as Model Rule 1.10 did not until recently), imputed *disqualification* would occur the moment the conflict was known.[130] In that case, the "knowledge" requirement would not discourage lawyers from discovering the conflict. Rather they would have an incentive to discover the conflict early, to avoid risking disqualification, or to seek a waiver. Adding a screening solution to an imputation rule should not transform the "knowingly" requirement into a free pass for lawyers in the firm until someone points out the conflict, at which point they are allowed to erect a screen.

CONCLUSION

The actual knowledge standard pervades the Model Rules and applies to lawyers in all areas of practice, whether transactional, litigation, or criminal. Given the importance of the actual knowledge standard, the Model Rule drafters need to provide better guidance to lawyers about the meaning of knowledge under the Model Rules. They should explicitly adopt Judge Friendly's definition of willful blindness in the definition of knowledge or its comment to be consistent with other law, in particular the law of fraud. Such a change would clear up the confusion created by the current definition of knowledge in Model Rule 1.0; the comments to some

126. *See* MODEL RULES OF PROF'L CONDUCT R. 1.18(d) (2013); VA. RULES OF PROF'L. CONDUCT R. 1.18 (2009).

127. *See* MODEL RULES OF PROF'L CONDUCT RR. 1.10(a)(2), 1.11(b), 1.12(c).

128. *Id.* R. 1.0(k) & cmt. 10.

129. *See* Lutron Elecs. Co. v. Crestron Elecs., Inc., No. 2:09-CV-707, 2010 WL 4720693, at *5 (D. Utah Nov. 12, 2010). This case was a motion for disqualification, not a disciplinary matter, and the court relied on other factors besides its conclusion that Utah's version of Rule 1.10 was not violated because the lawyers did not "know" of the conflict and instituted a screen once they did. *Id.*

130. *See* Moore, *supra* note 19, at 34.

knowledge-based rules, but not others adopting something like the recklessness standard; and the relationship of the knowledge-based rules to Model Rule 8.4(c). The drafters should further clarify where a duty to investigate or communicate otherwise exists, as a matter of other ethics rules or other law, in comments to rules including a knowledge requirement. Most important, they should add a comment to the definition of knowledge stating that the knowledge requirement does not negate or limit any duty to investigate or communicate that otherwise exists, and that the deliberate breach of these duties can be evidence of willful blindness and therefore knowledge. As the rules stand now, lawyers may be too tempted to conclude that when the rules use an actual knowledge standard, lawyers will be protected if they intentionally fail to acquire actual knowledge. That is a risky position to take, and one that not only exposes lawyers to potential disciplinary and other liability, but can harm clients and third parties as well. Lawyers have a right to know when they risk violating the ethics rules. As things stand today, their knowledge about the knowledge requirement is defective.

BUSINESS LAWYERING IN THE CROWDFUNDING ERA

JOAN MACLEOD HEMINWAY*

INTRODUCTION

Crowdfunding is all the rage in conversations about small business finance. Yet, as with many other rapidly developing business innovations, practicing lawyers were, perhaps, secondary players in the development of business models for crowdfunding. The advent of crowdfunding (and crowdfund investing, in particular) has exposed fault lines in business lawyering. This short Article defines the crowdfunding era, highlights a few examples of observed lawyering lapses, and, in concluding, offers a brief, preliminary assessment of possible sources of these dislocations and

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best practices. The conclusion also expresses a related cautionary note about the need for lawyers to redouble their efforts at engaging in legal, ethical, and professional decision-making in an exciting and rapidly evolving business environment.

Crowdfunding, an Internet-based financing method for businesses and projects, arose (at least in part) out of a frustration with the complexity and cost of raising small business capital. The advent of crowdfunding was facilitated by technology—especially the Internet technology underlying and facilitating social networking. If you can ask people to be your "friend" online, why not just ask them for a small bit of capital to launch your business? Why not? Because the law may not allow that type of capital formation to be undertaken in the manner envisioned by the principals of the business.[1] This answer is annoying for some, especially in the wake of the passage of the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act (the "CROWDFUND Act"), a part of the Jumpstart Our Business Startups Act (the "JOBS Act") that exempts crowdfunded securities offerings from various regulatory requirements, subject to the issuance of implementing regulations by the U.S. Securities and Exchange Commission ("SEC").[2]

An inspection of the process of advising businesses on the legal aspects of crowdfunding re-exposes a number of longstanding issues in business lawyering in a new context, offering the opportunity to review those issues and consider appropriate responses. Advances in technology and corporate finance interact with capital markets and the economy to create new and challenging avenues for a lawyer's exercise of his or her professional responsibility obligations. Throughout, the opacity of securities regulation contributes significantly to the struggles involved in lawyering in the crowdfunding era.

I. THE CROWDFUNDING ERA

Any rigorous discussion of a technology-driven business advance like crowdfunding requires the unpacking of some definitional background. Accordingly, this first part of the Article defines crowdfunding and the technological and legal contexts in which it has been created and conducted to date. The aggregate resulting depiction frames, for the purpose of this Article, the crowdfunding era.

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1. *See* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 907–21 (2011) (describing the impracticability of registration and the unavailability of any exemption from registration for offers and sales of securities in crowdfunded offerings under the Securities Act of 1933, as amended).

2. Pub. L. No. 112–106, §§ 301–305, 126 Stat. 306, 315–23 (2012).

A. Crowdfunding as a New Frontier in Financing Businesses and Projects

The definition of "crowdfunding" differs depending on the person defining the term. In its purest form, crowdfunding involves a democratization of capital—raising incrementally small amounts of capital from a large, undifferentiated mass of funders, most commonly through transactions carried out solely or principally on the Internet.[3] It is this definition of crowdfunding—in which the "crowd" is interpreted broadly and the Internet is employed to finance businesses and projects—that this Article uses. Popular published references to "Regulation D crowdfunding," "Rule 506 crowdfunding," "Title II crowdfunding," "accredited investor crowdfunding," "Regulation A crowdfunding," and "state crowdfunding exemptions," do not describe examples of crowdfunding under the definition employed in this Article. Each of these other types of financing sometimes labeled as crowdfunding may be made, or the offered securities must be sold, only to a restricted element of the crowd—restricted by number, status, or geography.[4] These other financing transactions interact with (and represent alternatives to), but are not part of, crowdfunding.

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3. *See, e.g.*, Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63, 66–68 (2011) (defining crowdfunding as "a many-to-one relationship between funders and recipients" with transactions made in "the presence of an intermediary, who serves as a matchmaker between promoters and funders."); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1434 (2012) ("[Crowdfunding] has become synonymous with efforts to raise funds from numerous donors, usually in small amounts through internet sources.").

4. Securities offerings made under Regulation D, other than Rule 506(c) offerings (in which all sales are made only to accredited investors), *see* Eliminating the Prohibition Against General Solicitation and General Advertising, 78 Fed. Reg. 44,771, 44,776 (Jul. 24, 2013) (to be codified at 17 C.F.R. pt. 230), may not be made to the crowd because of prohibitions on general solicitation and advertising. *See* 17 C.F.R. § 230.502(c) (2013). Moreover, sales in Rule 505 and Rule 506(b) offerings may be made to "accredited investors"—those who control the firm or are deemed to have the ability to bear the financial risk of a loss of their entire investment—or to a limited number of non-accredited investors. *See id.* §§ 230.505, 230.506(b). Sales in Rule 506(c) offerings must be made only to accredited investors. *See id.*; 78 Fed. Reg. 44,771, 44,776. Regulation A offerings require compliance with state regulations that may restrict the nature of permitted offerees or purchasers or increase offering expenses, making them hard to use for a broad-based crowd. *See* Rutheford B Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital,"* 31 DEL. J. CORP. L. 77, 106–10 (2006). Finally, state crowdfunding exemptions adopted to date (in Georgia and Kansas) provide that offerings must comply with SEC Rule 147, which requires that offers and sales be made wholly to state residents. *See* GA. COMP. R. & REGS. 590-4-2-.08(1)(b) (2012), *available at* http://rules.sos.state.ga.us/docs/590/4/2/08.pdf; KAN. ADMIN. REGS. § 81-5-21(a)(2) (2011), *available at* http://www.securities.state.ks.us/index.aspx ?NID=175.

Crowdfunding may, but need not, involve the offer and sale of securities. Endemic to the crowdfunding era is the question of whether the privileges or benefits offered to those who provide money capital to a business or project through a crowdfunded offering (or other characteristics of the funding interests or offering) cause the crowdfunded offering to be classified as a securities offering. Crowdfunding involving the offering of financial instruments classified under federal or state law as securities is referred to as, among other things, securities crowdfunding,[5] investment crowdfunding,[6] or crowdfund investing.[7] While the business model for securities crowdfunding may look very similar to that for other forms of crowdfunding, securities crowdfunding is subject to securities regulation on a federal and state basis. This means that, among other things, the offering cannot be conducted unless it is registered under Section 5 of the Securities Act of 1933, as amended ("1933 Act"), or it is exempt from registration.[8] The CROWDFUND Act includes an exemption from this registration requirement.

Both businesses, including those formally organized as legal entities under state or, less commonly, federal entity law, and projects can be financed through crowdfunding. A sole proprietor or a corporation, limited liability company, partnership, or other form of business entity might turn to the crowd to finance his, her, or its overall operations. However, a sole proprietor or business entity also might seek funds from the crowd to finance a particular product or other limited scope venture (for example, building a cistern for a specific community in need or recording an album). The financing of businesses and projects may look the same to funders and other observers, but the financial and legal aspects of different funding opportunities may vary significantly.[9]

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5. *See, e.g.*, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 49, 99; Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1457–59, 1478, 1489 (2013).

6. *See, e.g.*, Burkett, *supra* note 3, at 63–66, 71, 74–75, 77–79.

7. *See, e.g.*, Richard B. Levin et al., *The JOBS Act—Implications for Raising Capital and for Financial Intermediaries*, 26 J. TAX'N & REGULATION FIN. INSTITUTIONS 21, 25–28 (2013); Benjamin P. Siegel, Note, *Title III of the Jobs Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital or Fraudsters' Bank Accounts?*, 41 HOFSTRA L. REV. 777, 796, 802 (2013).

8. *See* 15 U.S.C. § 77e (2012).

9. *See, e.g.*, Nicolas Suzor, *Access, Progress, and Fairness: Rethinking Exclusivity in Copyright*, 15 VAND. J. ENT. & TECH. L. 297, 336–37 (2013). Crowdfunding innovations logically will be customized, at least to some extent, to reflect these distinctive characteristics.

> [T]here is no reason to adopt a one-size-fits-all model that assumes that large-scale commercial producers share the same motivations as artistically

Crowdfunding, as a systematized form of business finance, dates back only about five to ten years. Early repeated references to the term trace back to 2008.[10] But for many followers of finance, the first time crowdfunding entered their conscious lives was in June 2011, when the SEC imposed a cease-and-desist order on two individuals who attempted to raise funds over the Internet for the acquisition of the Pabst Brewing Company.[11] The SEC found that the individual funders in that financing scheme were offered securities without registration or the protection of an available exemption.[12] This queued up a much more public discussion of crowdfunding, both inside and outside the finance community, and helped to catalyze congressional engagement and drafting.[13]

Eventually, congressional legislative efforts resulted in the adoption and enactment of the CROWDFUND Act as Title III of the JOBS Act in April

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> motivated authors, or that fans will voluntarily pay for access no more than will rational investors. The second avenue for future research that this Article presents is the need for better empirical examination of the extent to which nonscarce models are workable and scalable. This research should try to develop a substantially better understanding of the types of situations and projects that are amenable to crowdfunding and other nonscarce business models; the characteristics and experiences of authors with successful and unsuccessful experiments; and the complex web of factors that influence users to support or not support various projects.

Id.

10. *See, e.g.*, JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING BUSINESS 281 (2008) ("Crowdfunding taps the collective pocketbook, allowing large groups of people to replace banks and other institutions as a source of funds."); *see also* Kristina Dell, *Crowdfunding*, TIME (Sept. 4, 2008), http://www.time.com/time/magazine/article/0,9171,1838768,00.html ("One part social networking and one part capital accumulation, crowdfunding websites seek to harness the enthusiasm—and pocket money—of virtual strangers, promising them a cut of the returns.").

11. *See* Migliozzi II, Securities Act Release No. 9216 (SEC June 8, 2011) [hereinafter BuyaBeerCompany.com Order], *available at* http://www.sec.gov/litigation/admin/2011/33-9216.pdf (releasing an order instituting cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933); *see also* Andrew Ackerman, *Fizzled Beer Deal Prompts 'Crowd-Funding' Hearing*, WALL ST. J. (Sept 14, 2011), http://online.wsj.com/article/SB10001424053111903927204576570614068591324.html.

12. *See* BuyaBeerCompany.com Order, *supra* note 11.

13. Congress held a highly publicized hearing focusing on crowdfunding in September 2011. *See Crowdfunding: Connecting Investors and Job Creators: Hearing Before the Subcomm. on TARP, Financial Services and Bailouts of Public and Private Programs of the H. Comm. on Oversight and Government Reform*, 112th Cong. (2011), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg73612/html/CHRG-112hhrg73612.htm (exploring crowdfunding and mentioning, in the process, the Pabst Brewing Company incident).

2012.[14] This law permits investment crowdfunding to proceed without registration under the 1933 Act if conducted through a registered broker or funding portal and otherwise in compliance with the law and related SEC regulations. SEC rulemaking is required to enable the CROWDFUND Act.[15] Those rules were, under the CROWDFUND Act, due at the beginning of 2013. At this writing, more than a year after the CRWODFUND Act became law, final rules are still forthcoming. The SEC's proposed rules were published at the end of October 2013.[16]

Crowdfunding—especially securities crowdfunding—has generated both rabid supporters and strenuous objectors. "There are two completely different ways of looking at crowdfunding," one commentator writes.[17] "It is either a) the best thing to happen to start-ups since Red Bull; or b) while sometimes useful, it's no serious substitute for other sources of money, including family & friends."[18] Another commentator similarly offers:

> Crowd-funding . . . is an extension of that urge to be social, where people share their ideas and we share our money. This means . . . fraud and bad ideas can spread as easily as good ones. But whether you believe that crowd-funding is the vehicle for the next big thing or an effective way to bilk people out of their hard earned cash, its [sic] hard to deny that crowd-funding has made investing social.[19]

When it comes to investment crowdfunding, some think the CROWDFUND Act may go too far in granting an exemption from 1933 Act registration[20] because of, for instance, the capacity of crowdfunding to lead to fraud that causes significant damage to investors.[21] Others think the

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14. Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315–23 (2012).

15. *See Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, SEC (Apr. 23, 2012), http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm (last visited Aug. 17, 2013).

16. *See* Crowdfunding, Securities Act Release No. 9470 (SEC Oct. 23, 2013), *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

17. Ari Zoldan, *3 Reasons Not to Crowdfund*, INC. (May 17, 2013), http://www.inc.com/ari-zoldan/3-reasons-not-to-crowdfund.html.

18. *Id.*

19. Rob Zorzi, *Crowd-funding and the Draw of Social Invention*, GOODBUGLY.COM (Feb. 28, 2013), http://www.goodbugly.com/2013/02/crowd-funding-and-draw-of-social.html.

20. 15 U.S.C. § 77e (2012).

21. *See* Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws - Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C.L. REV. 1735, 1737–38 (2012) (questioning whether the CROWDFUND Act, as implemented through SEC regulations, will include the kind of meaningful disclosure regulation required to adequately protect investors).

CROWDFUND Act may not go far enough in helping small businesses raise capital because of, among other things, the limitations and costs it imposes on issuers.[22] These tensions—practical and legal—help define the crowdfunding era and will not be resolved until there is a track record for crowdfunding sufficient to enable researchers to conduct relevant studies.

B. Technology and Law in the Crowdfunding Context

Crowdfunding results from the application of innovative technology to the practice of business finance and the applicable law. As the introductory paragraphs of this Article suggest, technology that powers online social networking also fuels crowdfunding.[23] The Internet facilitates the efforts of businesses or their principals in reaching out to the crowd for business capital, just as they would reach out to the crowd for customers, employees, or "likes" for their Facebook page. That is the essence of crowdfunding.

The intersection of technology and finance that crowdfunding exemplifies fills a gap in the market for domestic small business capital, while also creating new markets for services, including financial and legal services.[24] "While, traditionally, there have been numerous barriers to raising investment capital, such as the limited number of individuals with large amounts of money to invest or an innovator's limited ability to find and contact those individuals, these barriers can be overcome through new crowdfunding models."[25] New service providers are emerging or are likely to emerge to support or participate in crowdfunding. Crowdfunding service providers may include industry associations, funding portals (for securities crowdfunding under the CROWDFUND Act), and other transactional intermediaries, as well as other agents (e.g., firms assisting in performing due diligence on prospective or actual crowdfunding issuers).[26] These

22. *See* Cohn, *supra* note 3, at 1445 ("Opportunity knocked, but what began as a relatively straightforward approach to assist small business capital-formation ended with a regulatory scheme laden with limitations, restrictions, obligations, transaction costs and innumerable liability traps.").

23. *See* KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 1 (2010) ("Crowdfunding describes the collective cooperation, attention and trust by people who network and pool their money and other resources together, usually via the Internet, to support efforts initiated by other people or organizations .... The crowdfunding space is quite diverse, comprised of many niches, and shares a lot of social networking's energy."); Dell, *supra* note 10.

24. *See, e.g.*, Miriam A. Cherry, *Cyber Commodification*, 72 MD. L. REV. 381, 415–17 (2013) (indicating that crowdfunding fills unmet needs for small business capital raising and suggesting that crowdfunding is "an excellent illustration of the forces of cyber commodification").

25. *Id.* at 415.

26. *See, e.g.*, CROWDCHECK, http://www.crowdcheck.com (last visited Sept. 13, 2013) (due diligence); CROWDFUND CAP. ADVISORS, http://www.crowdfundcapital

emergent players all need legal advisors, and some, such as funding portals, are regulated entities that will likely require specialized legal counsel.[27]

Business innovations spurred by technology have the capacity to transform social, political, economic, and legal institutions. For example, technology often disrupts the *status quo* by prompting or fostering changes in the way business is conducted or business participants behave.[28] These changes, in turn, may expose flaws or weaknesses in, or other undesirable attributes of, regulatory systems and the laws and rules that constitute them. Law reform may result, but it most often lags well behind the advances in business practices.

Technology has the ability to alter the practice of law and the behavior of lawyers.[29] Technology-driven forms-based work product, Internet counseling, legal weblogs, and virtual law firms exemplify this phenomenon.[30] Even something as simple as electronic mail has changed the provision of legal advice.[31]

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advisors.com (last visited Sept. 13, 2013) (advisory services); CROWDFUND INTERMEDIARY REG. ADVOCS., http://www.cfira.org (last visited Sept. 13, 2013) (industry association); NAT'L CROWDFUNDING ASS'N, http://www.nlcfa.org/main.html, (last visited Sept. 13, 2013) (industry association). For an informal list of crowdfunding service providers and others engaged with the emergent crowdfunding industry, see *Who's in the online crowdfunding community?*, CROWDCRUX (July 18, 2013), http://www.crowdcrux.com/ whos-in-the-online-crowdfunding-community.

27. Sections 302 (codified in Section 4A(a) of the 1933 Act) and 304 (codified in Sections 3(a)(81) and 3(h) of the Securities Exchange Act of 1934, as amended) of the JOBS Act contain the core legislative mandates regarding the regulation of funding portals. Pub. L. No. 112-106, §§ 302, 304, 126 Stat. 306 (2012). Registered brokers also may serve as intermediaries in securities crowdfunding after full implementation of the CROWDFUND Act. *See id.* § 302(b), 126 Stat. at 316 (codified at § 4A(a)(1) of the 1933 Act).

28. *See* LAWTON & MAROM, *supra* note 23, at 1, 3 (predicting that crowdfunding will change the way we allocate capital "[i]n the same way that social networking changed how we allocate our time . . . ."); *see generally* Constantinos Markides, *Disruptive Innovation: In Need of Better Theory*, 23 J. PROD. INNOV. MGMT. 19, 19–20 (2006) (describing this type of dislocation—"the discovery of a fundamentally different business model in an existing business"—as "business model innovation").

29. Law is not the only service profession wrestling with these issues. Medicine, for example, is facing similar challenges. *See, e.g.*, Joseph A. Diaz et al., *Patients' Use of the Internet for Medical Information*, 17 J. GEN. INTERNAL MED. 180 (2002); Margaret A. Winker et al., *Guidelines for Medical and Health Information Sites on the Internet: Principles Governing AMA Web Sites*, 283 J. AM. MED. ASS'N 1600 (2000).

30. *See, e.g.*, John M. Garon, *Legal Education in Disruption: The Headwinds and Tailwinds of Technology*, 45 CONN. L. REV. 1165, 1181–84 (2013) (describing the virtual law firm and law firm networks and their respective effects on legal services); Stephen Gillers, *A Profession, If You Can Keep It: How Information Technology and Fading Borders Are Reshaping the Law Marketplace and What We Should Do About It*, 63 HASTINGS L.J. 953, 976–79 (2012) (describing virtual law offices and online legal research and their effects on the geographically focused nature of legal services and the regulation of lawyers); Jack A. Guttenberg, *Practicing Law in the Twenty-First*

More specifically, the centrality of the Internet in U.S life and law practice has seemingly irrevocably altered the behaviors of lawyers and clients. The Internet creates important dislocations in the practice of law that are relevant to a commentary on lawyering in the crowdfunding era.

> New technologies, particularly including computer software and the Internet, could fundamentally change the provision of legal advice. First, websites can convey large quantities of legal information directly to consumers. This reduces not only the need for legal advice, but also the information asymmetry between lawyer and client that provides the current rationale for state licensing.
>
> Second, Internet services and computer software blur the line between information provision and legal advice. This is partly because of the potential for interactivity, where information is provided based on the user's particular need or question, just as in a traditional lawyer-client setting.[32]

Both of these issues—the Internet's ability to convey large amounts of information to consumers and the Internet's tendency to confuse information provision and legal advice—are important pieces of the puzzle of lawyering in the crowdfunding era.

As a general matter, rapid technological change tends to leave lawyers behind.[33] Law is a profession that has historically been slow to change,

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Century in a Twentieth (Nineteenth) Century Straightjacket: Something Has to Give, 2012 MICH. ST. L. REV. 415, 453–54 (describing effects of the Internet on law practice); Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749, 780–82 (addressing technology's capacity to change legal services).

31. *See, e.g.*, Mass. Bar Ass'n, Ethics Op. No. 00-1 (2000), *available at* http://www.massbar.org/publications/ethics-opinions/2000-2009/2000/opinion-no-00-1/ (opining on the propriety of "[a] lawyer's use of unencrypted Internet e-mail to engage in confidential communications with his or her client" under Massachusetts Rule of Professional Conduct 1.6(a)); Andrew S. Friedberg, *The Electronic Lawyer: Traditional Transactions in a Virtual World*, 72 TEX. B.J. 534, 534 ("The advent of the Internet and concurrent explosion in the use of email as the primary mode of communication for lawyers and their clients has inevitably led to changes in everyday law practice."); Caroline D. Buddensick, *Risks Inherent in Online Peer Advice: Ethical Issues Posed by Requesting or Providing Advice via Professional Electronic Mailing Lists*, 22 GEO. J. LEGAL ETHICS 715, 715–16 (2009) ("The Internet and new technologies have transformed many facets of modern life, especially the ease and speed of communications. These pervasive changes affect lawyers personally as well as professionally.").

32. Larry E. Ribstein, *Lawyers As Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299, 324 (2004). It seems appropriate here to note the enormous role that Larry Ribstein played in analyzing and re-envisioning the legal profession in light of technology and other market forces. His voice is and will continue to be sorely missed.

33. *See generally* Lyria Bennett Moses, *Recurring Dilemmas: The Law's Race to*

and lawyering in the crowdfunding era seems to follow this rule. Yet, in a time of ongoing technological transformation—like the crowdfunding era—a client often has a desperate need to have a lawyer or lawyers on the advisory team who can use theory, policy, and a strong knowledge of doctrine to apply outdated law and legal practice norms to new and changing facts. Lawyers who respond to the call of clients operating in new high-tech fields of endeavor face both opportunities and challenges.

C. An Instructive Dialogue

The interchange included below exemplifies the kind of Web-based colloquy that raises questions about lawyering in the crowdfunding era. Among other things, the interchange illustrates several possible bases for a potential claim that an entrepreneur (Jessica Jackley, one of the founders of ProFounder, an early crowdfunding website) or her crowdfunding website is engaged in the unauthorized practice of law.[34] Based solely on her online biography, Jessica earned an MBA degree, but does not have a law degree or law license. The other two respondents, Scott Edward Walker and Mike Prozan, are both (again, based solely on online biographies) licensed practicing lawyers. All three, labeled in the following excerpts by their first names only, are responding to the question: "Is ProFounder in violation of any securities laws with their crowdsourced model for funding startups?"

In the first excerpt, Scott frames the substantive securities regulation issues he sees, as a lawyer, with ProFounder's business model, as then in operation. In each case, he outlines the applicable rule of law in reasonable detail (in some cases citing to it) and relates it to the relevant facts as he knows them. He concludes that each is a potential securities regulation violation and asks for a response.

> Scott:
> Based upon my cursory review of the ProFounder website, there are three significant, potential securities-laws violations, as discussed below. . . .
>
> #1 - Offers/Sales to Non-"Accredited Investors"

Keep Up With Technological Change, 7 U. ILL. J.L. TECH. & POL'Y 239 (2007) (explaining why technological change generates legal problems and classifying the types of problems that arise).

34. *See infra* Part I.C. The interchange also includes questionable and incorrect (or at least incomplete) statements of applicable law. Accordingly, none of the statements of law in the excerpted transcript should be relied upon or assumed to be accurate or complete.

Whenever a startup offers or sells its securities – whether to founders, friends and family, angel investors – federal and state securities laws must be addressed. Unfortunately, these laws are complex and are a potential minefield for the unwary. Moreover, in light of the Madoff affair and other external pressures, the Securities and Exchange Commission (SEC) and State securities law commissions are significantly stepping-up enforcement of the securities laws.

The basic rule is that a startup may not offer or sell its securities unless (i) the securities have been registered with the SEC and registered/ qualified with applicable State securities commissions; or (ii) there is an exemption from registration. The most common exemption used by startups is the so-called "private placement" exemption. As the term implies, a private placement is a private offering to a small number of investors – like a few friends; however, there are different rules depending upon whether the investors are accredited or non-accredited.

If a startup sells securities only to accredited investors, compliance is much simpler and cheaper because it can rely on SEC Rule 506, which has two important advantages over other SEC rules. First, Rule 506 preempts or overrides State securities laws, which means that the startup doesn't have to deal with State securities regulators for compliance purposes, other than filing a brief notice known as a Form D (which is also filed with the SEC). Second, there is no written disclosure requirement under Rule 506 if the investors are accredited.

On the other hand, if one or more of the investors is not accredited (which is the case via ProFounder), it opens a Pandora's box of compliance and disclosure issues under both federal and state law. Yes, there are ways for a startup to structure an offer and sale of securities to non-accredited investors in compliance with applicable federal and state securities laws; however, the cost, risks and onerous disclosure requirements generally outweigh the benefit.

Indeed, I am unclear how ProFounder "guides you through all this" (as it provides on its website); however, I would strongly advise any startup utilizing this site to retain experienced securities counsel or risk serious adverse consequences, including a right of rescission for the securities holders (i.e., the right to get their money back, plus interest), injunctive relief, fines and penalties, and possible criminal prosecution.

#2 - "General Solicitation"

Under the Securities Act of 1933, as amended (the "Securities Act"), and

Regulation D adopted thereunder, startups and any persons acting on their behalf are generally prohibited from any form of "general solicitation" in connection with the offer or sale of securities. The term "general solicitation" is not defined in the Securities Act, but has been broadly construed in SEC no-action letters to include any solicitations via mail, e-mail or other electronic transmission, unless there is a "substantial and pre-existing relationship" between the issuer and/or its agent, on the one hand, and the prospective investor, on the other.

Indeed, that's the critical issue: whether the issuer and/or its agent can demonstrate that there is a "substantial and pre-existing relationship." Under SEC no-action letters, a relationship is "substantial" if it involves interaction such that the issuer and/or its agent has reliable knowledge of the offeree's investment goals and objectives. Moreover, the nature and quality of the relationship must be such that the issuer/agent can determine that the offeree would be a suitable investor. To be "pre-existing," the relationship must be in place prior to the offering. The SEC considers other factors as well, such as the number of offerees, the identity of offerees, etc.; however, the relationship is key.

ProFounder seems to have recognized this issue in connection with so-called "Private Rounds" and expressly notes on the site that: "In a Private Round, entrepreneurs raise money for their businesses from investors who are friends and family. A substantial, pre-existing relationship must exist between the entrepreneur and each potential investor."

Obviously, it would be prudent for ProFounder to explain (as I have above) what this means and the significant limitations relating thereto; otherwise, startups again risk serious adverse consequences, as discussed above.

