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HOW THE SEC CAN HELP MITIGATE THE "PROACTIVE" AGENCY COSTS OF AGENCY CAPITALISM

BERNARD S. SHARFMAN*

To combat the "proactive" agency costs of agency capitalism, this Article proposes that the United States Securities and Exchange Commission ("SEC" or "Commission"), in whatever form it deems appropriate, requires mutual fund advisers to disclose, under the Proxy Voting Rule, their policies and procedures to: Avoid the opportunistic use of their voting power at public companies as a means to obtain new business from activists such as public pension funds and investment funds associated with labor unions; Eliminate pressures to support the activism of its own shareholders at its portfolio companies; and Identify an actual link between support for a shareholder proposal under Rule 14a-8 and the enhancement of shareholder value before voting in favor of any such proposal.

* Bernard S. Sharfman is the Chairman of the Main Street Investors Coalition Advisory Council ("Coalition"), an associate fellow of the R Street Institute, and a member of the *Journal of Corporation Law*'s editorial advisory board. The opinions expressed here are the author's alone and do not represent the official position of the Coalition or any other organization that he is affiliated with.

I. INTRODUCTION

Investment advisers to mutual funds ("mutual fund advisers"), exchanged traded funds, and separately managed accounts are typically delegated the authority to vote their clients securities, including the voting rights associated with a public company's common stock. Therefore, it should not be surprising that the SEC, in its Release establishing the Proxy Voting Rule ("Release"),[1] took the position that an investment adviser[2] "is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."[3] This was the rationale behind the Proxy Voting Rule requiring investment advisers, including mutual fund advisers, to create and disclose their proxy voting policies and procedures. [4]

However, the SEC and its staff have yet to clarify what these fiduciary duties mean for the largest mutual fund advisers, such as BlackRock, Vanguard, and State Street Global Advisors ("the Big Three"), now that they control an extraordinary amount of shareholder voting power at many of our largest public companies.[5] This phenomenon did not exist at the time the Proxy Voting Rule was implemented.[6]

Moreover, this concentration of voting power is expected to increase over time. In a recently posted article by John Coates, Professor Coates predicted that in the near future the majority of voting shares of United States ("U.S.")

1. Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, 79 SEC Docket 1673 (Jan. 31, 2003) [hereinafter Proxy Voting by Investment Advisers], https://www.sec.gov/rules/final/ia-2106.htm.

2. 15 U.S.C. 80b-2(a)(11) (2018) (defining investment advisor).

3. Proxy Voting by Investment Advisers, *supra* note 1.

4. 17 C.F.R. § 275.206(4)-6 (2018) (stating that the Proxy Voting Rule was promulgated under the Investment Advisers Act of 1940, 15 U.S.C. 80b-6(4)).

5. *See* Carmel Shenkar, Eelke M. Heemskerk & Jan Fichtner, *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, CPI ANTITRUST CHRON., June 2017, at 1, https://www.competitionpolicyinternational.com/wp-content/uploads/2017/06/CPI-Shenkar-Heemskerk-Fichtner.pdf; *see also* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 299 (2017) (discussing the recent shift from active to passive investment strategies in the United States, dominated by what the authors call "the Big Three" — BlackRock, Vanguard, and State Street — and their effect on shareholder power).

6. Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 5.

public companies will be held by only twelve mutual fund advisers.[7]

This concentration of voting power creates significant value for a mutual fund adviser if it can be traded for something that the adviser wants in return. For example, an adviser may use its voting power to support the activism of current and potential institutional clients in exchange for the ability to acquire more assets under management. Or, an adviser may use its voting power to support the activism of its own shareholders at the advisor's portfolio companies in exchange for those shareholders agreeing not to target the adviser itself for such activism. The result is that an adviser has not cast its delegated voting authority "*in a manner consistent with the best interest of its client*"[8] and has subrogated the "*client interests to its own*,"[9] a breach in its fiduciary duties to its mutual fund clients and its shareholders.

These examples demonstrate a certain type of agency cost, the "proactive" agency costs of agency capitalism.[10] Agency capitalism arises, as it has in the U.S. equity markets, when institutional investors such as mutual fund advisers not retail investors who provide the funds, come to dominate the voting of common stock and other voting instruments. According to the publication *Pensions & Investments*, institutional investors currently own approximately eighty percent of the market value of U.S. publicly traded equities.[11] This compares to approximately six percent in 1950.[12] Agency

7. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, SSRN (Sept. 20, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 (referencing the "Problem of Twelve" which means that twelve individuals will hold voting power over U.S. companies).

8. Proxy Voting by Investment Advisers, *supra* note 1 (emphasis added).

9. *Id.* (emphasis added).

10. While this is the first paper where these agency costs of agency capitalism are defined as being "proactive," I do discuss, without definition, this particular type of agency cost in several blog posts. *See* Bernard S. Sharfman, *Mutual Fund Advisors' "Empty Voting" Raises New Governance Issues*, COLUM. L. SCH.: BLUE SKY BLOG (July 3, 2017), http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/ [hereinafter *Empty Voting*]; Bernard S. Sharfman, *On Governance: The First Critique of the 'Framework for U.S. Stewardship and Governance*, THE CONF. BOARD CORP. GOVERNANCE CTR. BLOG (Dec. 14, 2017), https://www.conference-board.org/blog/postdetail.cfm?post=6655; Bernard S. Sharfman, *Commentary: Reforming a Broken System*, PENSIONS & INV. (Aug. 27, 2018), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system; Bernard S. Sharfman, *The Agency Costs of Agency Capitalism and Corporate Law*, DEL. CORP. AND COM. LITIGATION BLOG (Aug. 29, 2018), https://www.delawarelitigation.com/2018/08/articles/commentary/the-agency-costs-of-agency-capitalism-and-corporate-law/.

11. Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INV. (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.

12. MATTEO TONELLO & STEPHAN RABIMOV, THE 2010 INSTITUTIONAL INVESTMENT

costs of agency capitalism are generated when an institutional investor utilizes its voting power to satisfy its own preferences (and thereby enhancing the welfare of the institutional investor or its managers) and not the preferences of investors who have provided it with the funds to purchase securities.

The understanding that proactive agency costs of agency capitalism exist is nothing new. For example, the SEC Release, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, the companion release ("Companion Release")[13] to the release implementing the Proxy Voting Rule, recognized the agency costs generated when mutual fund advisers are reluctant to vote against a company's management for fear of losing the company's retirement business.[14] Even though it was not labeled as such, this type of agency cost falls in the proactive category.

Articles by Gilson and Gordon, and by Bebchuk, Cohen, and Hirst also focus on the economic disincentives mutual fund advisers have in becoming informed prior to voting their proxies.[15] These can be referred to as the "passive" agency costs of agency capitalism. Therefore, this Article is distinguished from those articles by its recognition of additional types of agency costs of agency capitalism that fall into the proactive category, as well as the use of the term "proactive," and by categorizing the agency costs generated by the economic disincentives that discourage mutual fund advisers from becoming sufficiently informed voters as falling in the passive category.

This Article does not address the passive agency costs of agency capitalism or the agency costs traditionally associated with public companies.[16] Instead, the focus of this Article is only on the proactive

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REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 TBL.10 (2010).

13. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. IC-25922 (Jan. 31, 2003), 68 Fed. Reg. 6564 (Feb. 7, 2003) [hereinafter Disclosure of Proxy Voting Policies], https://www.sec.gov/rules/final/33-8188.htm (accompanying the release on the proxy voting rule).

14. *See* discussion *infra*, Section II.

15. *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 95 (2017); Ronald J. Gilson & Jeffrey N. Gordon, *Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889–95 (2013).

16. *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 775 (2017) ("[T]he economic losses resulting from managers' natural incentive to advance their personal interests even when those interests conflict with the goal of maximizing their firm's value."); *see also* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1361

agency costs generated by mutual fund advisers that hold large concentrations of delegated voting power. These are the agency costs that the SEC can help mitigate.

To combat the proactive agency costs of agency capitalism, the Commission should provide clarification that mutual fund advisers must disclose how they will deal with these new conflicts in their voting policies, consistent with their fiduciary duties to act in the best interests of their mutual fund clients and their shareholders. In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, the adviser's voting policy must also explain how voting on these proposals are linked to maximizing shareholder value.

Furthermore, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule.[17] Such guidance should apply to any mutual fund adviser that is delegated voting authority. I urge the SEC to be diligent in enforcing breaches of the Proxy Voting Rule.

Finally, this article shares much of the same textual language with the October 8, 2018 comment letter I wrote to the Commission's staff roundtable on the proxy process.[18] Given that the reader has been provided this

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n.17 (2010) (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)) ("Under a classic theory of the firm, agency costs in the corporate context increase as ownership is separated from control. As the manager's ownership of shares in the firm decreases as a percentage of the total, the manager will bear a diminishing fraction of the costs of any nonpecuniary benefits he takes out in maximizing his own utility. To prevent the manager from maximizing his utility at the expense of the shareholders, shareholders will seek to constrain the manager's behavior by aligning the manager's interests with the shareholders' interests."); *id.* at 1361–62 (citations omitted) (explaining that these agency costs are the province of corporate law and its fiduciary requirements).

17. Proxy Voting by Investment Advisers, *supra* note 1 (emphasis added).

18. Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Oct. 8, 2018), https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf. I also wrote three other comment letters to the SEC's staff roundtable on the proxy process in the fall of 2018, and all four comment letters focused on the fiduciary duties required of institutional investors who are regulated under the authority of the Investment Advisers Act of 1940 ("Advisers Act") by virtue of being defined as investment advisers. *See* Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. and Exch. Comm'n (Oct. 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf, *reprinted in* HARV. L. SCH. FOR. ON CORP. GOVERNANCE AND FIN. REG. (Nov. 2, 2018), https://corpgov.law.harvard.edu/2018/11/02/comment-letter-in-advance-of-sec-staff-roundtable-on-the-proxy-process/; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. and Exch. Comm'n (Nov. 27, 2018), https://www.sec.gov/co

knowledge upfront, I do not believe it is necessary to continuously footnote quotes and cites from this comment letter.

Part II of the Article discusses the Proxy Voting Rule and the fiduciary duties of mutual fund advisers when voting their proxies. Part III discusses how the SEC has historically dealt with the proactive agency costs of agency capitalism. Part IV describes the ever-increasing voting power of mutual fund advisers, how it may lead to proactive agency costs of agency capitalism, and what the SEC can do to mitigate them.

II. THE PROXY VOTING RULE AND FIDUCIARY DUTIES

The Proxy Voting Rule requires mutual fund advisers, as registered investment advisers who have been delegated shareholder voting authority, to create and disclose their proxy voting policies and records:

> If you are an investment adviser registered or required to be registered under section 203 of the Act, it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act, for you to exercise voting authority with respect to client securities, unless you:
> (a) Adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the *best interest of clients*, which procedures must include how you address *material conflicts* that may arise between your interests and those of your clients;
> (b) Disclose to clients how they may obtain information from you about how you voted with respect to their securities; and
> (c) Describe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client.[19]

This rule rests on two important premises. First, under the holding in *SEC v. Capital Gains Research Bureau, Inc.*,[20] the Investment Advisers Act of 1940 ("Advisers Act") imposes a fiduciary duty on investment advisers, including mutual fund advisers.[21] Second, the objective of this fiduciary duty

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mments/4-725/4725-4684881-176574.pdf; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. and Exch. Comm'n (Dec. 17, 2018), https://www.sec.gov/comments/4-725/4725-4780983-176889.pdf. However, while the first targeted the fiduciary duties of mutual fund advisers when voting client securities, the last three focused on the fiduciary duties of proxy advisers, namely Institutional Shareholder Services and Glass Lewis.

19. 17 C.F.R. § 275.206(4)-6 (2018) (emphasis added) (citations omitted).

20. 375 U.S. 180 (1963).

21. *See also* Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17–18 (1979) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers. Indeed, the Act's legislative history leaves

is shareholder wealth maximization.

A. The Fiduciary Duty of Mutual Fund Advisers

As stated in the Release, "[u]nder the Advisers Act . . . an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."[22] Moreover, "[t]o satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the *best interest of its client and must not subrogate client interests to its own*."[23] This fiduciary duty extends to the shareholders of mutual funds:

> The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of utmost good faith, and full and fair disclosure. This fiduciary duty extends to all functions undertaken on the fund's behalf, including the *voting of proxies* relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.[24]

B. Shareholder Wealth Maximization is the Objective of the Fiduciary Duty

Second, the objective of this fiduciary duty is wealth maximization. According to the Companion Release, "the amendments [regarding proxy voting disclosure] will provide better information to investors who wish to determine: . . . whether their existing fund managers are *adequately maximizing the value of their shares*."[25] This release also noted that "proxy voting decisions may play an important role in maximizing the value of a fund's investments for its shareholders," and can have "an enormous impact on the financial livelihood of millions of Americans."[26] In sum, the

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no doubt that Congress intended to impose enforceable fiduciary obligations.").

22. Proxy Voting by Investment Advisers, *supra* note 1; *see* SEC Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) [hereinafter SEC Staff Legal Bulletin No. 20], https://www.sec.gov/interps/legal/cfslb20.htm (reaffirming the fiduciary approach from the final rule on proxy voting); Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. IA-4889 (Apr. 18, 2018), 83 Fed. Reg. 21203 (May 9, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

23. Proxy Voting by Investment Advisers, *supra* note 1 (emphasis added).

24. Disclosure of Proxy Voting Policies, *supra* note 13 (emphasis added).

25. *Id.* (emphasis added) (Investment Advisers Act Release No. IA-2106 and Investment Company Act Release No. 25922 were published as companion pieces in the Federal Register).

26. Disclosure of Proxy Voting Policies, *supra* note 13.

requirement of shareholder wealth maximization does not stop with portfolio management, it also must be adhered to when a mutual fund adviser votes the shares it has been delegated.

This objective is also consistent with the premise that the overwhelming majority of investors, including retail investors, simply want to earn the highest risk adjusted financial return possible,[27] including when they vote or have votes cast by investment advisers. Moreover, I believe this desire to earn the highest risk adjusted financial return possible is also shared by the overwhelming number of socially motivated investors who align their investments based on their moral or social values,[28] even though they give up some risk-adjusted return in terms of portfolio diversification and the possibility of losing out on the returns generated by those finite number of high performing stocks that allow the stock market to earn returns above Treasury rates[29] and may pay higher management fees for this customization. That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still

27. Paul Brest, Ronald Gilson & Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, STAN. SOC. INNOVATION REV. (Dec. 8, 2016), https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value; *see also* George David Banks & Bernard Sharfman, *Standing Up for the Retail Investor*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/ (explaining the new advocacy group, Main Street Investors Coalition, which aims to "reunite voting rights with those who actually take the economic risk, the retail investor").

28. *See* Brest, Gilson & Wolfson, *supra* note 27 ("Socially motivated investors who seek value alignment would prefer to own stocks only in companies that act in accordance with their moral or social values. Independent of having any effect on the company's behavior, these investors may wish to affirmatively express their identities by owning stock in what they deem to be a good company, or to avoid "dirty hands" or complicity by refusing to own stock in what they deem to be a bad company. Value-aligned investors may be concerned with a firm's outputs — its products and services; for example, they might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or the investors may be concerned with a firm's practices — the way it produces its outputs; they might want to own stock in companies that meet high environmental, social, and governance (ESG) standards, and eschew companies with poor ESG ratings. To achieve their goals, value-aligned investors must only examine their personal values and then learn whether the company's behavior promotes or conflicts with those values.").

29. Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 440 (2018). Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies that have made up the stock market from July 1926 to December 2016. He found that "in terms of lifetime dollar wealth creation the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills." *Id.* at 440, 454, tbl.5 (defining wealth creation as "accumulated December 2016 value in excess of the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns").

looking for the highest risk adjusted return possible given their investment constraints.

It also must be noted that this objective is consistent with corporate law's understanding of why shareholder voting adds value to corporate governance: "[w]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization."[30]

Finally, shareholder wealth maximization as the objective of shareholder voting is also consistent with the rationale for why profit making companies create so much value for society. As SEC Commissioner Peirce reminds us in a recent speech at the University of Michigan Law School:

> The hunt for profit drives companies to strive to identify and meet people's needs using as few resources as possible. Companies communicate with their customers and suppliers through the price system. People tell companies what they value when they pay for the products and services those companies offer. Suppliers, by raising or lowering prices, tell companies how valuable the resources are that the companies use. Companies respond to what their customers and suppliers tell them. In this way, companies help to ensure that people spend their time wisely and that resources are used for the things society values most. Companies combine the diverse and complementary talents of their employees to research, develop, explore, produce, sell, and provide services to willing customers. In these activities, corporations play an important role in expanding scientific and technological knowledge, enabling people to profit from their hard work, and ensuring that society's resources are allocated to the uses we most value.[31]

III. THE SEC AND THE PROACTIVE AGENCY COSTS OF AGENCY CAPITALISM

The Release and the Companion Release, with its particular emphasis on mutual fund advisers, were promulgated in 2003 to address concerns that an investment adviser may vote its own preferences, not the preferences of its

30. Kurz v. Holbrook, 989 A.2d 140, 178 (Del. Ch. 2010), *aff'd*, Crown Emak Partners v. Kurz, 992 A.2d 377, 388–89 (Del. 2010) (quoting Kurz with approval).