Moreover, I am unclear why ProFounder distinguishes so-called "Public Rounds" and provides that: "In a Public Round, entrepreneurs raise money for their businesses from the general public. Entrepreneurs will have a Public Fundraising website and can use any sort of campaign they choose to share the link and spread the word to potential investors." I welcome ProFounder's explanation.

#3 - "Broker-Dealer"

Finally, there is a significant issue of whether ProFounder is acting as a

> "broker-dealer," which is broadly defined under the Securities Exchange Act of 1934 to mean "any person engaged in the business of effecting transactions in securities for the account of others."
>
> If a finder is receiving some form of commission or transaction-based compensation, it will generally be deemed a broker-dealer and thus will be required to be registered with the SEC and applicable state commissions. If it is not registered and offer/sells securities on behalf of an issuer, the private placement will not be valid (i.e., will not be exempt from registration), and the issuer will have violated applicable securities laws – and thus will be subject to the serious adverse consequences discussed above.[35]

Jessica then answers, thanking Scott for his "thoughts" and apologizing for the delay in replying (due to ProFounders launch). Note that her response explains how ProFounder "guides you through" the process of complying with securities law—by software programmed to perform legal compliance tasks. Also note how Jessica freely offers rejoinders to Scott's legal analysis on behalf of the firm.

> Jessica:
>
> . . .
>
> First, re: sales to unaccredited investors: Our compliance engine is based around Reg D 504, not 506, in our effort to facilitate use of an exemption that allows entrepreneurs to include as many unaccredited investors as possible. It's true, state laws do come into play with this exemption, and those laws are difficult to keep track of, which is precisely why our platform is so powerful - it manages the "Pandora's box" (as you appropriately called it) of compliance and disclosure issues relevant to each entrepreneur's unique offering and unique set of investors. For example, our compliance engine takes into account limitations on # of unaccredited investors allowed per state, among other factors. As each investor makes a pledge to invest, our site automatically recalculates and readjusts the # of unaccredited investors allowed (per state and nationally), so it can intelligently inform an entrepreneur what each investor's participation will mean. The power of this tool will make it easy for an entrepreneur to include anyone she wants to include as an investor, and to know the consequences associated with each new investor's inclusion to her fundraising strategy. You're right though;

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35. *Is ProFounder in Violation of Any Securities Laws with Their Crowdsourced Model for Funding Startups?*, QUORA (Dec. 1, 2010 – June 25, 2011), http://www.quora.com/ProFounder/Is-ProFounder-in-violation-of-any-securities-laws-with-their-crowdsourced-model-for-funding-startups.

> trying to calculate these types of factors manually for each state involved - let alone across every combination of states - is a huge task, and of course as you said, the costs DO generally outweigh the benefits. Making this kind of burden dramatically less is just one of many reasons we created ProFounder.
>
> Second, re: general solicitation, we do allow entrepreneurs to decide with whom they have a substantial, pre-existing relationship. While we've spent a significant amount of time with each of our first few entrepreneurs explaining this on the phone or in person, our plan is to provide more and more information - without providing legal advice, per se - on the site so that entrepreneurs have the best possible understanding of this concept and can act accordingly. This (general solicitation) is only a concern for the Private Raises on our platform, not for Public Raises, because while in a Private Raise the entrepreneur is offering securities, in a Public Raise they are not (so none of these rules apply). Instead, in a Public Raise, an entrepreneur is allowing "investors" to receive a share of revenues up until the pt at which they make their original investment amount back, but share of revenues above and beyond this amount goes to a nonprofit instead. Thus, because there is no financial gain for the "investor," and no securities are offered, general solicitation doesn't matter.
>
> Third, you brought up the broker-dealer issue. Our fees for a Private Raise are not transaction-contingent, and are not commission-based (entrepreneurs are charged $1K to use the platform, regardless of whether or not they succeed in their raise). Fees for a Public Raise are 5% of a successful raise, so are both transaction-contingent and commission-based, but again, this is irrelevant for the b-d issue because there is no official offering of securities in a Public Raise.
>
> Hope this helps, and thank you again for your interest and thoughtful comments. We take the complexity of these issues seriously, and believe that ProFounder can make raising investment capital for a start-up or small business something anyone can understand, afford, and pursue with confidence.[36]

Mike then responds to Jessica's post. Mike is not satisfied with Jessica's legal conclusions or the legal compliance of ProFounder's business model. He adds substantive law and practical challenges to the original list created by Scott. In addition, he expressly raises the question of whether Profounder is engaging in the unauthorized practice of law through the judgment calls the software makes about accredited investor status (under

36. *Id.*

federal securities regulation) and about security status (under federal and state securities laws) and because of ProFounder's drafting of legal documents for offerings. Note that Mike expressly disclaims representation of ProFounder at the end of his post.

> Mike:
> Did you get an SEC no action letter here?
>
> Also, for tech companies seek more growth capital and acquistion [sic] or IPO, have you considered what a revenue sharing model here could do to their valuations?
>
> I see both a good idea here with value but the legal and business issues do not seem as well flushed out as they need to be.
>
> Scott tends to be a lot more conservative than me, but on a lot of issues here, I tend to be with him with what info I could find.
>
> Some of this depends on who the target user is. If this is intended to provide angel funding for companies that are going to go on to seek venture funding, who in turn are going to use, large expensive, conservative law firms, they are going to raise a lot of these issues in legal due diligence to be addressed which could kill a venture funding.
>
> Thus, the service is more problematic for companies expecting to grow, get more funding, and be acquired or go public, is that a revenue sharing model is going to impede valuations. I don't know the details of the model, but can you imagine the value of facebook [sic] today if it had entered into a revenue sharing model with its first $500K of investor? A lot less.
>
> If it is intended to provide one time funding, that then you still need to focus on the pure legal issues.
>
> I think you do a good job of addressing the non accredited issue and that this is likely to be a major success of your platform. But, by offering this service are you practicing law with out [sic] a license? As an attorney, another issue is that if I have a client who uses this platform, I can't take the platform's word for it and have to independently verify anyway, which is duplication, but duplication that I do not see any way around.
>
> And what about the documents for the private and public raises? Boy, drafting those on behalf of a third party sure sounds like practicing law to me. I doubt you would be able to convince all 50 state bar associations that it isn't.

> One way to generate value is would be to simply get an accredited investor questionnaire (which an attorney can approve or not because the attorney gets to see it) and prepare a report for the attorney with the investor, address and status. Doing that alone could generate $1K in value of attorney time avoided and avoid the issue of whether you are practicing law by determining for the client who is accredited, what the maximums are in each state, etc.
>
> Re: general solicitation, I see continuing issues. I would need to know more about what is offered, but if it is a revenue sharing arrangement, my guess is that the SEC would take issue with the conclusion these are not securities. And again, aren't you practicing law without a license by reaching that conclusion for third party clients?
>
> Also, the platform seems to permit abuse here. I think you would be far less likely to cross state and federal regulators if you put in maximums on # of people who could be solicited . . . on the theory that one person only has so many real contacts etc. as a trigger to minimize this risk.
>
> Re: Broker dealer. See above re: the "public" offering. Though I am less knowledgeable in B/D stuff, I agree with Scott that transaction contingent fees are more likely to raise B/D issues, but the fact that you charge a flat fee does not mean, in and of itself, that you are not likely to be a B/D.
>
> In fact, there may be a position here that even if you take a percentage that you are not performing a broker dealer function but instead are providing a platform for others to use in the sale of securities.
>
> Good luck. Sounds like a worthwhile idea and a good effort, but I think you've got a rockier road ahead with state and federal regulators as well as state bar associations.
>
> Oh yeah, the standard. I am a lawyer but not your lawyer. I am far from versed in all the facts here. If you don't already have one, you should get one.[37]

This dialogue offers much food for thought and supplies the foundation for a discussion of lawyering issues as they relate to crowdfunding.

II. LAWYERING IN A CROWDFUNDING CONTEXT

"Lawyering" is not a well-defined term of art; it means many things and

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37. *Id.*

signifies different things to different people.[38] For the purpose of this Article, "lawyering" refers broadly to what lawyers do and should do. It comprises legal reasoning and analysis, legal ethics, and professionalism. It includes actions by lawyers in their professional capacities inside and outside an attorney-client relationship.[39]

This Article frames a story of lawyering conducted principally outside the advocacy and dispute resolution contexts.[40] Lawyering in the crowdfunding context is a tale of entity formation and governance and "transactional lawyering,"[41] even though some of the parties to the transactions at issue are individuals and not entities. These elements of law practice are not focused on, although they may involve, traditional adversarial engagement.[42]

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38. *See, e.g.*, Josiah M. Daniel, III, *A Proposed Definition of the Term "Lawyering,"* 101 LAW. LIBR. J. 207 (2009) (surveying existing definitions and offering a new, more comprehensive definition).

39. The existence of an attorney-client relationship is the foundation of a relationship of trust and confidence in legal advisory contexts founded in fiduciary duties and other obligations and, as a result, creates a basis for malpractice and other legal actions. *See* Roger C. Cramton, *The Lawyer as Whistleblower: Confidentiality and the Government Lawyer*, 5 GEO. J. LEGAL ETHICS 291, 296 (1991) ("Normally, the identification of a lawyer-client relationship is a predicate to determining the lawyer's duties.").

> The lawyer-client relationship stands at the epicenter of our legal system. Part historical treasure, part myth, it is the subject of endless cultural fascination and rhetoric. In theory, the lawyer-client relationship approximates a sacred trust between a lawyer and a client. This relationship is characterized by open communication and complete confidentiality, which fosters the client's trust in the lawyer, and the lawyer's steadfast loyalty to the client.

Lindsay R. Goldstein, *A View from the Bench: Why Judges Fail to Protect Trust and Confidence in The Lawyer-Client Relationship - An Analysis and Proposal for Reform*, 73 FORDHAM L. REV. 2665, 2665 (2005). "[A] lawyer-client relationship may arise absent the lawyer's intent to form one." Frederick C. Moss, *"Is You Is, or Is You Ain't My [Client]?": A Law Professor's Cautionary Thoughts on Advising Students*, 42 S. TEX. L. REV. 519, 527 (2001).

40. This Article does not purport to be a formal study of lawyering in any context. Rather, it samples unscientifically from among the possible topics that could be covered in a more comprehensive work on being a lawyer in the age of crowdfunding. It does so as a means of raising issues and heightening awareness. Even the anecdotal sampling included here offers significant information to lawyers and lawyer-observers alike.

41. *See, e.g.*, Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, J. CORP. L. 497, 499 (2008) (defining transactional lawyering as "the structuring, negotiating, contract drafting, advisory, and opinion-giving process leading to 'closing' a commercial, financing, or other business transaction").

42. Carrie Menkel-Meadow, *Ethics and Professionalism in Non-Adversarial Lawyering*, 27 FLA. ST. U. L. REV. 153, 158–59 (1999).

Specifically, in the crowdfunding context, a lawyer's substantive tasks typically involve entity selection and organization, the legal aspects of business structuring, contract negotiation and drafting, and financial counseling and guidance (including advice on federal and state securities law compliance). Because crowdfunding is centered on bringing in funding for a business or project, financial considerations are central to the legal advisory context, putting securities law advice at a premium. The comments about substantive law set forth in the remainder of this Article relate primarily to the application of federal securities law in the crowdfunding context.

This Article's observations illustrate actual and potential areas of concern for lawyers practicing at the intersection of corporate finance and Internet-based social networking. The commentary is organized under relevant core principles of professional responsibility. Each principal (the unauthorized practice of law, competence, diligence, and public duties and obligations) identifies a different lawyering danger—a risk that lawyers assume—in the crowdfunding era.

A. The Unauthorized Practice of Law

The American Bar Association's House of Delegates has adopted the *Model Rules of Professional Conduct* (the "*Model Rules*"), which offer a structure and text for adoption on a state level and provide general guidance on the nature and extent of a lawyer's professional responsibility.[43] *Model Rule* 5.5 covers, among other things, the unauthorized practice of law. It provides, in relevant part, that:

> (a) A lawyer shall not practice law in a jurisdiction in violation of the regulation of the legal profession in that jurisdiction, or assist another in doing so.

> Some lawyers represent entities, either from within or without, and must manage internal organizational "constituency" problems as a matter of advice and counsel, whether or not there are particular legal disputes with the outside world. Modern in-house counsel or ombudsman-like lawyers may deal as much with internal organizational issues and management than with outside disputes, calling for very different skills and approaches to legal problem solving. Other lawyers are engaged to help individuals or entities form organizations or partnerships, draft wills or contracts, and may or may not have "issues" or "adversaries" in the way the adversarial model of lawyering understands them.

Id.; *see also* Guttenberg, *supra* note 30, 429–38 (describing lawyering for organizational, individual, and small business clients).

43. *See generally* MODEL RULES OF PROF'L CONDUCT ix–xi (2013).

> (b) A lawyer who is not admitted to practice in this jurisdiction shall not:
> (1) except as authorized by these Rules or other law, establish an office or other systematic and continuous presence in this jurisdiction for the practice of law; or
> (2) hold out to the public or otherwise represent that the lawyer is admitted to practice law in this jurisdiction.[44]

This rule frames a lawyer's professional obligation to be licensed in any jurisdiction in which he or she practices law.

In many cases, the observations about questionable lawyering activities made in this Article cannot be traced to the actions of a specific, named lawyer. One might then dismiss those observations as merely reflecting the actions of an unlicensed layperson. This dismissal would, however, be premature (at least in some cases). Both licensed attorneys and others may violate applicable judicial and legislative rules relating to the unauthorized practice of law.

1. Licensed Attorneys

Jurisdictions that license attorneys to practice law protect their licensees and the licensure system—as well as those in the state who are receiving legal services—by providing for enforcement against people who engage in the unauthorized practice of law. A licensed attorney may violate these rules by practicing in a jurisdiction in which he or she is not licensed.[45] This can be particularly tricky in business contexts that cross borders. Business conducted over the Internet, and therefore crowdfunding, natively involves cross-border business and legal considerations. Legal counsel working with these businesses must take the cross-border nature of crowdfunding into account in his or her practice.

Those providing capital to businesses or projects in crowdfunded offerings may come from a variety of different jurisdictions—jurisdictions distinct from those that govern the activities of the crowdfunding websites with which they interact and the crowdfunded businesses and projects they finance. In crowdfunded offerings not involving the offer and sale of securities, a contractual choice of law often can effectively govern the funding transaction and related interactions.[46] Assuming the enforceability

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44. *Id.* R. 5.5.

45. *See id.* R. 5.5(a), (b); *see also* Catherine J. Lanctot, *Scriveners in Cyberspace: Online Document Preparation and the Unauthorized Practice of Law*, 30 HOFSTRA L. REV. 811, 814 (2002) ("[T]he issue of multijurisdictional practice also focuses on whether lawyers who provide legal advice or other services across state lines have engaged in unauthorized practice of law").

46. A court should give effect to the parties' choice of law if the parties have contracted validly for application of a law that is substantially related to the parties or

of this choice of law provision, a transactional lawyer authorized to practice in the chosen jurisdiction should have little reason to engage in the practice of law in any other jurisdiction in advising the client.[47] The governing law typically will be chosen by the crowdfunding website; funders and businesses or projects seeking funding who contract with the crowdfunding website therefore are best advised to seek legal advice from counsel licensed to practice in that same jurisdiction.

However, crowdfunded securities offerings raise other, more significant issues relating to the unauthorized practice of law. Unless state securities (Blue Sky) law is preempted, multiple state securities laws (as well as federal securities law) may apply to the same crowdfunded offering.[48] The

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the transaction or otherwise reasonable, absent a statutory or decisional law rule or public policy to the contrary. *See generally* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1988). As applied in California to the validity of a choice of law provision in a valid and binding contract:

> [T]he proper approach under Restatement section 187, subdivision (2) is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law. If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a *fundamental* policy of California. If there is no such conflict, the court shall enforce the parties' choice of law. If, however, there is a fundamental conflict with California law, the court must then determine whether California has a 'materially greater interest than the chosen state in the determination of the particular issue . . . .' If California has a materially greater interest than the chosen state, the choice of law shall not be enforced, for the obvious reason that in such circumstance we will decline to enforce a law contrary to this state's fundamental policy.

Nedlloyd Lines B.V. v. Superior Court, 834 P.2d 1148, 1152 (Cal. 1992) (citation and footnotes omitted).

47. A lawyer may engage in temporary multijurisdictional practice under the American Bar Association's *Model Rules of Professional Conduct*, which have been adopted in some form by most states. Under the *Model Rules*:

> A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that:
> are undertaken in association with a lawyer who is admitted to practice in this jurisdiction and who actively participates in the matter; . . . or
> (4) are not within paragraphs (c)(2) or (c)(3) [addressing legal representation related to pending or potential tribunal or alternative dispute resolution proceedings] and arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

MODEL RULES OF PROF'L CONDUCT R. 5.5(c).

48. A recent federal trial court opinion summarized the law in this area:

applicable laws depend on the jurisdictions asserting to protect the crowdfunding offerees and purchasers (typically states in which those offerees and purchasers are resident or the securities offering is otherwise deemed to have been made).[49] A lawyer advising a crowdfunding website that desires to make offers and sales in multiple jurisdictions should ensure that she works with local counsel licensed in each of those jurisdictions to avoid allegations that she is engaging in the unauthorized practice of law in those jurisdictions in which he or she is not licensed to practice.[50]

In general, a lawyer providing services in the crowdfunding environment—a setting in which lawyering inherently crosses borders—must take care in ensuring compliance with rules of professional conduct that are, by their nature, rooted in distinct geographical territories. Professional responsibility rules on the unauthorized practice of law typically focus on where the lawyer is practicing law (e.g., where legal advisory activities take place or where the client is located) rather than the jurisdiction in which the legal rules were adopted.[51] In this context, it may

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> The growing weight of authority indicates that Blue Sky laws are additive rather than exclusive. These holdings are predicated on the notion that Blue Sky laws are designed to regulate securities transactions within (or impacting) a particular state. If a transaction touches multiple states, it follows that multiple Blue Sky laws may apply simultaneously.

Mass. Mut. Life Ins. Co. v. Countrywide Fin. Corp., Nos. 2:11-ML-02265-MRP (MANx), 2:11-CV-10414 (MANx), 2012 U.S. Dist. LEXIS 59620, at *10–11 (C.D. Cal. Apr. 16, 2012) (citations omitted).

49. The jurisdictional reach of state securities laws is generally circumscribed by the policies underlying those laws:

> State securities laws . . . specifically define key elements such as buy, sell, offer and acceptance and thereby direct determinations of whether a securities transaction took place within the state. This helps ensure that a satisfactory nexus exists with the state whose law is sought to be invoked. A court's thorough examination of whether alleged transactions fall under a state's well-defined securities law provisions will promote these goals . . . . [S]tate blue sky laws serve further interests as well. Many if not all such laws are written to protect purchasers of securities, regardless of the security's origin. Such statutes also seek to render liability on securities issuers whose activities within a given state fail to conform to that state's laws.

Klawans v. E. F. Hutton & Co., No. IP 83-680-C, 1989 U.S. Dist. LEXIS 18194, at *5–6 (S.D. Ind. Feb. 15, 1989).

50. This approach may provide legal counsel with the opportunity to engage in temporary multijurisdictional practice under the American Bar Association's *Model Rules of Professional Conduct*. *See* MODEL RULES OF PROF'L CONDUCT R. 5.5(c)(1).

51. *See supra* note 45. Having said that, advising a client on the law of a jurisdiction in which the lawyer is not licensed may be viewed as a potential

not be easy to determine exactly where law is being practiced, making for a very challenging professional responsibility milieu for lawyering in the crowdfunding era.[52]

2. Unlicensed Persons

Entrepreneurs and others in their firms who are not lawyers may also engage in the unauthorized practice of law by participating in activities that constitute law practice. For example, an entrepreneur or other agents of her firm may draft legal documents or offer advice on the legality of a particular action or practice of the venture. Advice on legal issues, even if caveated, may cross the line into legal advice. Those types of communications are situated squarely on the indistinct line between information provision and legal advice.

The Internet provides an environment in which the provision of law-related information by non-lawyers or unlicensed lawyers can look like, or in fact be, the unauthorized practice of law. Internet-based securities transactions involve certain specific legal perils in this regard because investors may come from many different jurisdictions, creating the need to evaluate unauthorized practice under the rules of multiple jurisdictions. The discourse among Scott, Jessica, and Mike excerpted *supra* Part I.C provides an apt illustration of the extent of the cause for concern.

Specifically, by mentioning the improbability of convincing "50 state bar associations" that certain activities do not constitute the unauthorized practice of law and in referencing a "rockier road ahead with . . . state bar associations," Mike highlights the fact that each jurisdiction has its own rules on the types of activities that constitute the unauthorized practice of law, although many states are concerned about legal advice purveyed over the Internet—and in particular, web-based legal document production and providers.[53] That is true for all of the rules of professional conduct applicable to lawyers. They vary from state to state, sometimes in substantive ways.

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incompetence issue for professional responsibility purposes (even if not the unauthorized practice of law in that jurisdiction). Charles W. Wolfram, *Sneaking Around in the Legal Profession: Interjurisdictional Unauthorized Practice by Transactional Lawyers*, 36 S. TEX. L. REV. 665, 672–674 (1995).

52. *See generally* Bruce A. Green, *The Need to Bring the Professional Regulation of Lawyers into the 21st Century*, A.B.A., http://www.americanbar.org/groups/professional_responsibility/committees_commissions/commission_on_multijurisditional_practice/mjp_bruce_green_report.html#Application (last visited Jan. 22, 2014) (outlining these challenges in Part III).

53. *See* Lanctot, *supra* note 45, at 849–53 (assessing the possibility that online document preparation and provision websites are engaged in the unauthorized practice of law).

What types of conduct may constitute the unauthorized practice of law under these state law rules? Under Tennessee law, for example, it is a misdemeanor to "engage in the practice of law or do law business, or both."[54] The statute confers both public and private enforcement rights.[55]

Is Jessica or ProFounder engaged in the unauthorized practice of law by conducting business operations under ProFounder's business model? As noted *supra* Part I.C, Mike raises a number of issues in this regard. Among them:

- whether ProFounder's system and practices for answering important threshold legal questions as to, e.g., the status of bundles of financial interests as securities and the classification of funders as accredited or non-accredited investors—constitutes the practice of law; and
- whether contract drafting services provided through ProFounder constitute law practice.

In addition, Jessica's remarks may be seen as statements of legal analysis or conclusions that may constitute the practice of law.

In evaluating a potential claim that ProFounder or Jessica engaged in the unauthorized practice of law, it is important to assess whether activities of these kinds constitute the practice of law under the laws and regulations in effect in every jurisdiction in which ProFounder or Jessica conducts those activities. Some broad guidance has been offered at the state level as to what might constitute the "practice of law."[56] Under Tennessee law, for

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54. TENN. CODE ANN. § 23-3-103(a) (2013). In addition, the Tennessee Supreme Court has adopted a licensure requirement to the same effect:

> No person shall engage in the "practice of law" or the "law business" in Tennessee, except pursuant to the authority of this Court, as evidenced by a license issued in accordance with this rule, or in accordance with the provisions of this rule governing special or limited practice.

TENN. SUP. CT. RULES R. 7, § 1.01 (2013).

55. TENN. CODE ANN. §§ 23-3-103(c)–(d), 23-3-112(a). The author is licensed to practice in Tennessee and has therefore chosen Tennessee examples to illustrate various points made in this Article.

56. For instance, the *Model Code of Professional Responsibility* provides that:

> Functionally, the practice of law relates to the rendition of services for others that call for the professional judgment of a lawyer. The essence of the professional judgment of a lawyer is his educated ability to relate the general body and philosophy of law to a specific legal problem of a client.

MODEL CODE OF PROF'L RESP. EC 3–5 (1986). Another commentator offers:

example:

> "Practice of law" means the appearance as an advocate in a representative capacity or the drawing of papers, pleadings or documents or the performance of any act in such capacity in connection with proceedings pending or prospective before any court, commissioner, referee or any body, board, committee or commission constituted by law or having authority to settle controversies, or the soliciting of clients directly or indirectly to provide such services . . . .[57]

It is unlikely that a court would find that ProFounder's systems and practices for resolving legal issues or drafting of offering documents or Jessica's commentary on legal issues constitute the practice of law. The definition of "practice of law" contemplates representation in advocacy or dispute resolution proceedings. These services were not being offered by ProFounder.

However, Tennessee law also prohibits doing "law business." Under Tennessee law:

> "Law business" means the advising or counseling for valuable consideration of any person as to any secular law, the drawing or the procuring of or assisting in the drawing for valuable consideration of any paper, document or instrument affecting or relating to secular rights, the doing of any act for valuable consideration in a representative capacity, obtaining or tending to secure for any person any property or property rights whatsoever, or the soliciting of clients directly or indirectly to provide such services . . . .[58]

This is where real arguments can be made that ProFounder or Jessica may be violating Tennessee's prohibitions on the unauthorized practice of law. Questions to be answered include the following:

> The definitions of "the practice of law" found in the case law and state statutes are astonishingly broad and varied. Essentially, they can be boiled down to the following: the practice of law is the application of legal knowledge, judgment, training, or skill in advising or otherwise assisting another to analyze or solve a particular legal problem or need.

Moss, *supra* note 39, at 522 (footnote omitted).

57. TENN. CODE ANN. § 23-3-101(3). Tennessee law also recognizes the guidance provided in MODEL CODE OF PROF'L RESP. EC 3–5. *See In Re* Burson, 909 S.W.2d 768, 776 (Tenn. 1995).

58. TENN. CODE ANN. § 23-3-101(1).

- Does ProFounder's determination that a particular bundle of investment interests is or is not a security under the 1933 Act or Securities Exchange Act of 1934, as amended, constitute doing law business in Tennessee because it is advising or counseling offerees and purchasers in Tennessee on securities law matters for valuable consideration (e.g., the share of the proceeds contributed by the investor that would inure to ProFounder's benefit)?
- Does ProFounder's determination that an investor is non-accredited for purposes of Regulation D under the 1933 Act constitute doing law business in Tennessee because it is advising or counseling offerees and purchasers in Tennessee on securities law matters for valuable consideration (same as above)?
- Does ProFounder's provision of contracts in connection with investment transactions made through its website constitute doing law business because it represents the procuring of or assisting in the drawing of any paper, document or instrument affecting or relating to a Tennessee investor's legal rights for valuable consideration (same as above)?
- Does Jessica's explanation of ProFounder's approach to various securities regulation issues constitute doing law business because it is advising or counseling offerees and purchasers in Tennessee on securities law matters for valuable consideration (same as above)?

There is no definitive answer to these questions under Tennessee decisional law. Moreover, Tennessee is just one among the many jurisdictions in which ProFounder's and Jessica's activities, conducted over the Internet, may be deemed to be conducted.

Given that each state defines and interprets the practice of law its own way and factual situations can be quite novel, individual questions in many jurisdictions are issues of first impression for regulators and courts. In most cases, relevant rules are expressed in broad standards that allow for significant interpretation—interpretation that is informed by all relevant factors, not a limited set of fixed, outcome-determinative guiding principles.[59] "[L]awyers have famously struggled for decades to define what it is that they do for a living, and it is the amorphous nature of the practice of law that makes inquiries into unauthorized practice principles so challenging."[60] Mike's questions about the unauthorized practice of law

59. Lanctot, *supra* note 45, at 812–13.

60. *Id.* at 811.

are good ones to ask, even if they cannot be definitively answered here.

It may be unlikely that an enforcement action would be brought under a statute prohibiting the unauthorized practice of law against a crowdfunding website or crowdfunded venture (or a principal or manager of either of them). Nevertheless, a risk of enforcement does exist if the manager drafts legal documents for signature by, or offers advice on legal issues to, funders or others. States like Tennessee have revised their statutes and stepped up enforcement efforts or made them more visible.[61] States also have introduced web-based complaint processes, making it relatively simple for a disgruntled funder or customer or employee to raise a question about the possible unauthorized practice of law.[62] As Scott and Mike suggest in their dialogue with Jessica, the laws governing crowdfunding (especially the federal and state securities laws) are complex enough that all participants should have independent legal counsel.

B. The Matter of Competence . . .

Having legal counsel licensed to practice in the appropriate jurisdictions may be necessary, but it certainly is not sufficient to assure compliance with relevant rules of professional conduct. Legal counsel engaged with participants in a crowdfunding venture should be well-versed in the laws governing the crowdfunding enterprise. The key (but by no means the only) laws relevant to crowdfunding are federal and state securities laws, state entity laws, and contract law, including principles of contract drafting. Crowdfunding also is likely to engage other areas of law, including intellectual property, tort, and agency law.

The *Model Rules* require that a lawyer "provide competent representation to a client."[63] Under the *Model Rules*, "[c]ompetent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."[64] A recent addition to the *Model Rules* comments incorporates expressly the need to keep abreast of technological innovation.[65] Competence is central to the

61. *See, e.g.*, William C. Bovender, *Treating the UPL Epidemic*, 42 TENN. B.J. 26, 27–28 (2006) (describing the Tennessee statute enacted in 2006 and the status of enforcement efforts at that time).

62. *See, e.g.*, *Prosecuting the Unauthorized Practice of Law (UPL)*, OFF. OF THE ATT'Y GEN. & REP. ROBERT E. COOPER JR., http://www.tn.gov/attorneygeneral/upl/upl.html (last visited Sept. 13, 2013).

63. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2013).

64. *Id.*

65. *Id.* R. 1.1 cmt. 8.

lawyer's task.[66] Among other things, a competent transactional lawyer may be able to reduce regulatory costs.[67]

Competent representation is critical to a venture's long-term success in the crowdfunding era. Yet, it may be hard to acquire for small businesses, including some crowdfunding websites and issuers. In particular, as indicated in the discourse among Scott, Jessica, and Mike excerpted *supra* Part I.C, securities regulation as applied in the crowdfunding context is specialized and complex. Experts in securities law—licensed practitioners who can accurately and completely apply federal and state doctrine to novel facts—often work in large law firms in major cities and bill out at relatively high rates, rates that may be unaffordable for small businesses.

In the year or two leading up to the passage of the JOBS Act, a number of crowdfunding websites and issuers were, by all outward signs, offering and selling investment contracts (an instrument recognized as a security under federal law, unless the context otherwise requires, that is also recognized as a security under state laws) to the public without registration or the availability of an applicable exemption.[68] These unregistered offers and sales violate Section 5 of the 1933 Act.[69] The web-based dialogue regarding ProFounder excerpted *supra* Part I.C references this issue.

That colloquy fails to expressly mention, however, that ProFounder, as the crowdfunding website, as well as the business or project being funded, may be deemed to be offering and selling securities without registration, since the statute includes a rather open definition of "offer" and the SEC interprets the word "offer" quite broadly.[70] Some crowdfunding websites continue to operate in a manner that raises questions about 1933 Act registration. For example, a crowdfunding website operating at the time this Article was written offers funders a share of the proceeds of the sale of a product in return for funding for the development or marketing of the product in a transaction structured to look like a wholesaling arrangement.

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66. *See* JAMES C. FREUND, LAWYERING: A REALISTIC APPROACH TO LEGAL PRACTICE 92–94 (1979).

67. *See, e.g.*, Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 500–02 (2007).

68. *See* Heminway & Hoffman, *supra* note 1, at 890–906 (analyzing crowdfunding interests with profit-sharing or revenue-sharing components under the *Howey* test and concluding that they are investment contracts and securities under federal securities law).

69. 15 U.S.C. § 77e (2012); *see also* Heminway & Hoffman, *supra* note 1, at 961 ("[C]rowdfunded ventures and crowdfunding websites that offer profit-sharing interests to funders violate Section 5 of the Securities Act when they offer or sell those interests without registration or compliance with an applicable exemption.").

70. *See* 15 U.S.C. § 77b(3); Heminway & Hoffman, *supra* note 1, at 922–27 (assessing the status of the crowdfunding website as, among other things, a co-issuer).

Scott's comments in the dialogue excerpted *supra* Part I.C also raise questions about whether ProFounder, as a crowdfunding website, is an unregistered broker dealer. This has been a concern of others when interests in a business or project being offered and sold through a website are securities under federal law.[71] At least one legal scholar specializing in small business finance concludes that crowdfunding websites offering securities outside the parameters of the CROWDFUND Act may be brokers.[72] The same scholar also raises questions about whether crowdfunding websites through which securities are offered and sold may be classified as exchanges or investment advisors, concluding that it is unlikely they are exchanges and unclear whether they are investment advisors.[73] Although the CROWDFUND Act addresses, expressly or implicitly, many of the substantive legal issues identified here, the identified crowdfunding activities have been taking place at a time when the CROWDFUND Act is not effective. Also, at least one crowdfunding website has been soliciting securities purchasers broadly on the Internet in what appears to be a non-compliant intrastate offering exemption.[74]

Several securities crowdfunding websites, including ProFounder, ceased operations in the months leading up to the adoption of the CROWDFUND Act.[75] ProFounder's principals stated, in their last post to the venture's weblog, that "the current regulatory environment prevents us from pursuing the innovations we feel would be most valuable to our customers, and we've made the decision to shut down the company."[76] Although causality cannot be presumed, the fact that the websites' business operations and plans contravened existing securities laws may have been a factor in the decision to shutter these businesses.

Competent representation may have avoided this result. Although there is public evidence that a number of the crowdfunding websites offering and selling securities (in the form of investment contracts) had legal counsel during the development of the website's business model or during its

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71. *See* Bradford, *supra* note 5, 52–67.

72. *See id.* at 67 (concluding that "[t]he crowdfunding sites' receipt of transaction-based compensation, continued involvement in the investor-entrepreneur relationship, public advertising, and for-profit status may cumulatively be too much to allow them to avoid broker status.").

73. *See id.* at 50–51 (regarding the status of crowdfunding websites as exchanges); *id.* at 67–80 (regarding the status of crowdfunding websites as investment advisors).

74. *See* 15 U.S.C. § 77c(a)(11); 17 C.F.R. § 230.147 (2013); *see also supra* note 4.

75. *See* Jessica Jackley, *Profounder Shutting Down*, PROFOUNDER, THE BLOG (Feb. 17. 2012), http://blog.profounder.come/2012/02/17/profounder-shutting-down/; *see also* Heminway & Hoffman, *supra* note 1, at 892 n.60 (noting that 33needs.com also took its site offline a few months earlier).

76. *ProFounder Shutting Down*, *supra* note 75.

operations, offers and sales of investment contracts proceeded under the watch of these lawyers in violation of federal securities law. The analysis of security status under federal law is straightforward, as is the registration/exemption analysis under Section 5 of the 1933 Act.[77] The analysis of broker and investment advisor status is less clear-cut.[78] But the legal peril in proceeding in the face of these risks is easily ascertained and significant.

C. A Lawyer's Diligence

Under the *Model Rules* and rules of professional conduct existing in the various states, lawyers must be diligent in addition to being competent. Specifically, the *Model Rules* provide that "[a] lawyer shall act with reasonable diligence and promptness in representing a client."[79] The comments to the diligence rule further provide that "[a] lawyer should . . . take whatever lawful and ethical measures . . . are required to vindicate a client's cause or endeavor"[80] and "must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf."[81]

The crowdfunding era has exposed potential diligence issues (in addition to competence issues) under federal securities law. For example, at least one crowdfunding website asserting compliance with the exemption from registration in Rule 506 under Regulation D[82] engaged in marketing activities that could be deemed to be general solicitation and advertising[83] after Title II of the JOBS Act was enacted but before Rule 506(c) was adopted by the SEC.[84] General solicitation and advertising invalidates a Rule 506 exemption conducted outside the scope of Rule 506(c). In fact, it was possible, at one time, to obtain a .pdf copy of the private placement memorandum for offerings being made on that website. (Private placement memoranda are marketing and disclosure documents for private placement

77. 15 U.S.C. § 77e.

78. *See* Bradford, *supra* note 5, at 52–80 (summarizing the analysis of broker and investment adviser status under federal securities law).

79. MODEL RULES OF PROF'L CONDUCT R. 1.3 (2013).

80. *Id.* R. 1.3 cmt. 1.

81. *Id.*

82. *See* 17 C.F.R. § 230.506 (2013).

83. *Id.* § 230.502(c).

84. Title II of the JOBS Act provides for the removal of the restriction on general solicitation and advertising for Rule 506 offerings in which all sales are made to accredited investors. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313–15 (2012). This provision is effectuated through Rule 506(c) under the 1933 Act, recently adopted by the SEC. *Id.*; *see also supra* note 4 and accompanying text (describing Regulation D private placement restrictions on general solicitation and advertising for offerings conducted without the benefit of Rule 506(c)).

transactions, including those conducted under Rule 506.) A visitor to the website merely had to click on a publicly available hypertext link—without pre-qualifying as an accredited investor or sophisticated offeree—to gain access to the private placement memorandum, further exacerbating the general solicitation and advertising problems on the site. Diligent lawyering by a competent lawyer should have prevented these lapses.[85]

The crowdfunding website that manifested these diligence issues included a web page that listed the principals of the firm, one of whom was a lawyer with experience in legal work and management in the financial services industry. It would be surprising if this lawyer did not have responsibility for securities compliance matters for the firm. However, it is important to note that a lawyer may be engaged by a firm for a specific matter, in which case "the relationship terminates when the matter has been resolved."[86] Regardless, a lack of diligent lawyering—or incompetence or even advice on the permissibility of engaging in activities that are unlawful (e.g., engaging in general solicitation and advertising before full implementation of Title II of the JOBS Act)—may have contributed to the legal compliance issues outlined here.

D. A Lawyer's Public Duties and Obligations

The preceding discussion of competence and diligence assumes the existence of a lawyer-client relationship. However, lawyers in the crowdfunding era also engage in professional activities that are outside the scope of their relationships with clients. Indeed, law is a public profession, and lawyers are, to some degree, public servants.[87] Lawyers engaging in these activities are not free from the constraints of professional responsibility rules.

For example, lawyers must be honest and truthful so as to uphold the integrity of the profession. Under the *Model Rules*, "[i]t is professional misconduct for a lawyer to . . . engage in conduct involving dishonesty, fraud, deceit or misrepresentation."[88] This rule, unlike a similar proscription in *Model Rule* 4.1(a), does not require that the lawyer be

85. Diligence and competence sometimes are closely related, since competence requires that a lawyer use the means necessary to achieve the desired legal end. *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 cmt. 5 ("Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners.").

86. *Id.* R. 1.3 cmt. 4.

87. *See generally* Debra Lyn Bassett, *Redefining the "Public" Profession*, 36 RUTGERS L.J. 721 (2005) (describing the roots and decline of the public nature of the legal profession).

88. MODEL RULES OF PROF'L CONDUCT R. 8.4.

operating in the course of a lawyer-client relationship.[89]

Lawyers have offered faulty advice to colleagues and the public about and in connection with crowdfunding—especially in the blogosphere. Sadly, the examples are too numerous to cover in full in this brief Article, but they run the gamut from incorrect statements of the law (including the legal provisions in the JOBS Act), through inadequate understandings of the facts, incorrect legal analysis, and inapposite legal conclusions. In a number of cases, lawyers incorrectly conflate crowdfunding under Title III of the JOBS Act with the loosening of general solicitation and advertising restrictions under Title II of the JOBS Act or otherwise erroneously mash legal prescriptions and proscriptions under the JOBS Act.

Law blogs are a public good. The *Model Rules* recognize a public education function for lawyers in providing that "a lawyer should further the public's understanding of and confidence in the rule of law and the justice system because legal institutions in a constitutional democracy depend on popular participation and support to maintain their authority."[90] This public education function is, however, presumably subject to the lawyer's responsibility to be honest and truthful under *Model Rule* 8.4(c) as well as additional professional conduct strictures that apply in other lawyering contexts, e.g., competence and diligence. In fact, the Preamble to the *Model Rules* generally provides that "[i]n all professional functions a lawyer should be competent, prompt and diligent."[91]

CONCLUSION

This Article highlights lawyering issues observed in the crowdfunding era. On the one hand, the challenges presented to legal counsel by crowdfunding are substantially the same as those observed in other transactional law contexts. As such, they are easily categorized based on tried-and-true rules of professional responsibility—the unauthorized practice of law, competence, diligence, and public duties and obligations. On the other hand, the nature and extent of the observed issues may relate in some ways to the unique context in which crowdfunding has developed

89. *See id.* R. 4.1(a) ("In the course of representing a client a lawyer shall not knowingly: (a) make a false statement of material fact or law to a third person . . . ."); *see also* Peter A. Joy & Kevin C. McMunigal, *Ethics Ethical Concerns of Internet Communication*, 27 CRIM. JUST. 45, 45 (2013) (noting that the prohibition in Rule 4.1(a) "contains no limitation to conduct in the course of representing a client" and adding that "it might reach false statements made by a lawyer on a blog about a case in which the lawyer is not participating").

90. MODEL RULES OF PROF'L CONDUCT pmbl. ¶ 6.

91. *Id.* pmbl. ¶ 4.

and is occurring.

Specifically, the unauthorized practice of law may be or may become more prevalent in the crowdfunding era due to the inherently multijurisdictional, Internet-driven nature of crowdfunding itself. Legal counsel to a crowdfunding website should be particularly careful to avoid engaging in law practice in a jurisdiction where he or she is unlicensed—including, as applicable under relevant law, by advising the client on the law of that other jurisdiction or by holding herself out or representing herself to others as a lawyer admitted to practice in that other jurisdiction. The business models for crowdfunding and the software that enables those business models also may be deemed to be providing legal advice by offering information to funders and the principals behind businesses and projects desiring funding.[92]

Competence issues in the crowdfunding era may be magnified by both the rarified (and sometimes nuanced) nature of U.S. securities regulation and the online nature of the communications that enable crowdfunding. Mistakes may be foundational—built into the core elements of certain crowdfunding business models (in particular, those for securities crowdfunding)—and, with the added transparency and reach of the Internet, may be highly visible. A lawyer not intending to give a crowdfunding client advice on securities regulation issues (or otherwise desiring to limit the scope of his or her engagement), whether for competence reasons or otherwise, should make this explicit in a valid engagement letter lest he or she be deemed to have created a lawyer-client relationship that includes representation on securities regulation matters.

Diligent representation also may be strained by attributes of the crowdfunding era. A lawyer working with any venture having an Internet presence must be vigilant in ensuring that the information conveyed on the firm's website is complete and accurate. Ideally, each web page should be reviewed by counsel; hypertext links should be identified, regularly tested, and, where broken, fixed; and content required by law or having legal substance should be evaluated through both compliance and professional responsibility lenses.

Technology plays a strong role in crowdfunding, including as a means of complying with law. Based on the provisions of the CROWDFUND Act, it can be expected that the role of technology in securities crowdfunding compliance will only grow after adoption of the SEC's enabling rules. Accordingly, a lawyer working with a crowdfunding participant—especially a participant in securities crowdfunding—must understand enough about the technology to be able to assure his or her client's

92. *See supra* note 32 and accompanying text.

compliance with law.

Lawyers also must remain cognizant of their duties and obligations to the public. Competence and diligence are at issue in this aspect of the lawyer's role as well as in lawyer-client relationships, especially in light of a lawyer's overall obligation to refrain from fraud, deceit, and misrepresentations. While potentially laudatory as a means of public education, the provision of legal advice over the Internet through websites and weblogs is an ethical trap for the unwary. The medical profession, which contends with online patient advice in a professional environment somewhat analogous to the legal advisory environment,[93] has directly addressed the provision of information through medical information websites in an opinion included in the American Medical Association's Code of Medical Ethics.[94] Perhaps the legal profession should engage this issue in a similarly direct manner.

Finally, the relatively long lag between the date that the President signed the JOBS Act into law and the adoption by the SEC of the rules enabling crowdfunded offerings under the CROWDFUND Act, together with the novelty and nature of crowdfunding, has created opportunities for gun-jumping and regulatory arbitrage, some of which undoubtedly is occurring with (rather than in spite of) the advice of counsel. A lawyer's ardent pursuit of a client's business ends must be lawful and compliant with applicable rules of professional responsibility. In this regard, a comment to *Model Rule* 1.3 provides that:

> A lawyer should . . . take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. A lawyer is not bound, however, to press for every advantage that might be realized for a client. For example, a lawyer may have authority to exercise professional discretion in determining the means by which a matter should be pursued.[95]

Blind advocacy of a client's desired business model is not contemplated by the *Model Rules* and is inconsistent with a lawyer's overall fiduciary duty to the client.[96] Novel, sexy business models (which, for some, may include

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93. *See supra* note 29.

94. *See* Am. Med. Ass'n, AMA Code of Med. Ethics, Op. 5.027 - Use of Health-Related Online Sites (2003), *available at* http://www.ama-assn.org//ama/pub/physician-resources/medical-ethics/code-medical-ethics/opinion5027.page.

95. MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 1.

96. *See generally* Paula Schaefer, *Harming Business Clients with Zealous*

crowdfunding), urged on legal counsel by exciting, passionate clients with compelling urgency, may present a lawyer with challenges that require a calm, dispassionate return to those fiduciary principles and general notions of ethics and professionalism.

We can learn many lessons about pitfalls to avoid as business lawyers by looking at and analyzing examples of business lawyering gone awry. This Article takes a limited step in that direction as a means of providing guidance to transactional counsel and others. The issues presented and observations made here are not unique, but the context in which they arise—a potent combination of rapidly evolving social media technology and creative corporate finance—is a new one that may be here to stay. By appreciating these issues and observations and focusing on, among other values, attorney licensure, competence, and diligence, as well as fiduciary duties, ethics and the integrity of the legal profession as a public profession, legal counsel should be better able to engage in productive, valued lawyering in the crowdfunding era and beyond.

Advocacy: Rethinking the Attorney Advisor's Touchstone, 38 FLA. ST. U. L. REV. 251 (2011) (arguing, among other things, that the "[p]rofessional conduct rules should introduce all lawyers to fiduciary duty as a new mantra for decisionmaking").

NON-PARTY INTERESTS IN CLOSING OPINION LETTERS

HEATHER HUGHES*

INTRODUCTION

What do transactional lawyers do when they issue third-party opinion letters in financial transactions? This descriptive question turns out to be quite complex[1]—so complex that the normative question of what lawyers should do when they issue opinions, as well as the practical question of what they could do, are difficult to answer.

This Symposium Article reflects upon third-party closing opinions as a central aspect of business law practice that can be opaque to outsiders. The ideas expressed here are exploratory. In the spirit of reflecting on what transactional lawyers do, this contribution considers deal lawyer strategies as potential tools for advancing the interests of non-parties affected by commercial transactions.

Many types of transactions call for opinions of counsel as a condition precedent to closing.[2] This Symposium Article focuses on certain types of opinions to third parties—namely, closing opinions in commercial finance

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1. *See infra* text accompanying notes 5–10.

2. *See generally* DONALD W. GLAZER ET AL., GLAZER & FITZGIBBON ON LEGAL OPINIONS (2d ed. 2001 & Cum. Supp.); LEGAL OPINION LETTERS FORMBOOK (A. Sidney Holderness, Jr. & Brooke Wunnicke eds., 3d ed. 2010); Thomas L. Ambro & Arthur Norman Field, *The Legal Opinion Risk Seminar Papers*, 62 BUS. LAW. 397 (2007).

transactions. These opinions assure investors that, among other things, the transaction will be enforceable against the attorney's client at closing.

Attorneys commonly issue closing opinions to parties who have some relationship to the transaction; these are the third parties who request and receive opinions.[3] But there are also other parties, with no relationship to the deal and who are not named recipients of any opinion, who can nonetheless take interest in the existence and forms of closing opinion letters. Typical non-parties interested in closing opinions include rating agents or accountants who assess transactions.[4] After all, opinions signal that a deal conforms to legal standards and should be priced and accounted for as such.

This Symposium Article considers the scope of non-party interests in opinion letters, exploring new kinds of interests in these letters that non-parties could take. It presents—in a preliminary way—the possibility of opinions practice as a site for expressing social or environmental commitments.[5]

Transactional representation, among other things, effectuates private ordering and governance. Deal lawyers translate the initiatives of market actors into legally enforceable contracts and conveyances. Private ordering involves commitment to industry social and environmental standards.[6] Lawyers for corporations entering into transactions with social or environmental consequences, then, participate in the implementation (or not) of self-regulation or industry norms.

When a type of transaction affects non-parties—such as community or environmental groups—these groups often express their interests by pressuring transacting parties to adhere to their favored norms. These outsiders tend to focus on corporate reputation, creating pressure on companies to behave in accordance with the social and environmental commitments that they express publicly, but may not always implement.

What transactional lawyers do can be opaque to outsiders. This can result in lost opportunities for non-parties as they engage in strategic behavior to enforce industry norms that are central to contemporary, private governance.

For example, lawyers for non-governmental organizations ("NGOs") concerned with the consequences of transactions could develop forms of

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3. *See* Lipson, *infra* note 14, at 1203.

4. *See id.*

5. This Symposium Article does not intend to express any concrete proposals or normative commitments; the ideas presented below are purely exploratory and would require significant further trouble-shooting and research.

6. *See infra* text accompanying notes 32–35.

legal opinion. Organizations could demand of investors that they receive certain forms of opinion as a way of ensuring compliance with the organizations' standards. Failure to request or to obtain the opinion would signal to non-parties that a deal may be adverse to their interests. This type of exercise might enable interested non-parties to generate information about transactions with a level of specificity that they currently lack.

Part I briefly describes closing opinions in financial transactions. Part II describes non-party interests in closing opinions. Part III relates closing opinions to concepts of private lawmaking and of new governance. Part IV synthesizes the first three parts into a proposition that perhaps non-parties with normative agendas could make strategic use of opinions. It presents one sample context in which this idea could have traction: 'no violation of law' opinions in project finance transactions in which the lender has adopted the Equator Principles.[7]

Opinion letters are about deal details. Giving affected non-parties better understanding of transactional lawyering strategies could enable them to harness the power of specificity with respect to transactions with significant environmental or community effects.

I. OPINION LETTERS IN FINANCE

Third-party closing opinions are letters that attorneys issue on behalf of clients for the benefit of lenders or other parties to a transaction. A clean opinion will assure parties to a transaction that the deal meets certain legal criteria, including enforceability. A qualified opinion will identify legal risks; a reasoned opinion will explain the lawyers' views on identified issues.

Literature on opinions practice discusses third-party closing opinions' (i) value to transactions,[8] (ii) risk of liability for issuing attorneys,[9] or (iii) scope and degree of qualification.[10] Scholars discuss both economic and non-economic reasons for opinions practice. In economic terms, these letters can reduce information asymmetries or can function as a type of deal insurance.[11] In non-economic terms, some scholars say opinions persist

7. *See infra* note 40.

8. *See generally* Lipson, *infra* note 14.

9. *See id.* at 1203–04; *see generally* John P. Freeman, *Symposium: Rethinking Legal Opinion Letters: Current Trends in Legal Opinion Liability*, 1989 COLUM. BUS. L. REV. 235 (1989).

10. *See generally* DONALD W. GLAZER ET AL., *supra* note 2; LEGAL OPINION LETTERS FORMBOOK, *supra* note 2; Kettering, *infra* note 17.

11. *See, e.g.*, Ronald Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale L.J. 239, 290–91 (1984); *cf.* Barnett, *infra* note 16.

because of path dependency and conceptions of lawyers' professional roles in transactions.[12]

Many say that opinions are not cost-justified, and yet they endure as routine features of transactions.[13] Others observe that it is difficult to determine when a closing opinion is cost-justified, because parties do not know the value of the opinion until after the client incurs the costs of its preparation.[14] If a letter reveals important information about a transaction, it can be well worth its cost to the parties. If it does not, it may cost considerably more than the information provided adds to the deal.[15] Some question the usefulness of opinions' signaling or certification capacity, given that they are often highly qualified and difficult to interpret.[16]

Opinions can be so full of caveats and qualifications that their effectiveness is questionable.[17] The scope of exceptions to a legal opinion is often subject to negotiation between the attorney issuing the opinion and the opinion's beneficiaries. While some critics find a highly qualified opinion to be of little value, others find that the uncertainty such an opinion can convey is itself valuable information about a deal.[18]

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12. *See* Jonathan C. Lipson, *Price, Path & Pride: Third-Party Closing Opinion Practice Among U.S. Lawyers (A Preliminary Investigation)*, 3 BERKELEY BUS. L.J. 59, 113–15 (2005); Jonathan Macey, *The Limits of Legal Analysis: Using Externalities to Explain Legal Opinions in Structured Finance*, 84 TEX. L. REV. 75, 78 (2005).

13. *See* BUS. LAW SECTION, STATE BAR OF CAL., REPORT ON THIRD-PARTY REMEDIES OPINIONS 2007 UPDATE (2007), *available at* http://apps.americanbar.org/buslaw/tribar/materials/20120820000005.pdf.

14. Jonathon C. Lipson, *Cost-Benefit Analysis and Third-Party Opinion Practice*, 63 BUS. LAW. 1187, 1198 (2008) (presenting a qualitative empirical analysis of whether and when closing opinions are justified by cost-benefit analyses).

15. *See id.*

16. *See* Jonathan M. Barnett, *Certification Drag: The Opinion Puzzle and Other Transactional Curiosities*, 33 J. CORP. L. 95, 102–03 (2007) (discussing the wide use of closing opinions in corporate practice even where opinions contribute little informational value).

17. *See, e.g.*, Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1684 (2008) (noting that opinion letters in securitization opinions can contain so many caveats that they are virtually ineffectual); *see also* Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1070 n.242, 1080 (2009) (referring to transactional lawyers' opinion letters as attorney work product loaded with *ad nauseum* caveats).

18. Attorneys distinguish qualified opinions from "non-opinions"—opinions that are so extensively qualified that they do not actually give the opinion they purport to render. ABA Guidelines advise against issuing "non-opinion" letters in favor of more explicitly expressing to the client and third party that the attorney cannot give the requested opinion. *See, e.g.*, The ABA Silverado Guidelines, II.C. (4) (1991) (accompanying the 1991 Third-Party Legal Opinion Report and Accord).

Opinions practice has resisted centralized best-practices or regulation. In his qualitative empirical study, Jonathan Lipson finds that opinions practice appears to resist market-based change, and that the main forces behind changing practices are bar associations.[19] Even bar associations, though, have not necessarily succeeded in establishing centrally-articulated standards.[20]

II. RELATING NON-PARTY INTERESTS TO OPINIONS

Legal opinions serve a signaling function in markets. For example, opinions are integral to the creation of asset-backed securities.[21] In a securitization, opinions assure investors that a company conveyed assets to a special purpose vehicle (SPV) in a sale—not to secure debt—and that the SPV is a legal entity distinct from the company such that it would not be consolidated with the company in bankruptcy. Attorneys for securitization originators issue opinion letters to investors, but accountants and rating agents often rely on the letters as well. The securitization context generates specific non-parties interested in specific forms of third-party opinion letter.[22]

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19. *See* Lipson, *supra* note 12, at 64. Practitioners involved with the American Bar Association Opinion Committee observe that "business law practice has become more national and even international in the years since Silverado"—the 1989 conference where the ABA Section of Business Law attempted (without success) to garner institutional support for opinions standards. *See* Ambro & Field, *supra* note 2, at 397–98. Therefore, "the consensus that malpractice insurers, financial institutions, opinion recipient interests and rating agencies needed to agree as to customary practice is relatively recent." *Id.* at 398.

20. *See* Ambro & Field, *supra* note 2, at 397–98. Various bar association committee reports do address opinions practice. *See, e.g.*, Ops. Comm., Cal. St. B. Bus. L. Sec., *Toward a National Legal Opinion Practice: The California Remedies Opinion Report*, 60 BUS. LAW. 907 (2005); TriBar Op. Comm., *U.C.C. Security Interest Opinions—Revised Article 9*, 58:4 BUS. LAW. 1449 (2003).

21. *See generally* Kettering, *supra* note 17; Schwarcz, *infra* note 22.

22. Another group of non-parties potentially affected by securitization transaction opinions are investors in originators. Steven Schwarcz has observed that opinion letters can create negative externalities if they mislead investors in originators' securities. This is a function of an information problem: attorneys issue opinions to assure the bankruptcy remoteness of assets assigned to an SPV, as a legal matter, but then accountants use them for purposes of accounting for transactions as off-balance sheet sales. As Schwarcz observes, investors could learn about contingent recourse in these transactions if they more closely read disclosure statements. Steven L. Schwarcz, *The Limits of Lawyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 1, 2, 4, 7 n.33 (2005). Schwarcz is concerned with the effects of off-balance-sheet financing on investors, given investors' capacities to access and understand information. But the government, not attorneys, he argues, should address the problem that off-balance sheet financing can be opaque to investors.

However, legal scholars writing about a range of transactional law subjects suggest that non-parties have interests in closing opinions.[23] These projects express concern for lawyers' professional responsibility generally and for lawyers as gatekeepers in complex markets.[24] Non-parties such as market participants, or parties affected by corporate practices, have interests in third-party opinions in situations where those opinions are supposed to serve a gatekeeping function.

For example, Susan Block-Lieb and Edward Janger write about the need for effective gatekeeping in the market for mortgage-backed securities.[25] Lawyers issuing opinions are one form of gatekeeper in this market. To the extent that the market relies upon the quality of gatekeepers, market participants generally are non-parties with interests in the opinions that lawyers issue upon analyzing the legal status of, and level of recourse in, any given issuance.

Peter Margulies also discusses the importance of lawyers as gatekeepers.[26] He writes that we should not frame lawyers' professional responsibility and potential liability in terms of the independence that lawyers enjoy.[27] Rather, the measure of lawyers' acceptable behavior should fall between the opposing forces of (i) the lawyer's need to build an individual brand and business, and (ii) the collective need for protection from societal harms.[28] To the extent that rendering opinions is a crucial aspect of lawyering, Margulies implies a general, non-party interest in closing opinions to the extent that they sanction corporate practices that can cause societal harms in the name of innovation or boundary-pushing.[29]

William H. Simon has written about the secrecy of opinions, explaining that they are only revealed to the public when a client finds doing so to be in its best interest.[30] If lawyers shirk their professional responsibility in the

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23. *See, e.g.*, Barnett, *supra* note 16; Schwarcz, *supra* note 22; Kettering, *supra* note 17.