31. Hester M. Peirce, Comm'r, U.S. Sec. & Exch. Comm'n, Wolves and Wolverines: Remarks at the University of Michigan Law School (Sept. 24, 2018), https://www.sec.gov/news/speech/speech-peirce-092418.

funds and their shareholders. If that were to occur, then an adviser would be in breach of its fiduciary duties and shareholder wealth maximization may not occur. In what fact patterns would this happen?

In the Companion Release, the SEC focused on the concern that mutual fund advisers would, in some situations, be reluctant to vote against management for fear that doing so would "threaten their ability to retain that company as a client for corporate retirement fund assets."[32] As stated in the Companion Release:

> [I]n some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.[33]

For example, in an op-ed piece in the *Wall Street Journal*, Todd Henderson and Dorothy Shapiro Lund discuss how an activist hedge fund, acting with the support of the two leading proxy advisors, was allegedly impeded in moving forward on its proxy contest because several large mutual fund advisers balked at voting to support the hedge fund's director nominees for fear of losing the company's retirement fund business.[34] This type of conflict of interest, a classic example of the agency costs that can be generated by mutual fund advisers, has been well documented and, according to Cvijanović, Dasgupta, and Zachariadis, appears to persist despite the implementation of the Proxy Voting Rule.[35] Thus, as far back as 2003, the SEC had recognized a type of proactive agency cost of agency capitalism but without identifying it as such.

Another type of conflict noted in the Release, and the one most relevant to the discussion below, is where "[t]he adviser may also have business or personal relationships with other proponents of proxy proposals, participants

32. M. Todd Henderson & Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL STREET J. (June 23, 2017, 6:30 PM), https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623.

33. Disclosure of Proxy Voting Policies, *supra* note 13; *see also* Bebchuk, Cohen & Hirst, *supra* note 15 ("[T]he agency problems of institutional investors can be expected to lead them to . . . side excessively with corporate managers. . . .").

34. Henderson & Lund, *supra* note 32.

35. Dragana Cvijanović, Amil Dasgupta & Konstantinos E. Zachariadis, *Ties That Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933, 2934 (2016).

in proxy contests, corporate directors or candidates for directorships."[36] For example, such a conflict may exist where "the adviser may manage money for an employee group."[37]

Such a conflict was described in the SEC's enforcement case against INTECH.[38] Here, the registered investment adviser, INTECH Investment Management LLC, had initially voted its proxies based on an Institutional Shareholder Services recommendation platform that was purposely designed to side with management. Between 2003 and 2006, INTECH moved to a different ISS recommendation platform that followed the voting recommendations of the AFL-CIO.[39] According to footnote 3 of the SEC's order instituting proceedings, such voting recommendations intended to promote a "position that is consistent with the long-term economic best interests of plan members embodied in the principle of a worker-owner view of value."[40] Apparently, this approach was significantly different than the one taken in the original recommendation platform.

INTECH switched to this new platform in order "to retain and obtain business from existing and prospective union-affiliated clients."[41] Soon after, some of INTECH's original clients started making inquiries regarding the higher number of votes against management on shareholder proposals.[42]

INTECH made the switch in voting platforms without having any written procedures or policies that addressed material potential conflicts between INTECH's interests in seeking more union-affiliated clients and those of its clients who did not favor the AFL-CIO.[43] By doing so, it had subrogated its client interests to its own, a breach in its fiduciary duty of loyalty. Therefore, this was a clear violation of the Proxy Voting Rule. INTECH paid a civil penalty of $300,000.[44]

Most importantly, this is an example of how the SEC has recognized another type of proactive agency cost of agency capitalism and has taken

36. Proxy Voting by Investment Advisers, *supra* note 1.

37. *Id.* at n.4.

38. Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), http://www.sec.gov/litigation/admin/2009/ia-2872.pdf.

39. *Id.* at 2.

40. *Id.* at 4 n.3.

41. *Id.* at 2.

42. *Id.* at 4.

43. *Id.* at 4–5.

44. *Id.* at 7; *see SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser*, ROPES & GRAY (May 20, 2009), https://www.ropesgray.com/-/media/Files/alerts/2009/05/sec-brings-second-case-alleging-improper-proxy-voting-by-an-adviser.pdf (an excellent discussion of the INTECH settlement).

action to mitigate it. However, there are more proactive agency costs to be dealt with and most likely more SEC enforcement actions to be initiated.

IV. THE EVER-INCREASING VOTING POWER OF MUTUAL FUND ADVISERS AND PROACTIVE AGENCY COSTS OF AGENCY CAPITALISM

This Part describes the ever-increasing voting power of mutual fund advisers, how it may lead to proactive agency costs of agency capitalism, and what the SEC can do to mitigate them.

A. The Increasing Voting Power of Mutual Fund Advisers

Of course, the world has changed since the Proxy Voting Rule first went into effect in 2003. Currently, an unprecedented concentration of voting power now resides in the hands of our largest mutual fund advisers. For example, the Big Three now control enormous amounts of proxy voting power without having any economic interest in the shares they vote. According to Shenkar, Heemskerk, and Fichtner, this concentration of voting power was and is being caused by a large shift from actively managed equity funds to equity index funds:

> In contrast to the fragmented and sizeable group of actively managed mutual funds, the fast-growing index fund sector is highly concentrated. It is dominated by just three giant U.S. asset managers: BlackRock, Vanguard and State Street — what we call the "Big Three." Together they stand for a stunning seventy-one percent of the entire Exchange Traded Fund (ETF) market and manage over ninety percent of all Assets under Management . . . in passive equity funds. As a consequence of this leading role in the market for passive investment, the Big Three have become dominant shareholders. Seen together, the Big Three are the largest single shareholder in almost ninety percent of all S&P 500 firms, including Apple, Microsoft, ExxonMobil, General Electric and Coca-Cola. Such concentration of corporate ownership is remarkable and may not have been seen since the days of the Gilded Age.[45]

This new concentration of voting power originated in the industry practice of centralizing mutual funds' votes into the hands of their advisor's corporate governance department. In essence, not only would portfolio management be delegated to the mutual fund adviser, but also the voting of proxies. I refer to this as the "empty voting of mutual fund advisers."[46] That is, they have the voting rights but not the economic interest in the underlying shares.

This low cost approach to proxy voting was innocuous enough when proxy voting was not concentrated. However, as the market share of equity

45. *See* Shenkar, Heemskerk & Fichtner, *supra* note 5.

46. *Empty Voting*, *supra* note 10.

index funds has grown, this empty voting has given rise to an *unintended* consequence.[47] The Big Three now control, without having any economic interest in the underlying shares, the voting rights associated with trillions of dollars' worth of equity securities. For example, as of December 31, 2017, BlackRock had over $6.3 trillion of assets under management, with almost $3.4 trillion of those assets being equity securities.[48] This represents an astonishing amount of voting control. Therefore, at many public companies, the respective corporate governance departments of the Big Three, as well as other large mutual fund advisers, may now control the fate of a shareholder or management proposal, whether a nominated director receives a required majority of votes to remain on the board of directors, or if a proxy contest succeeds or fails.

B. The Courting of Public Pension Fund Assets

Such a concentration of power always brings with it the potential for abuse. It is easy to envision scenarios where this voting power can generate significant value for the advisor if it decided to vote in a certain way, whether or not it is in the best interests of its clients to do so. In essence, the large mutual fund adviser will be tempted to breach its fiduciary duties and monetize or take special advantage of the delegated voting power it has accumulated.

One scenario where a large mutual fund adviser may be tempted to monetize its newly found voting power is to vote in unison with public pension and union-related funds, such as on shareholder proposals these funds initiate or promote, if the vote will lead to bringing more assets under management. Public pension funds control approximately $4.3 trillion in assets,[49] a prime target for a mutual fund adviser looking to increase the size of its mutual funds, especially its equity index funds. Since the objective of an index fund is not to beat the market, but simply to match it, increasing profitability through increased assets under management is a critical business strategy for the adviser.

Public pension funds and union-related funds are leaders in the shareholder empowerment movement. This form of shareholder activism

47. Bernard S. Sharfman, *Dual Class Share Voting versus the "Empty Voting" of Mutual Fund Advisors'*, CONF. BOARD CORP. GOVERNANCE BLOG (July 2, 2018), https://www.conference-board.org/blog/postdetail.cfm?post=6812&blogid=8.

48. BLACKROCK, INC., BLACKROCK 2017 ANNUAL REPORT 2, http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287.

49. *Public Pension Fund Assets: Quarterly Update (Q2 2018)*, NAT'L ASS'N OF ST. RETIREMENT ADMINS., https://www.nasra.org/content.asp?contentid=200 (on file with author).

advocates shifting corporate decision-making authority to shareholders, and thus away from boards of directors and executive management, and arguably without regard to the impact on the value of a public company's stock. That is, satisfaction with company performance does not factor into the decision to support a proposal that shifts decision making away from the board of directors.

For example, consider the shareholder empowerment movement's take-no-prisoners approach to dual class share structures even though these structures have been successfully used by companies such as Berkshire Hathaway, Facebook, Comcast, Nike, and Alphabet (Google).[50] Such zealous advocacy should not be a surprise since dual class shares are an obvious threat to the movement's power. As I have previously observed, "the more public companies that utilize a dual-class share structure, the more controlled companies exist and the less power the movement has."[51] Or, as another example, the New York City Public Pension Funds' crusade to implement proxy access at all public companies without regard to an individual company's performance.[52]

Incidentally, based on their 2018 voting guidelines,[53] the Big Three unanimously support a standardized form of proxy access and equal voting rights. This should be no surprise as it is consistent with their own preferences for retaining or increasing their public pension and union-related funds business.

Shareholder empowerment reflects an agreement with the following theory as articulated by Delaware Supreme Court Chief Justice Leo Strine:

> [T]here is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels

50. Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1, 2 (2018).

51. Bernard Sharfman, *Dual-class Shares and the Shareholder Empowerment Movement*, R STREET INST. BLOG (June 12, 2017), https://www.rstreet.org/2017/06/12/dual-class-shares-and-the-shareholder-empowerment-movement/.

52. Press Release, City of N.Y., Office of Comptroller, Comptroller Stringer, NYC Funds: After Three Years of Advocacy, "Proxy Access" Now Close to a Market Standard (Jan. 30, 2018), https://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-funds-after-three-years-of-advocacy-proxy-access-now-close-to-a-market-standard/.

53. STATE STREET GLOBAL ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES NORTH AMERICA (UNITED STATES & CANADA) 4 (Mar. 2018), https://www.ssga.com/our-insights/viewpoints/2018-proxy-voting-and-engagement-guidelines-north-america.html; BLACKROCK, INC., PROXY VOTING GUIDELINES FOR U.S. SECURITIES 8 (Feb. 2018); *Policies and Guidelines*, VANGUARD, https://about.vanguard.com/investment-stewardship/policies-and-guidelines/ (discussing proxy voting).

> from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users' money to buy and sell stocks for their benefit. [54]

Such a theory ignores the continued need for the decision-making authority of the board of directors, as the most informed locus of authority in a corporation, to take precedence over the accountability that can be provided by the agents of investors, institutional shareholders such as mutual fund advisers, through their ability to vote and engage on corporate matters. As I have stated in the past, "corporate law concentrates decision-making authority in the Board because it recognizes that a centralized, hierarchical authority is necessary for the successful management of a corporation, especially if it is a public company."[55] This is the only way that shareholder wealth maximization can be achieved.

I cannot overstate the harm caused by an institutional investor adopting a shareholder empowerment approach to corporate governance. This is particularly true when it comes to the private ordering of corporate governance arrangements. Shareholder empowerment is a one-size-fits-all approach and should not be confused with our traditional understanding of private ordering. This understanding assumes that, "observed governance choices are the result of *value-maximizing* contracts between shareholders and management."[56] For example, it may or may not include such corporate governance arrangements as dual class shares (with or without time-based sunset provisions),[57] staggered boards, or super-majority shareholder voting. That is the whole point of private ordering and why it has value; it "allows the internal affairs of *each* corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."[58]

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54. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014).

55. Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long – Term Value?*, 2015 COLUM. BUS. L. REV. 813, 821 (2015).

56. David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011) (emphasis added).

57. *See* Letter from Bernard S. Sharfman to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch. Inc. (Mar. 21, 2019); Letter from Bernard S. Sharfman to John Zecca, Senior Vice President, Gen. Counsel, N. Am. & Chief Regulatory Officer, NASDAQ Stock Mkt. (Mar. 21, 2019). Both letters are reprinted in full at Bernard S. Sharfman, *Comment Letters to Nasdaq and NYSE: Time-Based Sunsets and the Problem of Early Unifications of Dual Class Share Structures*, SSRN (Mar. 21, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3352177.

58. Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at Open

Private ordering that results from shareholder empowerment disregards what is wealth maximizing for shareholders at each company. I refer to this phenomenon as the "bastardization of private ordering" or "sub-optimal private ordering." When a mutual fund adviser adopts voting policies that include sub-optimal private ordering, whether or not they are inspired by a desire to retain or increase assets under management, it is a breach of its fiduciary duty under the Proxy Voting Rule. That is, the breach is a result of a failure to disclose how such voting policies adequately maximize the wealth of its mutual fund clients and their shareholders.[59]

Recommendation: Consistent with the Proxy Voting Rule's requirement that mutual fund advisers vote their proxies in the *best interests* of their clients, mutual fund advisers who have obtained concentrated voting power due to the delegation of voting authority, must disclose in their voting policies the *procedures* they will use to eliminate the temptation to use their delegated voting power to retain or acquire more public pension and union-related fund assets under management.

C. Appeasing the Mutual Fund Adviser's Own Shareholder Activists

A mutual fund adviser may also utilize its delegated voting power to appease shareholder activists who attack the business decisions, procedures, and objectives of the adviser's management. For example, in early 2017, both BlackRock[60] and Vanguard (two of its equity funds received the proposals, 500 Index Fund and Total Stock Market Index Fund)[61] "received shareholder resolutions from Walden Asset Management requesting a review of their proxy voting policies and practices related to climate change."[62] Yet, the clear intent of the proposals was not just to review, but to encourage the advisers to be stronger supporters of climate change proposals. According to the language in both proposals:

Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), http://www.sec.gov/news/speech/2009/spch052009tap.htm (emphasis added).

59. *See supra* text accompanying notes 27–32.

60. *Review and Report on ESG Proxy Voting (BLK, 2017 Resolution)*, CERES, https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0l12000005OdxTAAS [hereinafter BlackRock Report] (filed by Walden Asset Management).

61. Vanguard Funds, Preliminary Proxy Statement (Schedule 14A) at 2–3 (Aug. 21, 2017), https://www.sec.gov/Archives/edgar/data/34066/000093247117004594/pre14aproxystatement.htm [hereinafter Vanguard Proxy Statement].

62. Rob Berridge, *Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How About Your Funds?*, CERES (Dec. 21, 2017), https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about.

> Vanguard [BlackRock] is a prestigious member of the Principles for Responsible Investment (PRI) a global network of investors and asset owners representing more than $62 trillion in assets. One of the Principles encourages investors to vote conscientiously on ESG issues.[63]
>
> Yet Vanguard [BlackRock] funds' publicly reported proxy voting records reveals [sic] consistent votes against all climate related resolutions (except the few supported by management), such as requests for enhanced disclosure or adoption of greenhouse gas reduction goals, even when independent experts advance a strong business and economic case for support.[64]

As worded, the submitted proposals were intended to dictate to both BlackRock and Vanguard how they were to fulfill their fiduciary duties under the Proxy Voting Rule.

It appears that the tactic worked. Walden Asset Management withdrew both proposals in return for commitments by the companies to address the request.[65] Moreover, both companies started to support 2-Degree Scenario Proposals, something neither company did prior to 2017.

Coincidentally or not, subsequent to the agreement with Walden Asset Management, both companies had the exact same record on 2-Degree Scenario Proposals. In 2017, both BlackRock and Vanguard voted in favor of 2-Degree Scenario proposals at ExxonMobil and Occidental (both proposals received majority support);[66] while voting against 2-Degree Scenario proposals at twelve other companies.[67]

It is important to point out just how valuable the voting power of these two advisers is to climate change activists and why it should be expected that the Big Three will continue to use their power to maintain peace with climate change activists who are also shareholders. According to a 50/50 Climate Project report, if BlackRock had voted 100 percent of their mutual fund shares in support of the twelve other 2-Degree Scenario proposals, even without Vanguard's, ten of the twelve rejected proposals would have received majority support.[68] If Vanguard had done the same, even without BlackRock's support, eight out of twelve additional proposals would have

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63. BlackRock Report, *supra* note 60.

64. Vanguard Proxy Statement, *supra* note 61 (showing Walden Asset Management's identical proposals for both Vanguard and BlackRock).

65. Berridge, *supra* note 62.

66. *Id.*

67. MARKA PETERSON, JIM BAKER & KIMBERLY GLADMAN, ASSET MANAGERS AND CLIMATE-RELATED SHAREHOLDER PROPOSALS: REPORT ON KEY CLIMATE VOTES, THE 50/50 CLIMATE PROJECT 14, 19 (Mar. 2018), https://5050climate.org/wp-content/uploads/2018/03/AM-Report-3-13-FINAL.pdf.

68. *Id.* at 14.

received majority support.[69]

In sum, this is another scenario where a mutual fund adviser may be tempted to trade its voting power for something that would be of value to it, no matter how it impinges on the fiduciary duties it owes to its mutual fund clients and their shareholders. Here, activists imbedded in an adviser's shareholder base are telling the adviser how to go about implementing its fiduciary duty under the Investment Advisers Act of 1940 and the Proxy Voting Rule.

Recommendation: Mutual fund advisers must disclose how they will eliminate the pressures placed on them by their own shareholders when voting their proxies. Such pressures deserve the creation of a wall that needs to be disclosed pursuant to the Proxy Voting Rule. Such a wall will allow them to fulfill the fiduciary duties they owe their clients.

D. Voting Policies on Shareholder Proposals and Wealth Maximization

Shareholder proposals provide a significant opportunity for mutual fund advisers to abuse their voting power for purposes other than shareholder wealth maximization. In 2017, at least 911 shareholder proposals were submitted to public companies for voting at their annual meetings.[70] Of these, at least 502 went to a vote.[71]

Unfortunately, many of these proposals have nothing to do with shareholder wealth maximization and may ultimately end up having a negative impact. A recent study by Kalt and Turki found that the adoption of climate change resolutions "has no statistically significant impact on company returns one way or the other."[72] They also found that this result should not be surprising:

> [T]here is no general expectation that corporate managers have special abilities in predicting tastes, preferences, voting behavior, and/or institutional capabilities across a wide and varied number of independent political actors operating within independently acting nations across the globe. Under such conditions, resolutions that, for example, compel disclosure of outcomes under particular political scenarios (e.g., the

69. *Id.* at 20.

70. E-mail from Sebastian V. Niles, Partner, Wachtell, Lipton, Rosen & Katz, to Bernard S. Sharfman (June 22, 2018, 11:22 EST) (on file with author).

71. *Id.*

72. JOSEPH P. KALT ET AL., POLITICAL, SOCIAL, AND ENVIRONMENTAL SHAREHOLDER RESOLUTIONS: DO THEY CREATE OR DESTROY SHAREHOLDER VALUE? 3 (June 2018), MAINSTREET INVESTORS, https://mainstreetinvestors.org/wp-content/uploads/2018/06/ESG-Paper-FINAL.pdf.

> political paths that might put the world on a trajectory to achieve a goal such as the "not more than 2 degrees temperature rise" goal that came out of the Paris climate accords in 2015) do not add materially to the information already available to investors from other sources. As such, they cannot be expected to add to shareholder value.[73]

Matsusaka, Ozbas, and Yi found that labor unions use shareholder proposals as bargaining chips to extract side payments from management.[74] Matsusaka, Ozbas, and Yi, in a separate paper, found that the stock market reacted positively when the SEC permitted shareholder proposals to be excluded.[75]

Moreover, it is not difficult to assume that shareholder proposals that deal with human rights, political contributions, lobbying disclosure, greenhouse gas emissions, climate change, etc. are most likely not submitted for purposes of shareholder wealth maximization. This is something that activists most likely understand from the outset. Instead, the submission of such proposals is to try and resolve issues of national and international importance through shareholder activism, not the political process.

I do not mean to say that such issues are not extremely important to all of us. However, submitting shareholder proposals is not the way to solve them. According to Kalt and Turki,

> None of this is to say that we should not be extremely concerned about such issues as global climate change, human trafficking, cybersecurity, and the like. Effectively dealing with such problems, however, will require that wise public policy measures be taken across a wide swath of the world's nations. While frustration with slow progress on this front is

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73. *Id.* at 3–4.

74. John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Opportunistic Proposals by Union Shareholders* (Marshall Sch. of Bus., Working Paper No. 17-3, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2666064 ("We find that in contract expiration years compared to nonexpiration years, unions increase their proposal rate by one fifth, particularly proposals concerning executive compensation, while nonunion shareholders do not increase their proposal rate in expiration years. Union proposals made during expiration years are less likely to be supported by other shareholders or a leading proxy advisor; the market reacts negatively to union proposals in expiration years; and withdrawn union proposals are accompanied with higher wage settlements.").

75. John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letter Decisions* (Marshall Sch. of Bus., Working Paper No. 17-7, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2881408 ("We find that over the period 2007–2016, the market reacted positively when the SEC permitted exclusion. Investors appear to have been most skeptical about proposals related to corporate governance and proposals at high profit firms, suggesting that investors believe some proposals can hurt shareholders by disrupting companies that are already performing well. The evidence is compatible with the view that managerial resistance is based on a genuine concern that proposals can harm firm value.").

> understandably accompanied by the desire to "do something[,]" doing something effective in such arenas is the task of our political institutions. Shareholder resolutions targeted at prominent corporations is an ineffectual substitute for sound policy making via the political institutions of democracy.[76]

This lack of connection between shareholder proposals and shareholder wealth maximization is an issue that should concern all retail investors. Shareholder proposals, if implemented subsequent to a shareholder vote, or prior to through the process of engagement, while perhaps not reducing shareholder wealth, may at best do nothing to enhance it. If so, then wealth maximizing opportunities may be foregone as finite company resources are devoted to responding to and subsequently implementing these proposals.

Recommendation: Mutual fund advisers must disclose in their voting policies the procedures they utilize to identify an actual link between support for a shareholder proposal and the enhancement of shareholder value. This is necessary to make sure that mutual fund advisers are complying with a primary objective of their fiduciary duties: "*adequately maximizing the value of their shares*."[77]

V. CONCLUSION

In 2003, the SEC made the following statement in the Release:

> Investment advisers registered with us have discretionary authority to manage $19 trillion of assets on behalf of their clients, including large holdings in equity securities. In most cases, clients give these advisers authority to vote proxies relating to equity securities. This enormous voting power gives advisers significant ability collectively, and in many cases individually, to affect the outcome of shareholder votes and influence the governance of corporations. Advisers are thus in a position to significantly affect the future of corporations and, as a result, the future value of corporate securities held by their clients.

This is truer today than it was in 2003, and will most likely be truer in 2023, especially in terms of mutual fund advisers and their ability to generate proactive agency costs of agency capitalism.[78] Therefore, the SEC must become more active in helping to mitigate these costs.

In *Transamerica Mortgage Advisors v. Lewis*,[79] the U.S. Supreme Court ruled that clients and their shareholders have no express or implied private right of action under Section 206 of the Investment Advisers Act of 1940. By extension, no private right of action exists under the Proxy Voting Rule.

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76. KALT ET AL., *supra* note 72, at 4.

77. Disclosure of Proxy Voting Policies, *supra* note 13 (emphasis added).

78. *See supra* note 8 and accompanying text.

79. 444 U.S. 11 (1979).

Therefore, it is imperative that the Commission clarify the scope of a mutual fund adviser's fiduciary duties under the Proxy Voting Rule as an integral part of the amendments it is considering to the proxy process.

According to Laby, "[b]y adopting rules and prosecuting enforcement actions, . . . the SEC fills in the details of what is required by the fiduciary duties of loyalty and care, and brings uniformity to the industry."[80] Unfortunately, there has been too little guidance provided by the SEC since it implemented the Proxy Voting Rule in 2003. The only guidance is the INTECH enforcement action and a staff legal bulletin: a bulletin that focuses on proxy advisors and does not address the issue of how proxy voting policy disclosures needs to be updated to conform to our current proxy voting environment.[81] An update to the process is long overdue.

In a proxy voting world where voting is dominated by a handful of extremely large investment advisers, the Commission should provide clarification that mutual fund advisers must disclose in their voting policies, consistent with the Proxy Voting Rule's requirement that they vote proxies in the best interests of their clients, the *procedures* they will use to deal with the temptation to use their voting power to retain or acquire more assets under management and to appease activists in their own shareholder base.

In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, mutual fund advisers must disclose the *procedures* they will use to identify the link between support for a shareholder proposal at a particular company and the enhancement of that company's shareholder value. This is necessary to ensure that that advisers are complying with a primary objective of their fiduciary duties, "*adequately maximizing the value of their shares*."[82]

Finally, consistent with these new disclosures and procedures, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule. I urge the SEC to be diligent in enforcing all breaches of the Proxy Voting Rule. While enforcement most clearly applies to the Big Three mutual fund advisers, it should also apply to any investment adviser, large or small, that has delegated voting authority.

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80. ARTHUR B. LABY, THE FIDUCIARY STRUCTURE OF INVESTMENT MANAGEMENT REGULATION, RESEARCH HANDBOOK ON MUTUAL FUNDS (JOHN D. MORLEY & WILLIAM A. BIRDTHISTLE, EDS.) (FORTHCOMING ELGAR PUBLISHING), https://ssrn.com/abstract=2993429.

81. SEC Staff Legal Bulletin No. 20, *supra* note 22.

82. Disclosure of Proxy Voting Policies, *supra* note 13 (emphasis added).

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"SOMETHING CALLED THE 'MUNICIPAL SECURITIES RULEMAKING BOARD'": UNEXAMINED ISSUES OF CONSTITUTIONALITY

RICHARD E. BRODSKY*

In the last three decades, many scholarly articles have critically examined the constitutionality of what might be called the "architecture" of governmental — and sometimes nominally private — entities in which Congress has vested the authority to regulate specific areas of the economy. In the past decade, there has been a trickle of Supreme Court decisions dealing with the same issues. By "architecture," I refer to the structure and governance of these entities. Noticeably absent from these discussions has been the Municipal Securities Rulemaking Board, a little-known entity created by an Act of Congress in 1975 to promulgate rules governing the municipal securities markets. This article seeks to subject the architecture of the MSRB to serious scrutiny. The purpose is not to weaken municipal securities regulation but to determine whether seemingly suitable regulation has been achieved at the cost of dubious constitutionality.

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I. INTRODUCTION

In the Securities Amendments of 1975,[1] Congress established limited regulation over municipal securities.[2] Congress directed the United States Securities and Exchange Commission ("SEC") to "establish" the Municipal Securities Rulemaking Board ("MSRB"). The MSRB was to "propose and adopt," subject to the approval of the SEC, "rules with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers."[3]

In this article, I examine the constitutionality of this Congressional enactment. I do not discuss the constitutional authority of Congress to establish the MSRB or regulate municipal securities issuers.[4] Instead, I

1. Securities Amendments of 1975 (1975 Amendments), Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in various sections of 15 U.S.C.).

2. *See id.*; Securities Exchange Act (Exchange Act) of 1934, 15 U.S.C. § 78c(a)(29) (2018) (containing the authoritative definition of "municipal security"); *see also* MUN. SEC. RULEMAKING BD., MSRB GLOSSARY OF MUNICIPAL SECURITIES TERMS 63 (3d ed. 2013), http://www.msrb.org/msrb1/pdfs/MSRB-Glossary-of-Municipal-Securities-Terms-Third%20Edition-August-2013.pdf (explaining that a streamlined definition is that a municipal security is "a bond, note, warrant, certificate of participation or other obligation issued by a state or local government or their agencies or authorities (such as cities, towns, villages, counties or special districts or authorities).").

3. 15 U.S.C. § 78o-4(b)(1).

4. *See* U.S. CONST. amend. XI ("The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."); Alden v. Maine, 527 U.S. 706, 756 (1999) (stating that unanswered questions remain concerning whether the Commerce Clause, U.S. CONST., Art. I, § 8, cl. 3, permits Congress to subject state governments or agencies to liability under the anti-

question what might be called the "architecture" by which this obscure organization[5] was created, and I conclude that there is a substantial possibility that the courts, if faced with a case involving the enforcement of MSRB rules, would declare the statute unconstitutional on one or more of three different theories:

First, that if the MSRB were deemed a private, non-governmental entity, in accordance with its legal form as a Virginia non-profit corporation,[6] the delegation of rule-making authority to this entity violates a constitutional prohibition against delegation to a private entity.

Second, that if the MSRB, despite its legal form, is deemed a public entity, the fact that MSRB members are appointed neither by the United States

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fraud provisions of the securities laws, and whether, if so, the Eleventh Amendment would immunize a State — or "arm of the state"); *see also id.* at 756 ("The immunity [under the Eleventh Amendment] does not extend to suits prosecuted against a municipal corporation or other governmental entity which is not an arm of the State."); Harold S. Bloomenthal & Samuel Wolff, 3A SECURITIES & FEDERAL CORPORATE LAW § 8:141 (2d ed. 2018) (describing an overview of these issues); Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 760 (2009).

5. *See* Tutor Perini Corp. v. Banc of Am. Sec. LLC, 842 F.3d 71, 86 n.11 (1st Cir. 2016) (referring to "something called the 'Municipal Securities Rulemaking Board'"). The panel that issued the *Tutor Perini* opinion had a combined tenure on that court of thirty-nine years. *Judges*, UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT, http://www.ca1.uscourts.gov/judges (last visited Apr. 4, 2019). My recent Google News search of "MSRB" yielded page after page of references to The Bond Buyer, widely known as the "industry bible" but, by its nature, restricted to a relatively narrow base of readers, while a search for "MSRB" on The New York Times' website yielded no results, and a search for "Municipal Securities Rulemaking Board" yielded only passing references to the MSRB over the past five years. GOOGLE NEWS, https://news.google.com/ (last visited Apr. 4, 2019) (follow "Google News" hyperlink; then search for "MSRB," which should yield "About 5,200 results"); N.Y. TIMES, https://www.nytimes.com/ (last visited Apr. 4, 2019) (follow "New York Times" hyperlink; in the upper left-hand corner, search for "MSRB," which should yield zero results); *id.* (last visited Apr. 4, 2019) (follow "New York Times" hyperlink; in the upper left-hand corner, search for "Municipal Securities Rulemaking Board," which should yield 133 results).

6. *See* MUN. SEC. RULEMAKING BD., AMENDED AND RESTATED ARTICLES OF INCORPORATION 1 (Sept. 14, 2016), http://www.msrb.org/~/media/Files/Goverance/RestatedArticlesofIncorporation.ashx?la=en [hereinafter AMENDED AND RESTATED ARTICLES] (explaining that although Congress, in authorizing the MSRB's establishment, did not specify the legal form of this entity, the MSRB is a Virginia nonprofit nonstock corporation); *Business Entity Details — Municipal Securities Rulemaking Board*, COMMONWEALTH OF VA. STATE CORP. COMMISSION, https://scce file.scc.virginia.gov/Business/0341001 (last visited Jan. 18, 2018); *see also* Brief for Respondent at 65–66, Tennessee Republican Party v. SEC, 863 F.3d 507 (6th Cir. 2017) (No. 16-3360/3732), 2016 WL 7386038, at *i, 20, 23 ("[I]ncorporated as a Virginia non-stock corporation . . . [the MSRB] is neither part of the Commission nor a federal agency.").

("U.S.") President nor by the SEC (or any employee thereof) violates the Appointments Clause of the Constitution.

Third, that if the MSRB is deemed a public entity, the fact that the President has no authority to remove MSRB members and (perhaps) is restricted in his ability to remove SEC Commissioners, who in turn are restricted in their ability to remove the members of the MSRB, unduly impinges on the executive powers of the President.[7] In addition, I touch on another important issue: whether MSRB Rule G-17, requiring fairness and honesty by municipal securities professionals, is unconstitutionally vague insofar as it prohibits municipal professionals from engaging in "unfair practices."[8]

This article should not be read to question the need for effective, sound regulation of the market for municipal securities. I ask, instead, whether, even if the MSRB has provided precisely this kind of regulation, the price should be a legislative scheme of questionable constitutionality? In the words of Justice Sutherland in *Carter v. Carter Coal Co.*,[9] "nothing is more certain than that beneficent aims, however great or well directed, can never serve in lieu of constitutional power."[10]

Part II of this article summarizes recent trends in constitutional analysis and litigation involving challenges to the constitutional structure of administrative agencies. Part III treats the background of the establishment of the MSRB and its salient features for the purposes of the constitutional issues raised. In Part IV, I discuss the nondelegation doctrine, and, in particular, the version of the doctrine that deals with delegation of rule-making authority to private entities. Part V deals with the constitutionality of the appointment of MSRB members under the Appointments Clause. Part VI discusses the restrictions on the ability of the President to affect the removal of members of the MSRB. Part VII discusses possible remedies if the MSRB statute were declared unconstitutional under one or more of the theories discussed.

II. THE RECENT CONSTITUTIONAL LANDSCAPE CONCERNING ADMINISTRATIVE ARCHITECTURE

For several decades what may be deemed the architectural aspects of federal administrative law have been in a state of increased constitutional scrutiny both by scholars and courts. For example, just with respect to the

7. *See infra* note 51 and accompanying text.

8. *See infra* notes 51–53 and accompanying text.

9. 298 U.S. 238, 291–92 (1936) (holding that the Bituminous Coal Conservation Act unconstitutionally delegated legislative authority to private entities).