24. *See* Block-Lieb & Janger, *infra* note 25; Margulies, *infra* note 26.

25. *See generally* Susan Block-Lieb & Edward Janger, *Demand-Side Gatekeepers in the Market for Home Loans*, 82 TEMP. L. REV. 465 (2009).

26. *See* Peter Margulies, *Lawyers' Independence and Collective Illegality in Government and Corporate Misconduct, Terrorism, and Organized Crime*, 58 RUTGERS L. REV. 939, 940–41, 947, 955 (2006); *cf.* Anthony V. Alfieri, *The Fall of Legal Ethics and the Rise of Risk Management*, 94 GEO. L.J. 1909 (2006) (discussing a shift in professional responsibility standards from an ethics-oriented approach with a sense of duty to the public, to a risk management approach focused only on advance clients' private interests and avoiding liability).

27. *See* Margulies, *supra* note 26, at 939, 940–41, 947, 955.

28. *Id.*

29. *Id.*

30. *See* William H. Simon, *The Market for Bad Legal Advice: Academic*

context of opinions practice, we are none the wiser because beneficiaries and clients have discretion to not disclose opinions. Regardless of whether one thinks opinions should be publicly available, the point here is that Simon articulates an interest of non-parties in opinions.[31] To the extent that non-parties cannot see closing opinions, they have no way of knowing the legal nuances of a deal.

This Symposium Article considers how and why certain other kinds of non-parties might take interest in closing opinions. To think about potential new kinds of interests that non-parties might take in opinions, the next section relates opinions practice to private ordering and governance.

III. OPINION LETTERS AND GOVERNANCE

Transactional lawyers work at the heart of private ordering. They translate market actors' normative goals and commitments into legally binding agreements. Transactional lawyers draft the contracts that can impose rules on others, or that can make broadly stated social commitments into legal requirements. Opinions practice relates to the effectiveness and effects of these agreements.

Legal scholars in recent years have studied private ordering and its relationship to lawmaking.[32] Governance is not necessarily top-down by the state, but also involves various modes of self-regulation—the private creation and enforcement of norms.

Along with the study of private ordering, scholars are writing about "new governance," studying the nature of lawmaking where power and regulatory action emanate from multiple state and non-state sources.[33] A key concern of new governance is how to facilitate self-regulation and diverse sources of power without devolving into a mode of de-regulation.[34]

Professional Responsibility Consulting as an Example, 60 STAN. L. REV. 1555, 1571 (2008).

31. Whether that interest deserves legal protection is a separate question. Some may say that disclosure rules already govern the scope of information that companies should provide, and that people should look to disclosures rather than opinions for information about deals. *Cf.* Schwarcz, *supra* note 22, at 4, 7 nn.33, 30–31.

32. *See, e.g.*, David V. Snyder, *Private Lawmaking*, 64 OHIO ST. L.J. 371 (2003).

33. *See, e.g.*, Orly Lobel, *New Governance as Regulatory Governance, in* THE OXFORD HANDBOOK OF GOVERNANCE (David Levi-Faur ed., 2012). Scholars can also describe new governance scholarship in methodological terms; it brings together empirical studies of regulation with normative scholarship about the role of the state. *Id.*

34. Lobel, *supra* note 33, at 3; *see also* ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS (2011) (building on new governance veins of legal scholarship to explore legal techniques used by private actors as a potential site of regulatory innovation).

New governance scholarship certainly does not exclude from study the role of the state in regulation; rather, it explores effective roles for the state amidst the shift towards private governance efforts.[35]

"Private lawmaking" refers to contexts in which a private body or group creates and imposes rules that govern many others.[36] Classic examples of private lawmaking include the activities of the National Conference of Commissioners on Uniform State Laws ("NCCUSL"). NCCUSL, a private body of experts, drafts form legislation—such as the Uniform Commercial Code—that state legislatures adopt.[37] Some scholars contend that standard form contracts themselves exemplify private lawmaking because the contract drafter imposes, effectively, legal terms and conditions on a broad class of people.[38]

Investors often request standardized forms of opinion in a financial transaction. A third-party beneficiary that requires the opinion will send its requested form to the attorney issuing the opinion. But the attorney issuing the opinion does not simply sign and return this form. Rather, the attorney will perform the due diligence necessary to render the opinion, and then consider the risk involved in issuing the opinion in the form the investor requests. The attorney may respond with a new form or with comments altering the investor's form. So, although initially forms of opinion may appear standardized and routine, it is not unusual to find opinions, as issued, bespoke.

It is beyond the scope of this Symposium Article's contribution to consider whether opinion letters are "private lawmaking." Opinions are key pieces of business transactions, and transactions express and implement market actors' normative commitments. As such, opinions operate at the heart of private ordering.

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35. *See* Lobel, *supra* note 33.

36. *See* Snyder, *supra* note 32.

37. *See generally* Alan Schwartz, *The Still Questionable Role of Private Legislatures,* 62 LA. L. REV. 1147 (2002); Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995).

38. *See* W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971). The hallmark of private lawmaking is simply that private actors effectively impose rules on numerous others. A contract between two market actors creates rules the parties can enforce against one another. This is not private lawmaking—the rules of enforceability lie in state contract law—but rather just two parties submitting to a legally enforceable arrangement. *See generally* Snyder, *supra* note 32.

IV. DEAL LAWYER STRATEGIES AND NORMATIVE COMMITMENTS

Given the power of private ordering, and the role of opinions in financial transactions, to what extent is opinions practice a site for expressing normative commitments? This Symposium Article considers the possible private ordering potential of closing opinions.[39]

Non-parties with normative agendas could develop forms of opinion that non-parties demand a deal include. Demanding the issuance of an opinion could be a strategy to advance social goals or to improve effects of transactions on natural resources. Failure to obtain certain forms of opinion would provide information—potentially, quite specific information—of interest to affected non-parties.

One context in which this could happen, for example, is the project finance context. Leading international project lenders have engaged in self-regulation by adopting industry standards known as the Equator Principles.[40] Non-parties, such as NGOs representing the interests of affected resources and populations, are concerned with enforcement of these privately adopted norms.[41] Opinions practice may provide an opportunity to gain information about these transactions that is beneficial to interested non-parties.

Clients may express norms, but then avoid enforcing them. The gap between norms as expressed and actual levels of implementation can emerge in deal documentation. Interested non-parties have no capacity to negotiate contracts and do not have standing to sue if parties include norms in contracts but then abandon them. Attorneys working with interested non-parties may generate a market for a different kind of transactional practice: one in which they develop independent forms, and review industry forms, to affect the levels of implementation of norms that commercial parties may publicly adopt but privately neglect.

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39. I have previously related Riles' presentation of legal techniques and regulatory possibilities to opinions practice in prior publication. *See* Heather Hughes, *Derivatives Traders Do What, Again?*, 30 J.L. & COM. 203, 216–218 (2012) (reviewing RILES, *supra* note 34, and raising the possibility of relating opinions practice in the securitization context to systemic risk regulation).

40. *The Equator Principles: A Financial Industry Benchmark for Determining, Assessing and Managing Social & Environmental Risk in Project Financing*, EQUATOR PRINCIPLES (June 2013), http://www.equator-principles.com/resources/equator_principles_III.pdf [hereinafter *The Equator Principles*]. Numerous major U.S. and foreign lenders, such as Bank of America, ABN AMRO, and Wells Fargo, are Equator Principles financial institutions.

41. *See, e.g.*, ADAPTATION FUND, www.adaptation-fund.org (last visited Nov. 10, 2013); *Equator Principles*, BANKTRACK, www.banktrack.org/show/pages/equator_principles (last visited Dec. 24, 2013).

Questions of transparency and access to legal documentation present a challenge to this kind of strategy; transparency has been an issue of ongoing concern to NGOs.[42] While this Symposium Article has no quick answer to this challenge, market conventions do contemplate disclosure of certain features of deals to non-parties, such as rating agents. Non-parties concerned with social and environmental impact could potentially achieve an auditing function that becomes conventional in the project finance market, and as such could gain access to transaction details not heretofore contemplated, as other kinds of gatekeepers and auditors do.

Leading project financers recently announced their support for the Equator Principles III ("EP III")—the third iteration of the project finance industry's statement of commitment to improving environmental and social impacts of international development projects.[43] Many applaud when banks become Equator Principles Financial Institutions ("EPFIs"), pledging to fund only projects that meet heightened standards. Critics, however, observe that EPFIs do not always require borrowers to comply with the principles.[44] Also, EPFIs have no obligation to exercise remedies when a project falls out of compliance post-closing.[45]

Equator Principle 8 is titled "Covenants."[46] It recognizes the importance of incorporating EP III compliance into financing documentation between EPFIs and project borrowers.[47] Under Principle 8, EPFIs commit to include covenants in financing documentation requiring the borrower to be in compliance with the principles.[48]

The Equator Principles attempt to hold project borrowers to higher social and environmental standards than local laws could require. The principles cross-reference International Finance Corporation ("IFC") and other World Bank requirements for projects in various industries.[49]

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42. For example, BankTrack (an NGO) has followed and commented on the development and implementation of the Equator Principles since the principles' inception. BankTrack has targeted the transparency problem at multiple junctures. *See, e.g.*, *Transparency and the Equator Principles: Proposals for EP Bank Disclosure Working Document*, BANKTRACK (Nov. 28, 2004), www.banktrack.org/manage/ems_files/download/transparency_for_the_equator_banks/041128_transparency_for_the_equator_banks.pdf.

43. *See The Equator Principles*, *supra* note 40.

44. *See, e.g.*, Ariel Meyerstein, *Global Private Regulation, Global Finance and the Future of Corporate Human Rights Accountability* (Mar. 9, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2018999.

45. *See The Equator Principles*, *supra* note 40, at 5–6.

46. *See id.* at 10.

47. *See id.* at 5–6.

48. *Id.*

49. *See id.*

What is the relationship between Equator Principles compliance and opinions practice? What form might an opinion from counsel to the project borrower take if its function were to ensure the transaction's compliance with EP III (which requires no violation of applicable environmental laws)? What is the relationship between the fact-finding and auditing that assures compliance, and a legal opinion about compliance?

Typically, a "no violation of law" opinion requires the issuing attorney to state that the client will not violate laws by entering into the subject transaction.[50] In a project finance transaction, the issuing attorney's client is the project entity—a company formed to own and run a specific project, such as a dam, manufacturing facility, or utility, for example. The third-party recipient of the opinion, again, is the project lender—a bank or syndicate of banks. Many major project lenders are EPFIs. So, the "no violation of law" opinion assures an EPFI that its borrower will not violate the law by performing under the contracts that document their deal.

But consider the following, typical qualification to "no violation of law" opinions:

> [W]e express no opinion as to any statutory laws other than statutory laws that lawyers in the State[s] of New York [and STATE] exercising customary professional diligence would reasonably recognize as being applicable to transactions of the type contemplated by the Credit Documents, assuming for such purpose that each Obligor conducts only businesses, and owns only assets, that are not subject to any special regulatory or other legal regime by reason of the type or nature of the business conducted or the assets owned.[51]

This qualification raises at least two issues for parties interested in ensuring that projects comply with the Equator Principles. The opinion speaks only to "statutory laws" of the jurisdiction the opinion covers. The various international standards for human rights and environmental compliance with which EPFIs are concerned are not "statutory law" within the meaning of the opinion. Also, the opinion is limited to laws that lawyers in the issuing attorney's jurisdiction "would reasonably recognize as being applicable to transactions of the type contemplated." A law concerned with environmental quality, for example, would likely fall outside of the scope of this opinion.

A non-party NGO or other group interested in implementation of the Equator Principles could, in theory, draft a form of opinion and

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50. *See* LEGAL OPINION LETTERS FORMBOOK, *supra* note 2.

51. *Id.* at 145.

qualification that recognizes the principles—and the IFC standards—as "law" for purposes of the opinion. The qualification would clarify that the Equator Principles "laws" are recognized as applicable to the transaction. If a non-party demanded that EPFIs request opinions of this form, it is possible the EPFI may do so, leading to better diligence and compliance with the principles. If the EPFI refused to request such an opinion, or the issuing attorney refused to render it, that fact would be information about the transaction that the interested non-party did not previously have. The information may or may not indicate failure to comply with the Equator Principles, but it is information, that could, nonetheless, be of strategic importance.

Lawyers typically assume the underlying facts on which their legal opinion is based. They do not do the fact-finding that underscores an opinion; rather, they expressly rely on representations of others. Rendering a legal opinion, however, can require clients to make factual representations that they may otherwise avoid. Also, attorneys issuing opinions do not (generally speaking) assume facts to be true that they know are false.

Costs associated with issuing opinions are allocated to the company—the client of the attorney issuing the opinion to third parties. Expanding the scope of an opinion in response to a non-party demand raises questions of cost allocation. In theory, if banks commit to EP III, and a corporate debtor seeks project financing from EPFIs, then transaction costs of EP III compliance should be priced into the transaction. However, because EP III adoption does not create legal liabilities,[52] parties can price EP III compliance out of project finance transactions. The question of allocating costs of the kind of hypothetical closing opinion presented here is a subset of the larger question of costs of implementing EP III standards.

In short, attorneys working with non-party stakeholders could potentially strengthen EP III implementation by creating form documentation that they then demand EPFIs use. This approach may provide a model for other contexts in which deal lawyers can, potentially, help to affect market actors' level of commitment to environmental and social standards.

Of course, the ideas presented in this Symposium Article would require significant further consideration before taking the form of any concrete proposal or normative agenda. The purpose, here, is to reflect in new ways on what transactional lawyers do—and what they might do.

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52. *See The Equator Principles*, *supra* note 40, at 12 (providing a disclaimer to the effect that adoption of the principles creates no liability and that implementation is entirely voluntary).

CONCLUSION

Transactional lawyers work at the nexus of law and markets. Many scholars and lawmakers adhere to the view that markets necessarily precede and outpace regulation.[53] Others emphasize the continuity of legal structure and market activity, observing that all private contracts are a function of legal order and require the government for enforcement.[54] Wherever one falls on this spectrum, deal lawyers are the ones that make legal structure and market movements cohere.

In transactional contexts where a client expresses commitment to certain norms, and non-parties have an interest in the company's adherence to the norms, opinions practice could, possibly, facilitate greater compliance and better information about compliance levels. Non-parties concerned about the effects of transactions could gain from strategically considering transactional lawyers' roles.

53. This view of regulation and markets we associate with Hayek. *See* RILES, *supra* note 34, at 157–81; Scott Beaulier, Peter J. Boettke, & Christopher J. Coyne, *Knowledge, Economics, and Coordination: Understanding Hayek's Legal Theory*, 1 N.Y.U. J.L. & LIBERTY 209, 209–24 (2004).

54. *See, e.g.*, R. L. Hale, *Law Making by Unofficial Minorities*, 20 COLUM. L. REV. 451 (1920); Duncan Kennedy, *The Stakes of Law, or Hale and Foucault!*, XV LEGAL STUD. F. 327 (1991).

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COMMENT

NUCLEAR INTENTIONS AND IMPLIED PREEMPTION: HOW *ENTERGY NUCLEAR VERMONT YANKEE, LLC V. SHUMLIN* GIVES INDIAN POINT A FIGHTING CHANCE TO STAY IN BUSINESS

ZACHARY MASON*

The New York State Department of Environmental Conservation ("NYSDEC") has denied subsidiaries of the Entergy Corporation a Clean Water Act Section 401 Water Quality Certificate for the cooling systems at the Indian Point Energy Center. This action effectively forces Entergy to construct cooling towers to continue operating, and might force Entergy to close the nuclear power plant because the cost of building new cooling systems would be prohibitively expensive. Federal law might preempt NYSDEC's action, however, because the Atomic Energy Act implies that the federal government has exclusive regulatory authority over the radiation hazards of nuclear power plants. This Comment argues that the present legitimacy of NYSDEC's action depends upon the past policy considerations that drove the decision-making process. If NYSDEC denied the Water Quality Certificate with the intention of regulating radiation hazards, then the Atomic Energy Act should preempt the state's denial. But the law might not preempt NYSDEC's action provided the agency made its water quality certification decision as a legitimate exercise of New York State's powers under the Clean Water Act. The ultimate outcome might hinge upon the decision of a similar case, Entergy Nuclear Vermont Yankee, LLC v. Shumlin, which was decided by the Federal District Court for the District of Vermont and recently affirmed in part by the United States Court of Appeals for the Second Circuit.

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INTRODUCTION

The State of New York and subsidiaries of the Entergy Corporation are currently engaged in a legal conflict over the future of the Indian Point Energy Center ("Indian Point") in Buchanan, New York.[1] The New York State Department of Environmental Conservation ("NYSDEC") has denied Entergy's joint application for a renewal of the Water Quality Certificate ("WQC") for the cooling systems of Indian Point Unit 2 and Unit 3.[2] The denial may force Entergy to close the nuclear power plant.[3] However, NYSDEC's regulatory action might be preempted by the Atomic Energy Act of 1954, which grants federal agencies broad powers to regulate nuclear power production.[4] Entergy appealed NYSDEC's denial of water quality certification on a number of claims, including preemption, to a NYSDEC administrative law judge.[5] At the time of this writing, Entergy's

1. *See* David M. Halbfinger, *New York State Denies Indian Point a Water Permit*, N.Y. TIMES (Apr. 3, 2010), http://www.nytimes.com/2010/04/04/nyregion/04indian.html.

2. Notice of Denial, *In re* Joint Application for CWA § 401 Water Quality Certification NRC License Renewal – Entergy Nuclear Indian Point Units 2 and 3 DEC Nos.: 3-5522-00011/00030 (IP2) & 3-5522-00105/00031 (IP3) (N.Y. Dep't of Envtl. Conserv. Apr. 2, 2010) [hereinafter Notice of Denial], *available at* http://www.dec.ny.gov/docs/permits_ej_operations_pdf/ipdenial4210.pdf.

3. *See* Halbfinger, *supra* note 1 (explaining the economic costs of Entergy constructing cooling towers).

4. *See generally* Atomic Energy Act of 1954, 42 U.S.C. §§ 2011–2284 (2012) (establishing the Atomic Energy Commission and granting it broad regulatory powers over the use of nuclear materials).

5. *See* Request for Adjudicatory Hearing on Notice of Denial, *In re* Entergy

appeal has not yet been fully adjudicated, though the administrative law judge has fully adjudicated the preemption claim.[6]

Indian Point consists of three Westinghouse pressurized water reactors: Indian Point Unit 1, Indian Point Unit 2, and Indian Point Unit 3.[7] The two working units are operated by wholly-owned subsidiaries of the Entergy Corporation: Entergy Nuclear Indian Point 2, LLC and Entergy Nuclear Indian Point 3, LLC.[8] Indian Point 2 has a maximum generating capacity of 1,022 megawatts, and Indian Point 3 has a maximum generating capacity of 1,040 megawatts.[9] Indian Point 1 was shut down in 1974.[10] Altogether, Indian Point generates approximately 30 percent of all electricity consumed in Westchester County and New York City.[11]

A nuclear reactor generates an enormous amount of excess heat, necessitating a cooling system to maintain a stable temperature.[12] Indian Point Unit 2 and Unit 3 operate with once-through cooling systems that regulate the temperature of the nuclear generating systems with a

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Nuclear Indian Point 2, LLC, Entergy Nuclear Indian Point 3, LLC, & Entergy Nuclear Operations Inc.'s Joint Application for CWA § 401 Water Quality Certification (N.Y. Dep't of Envtl. Conserv. Apr. 29, 2010) [hereinafter Request for Adjudicatory Hearing on Notice of Denial], *available at* http://www.dec.ny.gov/docs/permits_ej_operations_pdf/ip401denialhrgreq.pdf; *see also* John P. Cahill & Joseph A. Edgar, *Nuclear Faceoff*, PUB. UTILS. FORTNIGHTLY (Apr. 2012), *available at* http://www.chadbourne.com/files/Publication/e5446cf3-0b98-4e9e-8338-fe620b648b85/Presentation/PublicationAttachment/0c13127b-6498-481a-aee6-00c49fad4092/Cahill_PUF_NuclearFaceoff.pdf (explaining Entergy's appeal of the NYSDEC Water Quality Certificate decision).

6. *See generally* Ruling on Proposed Issues, *In re* Entergy Nuclear Indian Point 2, LLC, Entergy Nuclear Indian Point 3, LLC, & Entergy Nuclear Operations Inc.'s Joint Application for CWA § 401 Water Quality Certification (N.Y. Dep't of Envtl. Conserv. Dec. 13, 2010) [hereinafter Ruling on Proposed Issues], *available at* http://www.dec.ny.gov/hearings/70809.html.

7. *See Indian Point – Unit 1*, U.S. NUCLEAR REGULATORY COMM'N, http://www.nrc.gov/info-finder/decommissioning/power-reactor/indian-point-unit-1.html (last updated Nov. 20, 2013); *Indian Point Nuclear Generating Unit 2*, U.S. NUCLEAR REGULATORY COMM'N, http://www.nrc.gov/info-finder/reactor/ip2.html (last updated Sept. 11, 2013); *Indian Point Nuclear Generating Unit 3*, U.S. NUCLEAR REGULATORY COMM'N, http://www.nrc.gov/info-finder/reactor/ip3.html (last updated Sept. 24, 2013).

8. *Indian Point Energy Center*, ENTERGY NUCLEAR, http://www.entergy-nuclear.com/plant_information/indian_point.aspx (last visited Oct. 25, 2013).

9. *Id.*

10. *Indian Point – Unit 1*, *supra* note 7.

11. *See generally* Thomas Kaplan, *For Cuomo and Indian Point, New Round in a Long Fight*, N.Y. TIMES (Mar. 22, 2011), http://www.nytimes.com/2011/03/23/nyregion/23indian.html.

12. *See* CHARLES D. FERGUSON, NUCLEAR ENERGY: WHAT EVERYONE NEEDS TO KNOW 40–47 (2011) (explaining the mechanics of a nuclear reactor and cooling system).

continuously recharging supply of water.[13] Every day, the Indian Point cooling systems draw about 2.5 billion gallons of water from the Hudson River, circulate the water past the condenser coils to transfer heat from the generation equipment, and then discharge the water back into the river.[14]

NYSDEC issued a WQC for Indian Point Unit 1 and Unit 2 in 1970, issued a WQC for Unit 3 in 1975, and last renewed a joint WQC for Unit 2 and Unit 3 in 1982.[15] The 1982 WQC will expire for Indian Point Unit 2 and Unit 3's operating licenses in 2013 and 2015, respectively, prompting Entergy to submit a joint application to NYSDEC for a 20-year renewal.[16] In 2010, NYSDEC denied Entergy's application for the WQC,[17] explaining that Indian Point's cooling systems "do not and will not comply" with New York State water quality standards.[18]

Because NYSDEC denied a WQC for the cooling systems, Indian Point's future is in jeopardy. Without a WQC, Entergy may not renew its State Pollution Discharge Elimination System ("SPDES") permit for Indian Point; without the SPDES permit, Indian Point cannot legally discharge 2.5 billion gallons of hot water into the Hudson River each day.[19] To continue operating Indian Point without a WQC, Entergy would need to close Unit 2 and Unit 3 for an estimated 42 weeks[20] and retrofit the nuclear power plant with a closed-circuit cooling system (that is cooling towers) at a cost of approximately $1.19 billion.[21] Entergy claims that retrofitting Indian Point's cooling systems is prohibitively expensive to the point that it would be economically unfeasible for the company to continue running Indian Point, thereby forcing the company to either sharply raise its consumer rates or close the power plant altogether.[22]

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13. Notice of Denial of Joint Application for CWA § 401, *supra* note 2, at 2.

14. *Id.*

15. *See id.* at 3–4 (recounting Indian Point's licensing history).

16. *Id.* at 7.

17. *See id.* at 2 (rejecting the WQC application).

18. *See id.*

19. *See* Federal Water Pollution Control Act of 1972 § 401(a)(1), 33 U.S.C. § 1341(a)(1) (2012) (mandating that "[a]ny applicant for a Federal license or permit to conduct any activity . . . which may result in any discharge into the navigable waters" provide state certification to the permitting agency).

20. *See* Halbfinger, *supra* note 1.

21. *See* ENERCON SERVS., INC., ENGINEERING FEASIBILITY AND COSTS OF CONVERSION OF INDIAN POINT UNITS 2 AND 3 TO A CLOSED-LOOP CONDENSER COOLING WATER CONFIGURATION 7 (Feb. 12, 2010) [hereinafter ENGINEERING FEASIBILITY AND COSTS OF CONVERSION OF INDIAN POINT], *available at* http://www.dec.ny.gov/docs/permits_ej_operations_pdf/convclosloop.pdf (documenting Entergy's concerns about the costs of building cooling towers).

22. *See* Cahill & Edgar, *supra* note 5; *see also* Halbfinger, *supra* note 1 (calculating the economic burden of constructing new cooling towers on the Entergy

Whether Entergy can operate Indian Point Unit 2 and Unit 3 for another 20 years is of great importance to the corporation. If Entergy can operate Indian Point for an additional 20 years, its projected earnings total between $500 million and $1.4 billion in additional profits between 2013 and 2035.[23] Decommissioning the nuclear power plant is also an expensive endeavor that will cost hundreds of millions of dollars, and whether Entergy must pay for decommissioning within a few years or in two decades can have great ramifications on the corporation's bottom line.[24]

Indian Point's early closure would also have significant consequences for the regional energy market; specifically, New York City could suffer an energy shortfall, forcing local utilities to resort to greenhouse gas-emitting coal and gas-burning power plants.[25]

The early closure of Indian Point might also have profound ramifications on the local economy. Indian Point and its parent subsidiaries employ approximately 1,683 people in New York,[26] with a payroll of roughly $146 million.[27] The Business Council of Westchester claims that the closure of Indian Point and a rise in electric rates would lead to more than 3,300 jobs lost in Westchester County, and that the County would lose $75 million annually in property taxes and revenue sharing with New York State.[28]

Corporation).

23. *See* LEVITAN & ASSOCS., INC., INDIAN POINT RETIREMENT OPTIONS, REPLACEMENT GENERATION, DECOMMISSIONING/SPENT FUEL ISSUES, AND LOCAL ECONOMIC/RATE IMPACTS (June 9, 2005), *available at* http://pbadupws.nrc.gov/docs/ML1134/ML11348A160.pdf.

24. Matthew L. Wald, *N.R.C. Skimps on Financial Oversight, Audit Says*, N.Y. TIMES (May 6, 2012, 9:15 AM), http://green.blogs.nytimes.com/2012/05/06/n-r-c-falls-short-on-financial-oversight-audit-says/?_r=0.

25. Patrick McGeehan, *Dirtier Air and Higher Costs Possible if Indian Point Closes, Report Says*, N.Y. TIMES (July 6, 2011), http://www.nytimes.com/2011/07/07/nyregion/dirtier-air-and-higher-costs-may-follow-indian-point-closing.html?_r=0 (explaining that the local grid may suffer a shortfall of more than 2,000 megawatts, potentially causing the price of electricity in the New York metropolitan area to rise as much as 10 percent.)

26. NUCLEAR ENERGY INST., ECONOMIC BENEFITS OF INDIAN POINT ENERGY CENTER 5 (2004), *available at* http://www.nei.org/filefolder/economic_benefits_indian_point.pdf.

27. *Id.* (finding that Indian Point paid employees in five counties near the power plant $126.6 million in compensation, and an additional $19.3 million to employees in New York who live outside those five counties).

28. Pat Casey, *Business Council Energy Report Predicts Major Problems if Indian Point Goes Offline*, THE EXAMINER NEWS.COM (Sept. 11, 2012), http://www.theexaminernews.com/business-council-energy-report-predicts-major-problems-if-indian-point-goes-offline/ (referring to HOWARD J. AXELROAD, PH.D., ENERGY STRATEGIES, INC., AN ASSESSMENT OF ENERGY NEEDS IN WESTCHESTER COUNTY (Sept. 7, 2012), *available at* http://www.westchesterny.org/downloads/Energy%20Needs%20Assessment%20Final%20version.pdf).

The Indian Point nuclear power plant still operates with its once-through cooling systems, despite NYSDEC issuing a Notice of Denial on the Indian Point WQC, because Entergy is appealing NYSDEC's rejection of the Indian Point WQC.[29] The company has challenged NYSDEC's action on a number of grounds, including a claim that the water quality certification decision was motivated by concerns about nuclear safety and is therefore preempted by the Atomic Energy Act.[30] Administrative Law Judge Maria Villa rejected Entergy's preemption argument.[31]

The legal landscape changed considerably, however, when the United States Court of Appeals for the Second Circuit affirmed in part the Federal District Court for the District of Vermont's decision in *Entergy Nuclear Vermont Yankee, LLC v. Shumlin*.[32] The appellate court ruled that the Atomic Energy Act preempted Vermont's denial of a license for the Vermont Yankee Nuclear Power Plant because the legislature was motivated by concerns about the safety of the plant.[33] Because Entergy Nuclear Indian Point 1, LLC and Entergy Nuclear Indian Point 2, LLC are Delaware corporations with their principal places of business in New York,[34] and Entergy Nuclear Operations, Inc. is a Delaware corporation with significant ties in New York,[35] the companies are subject to the jurisdiction of the Second Circuit. As a consequence, the *Entergy Nuclear Vermont Yankee, LLC* decision now stands as precedent that can be used to challenge the NYSDEC WQC denial on preemption grounds.