10. *Id.* at 291.

nondelegation doctrine, which posits that Congress may not delegate legislative authority,[11] many articles have discussed this doctrine.[12] There have also been numerous articles on the other two doctrines discussed in this article: restrictions on the President's appointment and removal powers.[13] Although many of the authors have been of a "conservative" bent, and thus might be assumed — correctly or not — to be "anti-regulation," this is not uniformly the case, as a review of the articles (if not the authors) cited in notes 12 and 13 will confirm. Moreover, even those who might be "pro-regulation" cannot ignore cogent arguments coming from those with whom they may fundamental philosophical disagreements. While these articles are not of one piece, they generally share an inclination to breathe life into the doctrines that, together, deal with the balance of power between Congress and the President over who gets to run administrative agencies, a subject that, generally, pro-regulation analysts may have been more willing to ignore or consider dead and buried.[14] Meanwhile, there have been several recent Supreme Court decisions dealing, directly or indirectly, with all three of the doctrines discussed in this article.[15]

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11. *See, e.g.*, Touby v. United States, 500 U.S. 160, 164–65 (1991) (upholding congressional delegation of authority to Attorney General temporarily to add new drugs to status of "controlled substance").

12. *See, e.g.*, Peter H. Aranson et al., *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 7–17 (1982); A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE L.J. 17, 146 (2000); Gary Lawson, *Delegation and Original Meaning*, 88 VA. L. REV. 327, 371–72 (2002); Eric A. Posner & Adrian Vermeule, *Interring the Nondelegation Doctrine*, 69 U. CHI. L. REV. 1721, 1725–29 (2002); James M. Rice, Note, *The Private Nondelegation Doctrine: Preventing the Delegation of Regulatory Authority to Private Parties and International Organizations*, 105 CAL. L. REV. 539, 544–56 (2017); David Schoenbrod, *The Delegation Doctrine: Could the Court Give It Substance?*, 83 MICH. L. REV. 1223, 1229–37 (1985); Cass R. Sunstein, *Is the Clean Air Act Unconstitutional?*, 98 MICH. L. REV. 303, 349–50 (1999) [hereinafter *Is the Clean Air Act Unconstitutional?*]; Cass R. Sunstein, *Nondelegation Canons*, 67 U. CHI. L. REV. 315, 317–21 (2000); Alexander Volokh, *The New Private Regulation Skepticism: Due Process, Non–Delegation, and Antitrust Challenges*, 37 HARV. J. L. & PUB. POL'Y 931, 933, 936, 955–56 (2014); Keith E. Whittington & Jason Iuliano, *The Myth of the Nondelegation Doctrine*, 165 U. PA. L. REV. 379, 392–405 (2017).

13. *See, e.g.*, Lawrence Lessig & Cass R. Sunstein, *The President and the Administration*, 94 COLUM. L. REV. 1, 23 (1994) (discussing the theory of "unitary executive," including restrictions on the President's authority to remove federal officials); John T. Plecnik, *Officers Under the Appointments Clause*, 11 PITT. TAX REV. 201, 207 (2014) (discussing the meaning of the term "officers of the United States" in Appointments Clause).

14. *See* sources cited *supra* notes 12–13.

15. *See* Lucia v. SEC, 138 S. Ct. 2044, 2051 (2018) (holding the appointment of administrative law judge by agency employees violated the Appointments Clause); Free Enter. Fund v. Public Co. Accounting Oversight Bd., 561 U.S. 477, 484 (2010) (finding that the restriction of the President's "ability to remove a principal officer, who is in turn

Amidst this wealth of academic discussion and litigation, there has been sparse academic discussion of the MSRB; the few articles that have dealt with the MSRB have focused almost exclusively on the substance of municipal securities regulation, such as mandatory disclosure and "pay-to-play,"[16] but not on the constitutionality of the structure and governance of the MSRB.[17] Meanwhile, there has been a near dearth of case law discussing such issues.[18] The MSRB's relatively low profile in academia may be due

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restricted in his ability to remove inferior officer . . . that determines policy and enforces law[,]" contravenes constitutional separation of powers); *see also* Dep't of Transp. v. Ass'n of Am. R.R.s, 135 S. Ct. 1225, 1233–34 (2015) (finding that Amtrak was a public entity, reversing lower court decision declaring Congress' vesting rule-making authority to private entity unconstitutional delegation of legislative authority to private entity).

16. *See, e.g.*, Robert W. Doty & John E. Peterson, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U. L. REV. 283, 286, 294 (1976); Gabaldon, *supra* note 4, at 740; Ann J. Gellis, *Mandatory Disclosure for Municipal Securities: Issues in Implementation*, 13 J. CORP. L. 65, 67 (1987); Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. LAW 427 (1996) [hereinafter *Municipal Securities Market*]; Jon B. Jordan, *The Regulation of "Pay-to-Play" and the Influence of Political Contributions in the Municipal Securities Industry*, 1999 COLUM. BUS. L. REV. 489, 517 (1999); Joel Seligman, *The Municipal Disclosure Debate*, 9 DEL. J. CORP. L. 647, 650–51 n.14 (1984); Marc I. Steinberg, *Municipal Issuer Liability Under the Federal Securities Laws*, 6 J. CORP. L. 277, 279–80 (1980).

17. *But see* Donna M. Nagy, *Is the PCAOB a "Heavily Controlled Component" of the SEC?: An Essential Question in the Constitutional Controversy*, 71 U. PITT. L. Rev. 361, 363 (2010) (stating, before the Supreme Court decision in Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010), that "[a] ruling that the PCAOB is unconstitutional may also subject the [MSRB] . . . to new constitutional scrutiny"); Donna M. Nagy, *Playing Peekaboo With Constitutional Law: The PCAOB and its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1043 n.392 (2005) (citing Blount v. SEC, 61 F.3d 938, 941 (D.C. Cir. 1995)) (discussing whether MSRB is properly deemed a public entity, subject to constitutional requirements). There has been no follow-up after the Supreme Court decisions in Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010) and Dep't of Transp. v. Ass'n of Am. R.Rs., 135 S. Ct. 1225 (2015). Also worthy of mention are three other articles, one published before the Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477 (2010) decision, and two after. *See also* Robert Botkin, *FINRA and the Developing Appointments Clause Doctrine*, 17 WAKE FOREST J. BUS. & INTELL. PROP. L. 627, 637 (2017) (considering the possibility that FINRA structure violates the Appointments Clause); Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 196 (2008) (concluding that SROs should not — but could, under the law — be considered government agencies); Joseph McLaughlin, *Is FINRA Constitutional*, 12 ENGAGE 111, 113 (2011) (concluding that, at least to the extent that FINRA engaged in executive functions — investigating and enforcing FINRA rules and the securities laws among securities broker-dealers — FINRA should be deemed unconstitutional because of the inability of the SEC to remove FINRA members, even for cause, and excepting the MSRB from this analysis because it lacks executive power).

18. *But see* Blount v. SEC, 61 F.3d 938, 939–40, 948–49 (D.C. Cir. 1995) (holding that MSRB Rule G-37, which "restrict[s] the ability of municipal securities professionals

to the fact that the MSRB, unlike other self-regulatory organizations like the Financial Industry Regulatory Authority ("FINRA"), lacks the authority to investigate or enforce its own rules,[19] and to the fact that the municipal securities market is dwarfed by the equity and other bond markets.[20] But even if the MSRB has little or no "pizzazz," it definitely has significance. Its regulations[21] heavily influence an important governmental function — the issuance by local and state governments and agencies of securities used to finance the construction and redevelopment of a wide range of facilities and edifices — as well as the active, large secondary market for those securities. MSRB regulations affect the cost of financing for municipal entities by requiring underwriters to charge them "fair" prices,[22] as well as the integrity

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to contribute and to solicit contributions to the political campaigns of state officials from whom they obtain business[,]" passed constitutional muster under the First and Tenth Amendments); *id.* at 941 (rejecting the MSRB's argument that it was "a purely private organization," and finding that "MSRB Rule G-37 operates not as a private compact among brokers and dealers but as federal law;" no subsequent reported case has reviewed this decision for its broader implications concerning the constitutionality of the MSRB).

19. S. REP. NO. 94–75, at 47.

20. U.S. SEC. & EXCH. COMM'N, REPORT ON THE MUNICIPAL SECURITIES MARKET 1 n.1 (2012), https://www.sec.gov/files/munireport073112.pdf (estimating that in 1975 $235.4 billion of municipal securities were outstanding, after the issuance of $58 billion in municipal securities during that year); *Bond Market Size Vs. [sic] Stock Market Size*, ZACK'S, https://finance.zacks.com/bond-market-size-vs-stock-market-size-5863.html (last updated May 14, 2018) (providing data from SIFMA for 2017) (despite its growth, the market for municipal securities is dwarfed by the markets for U.S. equities ($30 trillion), U.S. Treasury debt ($14.4 trillion), mortgage bonds ($9.2 trillion), and corporate bonds ($8.8 trillion)); *see* Securities Industry and Financial Markets Association, *US Bond Market Issuance and Outstanding*, SIFMA, https://www.sifma.org/resources/research/us-bond-market-issuance-and-outstanding/ (follow "download" hyperlink) (last visited Feb. 2, 2019) (summarizing that by 2017, the market had grown to an estimated $3.85 trillion in outstanding municipal securities, with issuance during that year of $448.1 billion); *CPI Inflation Calculator*, BUREAU OF LABOR STATISTICS, http://www.bls.gov/data/inflation_calculator.htm/ (last visited Feb. 2, 2019) (to compare the same number from two different years and eliminate the effects of inflation, multiply the relevant number from earlier year by amount of inflation between then and comparison year) (adjusted for inflation, the amount of outstanding municipal securities in 2018 was 3.68 times the 1975 amount, while the amount of issuance was 1.73 times the 1975 amount).

21. *See* MUN. SEC. RULEMAKING BD., RULE BOOK IX [hereinafter RULE BOOK] http://www.msrb.org/msrb1/pdfs/MSRB-Rule-Book-October-1-2018.pdf (last updated Oct. 1, 2018) (explaining that since 1975 the MSRB has promulgated dozens of rules governing the market for municipal securities). Moreover, the MSRB now operates with a nearly $40,000,000 annual budget. *See* GARY HALL & LYNNETTE KELLY, MUN. SEC. RULEMAKING BD., EXECUTIVE BUDGET SUMMARY FOR THE FISCAL YEAR BEGINNING OCTOBER 1, 2018 4 [hereinafter BUDGET SUMMARY], http://www.msrb.org/~/media/Files/Resources/MSRB-Executive-Budget-Summary-FY-2019.ashx?la=en (last visited Jan. 15, 2019) (stating the MSRB now operates with a nearly $40,000,000 annual budget).

22. *See* MUN. SEC. RULEMAKING BD., REQUEST FOR COMMENT ON DRAFT

and liquidity of the secondary markets for these securities, by requiring more transparency in a notoriously opaque marketplace.[23]

III. MUNICIPAL SECURITIES AND THE ESTABLISHMENT OF THE MSRB

A. Regulation of Municipal Securities

Unlike the intensive regulation of stocks and corporate bonds, municipal securities remain subject to relatively sparse federal regulation. In a reflection of the very essence of our federal structure,[24] municipal securities have always occupied an anomalous position under the federal securities laws. On the one hand, since the enactment of the Securities Act of 1933 ("Securities Act"),[25] municipal securities have been statutorily exempt from the registration provisions of that Act,[26] meaning that municipal entities do not have to file registration statements with the SEC before they can offer municipal securities for sale in a public offering;[27] further, sales of these securities, unlike corporate securities, may occur without an "effective" registration statement containing a prospectus — a comprehensive disclosure document whose contents are established by the SEC.[28] On the other hand, municipal securities, like all securities, have always been subject to the anti-fraud provisions of the Securities Act[29] and the Exchange Act.[30] Thus, before 1975 the SEC was able to enforce those provisions by lawsuits or administrative proceedings against municipal securities professionals (and

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AMENDMENTS TO 2012 INTERPRETIVE NOTICE CONCERNING THE APPLICATION OF MSRB RULE G-17 TO UNDERWRITERS OF MUNICIPAL SECURITIES 45 (Nov. 16, 2018), http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/~/media/18AC702913A04ABF86733318BB13606B.ashx?.

23. *See* MUN. SEC. RULEMAKING BD., MILESTONES IN MUNICIPAL MARKET TRANSPARENCY THE EVOLUTION OF EMMA 18 (2018), http://www.msrb.org/Market-Topics/~/media/B6A5FFA809C34A7F9DA5C89E8A5F0681.ashx?.

24. *See* Gregory v. Ashcroft, 501 U.S. 452, 457–58 (1991) (describing "dual sovereignty between the States and the Federal Government").

25. 15 U.S.C. §§ 77a–77mm (1933).

26. *See id.* § 77c(a)(2) (listing classes of exempt securities); *see also id.* § 77f (outlining registration requirements for non-exempt securities and transactions).

27. *See id.* §§ 77c, 77f(c).

28. *Id.* § 77f(a)–(b). *But see* 17 C.F.R. § 240.15c2-12(b) (2018) (stating that disclosure is required of municipal securities issuances and requiring underwriters of municipal securities underwriters to obtain issuers' "official statements" (akin to prospectuses) for the securities they intend to sell and provide them to purchasers). *See generally* EMMA, https://emma.msrb.org (last visited Jan. 19, 2019) (compiling official statements now on the MSRB's EMMA website which also contains post-issuance trading data).

29. *See* 15 U.S.C. § 77q(a).

30. 15 U.S.C. § 78j-l(b) (1994) (Supp. | 1995); 17 C.F.R. § 240.10b-5 (2018).

an occasional action against a municipal securities issuer), and purchasers or sellers could enforce the anti-fraud provisions of the Exchange Act through an implied right of action.[31] Since 1975 at least, municipal securities issuers have become subject to claims under the Exchange Act.[32] This enactment presumably removed any basis for concluding that state and local governments and their agencies could not be liable under the anti-fraud provisions of the Exchange Act, 15 U.S.C. Section 78(j)(b), or rule 10b-5 thereunder, 17 C.F.R. Section 240.10b-5.[33]

Federal intervention in this market resulted in large part from the collapse of the market for securities issued by the City of New York.[34] Municipal securities markets had been marked by opaqueness favoring insiders and a lack of disclosure to investors.[35] One commentator's claim that "[d]isclosure

31. *See* 4 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12:197 n.3 (7th ed. 2016) (stating that while there is a long-recognized implied private right of action under the anti-fraud provisions of the Exchange Act, 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5, the vast majority of cases have concluded that no such right exists under 15 U.S.C. § 77q(a), the anti-fraud provision of the Securities Act).

32. *Compare* 15 U.S.C. § 78c(a)(9) (1976) (redefining "person" as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government"), *with* 15 U.S.C. § 77b(2) (1933) (defining person as "a corporation, a partnership, an association, a joint stock company, a business trust, or an unincorporated organization").

33. 15 U.S.C. § 78(j)(b) (2018); 17 C.F.R. § 240.10b-5 (2018). *But see* Margaret V. Sachs, *Are Local Governments Liable Under Rule 10b-5? Textualism and Its Limits*, 70 WASH. U. L.Q. 19, 56 (1992) (discussing the likely effects these regulations will have on local governments). However, this author's argument has not gained traction in the courts or in academia. For example, her article has never been cited in any case available on Westlaw, and has been cited as an outlier in articles. *See, e.g.*, Lisa M. Fairchild and Nan S. Ellis, *Rule 15c2-12: A Flawed Regulatory Framework Creates Pitfalls for Municipal Issuers*, 2 WASH. U. J.L. & POL'Y 587, 592 n.26 (2000) (citing for the proposition that 1975 Amendments subjected municipalities to liability under section 10(b) of the Exchange Act, and citing Sachs article with "But see" signal).

34. *See generally* H.R. REP. NO. 95-040, at 1 (1977) (reviewing the key events in the New York City debacle); Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L.J. 1119, 1119 (1976) (concluding that, for some time, New York City's expenses had exceeded its revenues, but, to appear to balance its budget and to avoid reforming its fiscal policies and structure, the City resorted to borrowing short-term to pay its current expenses. Doing so just enabled the City to kick the can down the road for ever-shorter distances and postponed the inevitable inability to attract new loans needed to pay off expiring debt. The end came in March 1975, in light of deep concerns that any more short-term debt was marketable, when the City's major banks — its underwriters — refused to issue any more short-term debt to finance the deficit).

35. U.S. SEC. & EXCH. COMM., REPORT ON THE MUNICIPAL SECURITIES MARKET v, 115 (2012), https://www.sec.gov/news/studies/2012/munireport073112.pdf (stating that the SEC described the secondary market for municipal securities as "a decentralized over-the-counter dealer market that is illiquid and opaque," resulting in "relatively high overall levels of markups and other transaction costs . . ." as late as 2012).

was not required and nonexistent"[36] is hardly an overstatement. In late 1974 and early 1975, for example, New York City issued $4.8 billion of notes (short-term securities), but "[n]o offering document was disseminated to investors in connection with the sale of City securities until March 13, 1975," when a rudimentary "Report of Essential Facts" was distributed.[37]

In the wake of the New York City debacle, and to prevent further "proliferation of fraudulent trading practices resulting in substantial losses to public investors, . . . represent[ing] a serious threat to the integrity of the capital-raising system upon which local governments rely to finance their efforts,"[38] Congress enacted the first federal legislation in U.S. history dealing with this important marketplace.[39] As part of the legislation, Congress required the SEC to establish a new entity, the MSRB.