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29. *See* Request for Adjudicatory Hearing on Notice of Denial, *supra* note 5.

30. *Id.*

31. *See* Ruling on Proposed Issues, *supra* note 6.

32. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183 (D. Vt. 2012), *aff'd in part, rev'd in part*, Nos. 12-707-cv (L), 12-791-cv (XAP), 2013 WL 4081696 (2d Cir. Aug. 14, 2013).

33. *Id.* at 228–31.

34. Div. of Corps., State Records & Unif. Commercial Code, *Entity Information: Entergy Nuclear Indian Point 2*, N.Y. DEP'T OF STATE, http://appext20.dos.ny.gov/corp_public/CORPSEARCH.ENTITY_INFORMATION?p_nameid=2658113&p_corpid=2628406&p_entity_name=Entergy%20Nuclear%20Indian%20point&p_name_type=A&p_search_type=BEGINS&p_srch_results_page=0 (last visited Jan. 21, 2014); Div. of Corps., State Records & Unif. Commercial Code, *Entity Information: Entergy Nuclear Indian Point 3*, N.Y. DEP'T OF STATE, http://appext20.dos.ny.gov/corp_public/CORPSEARCH.ENTITY_INFORMATION?p_nameid=2658113&p_corpid=2628406&p_entity_name=Entergy%20Nuclear%20Indian%20point&p_name_type=A&p_search_type=BEGINS&p_srch_results_page=0 (last visited Jan. 21, 2014).

35. Div. of Corps., State Records & Unif. Commercial Code, *Entity Information: Entergy Nuclear Operations Inc.*, N.Y. DEP'T OF STATE, http://appext20.dos.ny.gov/corp_public/CORPSEARCH.ENTITY_INFORMATION?p_nameid=2658113&p_corpid=2628406&p_entity_name=Entergy%20Nuclear%20Indian%20point&p_name_type=A&p_search_type=BEGINS&p_srch_results_page=0 (last visited Jan. 21, 2014).

This Comment explores the degree to which state governments can legally regulate the generation of nuclear power in light of competing federal law, and in doing so, addresses the validity of NYSDEC's Indian Point WQC decision. Part II introduces relevant selections of the Federal Water Pollution Control Act of 1972 ("Clean Water Act"), the Atomic Energy Act of 1954 ("Atomic Energy Act"), and jurisprudence governing preemption claims under the latter statute. Part III evaluates NYSDEC's denial of a WQC for Indian Point's once-through cooling systems according to an Atomic Energy Act preemption analysis. Part IV recommends how Entergy can make a preemption claim against NYSDEC's denial of the WQC, and how New York might avoid NYSDEC's action from being invalidated by preemption. Part V concludes that Entergy can make a strong preemption claim modeled after the Second Circuit's decision in *Entergy Nuclear Vermont Yankee, LLC v. Shumlin*. There is a significant chance, however, that such a claim would not prevail because there are major reasons for a court to distinguish New York's denial of certification for Indian Point and Vermont's actions regarding the Vermont Yankee Nuclear Power Station.

I. PERTINENT LAW AND ADMINISTRATIVE HISTORY

NYSDEC's denial of a WQC to Entergy may conflict with federal regulatory authority. The New York State government has the authority to exercise its traditional police powers guaranteed by the Tenth Amendment to maintain the health, safety, welfare, and morals of the people within its borders.[36] However, Article I, Section 8 grants Congress the power to regulate interstate commerce,[37] the Supremacy Clause of the Constitution provides that the United States Constitution and the laws of the United States are the "supreme Law of the Land," and they both override state laws which conflict with federal law or the United States Constitution.[38]

A. The Clean Water Act

Indian Point's operation is subject to a number of permitting requirements relevant to the cooling systems controversy. Most relevant to

36. U.S. CONST. amend. X ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the States respectively, or to the people.").

37. *Id.* art. I, § 8, cl. 3.

38. *Id.* art. VI, cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, anything in the Constitution or Laws of any State to the Contrary notwithstanding.").

the matter at hand is the Clean Water Act, which prohibits the discharge of certain pollutants into the navigable waters of the United States without a permit,[39] including radioactive and thermal pollution.[40]

Section 401 of the Clean Water Act mandates that every applicant have a WQC to receive a federal license to conduct any activity which may result in a discharge into the navigable waters of the United States.[41] A WQC establishes that the activity for which an applicant seeks a permit or license is consistent with Clean Water Act standards, including: federal effluent limitations for conventional and non-conventional pollutants (§§ 301-302); water quality standards (§ 303); new source performance standards (§ 306); requirements for toxic pollutants (§ 307); and relevant state and tribal laws.[42]

Section 402(a) of the Clean Water Act establishes the National Pollution Discharge Elimination System ("NPDES"), through which the United States Environmental Protection Agency ("EPA") can distribute discharge permits.[43] Section 402(b) allows the federal government to delegate this authority to states.[44] From this, the EPA has approved the NYSDEC's program to regulate the quality of certain navigable bodies of water in New York, including the Hudson River, via the SPDES.[45] For the EPA to issue a NPDES permit, or for a state to issue a SPDES permit to legally discharge effluent into a river however, either the EPA or the designated state agency must first grant the permit applicant a WQC.[46]

B. NYSDEC's Denial of the Water Quality Certificate

In 2010, NYSDEC denied Entergy's joint application for a 20-year renewal of its Clean Water Act § 401 WQC because Indian Point's cooling systems "do not and will not comply" with New York State water quality standards, no matter how modified.[47] NYSDEC expressed its concerns

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39. Federal Water Pollution Control Act of 1972 § 301(a), 33 U.S.C. § 1311(a) (2012) (declaring that "the discharge of any pollutant by any person shall be unlawful" except in compliance with this statute); *id.* § 1251.

40. 33 U.S.C. § 1362(6) (defining "pollutant" to include a multitude of things artificially inserted into the navigable waters of the United States, including "radioactive materials" and "heat").

41. *Id.* § 401(a).

42. *Id.*

43. *Id.* § 1342 ("[T]he Administrator may . . . issue a permit for the discharge of any pollutant, or combination of pollutants . . . .").

44. *Id.* § 1251(b).

45. *See* Notice of Denial, *supra* note 2, at 5.

46. *See* 33 U.S.C. § 1341(a)(1) (stating that applicants for federal discharge permits must provide water quality certification by the state).

47. *See generally* Notice of Denial, *supra* note 2 (declaring the cooling systems to

about the effects of Indian Point's "once-through" cooling system on the wildlife of the Hudson River.[48] The NYSDEC noted that the cooling system intake pipes suck larvae, plankton, and eggs into the cooling circuit ("entrainment"), where the entrainment kills them by extremely hot temperatures.[49] Moreover, the intake pipes pin larger fish onto the filtration screens ("impingement") and fish die from starvation, exhaustion, asphyxiation, crushing from pressure, or descaling.[50] NYSDEC's Notice of Denial also cited the discharge of 2.5 billion gallons of hot water into the Hudson each day, which stressed the estuarine habitat of many aquatic species.[51] It reported that Indian Point's cooling systems kill or adversely impact nearly one billion organisms yearly – including striped bass, river herring, American shad, Atlantic sturgeon, and the endangered shortnose sturgeon.[52]

NYSDEC may have encroached upon a field beyond its regulatory authority by noting its concerns that "radioactive material (including tritium, strontium-90, cesium, and nickel) from spent fuel pools, pipes, tanks, and other systems, structures, and components at Indian Point" were found in the groundwater underneath the Indian Point campus and in the Hudson River.[53] NYSDEC characterized the radionuclides as "deleterious substances" which might "impair the water for their best usage."[54]

NYSDEC's WQC decision must also be analyzed within the context of the agency's overall relationship with Indian Point. More than two years prior to issuing the Notice of Denial of Entergy's WQC joint application, NYSDEC released an official statement opposing the Nuclear Regulatory Commission's ("NRC") relicensing of Indian Point Unit 2 and Indian Point Unit 3, citing the risk of radionuclide leakage.[55] NYSDEC also argued that Indian Point's operating license should not be renewed because the spent

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be prohibited by the Clean Water Act's water quality standards).

48. *See id.* at 11–13 (citing thermal pollution of the Hudson River); *see also* Halbfinger, *supra* note 1.

49. *See* Notice of Denial, *supra* note 2, at 3 (addressing the entrainment of fish in the cooling systems).

50. *See id.* (detailing NYSDEC's concerns about impingement of fish on the cooling systems' intake pipes).

51. *See id.* at 3, 11–13 (citing the effects of thermal pollution on aquatic life).

52. *See id.* at 7–8 (enumerating some of the Hudson River species adversely affected by Indian Point's cooling systems).

53. *Id.* at 11 (addressing issues that could be fairly characterized as "radiological hazards").

54. *Id.*

55. *See DEC Position on Indian Point Relicensing*, N.Y. STATE DEP'T OF ENVTL. CONSERV., http://www.dec.ny.gov/permits/40237.html (last visited Aug. 18, 2012) (opposing the NRC relicensing Indian Point).

fuel pools have no containment structure, leaving radioactive material "exposed and unsecured," and rendering the nuclear facility "vulnerable to attack."[56] Moreover, the official NYSDEC statement questioned the power plant's evacuation plans adequacy in the case of a nuclear disaster.[57]

NYSDEC's denial of Entergy's WQC application must also be analyzed within the context of the past three Governors of New York, who established their intents to close Indian Point out of concerns about nuclear safety.[58] In 2007, Governor Eliot Spitzer and Attorney General Andrew Cuomo held a joint press conference announcing their submission of a petition calling for the NRC to deny Entergy's application to relicense Indian Point for another 20 years.[59] Governor Spitzer declared, "we should close Indian Point as soon as there is sufficient replacement power available."[60] Lieutenant Governor David Paterson added that New York's petition to the NRC "gives us reason to hope that we are one step closer to closing Indian Point forever."[61] Attorney General Cuomo explained that "opposing the relicensing in 2013 is only step one," complaining that "the NRC has repeatedly ignored the danger that Indian Point poses to New Yorkers from its vulnerability to a terrorist attack, to its incapability to withstand potential earthquakes, to its lack of a plausible evacuation plan in the event of a catastrophe."[62]

C. The Atomic Energy Act of 1954

The Atomic Energy Act charges the United States government with promoting peaceful development and nuclear power use.[63] The statute replaced the Atomic Energy Act of 1946,[64] which established the Atomic Energy Commission ("AEC") to regulate the processing and use of nuclear

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56. *Id.*

57. *Id.*

58. *See* Kaplan, *supra* note 11 (documenting Andrew Cuomo's history of public statements voicing concern about the hazards of a disaster at Indian Point); *see also* Danny Hakim, *Cuomo Takes Tough Stance on Nuclear Reactors*, N.Y. TIMES (June 28, 2011), http://www.nytimes.com/2011/06/29/nyregion/cuomo-emphasizes-aim-to-close-indian-point-plant.html (explaining Governor Cuomo's plan to close Indian Point).

59. Press Release, N.Y. Office of the Attorney Gen., Governor Spitzer & Attorney Gen. Cuomo Announce Effort to Halt Indian Point Relicensing (Dec. 3, 2007) [hereinafter Governor Spitzer and Attorney General Cuomo's 2007 Press Conference], *available at* http://www.ag.ny.gov/press-release/governor-spitzer-and-attorney-general-cuomo-announce-effort-halt-indian-point.

60. *Id.*

61. *Id.*

62. *Id.*

63. Atomic Energy Act of 1954 § 1, 42 U.S.C. § 2011 (2012).

64. *History*, U.S. NUCLEAR REGULATORY COMM'N, http://www.nrc.gov/about-nrc/history.html (last visited Oct. 4, 2013).

material by civilians in the private sector.[65] The Energy Reorganization Act of 1974 abolished the AEC[66] and transferred its regulatory authority over civilian nuclear power under the Atomic Energy Act to the NRC.[67]

Section 101 of the Atomic Energy Act makes it unlawful for any civilian in the United States to use nuclear material without a license,[68] and Section 103 grants the NRC the authority to issue licenses to civilians for the use of nuclear material.[69] The Atomic Energy Act also grants the NRC the authority to establish regulations on the nuclear material use "to promote the common defense and security or to protect health or to minimize danger to life or property."[70]

The Atomic Energy Act has a savings clause that explicitly reserves some regulatory authority to the states: "Nothing in this Act shall be construed to affect the authority or regulations of any Federal, State, or Local agency with respect to the generation, sale or transmission of electric power produced through the use of nuclear facilities licensed by the Commissions."[71] In the 1959 Amendment to the Atomic Energy Act, Congress explicitly reserved: "Nothing in this Section shall be construed to affect the authority of any State or local agency to regulate activities for purposes other than protection against radiation hazards."[72]

Altogether, the Atomic Energy Act serves as an enabling act for the NRC that establishes some prerogatives for the federal agency over the licensing and regulation of nuclear power plants. However, the Atomic Energy Act also reserves some fields of regulatory authority to the states. The Indian Point case might force the courts to clarify where those fields occupied by the Atomic Energy Act's federal regulatory regime end and where those fields protected by the savings clause begin.

D. The Northern States Power *and* Pacific Gas and Electric *Rules for State Regulation of Nuclear Power*

In *Northern States Power Co. v. Minnesota*,[73] the Federal District Court for the District of Minnesota and the United States Court of Appeals for the Eighth Circuit held that the Atomic Energy Act's federal regulatory regime

65. 42 U.S.C. § 2012.
66. Energy Reorganization Act of 1974 § 104(a), 42 U.S.C. § 5814.
67. *Id.* §§ 5841–5850.
68. Atomic Energy Act, 42 U.S.C. § 2131.
69. *Id.* § 2133(a).
70. *Id.* § 2201(b).
71. *Id.* § 2018.
72. *Id.* § 2021(k).
73. N. States Power Co. v. Minnesota, 447 F.2d 1143 (8th Cir. 1971), *aff'd*, 405 U.S. 1035 (1972).

preempts express state regulation of radiation hazards.[74] Chief Judge Edward J. Devitt reasoned that the statute strongly implies that the federal government has a presumed prerogative over nuclear safety issues because it delineates a process through which the Atomic Energy Commission could devolve regulatory authority to the states.[75]

In that case, the Northern States Power Company applied to the Minnesota Pollution Control Agency for a waste disposal permit for its nuclear power plant, and the Agency conditioned the permit on the power plant meeting radioactive liquid and gas emissions standards—standards that were stricter than the federal Atomic Energy Commission's emissions standards.[76] Because the Minnesota Pollution Control Agency expressly regulated radiological pollution emanating from a nuclear power plant, the Eighth Circuit found that the State of Minnesota encroached on a field of regulatory activity occupied by the federal government, and held that the Atomic Energy Act preempted the state licensing decision.[77]

In *Northern States Power*, the courts also found that Congress did not intend to limit "the power of states to regulate activities, other than radiation hazards" when enacting the Atomic Energy Act.[78] Just as the Atomic Energy Act impliedly preempts state regulation of radiation hazards, it explicitly does not preempt state regulation of most other aspects of nuclear power generation.

In *Pacific Gas and Electric Co. v. State Energy Resources Conservation & Development Commission*, the Supreme Court affirmed the reasoning in *Northern States Power* and held that the Atomic Energy Act does not preempt state regulation of nuclear power so long as the states' actions do not encroach on the federally occupied field of radiological safety.[79] In

74. *Id.* at 1148–49.

75. *See id.* at 1149 (expressing that "the whole tone of the 1959 amendment . . . demonstrates Congressional recognition that the AEC at that time possessed the sole authority to regulate radiation hazards"); *see also* 42 U.S.C. § 2021(b) (establishing the processes by which the federal government can devolve regulatory authority to the states).

76. *N. States Power Co.*, 447 F.2d at 1145.

77. *Id.* at 1154.

78. *Id.* at 1150 (reasoning that the only logical reason for Congress to include subsection k was to make clear that Congress did not intend to limit the powers of the states to regulate the activities of nuclear power plants aside from radiation hazards, because "[u]nless the federal government possessed exclusive authority over radiation hazards, the inclusion of [subsection k] would have been meaningless and unnecessary"); *see also* 42 U.S.C. § 2021(k) (reserving that "[n]othing in this Section shall be construed to affect the authority of any State or local agency to regulate activities for purposes other than protection against radiation hazards").

79. *See generally* Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n, 461 U.S. 190 (1983).

Pacific Gas and Electric, the Court upheld a provision of a California law, Section 25524.2 of the Warren-Alquist State Energy Resources Conservation and Development Act (the Warren-Alquist Act), which established a moratorium on the certification of new nuclear plants until the Commission "finds that there has been developed and that the United States through its authorized agency has approved and there exists a demonstrated technology or means for the disposal of high-level nuclear waste."[80] The Pacific Gas and Electric and San Diego Gas & Electric Companies filed suit in district court, seeking a declaratory judgment that certain provisions of the Warren-Alquist Act were null and void because they were preempted by the Atomic Energy Act.[81]

The Supreme Court distinguished *Pacific Gas and Electric* from *Northern States Power* because the California legislature enacted the Warren-Alquist Act to regulate the economic costs of nuclear waste storage – not to expressly regulate radiation hazards.[82] The Court noted that the Atomic Energy Act does not occupy the field of the economic aspects of nuclear power generation.[83] Moreover, the traditional police powers of the states have long included regulation of the energy market, specifically laws dealing with "the need for additional generating capacity the type of generating facilities to be licensed, land use, ratemaking, and the like."[84]

Accordingly, the Supreme Court declined to inquire into the California legislature's motives when enacting the Warren-Alquist Act and deferred to the California legislature's "avowed economic purpose" for enacting the statute.[85] Because California could cite a rationale unrelated to the occupied field of radiation hazards—minimizing state expenditures on the storage of nuclear waste—to justify its enactment of the Warren-Alquist Act, the Court ruled that the Atomic Energy Act does not preempt the statute.[86]

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80. *See id.* at 198; *see also* Warren-Alquist State Energy Resources Conservation and Development Act, CAL. PUB. RES. CODE § 25524.2 (West 1977).

81. *See Pac. Gas & Elec. Co.*, 461 U.S. at 190 (explaining the basic principles of Pacific Gas and Electric's preemption argument).

82. *See id.* at 212–13 (reasoning that the Minnesota law "fell squarely within the field of safety regulation reserved for federal regulation," whereas the California law did not).

83. *See id.* at 205, 207 (deducing that "the States retain their traditional responsibility in the field of regulating electrical utilities for determining questions of need, reliability, cost and other related state concerns.").

84. *Id.* at 190, 212.

85. *See id.* at 216 (accepting "California's avowed economic purpose as the rationale for enacting § 25524.2" and finding that, "[a]ccordingly, the statute lies outside the occupied field of nuclear safety regulation").

86. *See id.* at 223 (noting the Atomic Energy Act does not preempt the Warren-Alquist Act).

The *Northern States Power* and *Pacific Gas and Electric* cases provide fairly straightforward rules for preemption under the Atomic Energy Act. If a state law expressly regulates nuclear power generation with respect to radiation hazards, then the Atomic Energy Act preempts that law. If a state law on its face regulates a nuclear power plant in regard to something other than radiation hazards, however, then the Atomic Energy Act does not preempt the state law.[87] So long as the state can justify its regulation of nuclear power plants for the sake of a policy concern independent of radiation hazards, e.g. "the type of generating facilities to be licensed, land use, ratemaking, and the like,"[88] the courts ought to defer to the legislature's stated intent in passing a statute when conducting a preemption analysis.[89]

E. The Entergy Nuclear Vermont Yankee *Corollary to the* Pacific Gas and Electric *Rule*

In *Entergy Nuclear Vermont Yankee, LLC v. Shumlin*,[90] the District of Vermont and the Second Circuit created a corollary to the *Pacific Gas and Electric* rule – at least in the Second Circuit.[91] According to this new standard, in addition to considering whether a statute on its face regulates the field of nuclear safety, the federal courts "must also look to the statute's legislative history to determine if it was passed with an impermissible motive."[92] As Judge J. Garvan Murtha concluded, "where there is evidence the statute was motivated by and grounded in radiological safety concerns," the courts do not have to defer to a state's professed rationale for regulating nuclear power generation.[93]

The *Entergy Nuclear Vermont Yankee* case arose mainly out of two statutes that the Vermont legislature passed in 2006—Act 74 and Act 160—governing the state's sole nuclear power plant: the Vermont Yankee

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87. *See id.* at 223; N. States Power Co. v. Minnesota, 447 F.2d 1143, 1149 (8th Cir. 1971), *aff'd*, 405 U.S. 1035 (1972).

88. *Pac. Gas & Elec. Co.*, 461 U.S. at 212.

89. *See id.* at 216.

90. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183 (D. Vt. 2012), *aff'd in part, rev'd in part*, Nos. 12-707-cv (L), 12-791-cv (XAP), 2013 WL 4081696 (2d Cir. Aug. 14, 2013).

91. *See id.* at 228 (reasoning that "where there is evidence the statute was motivated by and grounded in radiological safety concerns, and the statute on its face empowers future legislatures to apply the statute to deny continued operation for radiological safety reasons and evade review," the courts can second-guess the claimed motives of legislative action).

92. *Entergy Nuclear Vt. Yankee, LLC*, 2013 WL 4081696, at *19.

93. *Entergy Nuclear*, 838 F. Supp. 2d at 228 ("Vermont's arguments that this Court should look no further, and that it need not be required to introduce evidence the legislature actually considered these non-preempted purposes, are unpersuasive.").

Nuclear Power Station.[94] These new laws altered the existing state regulatory regime based on a 1977 Vermont law that required a company constructing or operating a nuclear power plant in the state to have a Certificate of Public Good (CPG) issued by the Public Service Board.[95]

Act 74 required, after March 21, 2012, that the Vermont General Assembly must first affirmatively vote in favor of the Public Service Board issuing a CPG for the Board to issue the certificate.[96] Act 74 also required the operator of the nuclear power plant (Entergy Nuclear Vermont Yankee, LLC) to contribute to a Clean Energy Development Fund.[97]

Act 160 established that in the event that the General Assembly declined to pass affirmative legislation authorizing the Public Service Board to issue a CPG, the application would remain pending and the current CPG would expire – thereby establishing a pocket veto power for the General Assembly.[98] It also expanded the issues' scope, requiring legislative approval from just spent fuel storage to all aspects of the operation of Vermont Yankee.[99]

The most consequential action taken by the Vermont legislature was the Senate's vote on February 24, 2010 to reject a bill: S.289, "An Act Relating to Approval for Continued Operation of the Vermont Yankee Nuclear Power Station."[100] In accordance with Acts 74 and 160, the Public Service Board could not issue a CPG, and Vermont Yankee therefore could not obtain the certification necessary to operate past March 21, 2012.[101]

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94. *See id.* (articulating Vermont's contention that Act 160 was meant to address "the state's need for power, the economics and environmental impacts of long-term storage of nuclear waste, and choice of power sources among various alternatives") (quoting 2006 Vt. Acts & Resolves 204).

95. VT. STAT. ANN. tit. 30, § 248(e)(1) (West 2013) ("Before a certificate of public good is issued for the construction of a nuclear energy generating plant within the state, the public service board shall obtain the approval of the general assembly and the assembly's determination that the construction of the proposed facility will promote the general welfare.").

96. 2005 Vt. Acts & Resolves 599.

97. *Id.*

98. 2006 Vt. Acts & Resolves 204 ("No nuclear energy generating plant within this state may be operated beyond the date permitted in any certificate of public good granted pursuant to this title . . . unless the general assembly approves and determines that the operation will promote the general welfare, and until the public service board issues a certificate of public good under this section. If the general assembly has not acted under this subsection by July 1, 2008, the board may commence proceedings under this section and under 10 V.S.A. chapter 157 . . . .").

99. *Id.*

100. S. 289, 70th Leg. (Vt. 2010).

101. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, Nos. 12-707-cv (L), 12-791-cv (XAP), 2013 WL 4081696, at *7 (2d Cir. Aug. 14, 2013).

Entergy Nuclear Vermont Yankee, LLC brought suit in the District of Vermont, claiming that the Atomic Energy Act preempted Acts 74, 160, and a third statute, Act 189.[102] Judge Murtha first applied the rules of *Northern States Power* and *Pacific Gas and Electric* to his analysis of Acts 74 and 160.[103] Judge Murtha then diverged from prior Atomic Energy Act jurisprudence by also applying rules from tobacco preemption cases—namely *Greater N.Y. Metro Food Council, Inc. v. Giuliani*[104]—to allow the court to inquire into the legislature's motives where evidence existed that it enacted a statute with the implicit intent to regulate nuclear hazards.[105] The district court reasoned, and the Second Circuit affirmed, that the deference accorded to state governments in *Pacific Gas and Electric* was inapplicable in the context of *Entergy Nuclear Vermont Yankee* because there was a critical mass of evidence suggesting that the Vermont General Assembly and Public Service Board acted out of concern about radiological hazards.[106]

To understand the court's conclusions in *Entergy Nuclear Vermont Yankee*, it is necessary to contextualize the Vermont state government's acts within the history of the Vermont Yankee Nuclear Power Station. Long an object of environmental activists' ire,[107] the Vermont Yankee Nuclear Power Station became subject to intense scrutiny when a cooling tower wall collapsed in 2007.[108] The political climate in Montpelier turned

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102. *See* Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183, 189–90 (D. Vt. 2012), *aff'd in part, rev'd in part*, 2013 WL 4081696 (deciding not to review Entergy's preemption claim against Act 189 due to mootness).

103. *See id.* at 220–23.

104. *See id.* at 224 (holding that "courts cannot "blindly accept" a challenged statute's "articulated purpose," because to do so would allow legislatures to circumvent preemption and reasoning that the fact that "the City Council drafted a declaration of intent that recites a law enforcement goal while scrupulously avoiding any mention of the word 'health' simply cannot control our preemption analysis") (citing Greater N.Y. Metro. Food Council, Inc. v. Giuliani, 195 F.3d 100, 108 (2d Cir. 1999)).

105. *See id.* (creating a new rule for cases "where there is evidence the statute was motivated by and grounded in radiological safety concerns, and the statute on its face empowers future legislatures to apply the statute to deny continued operation for radiological safety reasons and evade review").

106. *See id.* at 230–31 (holding that "there is overwhelming evidence in the legislative record that Act 160 was grounded in radiological safety concerns"); *see also Entergy Nuclear Vermont Yankee, LLC*, 2013 WL 4081696, at *20 (agreeing with the district court's analysis).

107. *See* RICHARD A. WATTS, PUBLIC MELTDOWN: THE STORY OF THE VERMONT YANKEE NUCLEAR POWER PLANT 20–21 (2012).

108. *See, e.g.*, Bob Audette, *VY cuts output after cooling failure*, BRATTLEBORO REFORMER (Aug. 22, 2007), http://www.reformer.com/headlines/ci_6685658; Susan Smallheer, *Yankee Cooling Tower Fails*, THE RUTLAND HERALD (Aug. 22, 2007) (documenting the event which provided the backdrop for the Vermont state government's most recent push to close the Vermont Yankee power plant).

decisively against Vermont Yankee in 2009 when inspectors found radioactive tritium in monitoring wells on the Vermont Yankee campus,[109] and the Vermont state legislature held a series of contentious hearings on the safety of the nuclear power plant.[110] It was within this climate of apprehension about the safety of Vermont Yankee that in 2010 the General Assembly voted against allowing the Public Service Board to issue Vermont Yankee a CPG.[111]

The district court and the Second Circuit started with an analysis of the plain meaning of the text of Act 74, noting that the law plainly states the legislature's intention to make Vermont's "future power supply . . . diverse, reliable, economically sound, and environmentally sustainable."[112] But the courts found that there was "obvious coaching" of the legislature to refrain from expressing their nuclear safety-related motivation to enact Act 74 on the record.[113] Even so, the courts found that legislators articulated their concerns about "high level nuclear waste" and "the fact that [nuclear waste] lasts, it's dangerous for 100,000 years."[114] One committee member admonished another for veering off script, "we can't say that, anything about safety. It can only be about economics and aesthetics."[115] Hence, the courts found that the Vermont legislature passed Act 74 with the impermissible motive of regulating nuclear safety, and ruled that the Atomic Energy Act preempted the statute.[116]

The courts were also concerned that the Vermont legislature had in fact enacted the law to address concerns about the safety of the Vermont Yankee Nuclear Power Station because Act 160 did not explicitly regulate nuclear safety per se.[117] The Second Circuit noted the record showed that at legislative hearings on Act 160, Vermont state officials "repeatedly demonstrated awareness of the potential for a preemption problem and disguised their comments accordingly."[118] One legislator opined, "I understand that only the feds are allowed to think of safety issues, and we

109. *See Entergy Nuclear*, 838 F. Supp. 2d at 214–15.

110. *See* WATTS, *supra* note 107, at 61–79.

111. *See Entergy Nuclear*, 838 F. Supp. 2d at 243 (portraying the legislative and administrative processes by which the Vermont state government denied Vermont Yankee licenses necessary to operate).

112. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, Nos. 12-707-cv (L), 12-791-cv (XAP), 2013 WL 4081696, at *23 (2d Cir. Aug. 14, 2013).

113. *Id.* at *24.

114. *Id.*

115. *Id.*

116. *Id.* at *25, *27.

117. *Id.*

118. *Id.* at *21.

carefully don't use that word here."[119] The committee chair was warned about federal preemption of safety issues and responded, "Okay, let's find another word for safety."[120] Accordingly, the Vermont legislature paraphrased the decision in *Pacific Gas and Electric* and wrote the text of Act 160 as a statute addressing "the state's need for power, the economics and environmental impacts of long-term storage of nuclear waste, and choice of power sources among various alternatives."[121] Thus the district court and the Second Circuit agreed that the legislative history of Act 160 provided ample evidence of intent to regulate the radiological safety of the nuclear power plant, and was thereby preempted by the Atomic Energy Act.[122]

Northern States Power, *Pacific Gas and Electric*, and *Entergy Nuclear Vermont Yankee* create multiple options for any court that might adjudicate a preemption claim against NYSDEC's Indian Point water quality certification denial. The jurisprudence of *Northern States Power* and *Pacific Gas and Electric* gives great deference to the states to regulate nuclear power generation on the condition that they do not claim to regulate radiation hazards.[123] Now that the Second Circuit has affirmed Judge Murtha's decision in *Entergy Nuclear Vermont Yankee*, however, a federal court has established a powerful precedent, which Entergy can use to challenge NYSDEC's denial of a WQC for the Indian Point cooling systems.[124]

II. PREEMPTION ANALYSIS OF NYSDEC'S ACTION ON INDIAN POINT

The decision in *Entergy Nuclear Vermont Yankee, LLC v. Shumlin* would give significant support to any challenge by Entergy of NYSDEC's WQC decision on preemption grounds.[125] Now that the Second Circuit has

119. *Id.*

120. *Id.*

121. 2006 Vt. Acts & Resolves No. 160.

122. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183, 232, 233 (D. Vt. 2012), *aff'd in part, rev'd in part*, 2013 WL 4081696.

123. *See* N. States Power Co. v. Minnesota, 447 F.2d 1143, 1148–50 (8th Cir. 1971), *aff'd*, 405 U.S. 1035 (1972) (interpreting the Atomic Energy Act to preempt state regulation of radiation hazards but allowing state regulation of other aspects of nuclear power generation).

124. *See Entergy Nuclear*, 838 F. Supp. 2d at 228 ("[W]here there is evidence the statute was motivated by and grounded in radiological safety concerns, and the statute on its face empowers future legislatures to apply the statute to deny continued operation for radiological safety reasons and evade review.").

125. *Id.*

sustained Judge Murtha's decision,[126] Entergy can use the *Vermont Yankee* precedent to challenge NYSDEC's WQC decision.[127]

The best argument that the Atomic Energy Act preempts NYSDEC's denial of an Indian Point WQC is that the certification decision impermissibly relied on concerns about the release of radioactive materials into the groundwater and the Hudson River.[128] Moreover, in the context of Governor Spitzer's, Lt. Governor Paterson's, and Attorney General Cuomo's rhetoric about terrorist attacks and nuclear disaster,[129] it is entirely plausible that NYSDEC denied the WQC out of concern about nuclear safety, as a means to an ends of closing the nuclear power plant.

On the other hand, careful analysis suggests that the Atomic Energy Act might not preempt NYSDEC's decision because the denial of a Clean Water Act § 401 WQC does not regulate radiation hazards per se, and it does not directly conflict with any of the Nuclear Regulatory Commission's licensing decisions or safety regulations.[130] Rather, NYSDEC's action appears to be a facially valid exercise of the state's powers under the Clean Water Act to regulate the waters of the Hudson River.[131] Unlike in *Entergy Nuclear Vermont Yankee, LLC*, there does not appear to be any evidence in the public record suggesting that NYSDEC's concerns about the non-nuclear aspects of Indian Point's cooling systems are disingenuous.[132]

A. Express Preemption

Of the various forms of preemption, "[t]he most obvious is where Congress expressly states that it is preempting state authority."[133] "[W]hen

126. *Entergy Nuclear Vermont Yankee, LLC*, 2013 WL 4081696, at *29.

127. *See id.* at *19 (stating that the federal courts "must also look to the statute's legislative history to determine if it was passed with an impermissible motive"); *see also* Notice of Denial, *supra* note 2 (denying Entergy's WQC application for Indian Point Unit 1 and Unit 2).

128. *See* Notice of Denial, *supra* note 2, at 11.

129. *See* Kaplan, *supra* note 11; *see also* Governor Spitzer and Attorney General Cuomo's 2007 Press Conference, *supra* note 59; Hakim, *supra* note 58.

130. *See* Notice of Denial, *supra* note 2, at 16–17 (stating that Entergy can continue operating Indian Point Unit 2 and Unit 3 so long as it retrofits the facilities with closed-cycle cooling systems and closes the once-through cooling systems).

131. *See generally id.* (citing repeatedly NYSDEC's obligation to protect the water quality and ecosystem of the Hudson River); *see also* NUCLEAR ENERGY INST., ECONOMIC BENEFITS OF INDIAN POINT ENERGY CENTER: AN ECONOMIC IMPACT STUDY 5 (Apr. 2004), *available at* http://www.nei.org/filefolder/economic_benefits_indian_point.pdf (noting that New York's SPDES system has been approved by the US EPA).

132. *See* Notice of Denial, *supra* note 2, at 11 (noting concerns about radioactive materials).

133. Cnty. of Suffolk v. Long Island Lighting Co., 728 F.2d 52, 57 (2d Cir. 1984)

Congress has 'unmistakably . . . ordained' that its enactments alone are to regulate a part of commerce, state laws regulating that aspect of commerce must fall."[134]

Entergy is not likely to succeed on a claim of express preemption because nothing in the Atomic Energy Act explicitly forbids states from issuing or denying water quality certificates to nuclear power plants.[135] Indeed, the Atomic Energy Act contains no language that explicitly denies states the authority to regulate the generation of nuclear energy. In *Northern States Power Co. v. Minnesota*, the district court found that there was no express preemption provision in the Atomic Energy Act or its amendments, and this interpretation of the statute remains good law.[136]

B. The Implied Preemption Claim: Conflict Preemption

Even if a federal statute does not expressly preempt state laws, "Congress' intent to supersede state law may be found from 'a scheme of federal regulation . . . so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it.'"[137] In such cases, "federal law occupies an entire field of regulation."[138]

Entergy might argue that the Atomic Energy Act charges the NRC with issuing operating licenses to nuclear utilities;[139] NYSDEC's action therefore conflicts with the NRC's regulatory actions because it has the intent and practical effect of forcing Indian Point's closure.[140] It is unlikely, however, that a court would rule for Entergy on a conflict preemption challenge because there is no inherent conflict between the federal and state actions. There is no "physical impossibility" for Entergy to simultaneously abide by both the NRC and NYSDEC's regulatory

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(citing Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977)).

134. *Jones*, 430 U.S. at 525 (quoting Fla. Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 142 (1963)).

135. *See generally* Atomic Energy Act of 1954, 42 U.S.C. §§ 2018–2284 (2012).

136. *See* N. States Power Co. v. Minnesota, 447 F.2d 1143, 1155 (8th Cir. 1971), *aff'd*, 405 U.S. 1035 (1972) (recognizing that the Atomic Energy Act contains no express provision suggesting that the federal government has exclusive authority to regulate radiation emissions from nuclear power plants).

137. *Cnty. of Suffolk*, 728 F.2d at 57 (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 67 (1947)).

138. Wachovia Bank, N.A. v. Burke, 414 F.3d 305, 313 (2d Cir. 2005).

139. *See* 42 U.S.C. § 2012 (declaring as national policy that the federal government shall promote "the development, use, and control of atomic energy"); *see also id.* § 2011 (charging the Atomic Energy Commission—the precursor to what is now the Nuclear Regulatory Commission—with the regulation of "processing and utilization of source, by product, and special nuclear material" by civilian persons).

140. *See* Halbfinger, *supra* note 1 (explaining the practical ramifications of NYSDEC's denial of a Water Quality Certificate to Entergy for Indian Point).

actions and still operate Indian Point Unit 2 and Unit 3.[141] It is indeed possible for Entergy to continue operating each reactor according to renewed NRC operating licenses, while continuing to comply with NYSDEC's WQC decision so long as Entergy builds cooling towers to substitute for the once-through cooling systems.[142] As such, there is no conflict preemption.[143]

Entergy could also make a conflict preemption claim by arguing that the economic ramifications of the NYSDEC decision would conflict with the Atomic Energy Act's policy of promoting nuclear power.[144] If Entergy were to make such a claim, a court would most likely reject the arguments because the Atomic Energy Act's policy goal of promoting nuclear energy need not be accomplished "at all costs."[145] Clearly, the entire body of the statute establishes Congress' intent to promote the peaceful development of a civilian nuclear energy industry, albeit under a strict regime of federal regulation to protect public safety.

Entergy might also raise a claim that the cost of compliance with both NRC and NYSDEC's regulations is so onerous that it is technically possible to operate the facility, but it is impossible to do so and still make a profit.[146] Indeed, the construction of cooling towers might cost up to $1.19 billion,[147] and this cost would be so expensive that it would in all likelihood

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141. *See* Fla. Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 143 (1963) (establishing that there is no federal conflict preemption of state law where no "physical impossibility" of compliance with both federal and state regulations is presented in the record); *N. States Power Co.*, 447 F.2d at 1147 (noting that there was "no physical impossibility of dual compliance with both the AEC and Minnesota regulations" because a nuclear power plant that adhered to Minnesota's radiation emissions standards would also adhere to the less stringent AEC radiation emissions standards).

142. *See* Halbfinger, *supra* note 1 (explaining the costs of building cooling towers); *see also* ENGINEERING FEASIBILITY AND COSTS OF CONVERSION OF INDIAN POINT, *supra* note 21, at 50 (calculating these costs).

143. *See Fla. Lime & Avocado Growers, Inc.*, 373 U.S. at 143 (stating that there is no federal preemption of state law where there is no "physical impossibility" of "compliance with both federal and state regulations" presented in the record); *N. States Power Co.*, 447 F.2d at 1147 (recognizing "no physical impossibility of dual compliance with both the AEC and Minnesota regulations").

144. *See* 42 U.S.C. § 2011 (declaring the "development, use, and control of atomic energy" by civilian persons as a national policy of the United States government).

145. *See* Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n, 461 U.S. 190, 192 (1983) (finding that Section 25524.2 did not frustrate the policy goal of the Atomic Energy Act—i.e., the development of the commercial use of nuclear power—because the promotion of nuclear power need not be accomplished "at all costs").

146. *See* ENGINEERING FEASIBILITY AND COSTS OF CONVERSION OF INDIAN POINT, *supra* note 21, at 50.

147. *Id.*

force Entergy to either substantially raise its consumer rates or operate Indian Point at a net loss – that is, if it can operate the plant at all.[148] Nevertheless, business impracticality is not the same as "physical impossibility";[149] it is physically possible for Entergy to build cooling towers and it can operate the plant in compliance with both NRC and NYSDEC regulations – even if it would be operating at a loss.[150]

C. The Implied Preemption Claim: Field Preemption

Entergy's strongest preemption claim would be that the Atomic Energy Act impliedly preempts NYSDEC's action because language in the statute strongly suggests that Congress intended for the federal government to have exclusive regulatory authority over radiation hazards.[151] Even if a statute does not explicitly preempt state laws, "Congress' intent to supersede state law may be found from a scheme of federal regulation . . . so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it."[152] In such circumstances, "federal law occupies an entire field of regulation."[153]

The text of the Atomic Energy Act, especially the 1959 Amendment, strongly implies that Congress' intent was to endow the now NRC with exclusive authority to regulate radiation hazards.[154] In *Northern States Power*, the court found that by expressly delineating the situations in which the Atomic Energy Commission could devolve regulatory authority to the states, the Atomic Energy Act strongly implied a federal prerogative over nuclear safety issues.[155] In *Northern States Power* and *Pacific Gas and*

148. *See* Halbfinger, *supra* note 1 (explaining how the additional costs of constructing cooling towers would cause Entergy to operate Indian Point at a loss).

149. *See* Fla. Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 143 (1963) (finding no federal preemption of state law where no "physical impossibility" of "compliance with both federal and state regulations" is presented in the record); *see also* N. States Power Co. v. Minnesota, 447 F.2d 1143, 1147 (8th Cir. 1971), *aff'd*, 405 U.S. 1035 (1972) (noting "no physical impossibility of dual compliance with both the AEC and Minnesota regulations").

150. *See* Halbfinger, *supra* note 1 (demonstrating how the additional costs of constructing cooling towers would cause Entergy to operate Indian Point at a net loss).

151. *See, e.g.*, Atomic Energy Act § 274, 42 U.S.C. § 2021 (2012) (laying out the procedures for the federal government to delegate its regulatory authority over radiation hazards to state governments); *see also id.* § 2021(k).

152. Cnty. of Suffolk v. Long Island Lighting Co., 728 F.2d 52, 57 (2d Cir. 1984) (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

153. Wachovia Bank, N.A. v. Burke, 414 F.3d 305, 313 (2d Cir. 2005).

154. 42 U.S.C. § 2021(k) ("Nothing in this Section shall be construed to affect the authority of any State or local agency to regulate activities for purposes other than protection against radiation hazards."); *id.* § 2021(b) (establishing the processes by which the federal government can devolve regulatory authority to the states).

155. N. States Power Co. v. Minnesota, 447 F.2d 1143, 1149–50 (8th Cir. 1971),

Electric, the courts held that these provisions of the Atomic Energy Act impliedly preempt state regulation over the radiological safety of nuclear power.[156]

Likewise, for the courts to apply Atomic Energy Act analysis to any Indian Point preemption challenge and rule in this case like they did in *Northern States Power*, the analysis would hinge on whether New York directly encroached on the federal government's prerogative of regulating radiation hazards.[157] In Entergy's appeal of its WQC denial before a NYSDEC Administrative Law Judge, the company cited *Northern States Power* and argued that "NYSDEC cannot ground a WQC denial on radiological issues as a matter of law" - referring to NYSDEC's mention of leaking radionuclides in its Notice of Denial.[158]

Administrative Law Judge Maria Villa ruled against Entergy on this claim, rejecting Entergy's proposition that NYSDEC grounded its WQC denial on radiological issues.[159] Judge Villa noted that occupation of the field of radiological safety "necessarily includes control over radioactive effluents discharged from the plant incident to its operation."[160] She distinguished the fact pattern in *Northern States Power* from the *Indian Point* case, however, explaining that the radioactive emissions from the nuclear power plant in Minnesota were "a release incident to operation," and the radioactive leakage from Indian Point into the groundwater and the Hudson River was not.[161] Likewise, she ruled that NYSDEC was within its power to consider that Indian Point's radioactive leakage violated federal safety regulations when it denied Indian Point a WQC.

Judge Villa's rejection of *Northern States Power*'s application to the Indian Point WQC controversy suggests that the case is more like *Pacific Gas and Electric*.[162] Likewise, NYSDEC's denial of the WQC, based in

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aff'd, 405 U.S. 1035 (1972).

156. *See id.* at 1149 (interpreting that the "whole tone of the 1959 amendment" demonstrates a recognition by Congress that the Atomic Energy Commission had "the sole authority to regulation radiation hazards" associated with nuclear materials and nuclear power generation).

157. *See id.* at 1147 (applying preemption analysis to Minnesota's regulation of radiation emissions).

158. Request for Adjudicatory Hearing on Notice of Denial, *supra* note 5, at 8–9; *see also* Notice of Denial, *supra* note 2, at 11.

159. *See generally* Ruling on Proposed Issues, *supra* note 6.

160. *See id.* at 23 (citing *N. States Power Co.*, 447 F.2d at 1149 n.6).

161. *See id.* at 23–24 (noting that "the radioactive material that has escaped from the Facilities is not a regulated discharge, or a release incident to operation. Rather, the situation is one where radioactive material is leaking from the Facilities, and consequently, those leaks may adversely affect the State's groundwater and surface waters, impairing the best usages of those waters").

162. *See* Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n,

part on Indian Point's radioactive leakage into the groundwater, most likely falls into the category of policy fields over which the states exercise their traditional regulatory authority.[163] Hence, New York's regulation of water pollution caused by the nuclear power plant's cooling system could fall into a field of state regulatory activity that is not preempted by the Atomic Energy Act.

It would be quite appropriate for a court to find that any preemption challenge to NYSDEC's WQC decision is comparable to *Pacific Gas and Electric*. Like the Warren-Alquist Act in *Pacific Gas and Electric*, the regulation of water quality-related environmental problems arising from the Indian Point nuclear power plant do not amount to the regulation of radiological hazards per se. Rather, NYSDEC only regulated Indian Point's cooling systems and discharges into the Hudson River – a small but consequential distinction. NYSEDC's permitting decision also appears to fit more in the category of subjects "other than . . . radiation hazards"[164] which Congress impliedly reserved to the regulatory authority of the states. Therefore, if any tribunal were to apply the *Pacific Gas and Electric* rule, it would likely defer to NYSDEC's avowed non-nuclear environmental purpose for denying the WQC, such as protecting the fauna of the Hudson River from entrainment, impingement and thermal pollution.[165]

When Judge Villa ruled against Entergy's preemption claim in its WQC appeal in December 2010, however, Judge Murtha had not yet issued his opinion in *Entergy Nuclear Vermont Yankee, LLC v. Shumlin*, and the Second Circuit had not yet affirmed the district court's ruling on the preemption count. Now that the Second Circuit has affirmed Judge Murtha's decision in the *Entergy Nuclear Vermont Yankee* decision, there is a precedent—in the Second Circuit at least—allowing for the federal courts to inquire into legislative intent when conducting Atomic Energy Act preemption analysis.[166] Now that *Entergy Nuclear Vermont Yankee* has paved a wider avenue to preemption, the most salient question is not whether NYSDEC's denial of a WQC for Indian Point is more like *Pacific Gas and Electric* than *Northern States Power*, but whether it is more like *Entergy Nuclear Vermont Yankee* than *Pacific Gas and Electric*.

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461 U.S. 190 (1983).

163. *See* Notice of Denial, *supra* note 2, at 11.

164. Atomic Energy Act § 274(k), 42 U.S.C. § 2021(k) (2012).

165. *See* Notice of Denial, *supra* note 2, at 11 (articulating that NYSDEC denied the WQC was out of concerns about thermal pollution, entrainment and impingement of fish).

166. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, Nos. 12-707-cv (L), 12-791-cv (XAP), 2013 WL 4081696, at *19-25 (2d Cir. Aug. 14, 2013).

At the time of this publication, Entergy's appeal of NYSDEC's WQC decision is still pending before Judge Villa. Judge Villa might recommend that the NYSDEC Commissioner grant Entergy's WQC, and the Commissioner might do so for a number of reasons unrelated to preemption.[167] However, if the Commissioner decides to deny Entergy's WQC application, that would be a final agency action.[168]

So long as the NYSDEC Commissioner affirms the agency's WQC decision, Entergy would have standing to bring the matter to court.[169] Entergy could file suit in a New York State or federal court and petition the court for a permanent injunction and declaration that NYSDEC's denial of Entergy's WQC is invalid under the Supremacy Clause of the United States Constitution because it is preempted by the Atomic Energy Act.[170] Following the template that the company set in *Entergy Nuclear Vermont Yankee, LLC v. Shumlin*, a state or federal trial judge might be more sympathetic to a preemption claim than a NYSDEC Administrative Law Judge.

In *Entergy Nuclear Vermont Yankee*, the district court held and the Second Circuit affirmed that "where there is evidence the statute was motivated by and grounded in radiological safety concerns, and the statute on its face empowers future legislatures to apply the statute to deny continued operation for radiological safety reasons and evade review," the Atomic Energy Act preempts the state law.[171] Likewise, a court could cite statements by state officials, including NYSDEC commissioners, New York governors, and New York attorneys general, to support the conclusion that NYSDEC's water quality certification decision was primarily motivated by concerns about radiological safety.[172]

Now that the *Vermont Yankee* case allows courts to second-guess the state's professed intent in regulating nuclear power plants, a court hearing a preemption claim on NYSDEC's WQC decision may look not only at NYSDEC's fleeting mentions of tritium, cesium, and strontium-90 in the Notice of Denial,[173] but also at NYSDEC's concerns about the prospect of

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167. *See* N.Y. A.P.A. § 307 (McKinney 2003).

168. *See id.*

169. *Id.*

170. *See* Fed. R. Civ. P. 5.1; N.Y. C.P.L.R. § 7803 (McKinney 2008).

171. Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183, 228 (D. Vt. 2012), *aff'd in part, rev'd in part*, 2013 WL 4081696.

172. *See, e.g.*, Kaplan, *supra* note 11 (recounting then-Attorney General and later Governor Cuomo's statements that Indian Point is a "catastrophe waiting to happen" and "should be closed" because the "plant in this proximity to the city was never a good risk").

173. Notice of Denial, *supra* note 2, at 11.

a terrorist attack on the nuclear facility in its public statement opposing the NRC's relicensing of Indian Point.[174] A court could also look at Eliot Spitzer, Andrew Cuomo and David Paterson's public statements invoking the specter of nuclear terrorism and inadequate evacuation routes and lobbying the NRC against the relicensing of Unit 2 and Unit 3 to demonstrate that NYSDEC's WQC decision was based upon the state's concerns about nuclear safety.[175]

Given the public pronouncements of New York State officials voicing concern about Indian Point's nuclear safety hazards,[176] a court might find that these public invocations of nuclear disaster are comparable to the Vermont legislators' hushed discussions of safety in that they reveal the state's primary motivation for denying certification to Indian Point.[177] A court could find that, NYSDEC's protests against the impingement of fish and thermal pollution notwithstanding, such stated concerns were merely a subterfuge and that NYSDEC's decision to reject Entergy's WQC application was in reality an attempt to regulate the Indian Point's feared radiation hazards.[178] In that case, a court need not defer to NYSDEC's stated rationale for denying Entergy's WQC application, and might be more inclined to hold that NYSDEC's decision invaded the NRC's exclusive domain of regulating the radiological safety of nuclear power plants and is therefore invalid.[179]

A court could still conclude that the Atomic Energy Act does not preempt NYSDEC's decision to deny Entergy's WQC application, however, even taking into account the *Entergy Nuclear Vermont Yankee* precedent.[180] After all, *Entergy Nuclear Vermont Yankee* stands for the proposition that when conducting preemption analysis, the court "must also look to the statute's legislative history to determine if it was passed with an impermissible motive,"[181] and that it is not bound to defer to a state's professed rationale "when there is evidence the statute was motivated by

174. *DEC Position on Indian Point Relicensing*, *supra* note 55.

175. *See* Governor Spitzer and Attorney General Cuomo's 2007 Press Conference, *supra* note 59; *see also* Kaplan, *supra* note 11.

176. *See supra* note 175.

177. *See, e.g.*, Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183, 206 (D. Vt. 2012), *aff'd in part, rev'd in part*, Nos. 12-707-cv (L), 12-791-cv (XAP), 2013 WL 4081696 (2d Cir. Aug. 14, 2013).

178. *See* Notice of Denial, *supra* note 2, at 3, 7–8, 11–13 (declaring the cooling systems to be prohibited by the Clean Water Act's water quality standards).

179. *See Entergy Nuclear*, 838 F. Supp. 2d at 228–33 (inquiring into the legislative histories of Acts 74, 160, and 189).

180. *See generally id.* (allowing—but not requiring—courts to second-guess a legislature's stated reason for regulating nuclear power).

181. *Entergy Nuclear Vermont Yankee, LLC*, 2013 WL 4081696, at *19.

and grounded in radiological safety concerns."[182] This corollary does not mandate that the court must void any state action with any scintilla of influence from concerns about radiation hazards, but merely that the court can do so. A court might inquire into NYSDEC's intentions when denying Entergy a WQC, failing to find sufficient evidence that the state regulation was an improper attempt to regulate radiation hazards by other means.[183]

A court could find that the Vermont General Assembly and the Public Service Board's professed reasons for denying a Certificate of Public Good to Vermont Yankee are distinguishable from NYSDEC's stated reasons for denying a WQC for Indian Point's cooling systems because whereas the former were contrived, the latter appear to have some genuine merit.[184] Indeed, the long history of federal regulatory agencies and Indian Point cooling systems regarding the thermal pollution of the Hudson River and the entrainment and impingement of fish make it difficult for Entergy to argue that NYSDEC's environmental reasons for denying the WQC are recent inventions.[185] Whereas in *Entergy Nuclear Vermont Yankee*, the legislative record was replete with evidence that the state implicitly regulated an occupied field and called it something else, Entergy might have to find more probative evidence than currently exists in the public record to establish that NYSDEC's WQC decision was inappropriate.

It is also quite likely that a court might find Indian Point's case distinguishable from *Northern States Power* and *Entergy Nuclear Vermont Yankee* because, whereas those latter cases arose from state actions derived from concerns about radiation hazards,[186] the Indian Point case involves a state agency action spurred by multiple environmental concerns – of which radiation hazards are just one of many. Though New York State officials have voiced concerns about the potential radiation hazards from Indian Point, this does not mean that those same officials are thereby disqualified

182. *Entergy Nuclear, LLC*, 838 F. Supp. 2d at 228–30.

183. *See id.* at 228–33.

184. *See id.* at 229 (finding "this preempted radiological safety purpose was a primary motivation among others advanced for Act 160"). *But see* Notice of Denial, *supra* note 2 (listing the environmental concerns about the cooling systems' thermal pollution and entrainment and impingement of fish).

185. *See* Notice of Denial, *supra* note 2 (articulating that NYSDEC denied the WQC was out of concerns about thermal pollution, entrainment and impingement of fish). In 1975, the Nuclear Regulatory Commission tried to force Con Edison to retrofit Indian Point with a closed-circuit cooling system, citing "the unacceptability of long-term impacts of entrainment and impingement on the Hudson River fishery." *Id.* at 4. In 1977, the EPA tried to use its NPDES permit distribution power to force Con Edison to address Indian Point's thermal pollution of the Hudson River. *Id.* at 6.

186. N. States Power Co. v. Minnesota, 447 F.2d 1143, 1149–50 (8th Cir. 1971), *aff'd*, 405 U.S. 1035 (1972); Entergy Nuclear Vt. Yankee, LLC v. Shumlin, 838 F. Supp. 2d 183, 228 (D. Vt. 2012), *aff'd in part, rev'd in part*, 2013 WL 4081696.

from abiding by their legal obligations under the Clean Water Act to regulate the nuclear power plant's discharges into the Hudson River.[187]

Accordingly, of the three major avenues of preemption analysis with which to address a preemption claim against NYSDEC, a court would most likely apply *Pacific Gas and Electric* because in this case the New York State agency regulated a nuclear power plant in regards to the non-radiological aspects of its operation.[188] If a court does apply *Pacific Gas and Electric*, the court would likely defer to NYSDEC's avowed non-radiological environmental reason for denying Entergy a WQC, and it would likely hold that the federal Atomic Energy Act does not preempt the NYSDEC's action.[189]

Now that the Second Circuit established a corollary to the *Pacific Gas and Electric* rule allowing for inquiry into legislative intent, a court might apply the corollary rule to any challenge to NYSDEC's certification decision. The application of the *Vermont Yankee* rule does not imply that a judge would hold NYSDEC's denial to be preempted and invalid, but it would give Entergy the legal basis to make such an argument in a way that could apply to Indian Point.

III. THE ROAD AHEAD FOR NEW YORK STATE, ENTERGY, AND INDIAN POINT

Entergy is in a difficult position because it has been denied a Clean Water Act § 401 WQC, and it faces a hostile New York State government which does not appear willing to issue a WQC or any other permits that are necessary for the plant's continued operation. Unless NYSDEC reverses its WQC decision, Entergy most likely faces the hard choice of spending $1.19 billion on cooling towers or closing the nuclear power plant.

A preemption lawsuit might be the best way for Entergy to keep Indian Point running. Now that the Second Circuit has partially affirmed Judge Murtha's decision, the door of opportunity for Entergy to challenge NYSDEC's decision on preemption grounds remains ajar. In the event that Entergy receives an unfavorable outcome from NYSDEC, it ought to challenge NYSDEC's action in court.

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187. *See, e.g.*, Federal Water Pollution Control Act of 1972 § 401, 33 U.S.C. § 1341 (2012) (establishing rules for compliance with applicable requirements, application, procedures, license application).

188. *See* Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n, 461 U.S. 190 (1983) (reasoning that the courts will defer to states' articulated reasons for regulation of non-radiological aspects of nuclear power production).

189. *See* Notice of Denial, *supra* note 2 (declaring the cooling systems to be prohibited by the Clean Water Act's water quality standards).