B. The Establishment of the MSRB

As a preliminary matter, the 1975 Amendments were careful to make clear that issuers of municipal securities — state and local governments and agencies — were not made subject to direct regulation by the SEC or the newly created MSRB.[40] Thus, aside from the creation of the MSRB, the only major change in municipal securities regulation was a provision that barred "municipal securities dealers" (basically, banks or bank departments dealing in such securities) from using interstate commerce for transactions in municipal securities unless registered as such with the SEC, bringing them in line with securities brokers and dealers; registration of "municipal advisors" was added in 2010.[41]

Congress instructed the SEC to "establish" a new entity, the MSRB, to "propose and adopt rules" governing "transactions in municipal securities

36. *Municipal Securities Market*, *supra* note 16, at 428.

37. *See* H.R. REP. NO. 95-040, at 641.

38. S. REP. NO. 94-75, at 38 (1975).

39. Securities Amendments of 1975 (1975 Amendments), Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.).

40. *See* The Tower Amendment, 15 U.S.C. § 78o-4(d)(1) (1976) (prohibiting the SEC and the MSRB from requiring municipal securities issuers to submit information to them prior to the sale of securities); § 78o4(d)(2) (prohibiting the MSRB from requiring any municipal issuer to furnish it, or any purchasers or prospective purchasers, with any information either before or after the sale of securities); *see also* S. REP. NO. 94-75, at 1, 44 (stating that in enacting the Tower Amendment, Congress was being "mindful of the historical relationship between the federal securities laws and issuers of municipal securities"); *id.* at 44 (showing that this "mindfulness" was prominently displayed in the sub-heading in the Senate Report introducing a discussion of the Tower Amendment: "REGULATION OF MUNICIPAL SECURITIES PROFESSIONALS-NOT ISSUERS"). *But see* 17 C.F.R. § 240.15c2-12 (2018).

41. 15 U.S.C. § 78o-4(a)(1) (2006 & Supp. IV 2011).

effected by brokers, dealers, and municipal securities dealers."[42] Congress required that the rules enacted by the MSRB

> be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities[,] . . . to remove impediments to and perfect the mechanism of a free and open market in municipal securities[,] . . . and, in general, to protect investors . . . and the public interest; and not be designed to permit unfair discrimination among customers, municipal entities, obligated persons, municipal securities brokers, municipal securities dealers, or municipal advisors, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by municipal securities brokers, municipal securities dealers, or municipal advisors, to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the Board, or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter.[43]

The Exchange Act subjects all rules issued by securities self-regulatory agencies, including the MSRB, to SEC approval.[44] In addition, the SEC retains the power under the Exchange Act to amend MSRB rules through its own notice and comment rulemaking.[45] In the meantime, Exchange Act section 15A(f)[46] prohibits the FINRA from adopting rules applicable to transactions in municipal securities, and the SEC itself is given no original authority to promulgate rules over the municipal securities market.

The structure for enforcement of MSRB rules is wholly different than that for enforcement of FINRA rules. The MSRB itself was given no enforcement authority — rather, "[i]nspection and enforcement [of the MSRB rules] [are] the responsibility of the NASD [now FINRA], the banking agencies, and the SEC."[47] FINRA enforces its own rules (and

42. *Id.* §§ 78o-4(b)(1)–(2); Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78o-4(b)(3) (2018) (adding a provision enabling the MSRB to "establish information systems"); BUDGET SUMMARY, *supra* note 21, at 6 (referencing that the MSRB now operates the Electronic Municipal Market Access (EMMA) website, among other electronic information systems).

43. 15 U.S.C. § 78o-4(b)(2)(C) (2018) (requiring that the MSRB's rules assure the operational capability, competence, experience and training of municipal securities professionals, and prescribe rules governing the form and content of distributed quotations and related matters).

44. 15 U.S.C. § 78s(b)(1).

45. 15 U.S.C. § 78s(c)(1).

46. 15 U.S.C. § 78o-3(f).

47. S. REP. NO. 94–75, at 47 (1975).

applicable securities law provisions) through its own disciplinary proceedings, but FINRA's rules are not enforceable by the SEC and thus cannot give rise to SEC or criminal proceedings.[48] But there is a further wrinkle unique to the MSRB: the 1975 Amendments included a provision making virtually any market professional's violation of any MSRB rule (so long as it involves interstate commerce) a violation of that Act, [49] which can lead to civil or administrative enforcement actions by the SEC, FINRA or the relevant banking agencies,[50] or even criminal charges.[51]

Significantly, section 78o-4(c)(1) does not establish any requirement concerning the actor's state of mind: presumably, an MSRB rule based on strict (blameless) liability could qualify as a violation of the Exchange Act and therefore become grist for the enforcement mill. This feature accentuates the need for the rules to meet constitutional standards, including not being unduly vague, which is a risk present in at least one MSRB rule, G-17.[52] For example, the terms "fairly" and "unfair" are not defined in the

48. *See* Saad v. SEC, 873 F.3d 297, 299 (D.C. Cir. 2017) (upholding FINRA sanction against person associated with broker-dealer and describing the FINRA disciplinary process, including SEC and appellate court review of FINRA sanctions).

49. 15 U.S.C. § 78o-4(c)(1) ("No broker, dealer, or municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security, and no broker, dealer, municipal securities dealer, or municipal advisor shall make use of the mails or any means or instrumentality of interstate commerce to provide advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products, the issuance of municipal securities, or to undertake a solicitation of a municipal entity or obligated person, in contravention of any rule of the Board. A municipal advisor and any person associated with such municipal advisor shall be deemed to have a fiduciary duty to any municipal entity for whom such municipal advisor acts as a municipal advisor, and no municipal advisor may engage in any act, practice, or course of business which is not consistent with a municipal advisor's fiduciary duty or that is in contravention of any rule of the Board.").

50. *See, e.g.*, Complaint at 1, SEC v. Rhode Island Commerce Corp., No. 1:16-cv-00107 (D.R.I. Mar. 7, 2016) (charging underwriter with violation of section 78o-4(c)(1) for the underwriter's violation of two MSRB rules).

51. *See* 15 U.S.C. § 78ff (criminalizing willful violations of Exchange Act or of rules thereunder); United States v. Rudi, 927 F. Supp. 686, 687 (S.D.N.Y. 1996) (dismissing an indictment under section 78o4(c)(1) on ground that alleged kickback from underwriter not sufficiently connected to specific bond transaction to constitute violation).

52. RULE BOOK, *supra* note 21, at 155 (last updated Oct. 1, 2018) ("In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with alpersons and shall not engage in any deceptive, dishonest, or unfair practice."); *Rule G-17*, MSRB, http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2#_DA15225F-907A-43CC-A319-26F55EFFDECE (last updated May 4, 2017) (stating that the MSRB has called Rule G-17 "the core of [its] investor protection rules"); *id.* (discussing how a violation can be based solely on "fail[ing to] deal fairly with [any] person[ ]" or "engag[ing] in any . . . unfair practice," — that is, such a violation can

Rule or in the multitudinous guidance on Rule G-17 published by the MSRB.[53] Therefore, there is a need to ascertain whether the terms "fairly" and "unfair," which, by their nature, are broad, inherently vague terms, are overly so, and therefore are unconstitutionally vague. There is no case law defining the state of mind required in a G-17 claim alleging solely unfairness or lack of fairness. If scienter — "a mental state embracing intent to deceive, manipulate, or defraud"[54] — is not required for such a claim, this should increase the likelihood of the Rule's being held unconstitutionally vague.[55]

C. Structure and Governance of the MSRB

In the 1975 Amendments, Congress provided that the MSRB would be initially composed of fifteen members appointed by the SEC, and that, before the expiration of an initial two-year term, the existing Board members, not the SEC, were to elect new members.[56] Congress also directed that the MSRB promulgate rules concerning the membership of the Board, including the requirement that

> the public representatives shall be subject to approval by the Commission to assure that no one of them is associated with any broker, dealer, or municipal securities dealer and that at least one is representative of investors in municipal securities and at least one is representative of issuers of municipal securities.[57]

This requirement — that the SEC approve "public" members — was eliminated in 2010 by an amendment to the Exchange Act contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act.[58] Meanwhile, the By-Laws of the MSRB contain no reference to SEC approval or clearance of public members, and thus all Board positions, as vacancies occur, are filled by the Board, without any involvement by the SEC or any other government agency.[59]

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occur even in the absence of a charge of "deceptive" and "dishonest" conduct).

53. *See Rule G-17*, *supra* note 52.

54. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

55. *See* Vill. of Hoffman Estates v. Flipside, Hoffman Estates, Inc., 455 U.S. 489, 499 (1982) (holding the municipal ordinance not unconstitutionally vague because violation requires scienter and "a scienter requirement may mitigate a law's vagueness, especially with respect to the adequacy of notice to the complainant that his conduct is proscribed.").

56. Securities Amendments of 1975 (1975 Amendments), Pub. L. No. 94-29, 89 Stat. 97, 132 (codified as amended in scattered sections of 15 U.S.C.).

57. 15 U.S.C. § 78o-4(b)(2)(B) (amended 2010).

58. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. 111-203, § 975(b)(2)(C), 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78o-4(b)(2)(B)).

59. *See* MUN. SEC. RULEMAKING BD., BY-LAWS 1–4 (May 1, 2018), http://www.ms

The members of the MSRB may be removed from office by the SEC, but only for serious cause and after notice and the opportunity for hearing.[60] No other officer or employee of the federal government has any role in the removal of MSRB members.[61]

IV. HAS CONGRESS UNCONSTITUTIONALLY DELEGATED LEGISLATIVE AUTHORITY TO THE MSRB?

A. Nondelegation Doctrine

The "nondelegation" doctrine, in its purest form, states "that Congress may not constitutionally delegate its legislative power to another branch of Government."[62] The doctrine stems from Article I, Section 1 of the Constitution, which states that "[a]ll legislative Powers herein granted shall be vested in a Congress of the United States," and is an expression of the principle of separation of powers among the three branches of the Federal Government.[63]

It is traditionally observed that in only two cases — both in 1935 — has the Supreme Court ever declared an act of Congress to be unconstitutional under this doctrine,[64] which led one prominent scholar to quip in 1999 that the doctrine has had "One Good Year, Two Hundred and Two Bad Years."[65] Yet scholars have criticized these two cases, for good reason, for making it far from certain exactly what the contours of this doctrine really are,[66] and

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rb.org/~/media/Files/Goverance/By-Laws.ashx?la=en (providing for "21 members who are knowledgeable of matters related to the municipal securities markets," of whom 11 are to be public representatives and 10 persons associated with brokers, dealers, municipal securities dealers and municipal advisors).

60. 15 U.S.C. § 78o-4(c)(8) (authorizing the SEC to remove an MSRB member found to have "willfully (A) violated any provision of this chapter, the rules and regulations thereunder, or the rules of the Board or (B) abused his authority").

61. *See id.*

62. *See, e.g.*, Touby v. United States, 500 U.S. 160, 164–65 (1991) (upholding congressional delegation of authority to Attorney General temporarily to add new drugs to status of "controlled substance").

63. *Id.* (quoting U.S. CONST. art. I, § 1).

64. *See* A.L.A Schechter Poultry Corp. v. United States, 295 U.S. 495, 554 (1935) (voiding congressional delegation to private trade or industrial associations' authority to establish, subject to President's approval, "codes of fair competition" for their industry); Panama Ref. Co. v. Ryan, 293 U.S. 388, 389 (1935) (voiding, for lack of standards, congressional grant of authority to President to ban transportation of petroleum products in violation of state limits). *But see* Carter v. Carter Coal Co., 298 U.S. 238, 317–18 (1936) (invalidating part of the Bituminous Coal Conservation Act on the grounds congress overstepped its bounds trying to regulate industry within a state); *see also infra* text accompanying notes 86–93.

65. *Is the Clean Air Act Unconstitutional?*, *supra* note 12, at 330.

66. *See, e.g.*, Lawson, *supra* note 12, at 370–71 ("While the cases are major historical

there is even some debate as to whether there even is (or has been) a nondelegation doctrine.[67]

To start with, determining what is "legislative authority" has frequently bedeviled the courts of the U.S. Chief Justice Marshall, identified the problem almost two hundred years ago in *Wayman v. Southard*:[68]

> The difference between the departments undoubtedly is, that the legislature makes, the executive executes, and the judiciary construes the law; but the maker of the law may commit something to the discretion of the other departments, and the precise boundary of this power is a subject of delicate and difficult inquiry, into which a Court will not enter unnecessarily.[69]

The Court has seemingly forever been in search for a meaningful overriding standard to determine whether the authority that has been delegated is "legislative."[70] Although *Wayman* could be, and was, decided on a statutory analysis, which made discussion of the nature of a "legislative" delegation unnecessary, Chief Justice Marshall chose to discuss at length the defendant's argument that Congress had engaged in an unconstitutional delegation of legislative authority to the federal courts.[71] He suggested this rule for identifying legislative power:

> The line has not been exactly drawn which separates those important subjects, which must be entirely regulated by the legislature itself, from those of less interest, in which a general provision may be made, and power given to those who are to act under such general provisions to fill up the details. To determine the character of the power given to the Courts by the Process Act, we must inquire into its extent.[72]

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and doctrinal events, they shed little light on the proper methodology for analyzing nondelegation problems.").

67. Whittington & Iuliano, *supra* note 12, at 381 (stating that the nondelegation doctrine is a "myth," because "there was never a time in which the courts used the nondelegation doctrine to limit legislative delegations of power."); Jason Iuliano & Keith E. Whittington, *The Nondelegation Doctrine: Alive and Well*, 93 NOTRE DAME L. REV. 619, 620 (2017) (claiming that "despite the doctrine's disappearance at the federal level, it has become an increasingly important part of state constitutional law" and concluding "[c]ontrary to the conventional wisdom, the nondelegation doctrine is alive and well, albeit in a different location.").

68. 23 U.S. 1, 49–50 (1825) (holding that state law providing that state-created currency could be used to pay judgments was inapplicable in the execution of a judgment from a federal court).

69. *Id.* (stating that the Act of Congress authorizing federal courts to alter regulations concerning executions on judgments is not a delegation of legislative authority).

70. *See, e.g.*, Whittington & Iuliano, *supra* note 12, at 384–88 (discussing the nondelegation doctrine and how the Court used it prior to the New Deal).

71. *Wayman*, 23 U.S. at 42–47.

72. *Id.* at 43.

This language has been described by one scholar "as the Court's most sophisticated treatment of the [nondelegation doctrine]."[73] The suggested standard, while certainly not a bright-line rule — being somewhat akin to Justice Stewart's vague standard, announced when he famously declined to define "hard core pornography" except by saying "I know it when I see it"[74] — at least has the virtue of being based on the underlying nature of the authority being delegated: "important subjects . . . must be entirely regulated by the legislature itself," whereas "[subjects] of less interest, [may be regulated by] . . . a general provision . . . and power given to those who are to act under such general provisions to fill up the details."[75]

But the standard suggested in *Wayman* has gone into disfavor and has not been applied since 1928, when the Court upheld the delegation to the President the power to fix customs duties on certain products because the enabling legislation included "an intelligible principle to which the person or body authorized to [act] is directed to conform."[76] The "intelligible principle" standard, by focusing on the extent to which Congress has provided adequate guidance to the delegatee, tends to avoid deciding whether legislative authority has, in fact, been delegated, which, since at least *Wayman*, has been said to be strictly prohibited.[77] Thus, given the looseness of the "intelligible principle" standard, it is no surprise that the Supreme Court has routinely approved delegation schemes where it finds Congress has satisfied this very low hurdle.[78]

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73. Lawson, *supra* note 12, at 357.

74. Jacobellis v. State of Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring).

75. *Wayman*, 23 U.S. at 43.

76. J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928) (upholding delegation to President the power to fix customs duties).

77. *Wayman*, 23 U.S. at 42 ("It will not be contended that Congress can delegate to the Courts, or to any other tribunals, powers which are strictly and exclusively legislative."); *see also* Marshall Field & Co. v. Clark, 143 U.S. 649, 692 (1892) (upholding delegation to President duty to raise tariffs on specified goods where reciprocal tariffs imposed by other countries were "deemed . . . unequal and unreasonable" because it was consistent with the principle "[t]hat Congress cannot delegate legislative power to the president").

78. *See, e.g.*, Communications Act of 1934, 47 U.S.C. § 303 (1934) (providing the Federal Radio Commission with licensing and regulatory powers over the radio industry, according to the Commission's view of the "public convenience, industry or necessity"); Emergency Price Control Act of 1942, Pub. L. 77-421, 56 Stat. 23 (amended by An Act to Amend the Emergency Price Control Act of 1942, Pub. L. 77-729, 56 Stat. 765) (providing for the Federal Price Administrator to set maximum prices for rent and commodities, "which 'in judgment will be generally fair and equitable and will effectuate the purposes of this Act' when, in his judgment, their prices 'have risen or threaten to rise to an extent or in a manner inconsistent with the purposes of this Act'"); Yakus v. United States, 321 U.S. 414 (1944) (finding the Emergency Price Control Act constitutional); Nat'l Broad. Co. v. United States, 319 U.S. 190 (1943) (finding the

If the delegation of legislative authority is forbidden, then, logically, the standard to determine whether a delegation has occurred should not be whether Congress has provided the delegatee and the courts some (or even any) basis for deducing the breadth and scope of the delegated authority. Rather, such determination should be based on whether the delegated authority is legislative in nature. But given the vagueness and looseness of Congressional directives that have been upheld using the "intelligible principle" test, it would appear that the standards provided in the 1975 Amendments to guide the MSRB are sufficiently "intelligible" to survive attack under the nondelegation doctrine. This has been the result to challenges to the delegation of regulatory authority to the NASD, a predecessor of FINRA.[79]

Nevertheless, that conclusion necessarily rests on one of two assumptions: either that the MSRB is acting as a governmental entity when it adopts a rule, or that the real delegatee is the SEC, which must approve all MSRB rules to make them effective. But what if the MSRB were regarded as the delegatee and that its legal form—a non-profit corporation organized under state law—were recognized for purposes of analyzing the constitutionality of the delegation? If that were the case, then, under the cases, the delegation of rule-making power to the MSRB might still be unconstitutional.[80]

B. Delegation to Private Entities

There is a loosely-defined constitutional doctrine, theoretically separate from the "plain vanilla" nondelegation doctrine, that says that legislative authority may not be vested in a private entity.[81] This doctrine finds its source not in concern about Congress' delegating to another branch of government the job of establishing or fleshing out a particular set of rules, but rather about its delegating legislative authority to an entity other than one of the three branches of the federal government. This species of delegation raises issues of non-accountability and similar concerns, and has been questioned by courts and scholars both because it might violate due process

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Communications Act of 1934 constitutional).

79. *See, e.g.*, Sorrell v. SEC, 679 F.2d 1323, 1325 (9th Cir. 1982) (addressing a suit challenging a $6,000 fine for selling unregistered securities); Todd & Co. v. SEC, 557 F.2d 1008, 1010 (3d Cir. 1977) (addressing a breach of fair practices); R.H. Johnson & Co. v. SEC, 198 F.2d 690, 694–95 (2d Cir. 1952) (addressing the reviewability of the NASD decision by the courts). In none of these decisions was there an extensive discussion of the delegation issue.

80. *See infra* pp. 56–58 (discussing whether the MSRB should be deemed a private entity).

81. *See generally* Rice, *supra* note 12, at 539 (discussing the private nondelegation doctrine).

and because, under the Constitution, federal governmental power must be vested in one of the three coordinate branches.[82]

At least one court, a panel of the D.C. Circuit, has criticized the distinction between the two sources (due process or delegation to other than a federal governmental entity) of this doctrine: "[w]hile the distinction evokes scholarly interest, neither party before us makes this point, and our own precedent describes the problem as one of unconstitutional delegation. And, in any event, neither court nor scholar has suggested a change in the label would effect a change in the inquiry."[83] But academia takes this distinction seriously. If a delegation of governmental authority to a private entity is constitutionally problematic, given the jurisprudence on this issue,[84] such a delegation raises issues concerning the propriety of the delegation to a non-government agency, department or branch, rather than due process. This conclusion is based on the fact that while some of the concerns with private delegation rest on the unfairness of vesting a private interest with rule-making authority over its competitors, it is not necessary that this feature be present to make delegation to a private entity offensive, because, even without arming a private actor with the power to harm its competitors, vesting rule-making authority in a private entity is undemocratic and serves to obscure responsibility and accountability.[85]

The issue of whether Congress may vest rule-making authority in a private entity has its own pedigree. In *Eubank v. City of Richmond,*[86] the Court held that a local ordinance allowing owners of two-thirds of the properties on a street to make a zoning rule defining setbacks was a violation of the due process rights of those property owners affected by the rule.[87] While

82. *Compare* Froomkin, *supra* note 12, at 146 ("In contrast to the separation of powers concerns that animate the public nondelegation doctrine, the private nondelegation doctrine focuses on the dangers of arbitrariness, lack of due process, and self-dealing when private parties are given the use of public power without being subjected to the shackles of proper administrative procedure."), *and* Volokh, *supra* note 12, at 933, 936 (delegation to private entities generates due process, not separation of powers, issue), *with* Rice, *supra* note 12, at 544–56 (vesting legislative authority in a private entity violates Constitution's "vesting" clauses, entrusting federal government's powers exclusively to the three branches).

83. Ass'n of Am. R.R.s v. U.S. Dep't of Transp., 721 F.3d 666, 671 n.3 (D.C. Cir. 2013), *vacated and remanded*, Dep't of Transp. v. Ass'n of Am. R.R.s, 135 S. Ct. 1225 (2015).

84. *See* discussion *infra* notes 86–109.

85. *Ass'n of Am. R.R.s*, 721 F.3d at 675 (looking to both concerns — "delegating the government's powers to private parties saps our political system of democratic accountability" and "disinterested government agencies ostensibly look to the public good, not private gain.").

86. 226 U.S. 137 (1912).

87. *Id.* at 144.

reserving ruling on whether cities had the power "to establish a building line or regulate the structure or height of buildings," the Court held that "control of the property of plaintiff in error by other owners of property, exercised under the ordinance, . . . is the vice of the ordinance, and makes it, we think, an unreasonable exercise of the police power."[88] Similarly, in *Washington v. Roberge*,[89] the Court, citing *Eubank*, held unconstitutional a local ordinance requiring approval of two-thirds of neighboring property owners for the construction of "a philanthropic home for children or for old people," on the basis that the property owners' decision was unreviewable and that the property owners "are not bound by any official duty, but are free to withhold consent for selfish reasons or arbitrarily and may subject the trustee to their will or caprice."[90]

In the next decade, this doctrine was raised in the Court's decision in *A.L.A. Schechter Poultry Corp. v. United States*.[91] *Schechter* involved vesting private industry groups with the authority to set standards of "fair competition," subject to presidential approval.[92] The Court held that the delegation was void for lack of definiteness, including a failure to define "fair competition."[93] This invoked a version of the traditional nondelegation doctrine. Nevertheless, it was obvious that the Court was also concerned about vesting (albeit subject to Presidential approval) rule-making authority in private entities:

> [W]ould it be seriously contended that Congress could delegate its legislative authority to trade or industrial associations or groups so as to empower them to enact the laws they deem to be wise and beneficent for the rehabilitation and expansion of their trade or industries? Could trade or industrial associations or groups be constituted legislative bodies for that purpose because such associations or groups are familiar with the problems of their enterprises? And could an effort of that sort be made valid by such a preface of generalities as to permissible aims as we find in section 1 of title 1?[94]

The Court's immediate response to its own questions was stark: "The answer is obvious. Such a delegation of legislative power is unknown to our law, and is utterly inconsistent with the constitutional prerogatives and duties

88. *Id.*
89. 278 U.S. 116 (1928).
90. *Id.* at 118, 122.
91. 295 U.S. 495 (1935).
92. *Id.* at 495–96.
93. *Id.* at 531–32.
94. *Id.* at 537.

of Congress."[95] Whether this statement was dictum or holding — an issue on which there is academic disagreement[96] — it is obvious that the Court in *Schechter* expressed distaste both with standardless delegation to a coordinate branch and with vesting authority in a non-government entity.[97] This raises the question of whether the *Schechter* Court's references to both "delegation" doctrines amount to dictum in light of the narrower, as-applied ruling under the Commerce Clause.[98]

A year after *Schechter* was handed down, the Supreme Court's opinion in *Carter v. Carter Coal Co*[99] struck down the congressional delegation of authority to private coal miners and their employees to establish industry-wide regional wage rates and maximum hours of work in bituminous coal mining.[100] While *Carter* has justly been criticized for its lack of clarity,[101] Justice Sutherland's opinion for the Court did not lack in asperity:

> The power conferred upon the majority is, in effect, the power to regulate the affairs of an unwilling minority. This is legislative delegation in its most obnoxious form; for it is not even delegation to an official or an official body, presumptively disinterested, but to private persons whose interests may be and often are adverse to the interests of others in the same business. The record shows that the conditions of competition differ among the various localities. In some, coal dealers compete among themselves. In other localities, they also compete with the mechanical production of electrical energy and of natural gas. Some coal producers favor the code; others oppose it; and the record clearly indicates that this diversity of view arises from their conflicting and even antagonistic

95. *Id.*

96. *See, e.g.*, Rice, *supra* note 12, at 547 n.52.

97. *See A.L.A. Schecter Poultry Corp.*, 295 U.S. at 542–43 (holding that "the hours and wages of those employed by defendants in their slaughterhouses in Brooklyn and to the sales there made to retail dealers and butchers" did not involve transactions in interstate commerce and thus were not a proper subject of Congressional authority under the Commerce Clause).

98. *See id.*

99. 298 U.S. 238 (1936).

100. *Id.* at 283–85 (noting that the statute enacted by Congress permitted producers of two thirds of the coal in any region, with the approval of unions representing a majority of workers in the region, to set hours and wage standards).

101. *See, e.g.*, Harold J. Kent & Ethan G. Shenkman, *Of Citizens Suits and Citizen Sunstein*, 91 MICH. L. REV. 1793, 1823 n.44 (1993) (citing Carter v. Carter Coal Co., 298 U.S. 238 (1936)) ("[L]imits of Congress' ability to delegate policymaking outside the government remain unclear."); Andrew J. Ziaja, *Hot Oil and Hot Air: The Development of the Nondelegation Doctrine Through the New Deal, a History, 1813-1944*, 35 HASTINGS CONST. L.Q. 921, 958 (2008) ("[W]hile the [Carter] Court used the phrase 'legislative delegation' and cited *Schechter* for its bearing on the nondelegation doctrine, however, it neither cited *Hampton* nor raised the faintest whiff of the 'intelligible principle' test.").

> interests. The difference between producing coal and regulating its production is, of course, fundamental. The former is a private activity; the latter is necessarily a governmental function, since, in the very nature of things, one person may not be entrusted with the power to regulate the business of another, and especially of a competitor. And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property. The delegation is so clearly arbitrary, and so clearly a denial of rights safeguarded by the due process clause of the Fifth Amendment, that it is unnecessary to do more than refer to decisions of this court which foreclose the question.[102]

It is not entirely clear whether the base concern in either *Schechter* or *Carter* is that of delegating rule-making authority to a private entity, *per se*, which tends to raise structural constitutional issues, or that of delegating rule-making authority to a private party that can wield that authority against its competitors, which tends to raise due process issues. And the Court has never since voided an Act of Congress for delegation of legislative authority to a private entity.[103]

The Court has, however, subsequently distinguished *Carter* in a number of cases, including, most notably, *Sunshine Anthracite Coal Co. v. Adkins*.[104] In *Adkins*, the Court upheld the Bituminous Coal Act of 1937 (Coal Act),[105] which allowed coal producers (members of local boards of producers) to propose minimum coal prices to the Bituminous Coal Commission, a federal agency, which could approve, disapprove, or modify the proposals.[106] The Court held the Act constitutional because "members of the [boards] function[ed] subordinately to the Commission," which, under the Act, was given comprehensive and detailed "authority and surveillance" over the producers.[107] A thorough review of the precise statutory framework under the Bituminous Coal Act of 1937 is necessary before one can determine

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102. *Carter*, 298 U.S. at 311–12 (citing Schechter Poultry Corp. v. United States, 295 U.S. 495, 537 (1935); Eubank v. Richmond, 226 U.S. 137, 143 (1912); Washington ex rel. Seattle Trust Co. v. Roberge, 278 U.S. 116, 121, 122, (1928)).

103. *See* Rice, *supra* note 12, at 547–58 (outlining the history of the private nondelegation doctrine); *see also* Stephen Wermiel, *SCOTUS for Law Students: Non-delegation Doctrine Returns After Long Hiatus*, SCOTUSBLOG (Dec. 4, 2014 8:00 PM), https://www.scotusblog.com/2014/12/scotus-for-law-students-non-delegation-doctrine-returns-after-long-hiatus/ ("Regardless of which facet of the non-delegation doctrine one considers, it has been close to eighty years since the Supreme Court found an unconstitutional delegation, to either the executive branch or the private sector.").

104. 310 U.S. 381, 396–97 (1940).

105. Bituminous Coal Act of 1937 (Coal Act), ch. 127, Pub. L. No. 75-48, 50 Stat. 72 (codified in scattered sections of 15 U.S.C.) (expired 1943; repealed 1966).

106. *Sunshine Anthracite Coal Co.,* 310 U.S. at 388, 404.

107. *Id.* at 392, 399.

whether *Adkins* can be meaningfully distinguished when it comes to the MSRB.[108]

It has recently been observed that "[a]lthough this so-called 'private nondelegation' doctrine has been largely dormant in the years since [being applied by the Court], its continuing force is generally accepted."[109] The first reawakening of this doctrine was in a dispute concerning the delegation of rule-making authority concerning the operation of passenger and freight railroads.[110] A few years later, the District Court for the Northern District of Texas found fault in the Supreme Court's improper delegation of rule-making authority by a department of the federal government and private entities.[111] More such cases undoubtedly lie ahead.

C. The Amtrak Case

1. Background

In 2008, Congress charged the National Railroad Passenger Corporation ("Amtrak"), a for-profit corporation,[112] and the Federal Railroad Administration ("FRA"), an agency of the Department of Transportation, to develop new "metrics and minimum standards for measuring the performance and service quality of intercity passenger train operations."[113] Amtrak and the FRA were required to put these metrics and standards into effect, and if they could not agree, the dispute could be settled through

108. *See infra* notes 167–177 and accompanying text (discussing possible distinctions between the delegation discussed in *Adkins* and that involving the MSRB).

109. Boerschig v. Trans-Pecos Pipeline, L.L.C., 872 F.3d 701, 707 (5th Cir. 2017); *see also* Gen. Elec. Co. v. N.Y State Dep't of Labor, 936 F.2d 1448, 1455 (2d Cir. 1991) ("Eubank and Roberge remain good law today.").

110. Ass'n of Am. R.R.s v. U.S. Dep't of Transp., 721 F.3d 666, 670 (D.C. Cir. 2013), *vacated*, 135 S. Ct. 1225, 1225–26 (2015).

111. Texas v. United States, 300 F. Supp. 3d 810, 820, 843–844 (N.D. Tex.) (finding unconstitutional the interpretation of a statutory requirement that capitation rates be "actuarially sound" because it delegated the certification of capitation rates to actuaries credentialed by private entity and following private entity's practice standards), *appeal docketed*, No. 18-10545 (5th Cir. May 7, 2018).

112. *See infra* notes 121–125 and accompanying text (discussing the D.C. Circuit's analysis of Amtrak's corporate status). *See generally* AMTRAK NAT'L FACTS, https://www.amtrak.com/about-amtrak/amtrak-facts/amtrak-national-facts.html?stop_mobi=yes&ref=stop_mobile (last visited Feb. 11, 2019) ("Amtrak is a federally chartered corporation, with the federal government as majority stockholder. The board is appointed by the President of the United States and confirmed by the US Senate. Amtrak is operated as a for-profit company, rather than a public authority.").

113. Passenger Rail Investment and Improvement Act (PRIIA) of 2008, Pub. L. No. 110-432, § 207(a), 122 Stat. 4907 (codified in scattered sections of 49 U.S.C.).

binding arbitration.[114]

The D.C. Circuit struck down that provision as an unconstitutional delegation of authority to a private party, holding that "[f]ederal lawmakers cannot delegate regulatory authority to a private entity. To do so would be 'legislative delegation in its most obnoxious form.'"[115] The court stated that "[t]his constitutional prohibition is the lesser-known cousin of the doctrine that Congress cannot delegate its legislative function to an agency of the Executive Branch."[116] The court found two basic purposes for this rule: "[f]irst, delegating the government's powers to private parties saps our political system of democratic accountability. . . . Second, fundamental to the public-private distinction in the delegation of regulatory authority is the belief that disinterested government agencies ostensibly look to the public good, not private gain."[117]

Despite the prohibition against delegation to private parties, the D.C. Circuit recognized that "private parties . . . may . . . help a government agency make its regulatory decisions, for "'[t]he Constitution has never been regarded as denying to the Congress the necessary resources of flexibility and practicality' that such schemes facilitate."[118] The court framed the fundamental issue as "[p]recisely how much involvement may a private entity have in the administrative process before its advisory role trespasses into an unconstitutional delegation? Discerning that line is the task at hand."[119] Citing factors, such as Congress' giving Amtrak veto power over the FRA, its vesting a range of authority Amtrak "otherwise unknown in the law," and its authorizing private arbitrators to settle disputes between Amtrak and FRA, the court concluded that, since it deemed Amtrak to be a private party, the delegation of standards-making authority to it was unconstitutional.[120]

The Supreme Court reversed the D.C. Circuit.[121] Without deciding (or discussing) the constitutionality of vesting rule-making authority in a private party, the Court held "that, for purposes of determining the validity of the metrics and standards, Amtrak is a governmental entity."[122] Based on its

114. *Id.* § 207(d).