Facing the prospect of preemption of NYSDEC's WQC denial for Indian Point, New York State officials must keep in mind that the threat of preemption is directly related to the courts' perception of their motives.[190] State officials ought to take care not to sow reason to believe that NYSDEC's denial of a WQC to Entergy was an improper use of the state's Clean Water Act authority.[191] The more that state officials speak on the record about the risk of nuclear disaster at Indian Point, the more of an opening they give to a challenge according to *Vermont Yankee* implied preemption analysis.[192] Likewise, the Cuomo administration might be able corroborate the notion that New York State officials are in fact concerned about NYSDEC's stated policy reasons for denying Entergy's WQC. Governor Cuomo would be wise to organize a press conference, flanked by the Attorney General and the NYSDEC Commissioner, voicing the administration's concerns about the Indian Point cooling systems' thermal pollution of the Hudson River and its populations of striped bass, river herring, anchovy, American shad, Atlantic sturgeon, and the endangered shortnose sturgeon.

New York State officials ought to continue properly enforcing the Clean Water Act in regard to the state's nuclear power plants, for it is their obligation to enforce the law with impartiality.[193] However, NYSDEC and the Attorney General ought to avoid singling out Indian Point for enforcement in a harassing manner that might create the appearance that the state is trying to use existing state powers to do that which the Atomic Energy Act would otherwise preempt.[194] Under such circumstances, a judge might be more likely to apply the *Entergy Nuclear Vermont Yankee* precedent, which would result in a diminished deference to the state's articulated rationale for its regulation of the nuclear facility.[195]

If the Governor of New York, the New York State Attorney General, the NYSDEC Commissioner, or other state officials are concerned about the radiological safety of the Indian Point Energy Center, those officials ought

190. *See generally Entergy Nuclear Vt. Yankee, LLC*, 838 F. Supp. 2d at 183–243, *aff'd in part, rev'd in part*, 2013 WL 4081696.

191. *See id.* at 228 (treating with skepticism Vermont's arguments that the court should defer to its avowed economic rationale in enacting Acts 74, 160, and 189).

192. *See id.* at 228–33 (inquiring into the legislative history of Acts 74, 160, and 189).

193. *See, e.g.*, Federal Water Pollution Control Act of 1972 § 401, 33 U.S.C. § 1341 (2012) (charging states with the duty of distributing Water Quality Certificates to persons that seek to make permitted discharges into the navigable waters of the United States).

194. *See Entergy Nuclear*, 838 F. Supp. 2d at 232.

195. *See id.* at 228–33.

to register those concerns through the proper channels.[196] The Atomic Energy Act and the Energy Reorganization Act of 1974 charge the Nuclear Regulatory Commission with the exclusive authority to regulate the radiation hazards of nuclear power plants.[197] Therefore, the only legal option for New York State officials to remedy their concerns about the nuclear safety and possible radiation hazards of Indian Point is to advocate for a change of policy at the NRC.[198]

CONCLUSION

If Entergy were to challenge NYSDEC's denial of a WQC for Indian Point on preemption grounds, a court ought to invoke *Entergy Nuclear Vermont Yankee* and look to the public record to find that the implicit motivation for the permit denial was to regulate radiation hazards. If a court were to find that the preponderance of the evidence corroborates that NYSDEC's WQC decision was made with the impermissible intention of regulating radiation hazards, then the court would most likely hold that the NYSDEC's decision is preempted by the Atomic Energy Act and therefore invalid.[199]

However, to do this, Entergy probably must find more probative evidence. With only the information currently available on the public record, Entergy most likely could not persuade a court to find that NYSDEC's WQC decision was made with the intent to regulate radiation hazards and that it was not made for legitimate environmental policy concerns. Even if a court were to apply the *Entergy Nuclear Vermont Yankee* precedent, it might still hold that the Atomic Energy Act does not preempt NYSDEC's action. A court would most likely hold that this action was a legitimate exercise of the state's powers under the Clean Water Act, and rule that the Atomic Energy Act does not preempt NYSDEC's denial of water quality certification to Indian Point.[200]

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196. *See* Hakim, *supra* note 58.

197. Atomic Energy Act of 1954, 42. U.S.C. § 2133 (establishing the NRC's authority to distribute operating licenses for nuclear power plants).

198. *Id.* § 2201 (establishing the NRC's implied prerogative to regulate nuclear power plants in regards to safety and radiation hazards).

199. *See Entergy Nuclear*, 838 F. Supp. 2d at 228–33 (inquiring into the legislative history of Acts 74, 160, and 189).

200. *See* Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n, 461 U.S. 190, 212 (1983) (noting that states "exercise their traditional authority over the need for additional generating capacity, the type of generating facilities to be licensed, land use, ratemaking, and the like").

NOTE

PAY-TO-PLAY: THE IMPACT OF GROUP PURCHASING ORGANIZATIONS ON DRUG SHORTAGES

CHRISTIAN DEROO*

The United States prescription drug shortage crisis is a serious and preventable problem. Numerous reasons have been suggested as potential causes of the crisis; however, none are wholly satisfactory. This Note attempts to address the drug shortage crisis by arguing that the contracting practices of Group Purchasing Organizations (GPOs) create decreased pharmaceutical manufacturer diversity and a fragile supply chain. GPOs were formed with the purpose of consolidating buyer power for hospitals to secure the best possible prices for medical supplies, including prescription drugs, and the lowest possible cost for hospital patients. However, GPOs have strayed from this purpose, engaging in contracting practices that increase their profits at the expense of hospital patients and generic drug manufacturers. The contracting practices used by GPOs would be illegal under usual antitrust and fraud law, but GPOs enjoy several unique safe harbors that immunize them from prosecution. Eliminating the anticompetitive effect of GPOs will require significant reforms by both the executive and legislative branches. Repealing the safe harbors protecting GPOs from antitrust scrutiny will increase manufacturer diversity and lower manufacturer entry barriers. This will create a more robust healthcare supply chain capable of rapidly shifting production to meet demand in the face of potential shortages.

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INTRODUCTION

The United States is undergoing a critical shortage of certain prescription drugs. Although the impact of the shortage is undeniable, the cause of the

shortage remains an issue of considerable debate.[1] Commentators often point to manufacturing and production problems as the cause of the shortage.[2] This Note, however, argues that insufficient production capacity is a symptom, not the cause, of the problem. Policy positions taken by antitrust enforcement agencies and legislation legalizing certain types of kickbacks as "administrative fees" have exacerbated the problem. Group Purchasing Organizations ("GPOs") have been granted free reign to legally engage in anticompetitive practices that depress pharmaceutical production capacity for certain drugs, creating shortages.

Part II of this Note provides background information explaining how GPOs contribute to the drug shortage crisis. Part II examines the drug shortage crisis generally, the role of GPOs in health care, the federal antitrust agencies governing GPOs, and the application of the Federal Anti-Kickback Statute to GPOs. Part III analyzes how federal policies and practices have allowed for, and in some cases, even encouraged, anticompetitive behaviors by GPOs. Part III begins by applying a traditional antitrust analysis to GPO practices. Part III then examines the safe-harbor provision of the Federal Anti-Kickback statute[3] ("Safe-Harbor Provision"), as it relates to GPOs.

Part III argues that without the special protections afforded by the Safe-Harbor Provision, the "administrative fee" system under which GPOs operate would constitute fraud. Part III concludes by arguing that current practices lead to anticompetitive behaviors that raise entry barriers for drug and medical device manufacturers and increases certain generic drug costs. Part IV recommends that the executive and legislative branches of the

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1. *See The Causes of Drug Shortages and Proposals for Repairing These Markets: Testimony Before the H. Comm. on Oversight and Gov't Reform* (Nov. 29, 2011) (testimony of Scott Gottlieb), *available at* http://www.aei.org/speech/health/healthcare-reform/the-causes-of-drug-shortages-and-proposals-for-repairing-these-markets/ (arguing that the drug shortage crisis is due to various regulatory factors). *But see* Roxanne Nelson, *GPOs to Blame For Drug Shortages, Says Physicians Group*, MEDSCAPE TODAY (Jan. 24, 2013), http://www.medscape.com/viewarticle/778146 (discussing allegations before Congress that GPOs are a major factor in promoting the drug shortage crisis); Akiv Roy, *How Margaret Hamburg's FDA Causes Cancer Drug Shortages*, FORBES (June 15, 2012, 12:27 PM), http://www.forbes.com/sites/aroy/2012/06/15/how-margaret-hamburgs-fda-causes-cancer-drug-shortages/ (arguing that the drug shortage crisis is a result of FDA enforcement policies undertaken by Commissioner Margaret Hamburg).

2. *See* Doug Schoen, *The Drug Shortages Crisis in America*, FORBES (Feb. 13, 2012, 1:08 PM), http://www.forbes.com/sites/dougschoen/2012/02/13/the-drug-shortage-crisis-in-america/ (noting that while the FDA considers the cause of shortages to be manufacturing problems, other arguments include small profit margins for manufacturers, generic manufacturer consolidation, and ingredient shortages).

3. *Id.*

federal government reassess their policies to provide for stricter enforcement against anticompetitive behaviors by GPOs.

I. THE DRUG SHORTAGE CRISIS AND THE ROLE GPO'S PLAY

The drug shortage crisis affects millions of Americans each day, whether in the form of substituted medications, delayed procedures, or higher costs. The role GPOs play in contributing to the shortage may not seem readily apparent, but the impact is fundamental—an underlying force which drives down manufacturing capacity and leads to shortages. Federal regulation via administrative agencies and congressional legislation has contributed to this problem by creating safe harbors that shelter anticompetitive practices by GPOs.

A. Drug Shortages Occur Because Only a Few Key Manufacturers Produce Certain Drugs, Leading to a Fragile Supply Chain

The first instance of serious drug shortages in the United States occurred in 1999, and the problem has grown substantially since that time.[4] In 2011, the crisis peaked, with the United States suffering a record 251 drug shortages.[5] Since 2011, the numbers have diminished slightly, but the problem remains serious. The Food and Drug Administration ("FDA") reported over 100 ongoing drug shortages as of December 2013.[6] Certain classes of drugs are more susceptible to shortages than others.[7] The majority of serious drug shortages occur in the market for sterile injectable drugs, which account for approximately eighty percent of such shortages.[8]

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4. U.S. FOOD & DRUG ADMIN., A REVIEW OF FDA'S APPROACH TO MEDICAL PRODUCT SHORTAGES 3 (Oct. 31, 2011) [hereinafter APPROACH TO MEDICAL PRODUCT SHORTAGES], *available at* www.fda.gov/DrugShortageReport (explaining that the number of drug shortages in the United States tripled from 61 in 2005 to 178 in 2010).

5. *See* Katie Thomas, *Drug Shortages Persist in U.S., Harming Care*, N.Y. TIMES (Nov. 16, 2012), http://www.nytimes.com/2012/11/17/business/drug-shortages-are-becoming-persistent-in-us.html.

6. *See Current Drug Shortages Index*, U.S. FOOD & DRUG ADMIN., http://www.fda.gov/Drugs/DrugSafety/DrugShortages/ucm050792.htm (last updated Dec. 2, 2013).

7. *See* C. Lee Ventola, *The Drug Shortage Crisis in the United States: Causes, Impact, and Management Strategies*, 36 PHARMACY & THERAPEUTICS 740, 749 (2011) (reporting that certain classes of drugs, especially sterile injectables, are at a high risk for shortages); *see also* APPROACH TO MEDICAL PRODUCT SHORTAGES, *supra* note 4 (stating that in 2010–11, oncology drugs made up 28% of shortages, antibiotics 13%, and nutrition/electrolyte drugs 11%).

8. *See* APPROACH TO MEDICAL PRODUCT SHORTAGES, *supra* note 4; KEVIN HANINGER, AMBER JESSUP, & KATHLEEN KOEHLER, U.S. DEP'T OF HEALTH & HUMAN SERVS., ECONOMIC ANALYSIS OF THE CAUSES OF DRUG SHORTAGES (Oct. 2011) [hereafter HHS ECONOMIC ANALYSIS], *available at* http://aspe.hhs.gov/sp/reports/2011/drugshortages/ib.shtml (declaring that, in 2010, 74% of shortages involved sterile

The most common major therapeutic classes of drugs in shortage are oncology drugs, antibiotics, and electrolyte/nutrition drugs.[9] There have also been noticeable shortages in certain pain medications and anesthesia agents.[10]

There is no shortage of theories as to the cause of the drug shortage crisis.[11] Both the United States Department of Health and Human Services ("HHS") and the FDA have suggested a variety of causes as factors leading to the drug shortage crises; however, their analyses have largely focused on issues relating to manufacturing and shipping.[12] Although manufacturing and shipping problems can harm drug supply, the shortages caused by manufacturing and shipping issues are the symptom of a greater underlying problem: an unstable supply chain for certain types of drugs and medical devices.[13] A stable supply chain is a major protection against shortages, and stability is promoted by having a large and diverse group of suppliers.[14] However, only a few manufacturers produce the bulk of generic drugs, making generics particularly susceptible to shortages.[15]

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injectable drugs, and the majority of shortages for sterile injectables was concentrated in the generics industry).

9. *See* APPROACH TO MEDICAL PRODUCT SHORTAGES, *supra* note 4.

10. *See* Sharona Hoffman, *The Drugs Stop Here: A Public Health Framework to Address the Drug Shortage Crisis*, 67 FOOD & DRUG L.J. 1, 3 (2012) (noting that the drug shortage crisis has raised concerns from commentators of an "alarming dearth" of some chemotherapy drugs in recent years, as well as concerns regarding shortages in heart drugs, pain medications, attention deficit hyperactivity disorder therapies, and anesthesia agents).

11. *See id.* at 4–8 (discussing the various factors that commentators have pointed to as the cause of the drug shortage crisis).

12. *See* APPROACH TO MEDICAL PRODUCT SHORTAGES, *supra* note 4, at 15–16 (proposing various reasons for drug shortages, including causes such as manufacturing issues, labeling mistakes, increased demand, and poor business decisions); HHS ECONOMIC ANALYSIS, *supra* note 8, at 1 (indicating that interruptions to manufacturing are the primary culprit of drug shortages); *see also Frequently Asked Questions About Drug Shortages*, U.S. FOOD & DRUG ADMIN., http://www.fda.gov/Drugs/DrugSafety/DrugShortages/ucm050796.htm (last visited Oct. 13, 2013) (stating that the major reasons for drug shortages are quality/manufacturing issues).

13. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-12-116, DRUG SHORTAGES: FDA'S ABILITY TO RESPOND SHOULD BE STRENGTHENED 7 (2011), *available at* http://www.gao.gov /assets/590/587000.pdf.

14. *See* DIANA L. MOSS, THE AM. ANTITRUST INST., HEALTHCARE INTERMEDIARIES: COMPETITION AND HEALTHCARE POLICY AT LOGGERHEADS? 6 (2012), *available at* http://www.antitrustinstitute.org/~antitrust/sites/default/files/AAI%20White%20Paper%20Healthcare%20Intermediaries.pdf (indicating that supply chains with only a few competitors are at high risk for collapse following any unexpected disruption).

15. *See* Ventola, *supra* note 7 (declaring that most drug shortages affect generic medications and that most generic drugs are produced by only a few manufacturers); *see also* HHS ECONOMIC ANALYSIS, *supra* note 8, at 6 (reporting that only seven

B. GPOs are Upstream Purchasing Agents that Engage in Conduct That Raises Antitrust Concerns

GPOs are economic intermediaries originally established by hospitals to pool their purchasing power for more favorable contracts with medical suppliers.[16] Legislatively, a GPO is defined as "an entity authorized to act as a purchasing agent for a group of individuals or entities who are furnishing services for which payment may be made under a federal healthcare program."[17] By purchasing as a group, hospitals can achieve greater discounts and lower prices than they could achieve by bargaining independently, while also minimizing transaction costs.[18] Membership in a GPO is voluntary, however independent hospitals are subject to the added expense of directly contracting for drugs and supplies with individual manufacturers and distributors.[19] However, due to the fiscal efficiencies that GPOs can offer, GPO use is widespread in the healthcare industry. The Government Accountability Office ("GAO") has stated that ninety-eight percent of U.S. hospitals use GPO contracts to purchase products, and about seventy-three percent of purchases made by hospitals are done through GPO contracts.[20] The field for national GPOs is highly concentrated, with five GPOs commanding ninety percent of the market.[21]

Many of the agreements entered into between GPOs and pharmaceutical manufacturers amount to exclusionary agreements, either explicitly through contractual arrangements, or implicitly through arrangements between the

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manufacturers produce the bulk of generic drugs and that, of those, it is rare for more than three to produce any given drug).

16. *See* S. PRAKASH SETHI, INT'L CTR. FOR CORPORATE ACCOUNTABILITY, ICCA-2006.G-01, GROUP PURCHASING ORGANIZATIONS: AN EVALUATION OF THEIR EFFECTIVENESS IN PROVIDING SERVICES TO HOSPITALS AND THEIR PATIENTS 6, 17 (2006), *available at* http://www.icca-corporateaccountability.org/PDFs/HGPII_Report 07-20-06.pdf (stating that GPOs are a form of buying cooperative designed to combine purchasing power to form leverage to secure lower prices from sellers).

17. 42 U.S.C. § 1320a-7b(b)(3)(C) (2012); 42 C.F.R. § 1001.952(j) (2013).

18. *See* ROBERT E. LITAN & HAL J. SINGER, DO GROUP PURCHASING ORGANIZATIONS ACHIEVE THE BEST PRICES FOR MEMBER HOSPITALS? AN EMPIRICAL ANALYSIS OF AFTERMARKET TRANSACTIONS 2 (Oct. 2010), *available at* http://www.medicaldevices.org/sites/default/files/GPO_pricing_litan_singer_distributio n_oct%202010.pdf.

19. *See* Julie C. Klish, *Serving Economic Efficiencies or Anticompetitive Purposes: The Future of Group Purchasing Organizations and the Antitrust Safety Zone*, 2 IND. HEALTH L. REV. 173, 175 (2005).

20. U.S. GEN. ACCOUNTING OFFICE, GAO-10-738, GROUP PURCHASING ORGANIZATIONS: SERVICES PROVIDED TO CUSTOMERS AND INITIATIVES REGARDING THEIR BUSINESS PRACTICES 4 (2010) [hereinafter GAO-10-738], *available at* http://www.gao.gov/assets/310/308830.pdf.

21. HHS ECONOMIC ANALYSIS, *supra* note 8, at 5.

GPO and member hospitals.[22] These exclusionary contracting practices can be complicated, and often involve bundling arrangements, extended terms, and exclusivity provisions. Product bundling occurs when GPOs group together multiple drugs and/or medical devices and offer the package to member hospitals at a discount.[23] In addition to bundling, GPOs typically award long-term contracts to drug and medical device manufacturers.[24] These long-term agreements commit the GPO to purchasing the manufacturer's products and improve efficiency by reducing the need to renegotiate contracts.[25] Furthermore, GPOs frequently use exclusionary sole-source contracts. A sole-source contract requires that only one person or company provide the goods or services requested in the contract.[26] In general, member hospitals are not compelled by GPOs to purchase specific drugs or medical devices through GPO contracts; however, they must do so if they wish to obtain the discounts offered by their GPO.[27]

C. Regulations by Federal Antitrust Authorities Concerning GPOs

In 1993, the United States Department of Justice ("DOJ") and Federal Trade Commission ("FTC") first issued a joint guidance document explaining the agencies' views regarding joint purchasing arrangements in healthcare, last revised in 1996.[28] The joint guidance document concluded

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22. *Cf.* EINER ELHAUGE, THE EXCLUSION OF COMPETITION FOR HOSPITAL SALES THROUGH GROUP PURCHASING ORGANIZATIONS 2 (2002) [hereinafter EXCLUSION OF COMPETITION], *available at* http://www.law.harvard.edu/faculty/elhauge/pdf/gpo_report_june_02.pdf (arguing that many contracts GPOs enter into with medical device manufacturers amount to exclusionary agreements).

23. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-03-998T, GROUP PURCHASING ORGANIZATIONS: USE OF CONTRACTING PROCESSES AND STRATEGIES TO AWARD CONTRACTS FOR MEDICAL-SURGICAL PRODUCTS 6 (2003) [hereinafter GAO-03-998T], *available at* http://www.gao.gov/assets/90/82028.pdf (explaining that bundling links price discounts to specified groups of products, and discussing several types of bundling arrangements GPOs frequently engage in).

24. *See id.* at 14 (declaring that a study found that the two largest GPOs typically award with longer terms than the next five largest GPOs).

25. *See id.* (discussing motivation for GPO contract term length).

26. *See* GAO-10-738, *supra* note 20, at 2 (in which a letter from Sen. Chuck Grassley defines sole sourcing as "contracting with only one vendor for a given product when multiple vendors of comparable products are available").

27. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 3 (explaining that member hospitals are free to accept or reject exclusionary contracts on a contract-by-contract basis).

28. U.S. DEP'T OF JUSTICE & FED. TRADE COMM., STATEMENTS OF ANTITRUST ENFORCEMENT POLICY IN HEALTHCARE 1, 1–7 (1996) [hereinafter JOINT GUIDANCE DOCUMENT], *available at* http:// www.ftc.gov/reports/hlth3s.pdf (providing a history of the Joint Guidance Document).

that most GPO arrangements do not raise antitrust concerns, and that any antitrust concerns raised by such arrangements are typically outweighed by efficiencies that will benefit consumers.[29]

The joint guidance document primarily applies to the anticompetitive effects of GPOs on downstream market participants, such as hospitals and medical patients.[30] The joint guidance document suggests a low risk of downstream anticompetitive effects, finding few entry barriers to the formation of GPOs, and that hospitals are a low risk for collusive action due to the ease with which member hospitals may terminate their contract with GPOs.[31] As a result of these presumed protections, the joint guidance document states that the FTC and DOJ will not challenge GPOs absent "extraordinary circumstances," provided that GPO arrangements with health care providers meet a two-part test.[32]

The first condition of the two-part test provides that "the purchases [of a particular drug by a GPO] account for less than thirty-five percent of the total sales of the purchased product or service in the relevant market."[33] This effectively creates a monopsony safe harbor that is based on a market share threshold, with the idea that below the thirty-five percent threshold it is difficult for a GPO to depress prices below a competitive level.[34]

The second condition of the two-part test requires that "the cost of all the products and services purchased jointly [under GPO contract] accounts for less than twenty percent of the total revenues from all products or services sold by each of the competing participants in the joint purchasing arrangement."[35] This means that the total cost of all GPO purchases made by any member hospital cannot exceed twenty percent of that hospital's total profits.[36] This condition applies only where some or all of the GPO's member hospitals are direct competitors, and is intended solely to prevent collusive arrangements among GPO member hospitals.[37] As a result, the

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29. *See id.* at 53 ("Such collaborative activities typically allow the participants to achieve efficiencies that will benefit consumers.").

30. *See id.* at 53–60.

31. *See id.* at 58 (stating that entry barriers for GPOs are not high).

32. *See id.* at 54 ("[the agencies] will not challenge, absent extraordinary circumstances, any joint purchasing arrangement among healthcare providers where two conditions are present . . .").

33. *Id.* at 54–55.

34. *See* MOSS, *supra* note 14, at 8 (noting that the first test requirement of the joint guidance document effectively creates a monopsony safe harbor).

35. JOINT GUIDANCE DOCUMENT, *supra* note 28, at 55.

36. *See* Klish, *supra* note 19, at 178 (explaining that the aggregate purchases of GPO member hospitals cannot exceed 20% of the total profits made from all goods and services sold by each competing member).

37. *See* JOINT GUIDANCE DOCUMENT, *supra* note 28, at 55–56 (indicating that even

second condition creates a collusion safe harbor for contracts that do not raise concerns regarding price fixing among member hospitals.[38]

Despite the good intentions of the joint guidance document, it is in many ways woefully inadequate. Most importantly, the joint guidance document does not provide any guidance on enforcing exclusionary agreements between GPOs and suppliers.[39] Although the joint guidance document provides a list of mitigating factors for arrangements that fall outside the safe harbor, if an arrangement falls inside the safe harbor, the federal agencies cease to consider any possible anticompetitive effects of the arrangement.[40] Therefore, the agency safe harbor shields GPOs engaged in anticompetitive practices, so long as they meet the minimal requirements of the two-part test.

The joint guidance document is also alarmingly dated. Conditions today are vastly different than they were in 1996.[41] Market consolidation has lead to an oligopoly market structure for national GPOs, suggesting that entry barriers are no longer low.[42] Additionally, the prevalence of bundling and exclusivity contracts has placed disproportionate power in the hands of large GPOs, preventing smaller GPOs from offering comparable packages to hospitals.[43] This not only raises entry barriers, but also creates a market that naturally trends towards consolidation.

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where member hospitals are direct competitors, common GPO membership is not likely to facilitate collusive price-setting so long as the goods and services purchased account for only a small percentage of the total hospital profits).

38. *See* MOSS, *supra* note 14, at 8 (arguing that the second requirement effectively creates a collusion safe harbor).

39. EINER ELHAUGE, ANTITRUST ANALYSIS OF GPO EXCLUSIONARY AGREEMENTS 1 (Sept. 26, 2003), *available at* http://ftc.gov/os/comments/healthcarecomments2/elhauge.pdf.

40. *See* Klish, *supra* note 19, at 178 (noting that any GPO arrangements that fall within the antitrust safety zone are exempt from antitrust enforcement except in extraordinary circumstances).

41. *See* MOSS, *supra* note 14, at 8 (arguing that the healthcare intermediaries market currently has high entry barriers and operates as an oligopoly market, resulting in an environment in which it is more difficult for hospitals to compete without being a part of a major GPO).

42. *See id.* (declaring that GPO entry barriers have risen since 1996); HHS ECONOMIC ANALYSIS, *supra* note 8, at 5 (stating that five GPOs command 85–90% of the market).

43. *Cf.* EXCLUSION OF COMPETITION, *supra* note 22, at 4 (stating that exclusive dealing arrangements cause anticompetitive harm by denying rivals the economies of scale that they need to compete effectively).

D. GPOs are Protected from Prosecution Under the Federal Anti-Kickback Statute Through an Easily Attainable Safe Harbor

Purportedly, when a GPO seeks to carry a particular class of product, it attempts to secure the highest quality and lowest prices possible through a competitive bidding or auction process that allows vendors to bid for a contract to supply the GPO's entire network of member hospitals.[44] To cover operating expenses, GPOs are not paid a fee by hospitals; rather, they charge vendors "administrative" and other fees in exchange for providing contracting services to hospitals.[45] Under the Federal Anti-Kickback Statute of the Social Security Act ("Federal Anti-Kickback Statute"), it is illegal for anyone to receive payment from a party in exchange for contracting to order a good for the party if the good is in any way paid for through a federal healthcare program (e.g., Medicare).[46] However, in the late 1980s, GPO interest groups convinced Congress that by charging administrative fees to manufacturers rather than to medical providers, GPOs would achieve greater efficiencies, which would result in lower federal healthcare expenditures.[47] Congress, therefore, amended the Social Security Act in 1987, exempting GPOs from the statutory ban on kickbacks.[48]

In 1991, HHS formally established a GPO anti-kickback provision "safe harbor," (hereinafter "GPO Safe Harbor") which promulgated the specific requirements that GPOs must meet to be exempted from prosecution for fraud under the Federal Anti-Kickback Statute.[49] To meet the GPO Safe

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44. *See* LITAN & SINGER, *supra* note 18, at 2 (explaining that GPOs contract to supply the entirety of their member hospital networks through a bidding or auction process).

45. *See id.* (noting that GPOs cover operating expenses by charging vendors "administrative" fees based on a percentage of the proceeds generated by the auction, as well as through other fees); Daniel DeLay, *Watch out for GPOs*, FORBES (Nov. 12, 2009, 4:23 PM), http://www.forbes.com/2009/11/12/gpo-medicare-hospitals-medical-health-opinions-contributors-daniel-delay.html (explaining and critiquing the administrative fee system, which GPOs use instead of charging fees to hospitals).

46. 42 U.S.C. § 1320a-7b(b) (2012).

47. *See* Patricia Earl & Phillip L. Zweig, *Connecting the Dots: How Anticompetitive Contracting Practices, Kickbacks, and Self-dealing by Hospital Group Purchasing Organizations (GPOs) Cause the U.S. Drug Shortage*, CARE AND COST (Feb. 14, 2012) [hereinafter *Connecting the Dots*], http://careandcost.com/2012/02/14/connecting-the-dots-how-anticompetitive-contracting-practices-kickbacks-and-self-dealing-by-hospital-group-purchasing-organizations-gpos-caused-the-u-s-drug-shortage/ (stating that in 1987, GPO interest groups successfully lobbied Congress to allow them to charge administrative fees to vendors, arguing that this would be more cost efficient for consumers).

48. *See* 42 C.F.R. § 1001.952(j) (2013); S. REP. NO. 100–109, at 27 (1987).