115. *Ass'n of Am. R.R.s*, 721 F.3d at 670 (quoting Carter v. Carter Coal Co., 298 U.S. 238, 311 (1936)).

116. *Id.* (citing U.S. CONST., art I, § 1); *id.* (citing A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 529 (1935)).

117. *Id.* at 675.

118. *Id.* at 671 (quoting Pan. Ref. Co. v. Ryan, 293 U.S. 388, 421 (1935)).

119. *Id.*

120. *Id.* at 671–74.

121. Dep't of Transp. v. Ass'n of Am. R.R.s, 135 S. Ct. 1225, 1234 (2015).

122. *Id.* at 1228.

own detailed "independent inquiry" of "Amtrak's status as a governmental entity for purposes of separation of powers analysis under the Constitution," the Court found that "Amtrak is not an autonomous private enterprise" for those purposes.[123] The Court specifically discounted Congress's declarations to the contrary in Amtrak's enabling legislation.[124]

The Court summarized its rationale for its finding Amtrak to be a non-private entity as follows: "The political branches created Amtrak, control its Board, define its mission, specify many of its day-to-day operations, have imposed substantial transparency and accountability mechanisms, and, for all practical purposes, set and supervise its annual budget."[125] The Court also stated:

> Among other important considerations, its priorities, operations, and decisions are extensively supervised and substantially funded by the political branches. A majority of its Board is appointed by the President and confirmed by the Senate and is understood by the Executive to be removable by the President at will. Amtrak was created by the Government, is controlled by the Government, and operates for the Government's benefit. Thus, in its joint issuance of the metrics and standards with the FRA, Amtrak acted as a governmental entity for purposes of the Constitution's separation of powers provisions.[126]

The Supreme Court decisions in *Department of Transportation*, *Carter*, and *Adkins* lead to two questions concerning the constitutionality, for delegation purposes, of the statutory provisions giving rise to the MSRB: first, whether the MSRB is a private entity; and second, if so, whether vesting the authority to the MSRB transgressed constitutional limits.

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123. *Id.* at 1227, 1231–33.

124. *Id.* at 1233 ("LeBron teaches that . . . the practical reality of federal control and supervision prevails over Congress' disclaimer of Amtrak's governmental status."); *see also* 49 U.S.C. § 24301(a)(2) (2018) ("'Amtrak' . . . shall be operated and managed as a for-profit corporation. . . ."); § 24301(a)(3) ("'Amtrak . . . is not a department, agency, or instrumentality of the United States Government. . . ."); LeBron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 400 (1995) ("[W]here, as here, the Government creates a corporation by special law, for the furtherance of governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment.").

125. *Dep't of Transp.*, 135 S. Ct. at 1233.

126. *Id.* at 1228, 1232–33 (remanding to the D.C. Circuit for resolution of any "questions respecting the lawfulness of the metrics and standards—including questions implicating the Constitution's structural separation of powers and the Appointments Clause. . . ."); Ass'n of Am. R.Rs. v. Dep't of Transp., 821 F.3d 19, 27, 36, 39 (D.C. Cir. 2016) (holding on remand that "PRIIA violates due process" because it "gives a self-interested entity regulatory authority over its competitors" and violates the Appointments Clause because the arbitrator would act as a "principal officer" who required appointment by the President and confirmation by the Senate, as opposed to mere selection by the Surface Transportation Board).

2. Is the MSRB a Private or Public Entity?

In *Department of Transportation*, the Court engaged in a detailed "independent inquiry" of various aspects of Amtrak's setup to determine whether to treat it as a private corporation.[127] To hazard a reasonable guess as to how a future court would rule were it faced with whether the MSRB is a public or private entity for this purpose, one must compare Amtrak and the MSRB through the various lenses the Court used in *Department of Transportation*.

The first category reviewed by the Court was "ownership and corporate structure."[128] On virtually every facet of this issue as it was discussed in *Department of Transportation,* MSRB is clearly more appropriately deemed a private entity than Amtrak:

- Amtrak is a for-profit corporation, most of the common stock and all of the preferred stock of which is owned by the Secretary of Treasury.[129] The MSRB is a Virginia nonprofit nonstock corporation, although nothing in the statute authorizing its creation specified what type of legal entity it would be.[130]
- Eight of the nine voting members of Amtrak's Board are appointed by the President, subject to the advice and consent of the Senate, and the ninth is the Secretary of Transportation.[131] The MSRB is, literally, a self-perpetuating bureaucracy; all new members of the MSRB are chosen by sitting members of the MSRB.[132] In 2010, Congress eliminated the original statutory requirement that the SEC approve the MSRB's public members.[133]
- Amtrak Board salary limits are set by Congress, while there are no limitations on the compensation of the members of the MSRB Board.[134]
- Amtrak Board members are removable by the President of the U.S.

127. *Dep't of Transp.*, 135 S. Ct. at 1231.

128. *Dep't of Transp.*, 135 S. Ct. at 1231–32.

129. 49 U.S.C. § 24301(a)(2) ("Amtrak . . . shall be operated and managed as a for-profit corporation."); *Dep't of Transp.*, 135 S. Ct. at 1231–32 (noting Amtrak stock ownership).

130. *See* AMENDED AND RESTATED ARTICLES, *supra* note 6.

131. *See* 49 U.S.C. § 24302(a)(1) (2018); *see also* § 24302(a)(1)(B); 49 U.S.C. § 24303(a) (2018) (providing that the voting board members elect a non-voting board member, who acts as Amtrak's President).

132. *See supra* text accompanying notes 55–58.

133. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111–203, § 975(b)(2)(C), 124 Stat. 1376 (codified as amended at 15 U.S.C. § 78o-4(b)(2)(B)).

134. 49 U.S.C. § 24303(b); RULE BOOK, *supra* note 21, at 375 (Rule A-3).

without cause,[135] but only the SEC has any power of removal of MSRB members, and only for cause.[136]

- Amtrak Board members are to be chosen in consultation with Congress to represent major geographic regions served by Amtrak,[137] but there is no requirement that MSRB members be chosen in consultation with any arm of the federal government; the only restrictions are with respect to members' professional affiliation or experience.[138]

The second category reviewed by the Court was the Government's "supervision over Amtrak's priorities and operations."[139] Again, the facets considered by the Court regarding Amtrak point strongly to the MSRB's being deemed a private entity.

- Amtrak is required to submit annual reports to Congress and the President.[140] There is no such requirement for the MSRB.
- The Freedom of Information Act ("FOIA") "applies to Amtrak in any year in which it receives a federal subsidy."[141] Amtrak is required to maintain an inspector general, and Congress holds frequent oversight hearings over Amtrak budget and operations.[142] The FOIA does not apply to the MSRB,[143] it is not required to maintain an inspector general, and Congressional oversight of the MSRB is sparse at best. The MSRB prepares its own budget, which is not subject to SEC approval.[144] Until the start of the fiscal year in October 2017, the budget was not even made public. [145]

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135. Dep't of Transp. v. Ass'n of Am. R.R.s, 135 S. Ct. 1225, 1231–32 (2015).

136. *See also supra* text accompanying notes 55–53.

137. *Dep't of Transp.*, 135 S. Ct. at 1231–32.

138. 15 U.S.C. § 78o-4(b)(2)(F), (G).

139. *Dep't of Transp.*, 135 S. Ct. at 1232.

140. *Id.*

141. *Id.*

142. *Id.*

143. 5 U.S.C. § 551(1) (2018) (defining "agency" as "each authority of the Government of the United States, whether or not it is within or subject to review by another agency . . ."); § 552(a) (stating that FOIA applies to "agencies"); Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 183 n.151 (2008) (citing Ind. Invest. Protect. League v. NYSE, 367 F. Supp. 1376, 1377 (S.D.N.Y. 1973) (holding that the New York Stock Exchange is not an "agency" under FOIA) (assuming that the FINRA, another securities self-regulatory authority, is not, unless it were held to be a government agency).

144. *See generally* 15 U.S.C. § 78o-4(b) (2018) (listing the powers and abilities of the board, which include budget-like powers, without stating oversight is required).

145. *See* Press Release, Mun. Sec. Rulemaking Bd., MSRB Publishes Budget Summary in Support of Financial Transparency (Oct. 17, 2017),

- Amtrak is required to further specify operational goals set by Congress, including maintaining a route between Louisiana and Florida and improving the Northeast corridor pursuant to specified, detailed Congressionally-mandated priorities.[146] The SEC exercises some control over the MSRB through its power to approve, disapprove or amend rules adopted by the MSRB and power to remove its members,[147] but the MSRB has never been subject to the kind of specific directives that Congress imposed over Amtrak. The sole direction to the MSRB consists of a general description of the goals of the rules.[148]
- A final factor considered by the Court was that "Amtrak is also dependent on federal financial support. In its first 43 years of operation, Amtrak has received more than $41 billion in federal subsidies. In recent years these subsidies have exceeded $1 billion annually."[149] The MSRB receives no federal funding, unlike Amtrak; the vast majority of its revenues come from industry fees,

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http://www.msrb.org/News-and-Events/Press-Releases/2017/MSRB-Publishes-Budget-Summary-in-Support-of-Financial-Transparency.aspx. *See generally* GARY HALL & LYNETTE KELLY, MUN. SEC. RULEMAKING BD., EXECUTIVE BUDGET SUMMARY FOR THE FISCAL YEAR BEGINNING OCTOBER 1, 2018 (2018), http://www.msrb.org/~/media/Files/Resources/MSRB-Executive-Budget-Summary-FY-2019.ashx?la=en.

146. *See* Passenger Rail Investment and Improvement Act (PRIIA) of 2008, Pub. L. No. 110-432, § 207, 122 Stat. 4907 (codified in scattered sections of 49 U.S.C.) (requiring FRA and Amtrak to, jointly and in consultation with pertinent government agencies, railroads, employees and others, "develop new or improve existing metrics and minimum standards for measuring the performance and service quality of intercity passenger train operations, including cost recovery, on-time performance and minutes of delay, ridership, on-board services, stations, facilities, equipment, and other services. Such metrics, at a minimum, shall include the percentage of avoidable and fully allocated operating costs covered by passenger revenues on each route, ridership per train mile operated, measures of on-time performance and delays incurred by intercity passenger trains on the rail lines of each rail carrier and, for long-distance routes, measures of connectivity with other routes in all regions currently receiving Amtrak service and the transportation needs of communities and populations that are not well-served by other forms of intercity transportation."); *id.* § 208 (requiring the FRA to engage an independent entity to develop and recommend methodologies for Amtrak to use in its route and service planning decisions); *id.* § 209 (directing Amtrak's Board to develop a single system for allocating costs between Amtrak and states supporting rail service); *id.* § 210(a) (ranking its long-distance routes); *id.* § 210(b) (requiring Amtrak to publicize on its website a plan to improve performance of such routes, addressing nine specific factors); *Dep't of Transp.*, 135 S. Ct. at 1232.

147. *See infra* text accompanying notes 177–182.

148. *See* 15 U.S.C. § 78o-4(b)(2)(C) (2018).

149. *Dep't of Transp.*, 135 S. Ct. at 1232; *see also* 15 U.S.C. § 78o-4(b)(2)(C).

> while a small amount (less than three percent) come from fines collected by FINRA and the SEC from violators of MSRB rules.[150]

In sum, a comparative analysis of the factors considered by the Court in *Department of Transportation* shows, at the very least, a substantial possibility that if a court were to subject the MSRB to the same analysis, it would conclude that the MSRB, unlike Amtrak, is, for these purposes, a private entity.

3. If MSRB is a Private Entity, Is the Extent of Delegation Constitutional?

If the MSRB is a private entity for "constitutional purposes" of delegation, that leads to another question under the cases: did Congress go too far in delegating authority to the MSRB?[151]

In *Sunshine Anthracite Coal Co. v. Adkins*, the leading case in this jurisprudence, the Supreme Court considered the constitutionality of Congress' delegating substantial authority to regulate bituminous coal pricing and business standards to private entities.[152] The Bituminous Coal Act of 1937[153] created district coal boards (composed of regional coal producers who agreed to participate in such boards) to be involved in two kinds of regulation: setting minimum prices and promulgating standards and practices.[154] The district boards were established "to operate as an aid to the [Bituminous Coal] Commission but [were] subject to its pervasive surveillance and authority."[155] By reason of that "pervasive surveillance and authority," the Court held that Congress had not "delegated its legislative authority to the industry."[156]

My analysis of the Coal Act leads me to conclude that the "delegation" to the coal boards was more apparent than real, leaving very little, if anything, to the district boards' discretion. This leads to the inference that the whole

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150. *See* MUN. SEC. RULEMAKING BD., FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED SEPTEMBER 30, 2016 AND 2015, AND REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS 5, 9 (2016), http://www.msrb.org/msrb1/pdfs/MSRB-Financial-Statements-FY16.pdf.

151. Whether the MSRB could be considered a private entity for delegation purposes but a public entity for separation purposes is an interesting issue unnecessary to be resolved in this article; I assume that the MSRB is either a private entity or a public entity, but cannot be both depending on which constitutional measure is being taken.

152. 310 U.S. 381 (1940).

153. Bituminous Coal Act of 1937, ch. 127, Pub. L. No. 75-48, 50 Stat. 72 (codified in scattered sections of 15 U.S.C.) (expired 1943; repealed 1966).

154. *See id.* § 1; *Adkins*, 310 U.S. at 404.

155. *Adkins*, 310 U.S. at 388.

156. *Id.* at 399.

arrangement may very well have been a political compromise designed to give the appearance of industry involvement while vesting very little real authority in the private entities. Start with the fact that the Commission could step in and perform the actions required under the Act if a district board failed to act,[157] and this exact condition arose in the same year the law was enacted.[158] Even without such displacement, however, the authority of the district boards was substantially cabined.

The district boards were given the authority to "propose" minimum prices for "kinds, qualities, and sizes of coal produced in said district, and classification of coal and price variations as to mines, consuming market areas, values as to uses and seasonal demand in their region."[159] Congress required that the minimum prices so proposed be calculated to yield a return "equal as nearly as may be to the weighted average of the total costs, per net ton" in the local area, and specified eleven categories of costs to be considered.[160] The proposed minimum prices were to "reflect, as nearly as possible, the relative market value of the various kinds, qualifies, and sizes of coal . . . be just and equitable as between producers within the district . . and . . . have due regard to the interests of the consuming public."[161] Additionally, "[n]o minimum price shall be proposed that permits dumping."[162] The procedure used by the district boards in formulating the proposed minimum prices was to conform to rules promulgated by the Commission.[163] The Commission could "approve, disapprove, or modify" a district board's proposed minimum price schedule.[164]

After minimum prices were submitted to the Commission, another process was to occur — coordination of minimum prices with other district boards "in common consuming market areas," according to standards contained in the Act.[165] The proposed coordinated prices were to be submitted to the Commission, which could review and revise them.[166]

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157. Bituminous Coal Act § 6.

158. *See infra* note 166.

159. Bituminous Coal Act § 4II(a).

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.* § 4II(b).

166. *Id.* § 4I(a); WALDO E. FISHER & CHARLES M. JAMES, MINIMUM PRICE FIXING IN THE BITUMINOUS COAL INDUSTRY 53 (1955) http://www.nber.org/books/fish55-1 (last visited Apr. 4, 2019) (stating that, in practice, the scheme enacted by Congress to establish coordinated prices at least initially through the district boards proved unworkable; and in October 1937, when it became apparent that district boards would

The Act also empowered district boards to "propose reasonable rules and regulations incidental to the sale and distribution, by code members within the district, of coal."[167] Congress listed thirteen separate "practices with respect to coal [that] shall be unfair methods of competition and shall constitute violations of the code."[168]

There appear to be at least two defining differences between the statutory scheme ruled constitutional in *Adkins* and the statutory scheme creating the MSRB. First, the Coal Act expressly permitted the Bituminous Coal Commission to regulate the affairs of a local district without the involvement of the district board when it determined that the board had failed to act.[169] By contrast, the 1975 Amendments endowed the SEC with no such authority.[170] Its responsibility was limited to approving, disapproving, or amending an SRO's rule.[171] Second, the Coal Act provided detailed standards governing both the computation of minimum coal prices and the development of standards governing the coal market.[172] By contrast, the 1975 Amendments, at most, set broad goals for the rules the MSRB was to promulgate.[173] Thus, Congress required MSRB to enact rules "to prevent fraudulent and manipulative acts and practices[,] [and] to promote just and equitable principles of trade,"[174] but did not go further, as it did in the Coal Act, to identify the specific acts and practices that should be outlawed to achieve the goals of preventing fraud and promoting just and equitable trade practices.[175] Likewise, the requirement that MSRB rules "foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities" merely states the goal but does not prescribe the means to achieve the goal.[176] The same occurred with the mandate to adopt rules

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not be completing the process by a deadline established by the Commission, the Commission assumed the coordination task, acting pursuant to the provision of the Act, permitting it to take any action authorized or required by the Act upon the failure of a district board to act); *id.* (showing that the district boards' role in the price-fixing process was not necessary to effectuate the statutory purposes).