49. 42 U.S.C. § 1320a-7(b) (providing a detailed overview of the specific

Harbor, GPOs must meet the following requirements: (1) they must have a written agreement with each entity to which they provide services, (2) the agreement must be signed by both parties, and (3) the agreement must state either that administrative fees from vendors are capped at three percent or less of the purchase price, or the agreement must specify a fixed amount or percentage of the value of purchases each vendor will pay.[50] In other words, administrative fees are capped at three percent of total purchase value unless the contract explicitly provides any other amount or percentage.[51]

In most cases, a GPO's member hospitals actually own the GPO.[52] At the end of each fiscal year, GPOs redistribute a portion of their profits to their member hospitals in the form of patronage or corporate dividends.[53] In theory, this system encourages GPOs to secure the best possible deals for hospitals, since they are entering into those deals for themselves.[54] However, because administrative fees are a percentage of the price of total sales volume, it is not always in the best interest of GPOs to negotiate the lowest possible price with manufacturers.[55] This problem is compounded by the fact that member hospitals frequently do not have any incentive to pressure GPOs for lower negotiated prices, as a percentage of the supracompetitive profits are returned to hospitals in the form of dividends.[56] The end result is that, although hospitals and GPOs both

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requirements set forth by the HHS necessary to meet the safe-harbor requirements, as well as their rationale).

50. *See* 42 C.F.R. § 1001.952(j).

51. *See* GAO-10-738, *supra* note 20, at 11 (observing that, as reported by the GPOs, the average contract administrative fees weighted by purchasing volume ranged from 1.22 percent of purchases to 2.25 percent of purchases). *But see* GAO-03-998T, *supra* note 23, at 2 (noting that the administrative fees can be much higher, in one case reaching nearly 18 percent).

52. DeLay, *supra* note 45 (stating that most member hospitals are owners of their respective GPOs, acting akin to shareholders); *see also* EXCLUSION OF COMPETITION, *supra* note 22, at 41 (explaining that a portion of GPO revenue gets redistributed to shareholder hospitals).

53. *Cf.* HERBERT HOVENKAMP, HEALTH INDUS. GRP. PURCHASING ASS'N, COMPETITIVE EFFECTS OF GROUP PURCHASING ORGANIZATIONS' (GPO) PURCHASING AND PRODUCT SELECTION PRACTICES IN THE HEALTH CARE INDUSTRY 4 (Apr. 2002) (discussing shareholder hospitals and GPO profit redistribution); *see also* DeLay, *supra* note 45 (declaring that GPOs return a portion of excess fees to shareholder hospitals in the form of dividends).

54. *See id.*

55. *See* LITAN & SINGER, *supra* note 18, at 4 (arguing that if a GPO is receiving kickbacks equal to a percentage of the auction proceeds, the GPO lacks a strong incentive to seek out the lowest price; furthermore, administrative fees impose a cost on medical product vendors, causing them to bid less aggressively on price so that they have excess resources to afford the large side payment).

56. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 26 (discussing the

benefit from the administrative fee system, medical patients—the intended beneficiaries of the administrative fee system—do not receive any efficiencies.[57]

II. GPOs AND ANTICOMPETITIVE BEHAVIOR: A FAILURE OF FEDERAL REGULATION

Antitrust law traditionally bans a number of arrangements and practices considered anticompetitive. This section examines how federal policies and practices have allowed GPOs to engage in behaviors, which would otherwise be deemed anticompetitive, and examines what specific anticompetitive behaviors GPOs engage in. Part III(A) is divided into three sections, which analyze: (i) GPO exclusionary contracting practices, (ii) GPO bundling and tying arrangements, and (iii) market concentration and pricing issues. Part III(B) argues that the safe-harbor provision of the Federal Anti-Kickback statute has been subverted from its original purpose, and now effectively permits otherwise fraudulent kickbacks.

A. GPO Contracting Practices Led to Increased Market Consolidation

Current federal antitrust policies have allowed for, and in some cases promoted, GPO action that would constitute antitrust violations in different circumstances. This section analyzes the market structure and contracting practices of GPOs in relation to traditional federal antitrust regulations.

i. GPOs Utilize Sole-Source Contracts and Rebate Penalties to Restrict Member Hospitals From Purchasing From Independent Third Parties

Under Section 3 of the Clayton Act, it is an antitrust violation for a company to make a contract "where the effect of such . . . contract for sale . . . may be to substantially lessen competition or tend to create a monopoly in any line of commerce."[58] Subsequent case law has interpreted this to mean that vertical non-price restraints, including exclusionary contracts, are subject to a rule of reason analysis.[59]

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incentives member hospitals have to gain through compliance with the side-payment system).

57. *See id.* at 41 (stating that member hospitals benefit from both side-payment schemes, such as dividends to shareholder hospitals, and special discounts; both of which align the interest of member hospitals with GPOs, but which pass down additional costs to nonmember hospitals, patients, insurers, and government payors).

58. 15 U.S.C. § 14 (2012).

59. *See* Continental T.V. v. GTE Sylvania, 433 U.S. 36, 49–50 (1977) (declaring that the rule of reason applied to all vertical non-price restraints, and that per-se illegality was the exception). A "rule of reason" analysis, as first developed in Standard Oil Co. v. United States, 221 U.S. 1 (1911), provides that in certain situations

A contract may be legally analyzed as an exclusive dealing arrangement even if the agreement is not literally exclusive.[60] Few GPO contracts explicitly impose a restriction on their member hospitals that they may never deal with competitors.[61] An example of the typical requirements imposed upon GPO members may be seen in Premier's 2008 group purchasing policy, which incorporates a "market penetration target" of fifty percent of total supply purchasing for member hospitals, with penalties imposed on those who fail to meet the target.[62] While a requirements contract of ninety-five percent would likely be held to be anticompetitive, a requirement of only fifty percent is unlikely to raise any serious exclusionary concerns in court.[63] However, membership contracts are not the primary means by which GPOs engage in exclusive dealing.

The majority of exclusionary contracts entered into by GPOs are not mandatory arrangements.[64] Rather, the GPO member hospitals are given the option to opt into exclusionary agreements on a contract-by-contract basis.[65] These voluntary contracts offer significant incentives to hospitals, but at a high cost—they are frequently bundled to cover multiple products and manufacturers, they may impose retroactive fiscal penalties for deviation, and may even ban the purchase of specific rival products.[66]

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only business practices or contracts that unreasonably restrain trade shall be considered violations of Section 1 of the Sherman Act, 15 U.S.C. § 1 (2012), which allows for the circumstances of business practices to be considered in assessing their legality for antitrust purposes.

60. *See id.* (noting that certain contracts may, as a practical matter, exclude rivals without containing an express prohibition against dealing with rivals; and that such contracts may be analyzed as exclusive dealing contracts despite not being literally exclusive).

61. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 4 (declaring that many agreements GPOs enter into between both vendors and member hospitals qualify as exclusive agreements, even though many do not expressly prohibit dealing with all competitors in all instances).

62. *See* PREMIER, PREMIER GROUP PURCHASING POLICY (Jan. 1, 2008), *available at* http://www.alliant-has.com/sites/default/files/PremierPurchasingPolicy.pdf ("If a member's participation falls below 50%, adjustments to the member's fiscal year Supply Chain Improvement Plan will be developed to move participation to 50% or above.").

63. *See* ZF Meritor LLC v. Eaton Corp., 769 F. Supp. 2d 684 (D. Del. 2011) (enjoining use of market penetration ranges); MOSS, *supra* note 14, at 10–11 (observing that market penetration ranges have been successfully challenged in court).

64. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 3 (explaining that, although GPOs offer numerous exclusionary contracting arrangements, the majority of these arrangements do not mandate member hospital participation).

65. *See id.* (remarking that member hospitals are typically free to accept or reject the vast majority of exclusionary contracts offered to them by GPOs).

66. *See id.* at 3–4 (explaining the trade-off between the positive incentives GPO exclusionary agreements provide to hospitals, and the high costs they often impose:

Hospitals enter voluntary exclusionary agreements with GPOs for a wide variety of compelling reasons. The most common reason that a member hospital enters into a voluntary commitment contract through its GPO is that the GPO is capable of offering the hospital a supracompetitive price on the product through its monopsony buying power.[67] However, the incentives GPOs offer to hospitals through discounted goods only sometimes take the form of an outright cut to sale price. In some cases, hospitals find that the standardization resulting from sole-source or dual-source contracts is an efficiency benefit in of itself.[68] One common tactic GPOs employ in exclusionary contracts is the use of loyalty discounts or rebate programs.[69] In contracts employing a loyalty rebate, a member hospital is eligible for a rebate upon purchasing a high percentage share of specified GPO products.[70] These loyalty rebates typically last five to seven years, and may include a retroactive enforcement clause.[71]

The penalties GPOs assign for breach of voluntary contracts may, in some cases, exceed the penalties assigned for breach of a mandatory contract.[72] A failure to meet an explicit (mandatory) commitment contract can result in fines or penalties; however, these penalties are subject to antitrust scrutiny.[73] Under voluntary contracts, a GPO often does not issue fines—they instead withdraw rebate or discount offers. A GPO's withdrawal of a rebate offer has the same effect as an outright fine; however, by guising the penalty as loss of a rebate, the GPO can avoid scrutiny under antitrust law.[74] In many ways, loyalty rebates can be more

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binding hospitals to the mandated product despite the possible availability of better and/or cheaper products elsewhere).

67. *See id.* at 39 (contending that GPOs have the capacity to exercise monopsony power to demand supracompetitive rates on many items, and that the ability to exert such power is itself anticompetitive).

68. *See id.* at 5 (observing that various interested parties exert pressure on hospitals to encourage the use of standardized devices, and that standardization internally within a hospital often leads to efficiency benefits).

69. *See id.* at 7 (arguing that loyalty rebates are utilized by GPOs to impose penalties on noncompliant hospitals).

70. *See id.* at 8 (explaining that rebates or discounts are conditioned on purchasing a high share of the buyer's purchases from the supplier, as opposed to a standard discount, which would be a per item price cut).

71. *See id.* at 8–9 (disclosing that a retroactive enforcement clause means that if the hospital deviates from its agreement and purchases a lower share than required to meet the rebate, it has to refund the GPO the total amount of all prior rebates received).

72. *See id.* at 7–9 (noting that conditioned rebates have the potential to impose much harsher penalties for noncompliance than a traditional contract).

73. *See id.* at 7 (stating that GPOs may assign contractual penalties to purchasing arrangements for breach by a buyer, but that any such penalties may not unreasonably restrain trade).

74. *See id.* at 7 (stating that the termination penalty imposed on buyers that do not

exclusionary than an explicit sole-source contract.[75] This is primarily due to retroactive enforcement clauses, which can result in a higher financial penalty for a hospital breach of the agreement than would be otherwise allowed under the law for breach of contract.[76]

Both sole-source contracts and loyalty rebate contracts are designed to exclude rivals from the relevant market. Each form of contract is designed to secure the GPO the highest possible market share for the product in question, leaving rivals with a share that is not large enough to support economies of scale.[77] This raises entry barriers for manufacturers and concentrates the supply chain.

Although exclusive arrangements between hospitals and GPOs can have notable anticompetitive effects, the most significant antitrust concern regarding exclusive dealing arrangements arises from contracts with sellers, particularly generic manufacturers who sell to GPOs.[78] These companies operate on razor-thin margins, and, due to economies of scale, acquiring a GPO contract is integral in determining whether the manufacturer can make a profit.[79] Upriver exclusive dealing arrangements significantly raise entry barriers for small manufacturers attempting to enter the generic drug market, and create a risk that large manufacturers and GPOs will enter into collusive arrangements designed to keep small generic manufacturers out of the market.[80]

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comply with rebate programs is serious enough to make exclusive dealing agreements raise antitrust concerns); *see also* Moss, *supra* note 14, at 11 (stating that "a lost rebate or discount is, in effect, damages for breach of contract," and in many cases may far exceed the damages for an actual breach of contract).

75. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 11 (arguing that the fact that payments given for loyalty commitments are often not proportional to volume actually worsens the anti-competitive effect of such agreements by creating a more effective means of dividing monopoly profits created by seller-buyer collusion designed to enhance seller market power).

76. *See id.*

77. *See id.* at 14, 17 (declaring that, even in cases where a new entrant can enter the market, if the innovators who succeed cannot access a large share of the product market and gain economies of scale, then capital markets will provide less funding for innovation than they otherwise would).

78. *See Hospital Group Purchasing: Lowering Costs at the Expense of Patient Health and Medical Innovation?: Hearing Before Subcomm. on Antitrust, Bus. Rights, & Competition of. S. Comm. of the Judiciary*, 107th Cong. 68 (2002) (statement of Sen. Orrin Hatch), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-107shrg85986/pdf/CHRG-107shrg85986.pdf ("'[S]ole source' contracts . . . create strong disincentives for hospitals to purchase competing products, effectively shutting smaller competitors out of the market.").

79. *See id.* (statement of Sen. Herbert Kohl, Subcomm. Chairman) ("Gaining a GPO contract is essential for any [pharmaceutical or] medical equipment supplier.").

80. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 4, 30 (stating that exclusive dealing arrangements raise rivals' costs by denying those competitors economies of

ii. GPOs Utilize Bundling Arrangements to Expand Market Share and Exclude Potential Competition

GPOs often offer discounts that are conditioned on a hospital buying multiple products together.[81] Federal antitrust enforcement authorities have adopted policies that allow GPOs to engage in both upriver and downriver bundling and tying agreements.[82]

"Tying" and "bundling" are not always easily defined. In theory, tying simply describes an arrangement where a supplier conditions the sale of one product on the purchaser's agreement to purchase another (often complementary) product.[83] Bundling is like tying, with the caveat that the customer is not actually required to buy a second product, but must do so to qualify for a discount on the first product.[84] Despite this difference, in practice, bundled discounts can produce many of the same anticompetitive effects as tying.[85]

To secure a contract with a GPO, many large manufacturers are encouraged to bundle various product lines together, with one product acting as a loss leader.[86] Most GPOs use some form of bundling, and the two top national GPOs do a majority of their business through bundled buying and selling.[87] The prevalence of manufacturer bundling deals provides a significant advantage to incumbent suppliers and raises entry barriers for smaller manufacturers with fewer products.[88] Smaller

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scale, and that powerful buyers have incentives to agree to terms that enhance seller market power in instances where the seller can share supracompetitive profits).

81. *See* LITAN & SINGER, *supra* note 18, at 35 (noting that GPOs frequently offer discounts that are conditioned on bundling).

82. For the purpose of economic analysis, "upriver" means companies upstream in the supply chain, and "downriver" means companies downstream in the supply chain.

83. *See* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397, 399–400 (2009) (defining and discussing tying in light of the Chicago school of economics).

84. *See id.* ("Bundled discounts can produce the same anticompetitive effects as tying without substantial tied foreclosure, but only when the unbundled price exceeds the but-for price.").

85. *See id.* ("[W]hen the unbundled price exceeds the but-for price, bundled discounts should be condemned based on market power absent offsetting efficiencies, with the same exception for products with a fixed ratio that lack separate utility. When the unbundled price does not exceed the but-for price or this exception applies, bundled discounts should be condemned only when a substantial foreclosure share or effect exists.").

86. *See Connecting the Dots*, *supra* note 47, at 9 ("To win a contract, a manufacturer would often use a drug as a loss leader, bundling it with other generics in its product line.").

87. *See* GAO-03-998T, *supra* note 23, at 11 (noting that the two largest national GPOs used bundling agreements to conduct a majority of their business).

88. *See* MOSS, *supra* note 14, at 13–14 (stating that the effect of losing bundled

manufacturers, if they produce more than one product, may lack the variety of product line to create a compelling bundle and compete for GPO contracts. Additionally, smaller manufacturers who are able to offer a bundled deal may lack the resources to compete with one of their products sold as a loss leader.[89] The lack of any antitrust protection against bundling poses real problems for medical supply chains in particular, as bundling arrangements that exclude rivals can increase the cost of medication, reduce choice, and discourage entry and innovation—all factors that contribute to the drug shortage crisis.[90]

iii. GPOs are Currently Operating as Oligopolies Which Leads to Many of the Same Anticompetitive Concerns as Monopolization

Currently, six GPOs dominate the national market for acute care medical supplies, controlling over ninety percent of sales.[91] Within the GPO industry, the three largest firms—MedAssets, Novation, and Premier—dominate industry earnings, controlling approximately seventy-five percent of total industry revenue in 2012.[92]

GPO sole-source contracts and near-mandatory bundling packages have resulted in upstream market consolidation by raising entry barriers and concentrating market share in the hands of large manufacturers who are able to secure GPO contracts.[93] Monopolies or oligopolies on multiple tiers of a single supply chain have the potential to be particularly anticompetitive.[94] When both an intermediary and its supplier have

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discounts is so significant that smaller competitors attempting to enter the market would, in some instances, have to actually pay the buyer to purchase their product(s) to fully compensate the buyer for the loss of the bundled discount).

89. *Cf. id.* at 14 (observing that competition in a market that primarily deals in bundles inherently disadvantages the smaller competitor and single-product new entrants, who are unable to offer comparable discounts).

90. *See id.* at 6 (noting that the exclusionary effects of bundled discounts lead to fewer market entrants and a more fragile supply chain, resulting in limited choices in drugs and medical devices, depriving consumers of innovation and product diversity).

91. *See The Effect of Regulatory Neglect on Health Care Consumers: Hearing on Competition in the Health Care Marketplace Before the Subcomm. on Consumer Prot., Prod. Safety and Ins. of the S. Comm. on Commerce, Sci. and Transp.*, 111th Cong. 2 (2009) (statement of David Balto, Senior Fellow, Center for American Progress Action Fund), *available at* http://www.pbmwatch.com/uploads/8/2/7/8/8278205/balto.senatecommerce09.testimony.pdf.

92. *See GPO Facts and Figures*, HEALTHCARE PURCHASING NEWS (Oct. 2012), http://www.hpnonline.com/resources/GPOs.html.

93. *See* LITAN & SINGER, *supra* note 18, at 39 (arguing that there is significant economic literature supporting the proposition that bundling and exclusive contracting agreements result in anticompetitive harm by raising entry barriers).

94. *See* MOSS, *supra* note 14, at 3 (stating that healthcare intermediaries can influence market outcomes not only at the level in which they compete, but also in

monopoly power, traditional competition is replaced by bargaining.[95] These arrangements are not only at high risk for vertical collusion, they also raise entry barriers by promoting exclusion of smaller rivals in the supply chain.[96]

B. A Rose by any Other Name: Administrative Fees and the Side-Payments as Kickbacks

The most problematic anticompetitive behaviors leading to decreased market competition and drug shortages are kickbacks paid by manufacturers to GPOs in exchange for exclusive contracts. At first glance it may seem odd for GPOs to engage in practices like sole-sourcing, which increase manufacturer market power (by consolidating the manufacturing market), as this can result in manufacturers being able to charge higher prices; however, GPOs are actually rewarded for such practices because manufacturers share their supracompetitive profits through side-payments.[97] GPOs benefit when the manufacturer pays a higher administrative fee, and the increased price for the monopolized good is simply passed on to the buyer's customers in the form of increased marginal cost.[98] Since hospitals also receive a cut of the side-payments through dividends, the only loser in this scenario is the consumer of the good—the medical patient. The following section examines these side-payments, or "kickbacks," in greater detail.

i. The Administrative Fee System is Not Only a Kickback, It Actually Raises Drug and Medical Device Costs

The Federal Anti-Kickback statute was originally enacted in 1972, and provides both civil and criminal penalties for offering or paying any remuneration to induce someone to purchase, lease, or order any item or service for which payment may be made under a federal healthcare

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complimentary markets, and arguing that GPOs have significant influence).

95. *See id.* (declaring that when multilateral monopoly or oligopoly characterizes the relationship between an intermediary and upstream seller, bargaining displaces traditional market forces).

96. *See id.* (claiming that small upstream vendors are particularly at risk from GPO control over complimentary markets).

97. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 29 (providing an analysis of why buyers might agree to an arrangement that enhances seller market power, suggesting that one such method is for intermediaries to pass along the increased profits to the buyers through various mechanisms).

98. *See id.* (stating that because such cost increases are passed onto consumers, the participating buyer's only actual losses are from reduced sales, the cost of which is effectively offset by side-payments from the seller's monopoly overcharge).

program.[99] Initially, the administrative fee system under which GPOs currently operate violated the Federal Anti-Kickback statute.[100] However, in 1987, the GPO Safe Harbor was passed under the belief that GPOs could operate more efficiently if they were able to charge administrative fees to manufacturers rather than rely solely on the participation fees of hospitals.[101] The GPO Safe Harbor has permitted GPOs to require significant payments from manufacturers in exchange for awarding contracts. Because GPO contracts are often exclusionary, administrative fees effectively act as payments by manufacturers to exclude competitors.[102]

Under the Safe Harbor provision, administrative fees theoretically have a soft cap at three percent of sales.[103] Anything above this limit requires that the GPO annually disclose the percentage of administrative fees to the Secretary of HHS.[104] However, GPOs have managed to avoid the reporting requirements by inventing new fees or accepting payments which together frequently may amount to twenty percent or more of the total sales price.[105] In one instance, the fees reportedly reached ninety-four percent of total sales volume.[106] The sheer scale of the kickbacks required from many GPOs is problematic, as smaller manufacturers may not have the capital or manufacturing capacity necessary to meet GPO demands.[107]

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99. 42 U.S.C. § 1320a-7b(b) (2012).

100. *See* CYNTHIA Y. REISZ & CATHERINE J.B. SLOAN, 2006 HEALTH L. HANDBOOK § 12:3 (Alice G. Gosfield ed., 2006) (arguing that prior to 1987, the administrative fees system under which GPOs currently operate would have constituted fraud).

101. *See Hospital Group Purchasing: Lowering Costs at the Expense of Patient Health and Medical Innovation?: Hearing Before Subcomm. on Antitrust, Bus. Rights, & Competition of. S. Comm. of the Judiciary*, 107th Cong. 4 (2002) (statement of Sen. Mike DeWine), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-107shrg85986/pdf/CHRG-107shrg85986.pdf ("GPOs in some cases have strayed from their original purpose of allowing hospitals to work together to limit costs."); REISZ & SLOAN, *supra* note 100, § 12:3.

102. *See generally Connecting the Dots*, *supra* note 47 (providing a critique of the administrative fees system, with a particular focus on the exclusionary effect on innovative manufacturers).

103. 42 C.F.R. § 1001.952(j) (2013).

104. *Id.*

105. *See Connecting the Dots*, *supra* note 47, at 5 (noting that GPOs frequently accept additional payments such as up-front payments, signing bonuses, prebates, and rebates in addition to the contracted administrative fees).

106. *See* Mariah Blake, *Dirty Medicine*, Washington Monthly (July/Aug. 2010), *available at* http://www.washingtonmonthly.com/features/2010/1007.blake.html (stating that the total annual fees one manufacturer paid to a major GPO amounted to ninety-four percent of the total sales volume).

107. *Cf.* United States *ex rel.* Fitzgerald v. Novation, L.L.C., No. 3:03-CV-1589-N, 2008 WL 9334966, at *2–3 (N.D. Tex. Sept. 17, 2008) (asserting that GPOs engaged in anticompetitive practices which purposefully excluded smaller competition).

Offering a large side-payment is one way that dominant manufacturers may secure a sole-source contract from a GPO, thereby excluding rivals that may offer a better quality product or more competitive price.[108] The incentive GPOs have to acquire large kickbacks and the incentive manufacturers have to acquire market power have led to instances of GPOs auctioning off exclusive contracts to manufacturers in exchange for large kickbacks.[109]

In addition to having exclusionary effects, side-payments may raise the costs of drugs and medical supplies. Because GPO revenue is derived from kickbacks, and is largely based on a percentage of vendor sales volume, higher product prices mean more money for GPOs.[110] The additional cost is then passed on to buyers downstream.[111] One may expect that hospitals would not agree to a side-payment system that creates upstream market consolidation and raises prices, however, because most member hospitals are GPO shareholders and receive dividends, the hospitals also benefit from the side-payment system.[112]

There is considerable evidence that GPOs do not actually lower drug and medical device prices when compared to a market able to operate freely.[113] A 2002 GAO report found that in some instances, hospitals may pay up to thirty-nine percent more for goods purchased through GPOs than if they had negotiated the purchase of those same goods directly with the manufacturer.[114] A 2010 independent analysis of the subject found that hospitals could save an average of fifteen percent on the cost of drugs and medical supplies by bidding outside of GPO contracts.[115] These studies are

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108. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 39–31 (declaring that GPO exclusionary agreements are likely to be particularly attractive to incumbent device manufacturers who face or fear entry by innovative new products).

109. *Cf. Novation, L.L.C.*, 2008 WL 9334966, at *2–3 (in which Novation was sued for allegedly auctioning off exclusive contracts in exchange for kickbacks).

110. *See* EXCLUSION OF COMPETITION, *supra* note 22, at 30 (noting that GPOs are not incentivized to drive down prices for consumers).

111. *See id.* (explaining how the side-payment system ultimately raises costs for consumers).

112. *See id.* (discussing hospital participation in the side-payment system).

113. *See generally Pilot Study Suggests Buying Groups Do Not Always Offer Hospitals Lower Prices: Hearing Before the Subcomm. on Antitrust, Competition, and Bus. and Consumer Rights of the S. Comm. on the Judiciary*, 107th Cong. (2002) (statement of William J. Scanlon, Director, Health Care Issues) (stating that by eliminating competition and extracting fees of indeterminable amounts from manufacturers, GPOs inflate the cost of drugs beyond what it would be if the market were able to operate freely).

114. *See id.* at 3 (declaring that, for some product models, hospitals using GPO contracts got prices up to 39 percent higher than hospitals not using GPO contracts).

115. *See* LITAN & SINGER, *supra* note 18 (noting that an independent study determined that GPOs charge in excess of 15% compared to a free market); *Connecting*

a major critique of the administrative fee system, as they show that the effect of GPOs directly contradicts their intended purpose.

III. THE NECESSARY PARADIGM SHIFT: HOW THE FEDERAL GOVERNMENT SHOULD REGULATE GPOS

Anticompetitive effects associated with GPO contracting practices can work against achieving important public policy goals in healthcare, such as ensuring drug availability and affordable healthcare costs. Eliminating GPOs entirely is unnecessary—GPOs have the potential to act as efficient intermediaries to lower costs without causing any anticompetitive effects. Rather, the solution is to eliminate the anticompetitive business practices of GPOs. Achieving this goal will require both the executive and legislative branches to take action.

A. Executives Agencies Should Impose Traditional Antitrust Scrutiny on GPOs

Federal antitrust engagement authorities need to reassess their position regarding GPOs, and more vigorously enforce antitrust laws in the healthcare market. This can be achieved through several steps. First, the 1996 joint guidance statement issued by the FTC and DOJ should be revised so that antitrust concerns in healthcare are treated more consistently with general antitrust analysis. There should not be an automatic assumption of procompetitive effects for GPOs. Second, the FTC and DOJ should perform a new analysis of market concentration and barriers to entry on all levels of the medical supply chain. The areas of the market that pose the greatest competitive problems, such as GPOs, should face heightened scrutiny and lower barriers for antitrust enforcement actions. Given the need for significant reform in the market, the FTC and DOJ should set up a temporary new division to protect competition in the healthcare supply chain, which should exist for a period of approximately ten years, long enough to establish a new corporate culture for GPOs.

B. Congress Should Revoke the GPO Safe Harbor from the Federal Anti-Kickback Statute

Perhaps the most important reform necessary for halting GPO anticompetitive practices is for Congress to take steps to eliminate the supplier-funded business model for GPOs. To achieve this, Congress should ban GPOs from having any investment interest or option in

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the Dots, *supra* note 47, at 19 (stating that based upon a study by Navigant Economics, in a truly free market a vial of propofol (sold in GPO for $.048 per vial, and out of GPO for $7.60 per vial) would cost hospitals only $0.36).

pharmaceutical or medical device manufacturers. Preventing GPOs from investing directly in any specific drug or medical device will ensure that decisions to supply a particular drug or medical device are based on the merits of that product, not whether the GPO has a fiscal interest in the success of the product. Further, Congress should provide a general ban on GPOs taking any payments from manufacturers with whom they contract, regardless of whether these payments are tied to purchasing volumes. Although it seems like these policies might be difficult to legislate, the solution is actually quite simple. The only step necessary to provide a total ban on GPO side-payments is for Congress to repeal the GPO anti-kickback safe harbor provision.[116] Without the safe-harbor provision, side-payments would be considered fraud, and subject to civil and criminal penalties.

To the extent that any side-payments are permitted, GPOs engaging in such practices should be required to disclose the full terms and conditions of any such agreement, as well as the terms and conditions of any alternate bids to appropriate government agencies, most likely HHS and FTC. Such agreements should be subject to heightened scrutiny for anticompetitive effect.

CONCLUSION

GPOs engage in anticompetitive behaviors that damage the pharmaceutical supply chain and lead to drug shortages. The contracting practices of GPOs have led to significant market consolidation, not only for healthcare intermediaries, but also for upstream suppliers. Current GPO contracting practices would violate antitrust law if not for the safe harbors granted to GPOs by both federal antitrust enforcement authorities and Congress. Those safe-harbors have been abused by the GPO industry.

To eliminate anticompetitive action by GPOs, both the executive and legislative branches must take action and revise their treatment of GPOs. Federal antitrust agencies should apply traditional antitrust law scrutiny for GPOs, and Congress should repeal the GPO Safe Harbor. Applying these recommendations would lead to a stronger and more robust drug and medical device supply chain, and lower the potential for serious drug shortages.

116. *See Connecting the Dots*, *supra* note 47, at 21 (arguing that the GPO safe harbor of the Anti-Kickback Statute should be repealed).