167. Bituminous Coal Act § 4II(a).

168. Bituminous Coal Act § 4II(i).

169. Bituminous Coal Act §§ 4II(d); 6(a).

170. *See* Securities Acts Amendments of 1975 (1975 Amendments), Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in various sections of 15 U.S.C.).

171. *Id.* § 19(b)(1).

172. Bituminous Coal Act §§ 4(a)–(b).

173. 1975 Amendments § 2.

174. *Id.* § 15B(b)(2)(C).

175. Bituminous Coal Act § 4II(i).

176. *Id.*

"to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest."[177] While the legislative details may suffice for particular mandated rulemakings,[178] where the issue, at a minimum, is whether Congress provides the federal agency with an "intelligible principle" how to act, the guidance is far less detailed, and therefore far more open to the MSRB's own discretion, than that provided under the Coal Act.[179] Thus, the controls over the MSRB fall far short of the kinds of restrictions to which the *Adkins* Court looked when it concluded that the coal boards were established "to operate as an aid to the [Bituminous Coal] Commission but subject to its *pervasive surveillance and authority*."[180]

In summary, it is fair to conclude that a future Supreme Court could justifiably distinguish *Department of Transportation* and hold that the MSRB is a private entity, and distinguish *Adkins* and hold that the power vested in the MSRB, compared to the extent of actual governmental control, crosses the constitutional line.[181] At the very least, these appear to be substantially closer questions than those considered in both *Department of Transportation* and *Adkins.*

V. IF THE MSRB IS A PUBLIC ENTITY, DOES THE FACT THAT MEMBERS OF THE MSRB ARE APPOINTED BY OTHER MSRB MEMBERS VIOLATE THE CONSTITUTION?

Suppose, despite its formal status as a private entity, the MSRB, like Amtrak, were deemed a public entity. At least two constitutional issues would follow. The first would be whether the method by which MSRB members are appointed — since 1977, new MSRB members have been appointed by the other members of the Board[182] — violates the Appointments Clause of the Constitution.[183]

The Appointments Clause provides:

> [The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . all . . . Officers of the United States, whose Appointments are not herein otherwise provided for, and which

177. *Id.*

178. *See supra* notes 172–175 and accompanying text.

179. *See supra* notes 76–78 and accompanying text.

180. *See* Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 388 (1940) (emphasis added).

181. Dep't of Transp. v. Ass'n of Am. R.R.s, 135 S. Ct. 1225, 1227, 1231–33 (2015); Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 399 (1940).

182. *See supra* text accompanying notes 55–58.

183. U.S. CONST. art. II, § 2, cl. 2.

> shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.[184]

One who works in the federal government is either an "officer of the United States" (usually referred to as a "principal officer"), an "inferior officer," or a mere employee.[185] The Constitution, through the Appointments Clause, covers only the first two categories.[186] Thus, if one is an employee, "part of the broad swath of 'lesser functionaries' in the Government's workforce, . . . the Appointments Clause cares not a whit about who named them."[187] On the other hand, if one is an officer — principal or inferior — one's appointment must be made in accordance with the specific procedure applicable under the Appointments Clause.[188]

Thus, whether the MSRB's arrangement runs afoul of the Appointments Clause depends on whether MSRB members are considered mere employees or "officers." If MSRB members are considered "officers" — even if MSRB members are deemed "inferior officers"— this method of appointment violates the Appointments Clause.

A recent, and leading, Supreme Court decision discussing the officer-or-employee issue is *Lucia v. SEC*,[189] in which the Court held that the appointment of administrative law judges ("ALJs") by SEC employees violated the Appointments Clause.[190] The Court found that ALJs were "officers" for purposes of the Appointments Clause.[191] ALJs are officers, not employees, because they "occupy a continuing position established by law," as opposed to an "occasional or temporary position," and because they "exercise[e] significant authority pursuant to the laws of the United States" and, in doing so, "exercise . . . significant discretion" in doing so.[192] The Court stated that the SEC's ALJs "are near-carbon copies" of the tax-court

184. *Id.*

185. *See* N.L.R.B. v. SW Gen., Inc., 137 S. Ct. 929, 945 (2017) ("'[F]or purposes of appointment,' the Clause divides all officers into two classes—'inferior officers' and noninferior officers, which we have long denominated 'principal' officers") (quoting United States v. Germaine, 99 U.S. 508, 510 (1879)); Freytag v. Comm'r., 501 U.S. 868, 880–81 (1991) (distinguishing officers and employees).

186. Lucia v. SEC, 138 S. Ct. 2044, 2049 (2018).

187. *Id.* at 2051; *see also* Buckley v. Valeo, 424 U.S. 1, 126, n.162 (1976) ("'Officers of the United States' does not include all employees of the United States. . . . Employees are lesser functionaries subordinate to officers of the United States.").

188. *Lucia*, 138 S. Ct. at 2051.

189. *Id.*

190. *Id.* at 2049.

191. *Id.*

192. *Id.* at 2053–54.

judges ruled to be "officers" in *Freytag v. Commissioner*;[193] "*Freytag* says everything necessary to decide this case" and therefore dispenses with the need to "elaborate on [the] 'significant authority' test."[194]

Since *Lucia* and *Freytag* deal with "adjudicative officials"[195] (i.e. judges), arguably they have limited application to MSRB members, who issue rules. Thus, we could look to cases not involving judges to test whether the MSRB statute violates the Appointments Clause. We need not look further than *Lucia*, in which the Court pointed to two other Supreme Court cases — *United States v. Germaine*[196] and *Buckley v. Valeo*[197] — which the Court said "set out [its] basic framework for distinguishing between officers and employees."[198]

In *Germaine*, Congress gave the Commissioner of Pensions the authority to hire surgeons, who examined pensioners and applicants for pensions and were paid on a per-examination basis from funds appropriated to pay pensions.[199] A surgeon was indicted for extorting a pensioner under a statute applying only to "officers of the United States."[200] The Court held that because the surgeon's "duties are *not* continuing and permanent, and they *are* occasional and intermittent," the surgeon was not an officer.[201] As the Court explained,

> [t]he surgeon is only to act when called on by the Commissioner of Pensions in some special case, as when some pensioner or claimant of a pension presents himself for examination. He may make fifty of these examinations in a year, or none. He is required to keep no place of business for the public use. He gives no bond and takes no oath, unless by some order of the Commissioner of Pensions of which we are not advised. No regular appropriation is made to pay his compensation. . . .[202]

Buckley dealt with the Federal Elections Commission ("FEC"), of which four of the six voting members were appointed by the House Speaker (two members) and the President pro tempore of the Senate (two members).[203] If the FEC members were officers, this method violated the Appointments Clause, because the two members of the Congress were not among the three

193. *Id.* at 2052; Freytag v. Comm'r., 501 U.S. 868, 880–81 (1991).
194. *Lucia*, 138 S. Ct. at 2051.
195. *Id.* at 2052; *Freytag*, 501 U.S. at 881.
196. *See* United States v. Germaine, 99 U.S. 508 (1879).
197. *See* Buckley v. Valeo, 424 U.S. 1 (1976).
198. *See Lucia*, 138 S. Ct. at 2051.
199. *Germaine*, 99 U.S. at 508–09.
200. *Id.* at 509.
201. *See id.* at 512.
202. *Id.*
203. Buckley v. Valeo, 424 U.S. 1, 2 (1976).

categories of those who may nominate officers (U.S. President, courts of law, or heads of departments).[204] The Court held that "any appointee exercising significant authority pursuant to the laws of the United States is an 'Officer of the United States.'"[205] The Court's exposition of this point was largely limited to stating that FEC commissioners must be characterized as at least "inferior Officers" if, as was the case, postmasters and district court clerk were.[206] The Court also provided this analysis:

> "Officers of the United States" does not include all employees of the United States, but there is no claim made that the Commissioners are employees of the United States rather than officers. Employees are lesser functionaries subordinate to officers of the United States, whereas the Commissioners, appointed for a statutory term, are not subject to the control or direction of any other executive, judicial, or legislative authority.[207]

The Court separately analyzed the powers of the FEC and divided them into three categories:

> [1] functions relating to the flow of necessary information receipt, dissemination, and investigation; [2] functions with respect to the Commission's task of fleshing out the statute rulemaking and advisory opinions; and [3] functions necessary to ensure compliance with the statute and rules informal procedures, administrative determinations and hearings, and civil suits.[208]

It held that the first category of duties, "falling in the same general category as those powers which Congress might delegate to one of its own committees," did not violate the Appointments Clause.[209] As to each of the other two categories, however, the Court found them to "represent[ ] the performance of a significant governmental duty exercised pursuant to a public law;"[210] thus, the method of appointing FEC members violated the clause. The second of the three categories of powers is vested in the MSRB.

Two lower court pre-*Lucia* cases may also provide useful guidance. In *Tucker v. Commissioner of Internal Revenue*,[211] the D.C. Circuit, focusing on "(1) the significance of the matters resolved by the officials, (2)

204. *See id.* at 5 (citing U.S. CONST. art. 2, § 2, cl. 2).
205. *Id.* at 126.
206. *Id.*
207. *Id.* at 126 n.162 (internal citations omitted).
208. *Id.* at 137.
209. *Id.*
210. *Id.* at 138–41.
211. 676 F.3d 1129 (D.C. Cir. 2012).

the discretion they exercise in reaching their decisions, and (3) the finality of those decisions,"[212] held that Internal Revenue Service ("IRS") personnel involved in handing appeals and collections ("Appeals" personnel) were not officers. The court concluded that "we can assume here that the issue of a person's tax liability is substantively significant enough to meet factor (1),"[213] but the actual authority of the personnel in question was cabined:

> The office is authorized to compromise disputed tax liability on the basis of its probabilistic estimates of the hazards of litigation. Thus, if Appeals estimates that the IRS's chances of prevailing on a disputed point of law are 60%, it may agree to accept only 60% of the liability that turns on the point.[214]

Moreover, in making decisions, "[the office of] Appeals is subject to consultation requirements, to guidelines, and to supervision."[215]

Likewise, *United States v. Cisneros*[216] involved an Appointments Clause challenge to deputies to and associates of an independent counsel, who appointed them.[217] The court held that the deputies and associates were employees, not "officers," because they were not appointed pursuant to a federal statute, there was no statutory definition of their duties, and "the ultimate prosecutorial decisions still rest with the Independent Counsel himself."[218]

The upshot of these cases is that there are no bright-line standards for determining whether someone is an officer, rather than an employee, and therefore must be appointed in conformity with the Appointments Clause.[219] The common elements of an officer appear to be (a) that the tenure be continuous (at least for a period of time), (b) that the duties involve the exercise of discretion, (c) that the duties involve relatively important decisions on behalf of the Government, and (d) that the performance of these

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212. *Id.* at 1133; *see also* Lucia v. SEC, 138 S. Ct. 2044, 2052–53 (2018) (stating that the first two criteria were later approved of in *Lucia*, but the Court read *Freytag* as "explicitly reject[ing the] theory that final decisionmaking [sic] authority is a *sine qua non* of officer status."); Bandimere v. SEC, 844 F.3d 1168, 1183–84 (10th Cir. 2016), *cert. denied sub nom.* SEC v. Bandimere, 138 S. Ct. 2706 (2018) ("Final decision-making power is relevant in determining whether a public servant exercises significant authority. But that does not mean *every* inferior officer *must* possess final decision-making power. *Freytag*'s holding undermines that contention.").

213. *Tucker*, 676 F.3d at 1133.

214. *Id.* at 1134.

215. *Id.*

216. United States v. Cisneros, 26 F. Supp. 2d 13, 22 (D.D.C. 1998).

217. *Id.* at 22.

218. *Id.* at 24.

219. *See Tucker*, 676 F.3d at 1133; *Cisneros*, 26 F. Supp. 2d at 24.

duties is not subject to extensive supervision by a superior official.[220]

The MSRB's role, unlike the FEC's, is limited to rule-making, but that is one of the powers of the FEC that resulted, in *Buckley*, in a finding that the method of appointing four of the FEC's members was unconstitutional.[221] Congress entrusted rule-making authority to the MSRB over an important segment of the securities markets. Its members serve for continuous terms. By definition, promulgating rules involves the exercise of discretion. The SEC must approve MSRB rules, but its members are not subject to detailed "supervision" by the SEC. These factors are likely enough to qualify MSRB members (if the MSRB is deemed for constitutional purposes to be a public entity) as officers, not employees. Since new MSRB members are appointed by existing members — and not the President, the courts, or the head of a department — this conclusion would mean that the method of appointing MSRB members violates the Appointments Clause.

VI. DOES THE WAY IN WHICH THE MSRB'S MEMBERS CAN BE REMOVED VIOLATE THE CONSTITUTION?

At the other end of the spectrum from the power of appointment is the power to remove. Assuming, again, that, despite its form, the MSRB is a public entity, this requires deciding whether the procedure for removal of MSRB Board members is unconstitutional.

In *Free Enterprise Fund v. Public Company Accounting Oversight Board*,[222] the Court held the procedure for removal of members of the Public Company Accounting Oversight Board ("PCAOB")[223] was an unconstitutional infringement on the President's responsibilities.[224] PCAOB members, whom the Court held were "officers of the United States," were removable only by the SEC — and then for what the Court described as "an unusually high standard that must be met before Board members may be removed," *i.e.*, "willful violations of the Act, Board rules, or the securities laws; willful abuse of authority; or unreasonable failure to enforce compliance."[225] The Court found that members of the SEC may not be removed by the President except for cause.[226] The Court then characterized

220. *See Tucker*, 676 F.3d at 1133; *Cisneros*, 26 F. Supp. 2d at 24.

221. Buckley v. Valeo, 424 U.S. 1 (1976).

222. 561 U.S. 477, 503 (2010).

223. Created by Congress, the PCAOB is *"*charged with enforcing the Sarbanes–Oxley Act, the securities laws, the Commission's rules, its own rules, and professional accounting standards." *Id.* at 485.

224. *Id.* at 484.

225. *Id.* at 503.

226. *Id.*

this contraption as "dual for-cause limitations on the removal of [PCAOB] Board members."[227] Given that the President has no direct role in the appointment or removal of MSRB members, who may be removed by the SEC for essentially the same level of "cause" for which PCAOB members may be removed, [228] does the holding in *Free Enterprise* dictate the same conclusion with respect to the MSRB?

The Constitution provides that "[t]he executive Power shall be vested in a President,"[229] who must "take Care that the Laws be faithfully executed . . . ." The Supreme Court has recognized that "[t]he vesting of the executive power in the President was essentially a grant of the power to execute the laws. But the President alone and unaided could not execute the laws. He must execute them by the assistance of subordinates."[230] And, concomitant with the power to execute the law through others came the power to appoint these subordinates and the power to remove them:

> As he is charged specifically to take care that they be faithfully executed, the reasonable implication, even in the absence of express words, was that as part of his executive power he should select those who were to act for him under his direction in the execution of the laws. The further implication must be, in the absence of any express limitation respecting removals, that as his selection of administrative officers is essential to the execution of the laws by him, so must be his power of removing those for whom he cannot continue to be responsible.[231]

Nevertheless, the Court has recognized limits on the doctrine that the President must have the unfettered authority to remove subordinate officials, *i.e.*, without cause.[232]

As noted, the holding in *Free Enterprise* was based on the Court's finding that the President may not remove SEC Commissioners except for cause.

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227. *Id.* at 492.

228. *Compare* 15 U.S.C. § 7217 (d)(3) (2018) (establishing criteria for removal of PCAOB members), *with* 15 U.S.C. § 78o-4(c)(8) (establishing criteria for removal of MSRB members).

229. U.S. CONST. art. II, § 1, cl. 1.

230. Myers v. United States, 272 U.S. 52, 117 (1926) (explaining that an Act of Congress requiring Senate consent to President's removal of postmaster violated the Constitution's vesting of that power in President).

231. *Id.*

232. *See, e.g.,* Morrison v. Olson, 487 U.S. 654, 696–97 (1988) (holding that both sustained similar restrictions on power of principal executive officers, responsible to President — to remove their own inferiors); Humphrey's Executor v. United States, 295 U.S. 602, 632 (1935) (permitting elimination of President's authority to remove independent agencies' members without cause); United States v. Perkins, 116 U.S. 483, 484 (1886).

But the statute creating the SEC is silent on removal of Commissioners[233] and the Court, in *Free Enterprise*, performed no analysis of that issue, basing its analysis and holding on the parties' agreement.[234] This was one of the bases of a vigorous dissent from Justice Breyer.[235] It was unquestionably a thin reed on which to lean a judicial determination that the PCAOB statute is unconstitutional.[236]

Nevertheless, in *Free Enterprise*, at least, the parties' agreement sufficed to prove the basis for the Court's holding that the arrangements violated the Constitution's separation of powers.[237] Is there a basis to distinguish the removal provisions for the MSRB and that for the PCAOB if, as it appears, the two provisions are substantially identical to each other? A preliminary issue is how the Court would deal this time with the fact that the Exchange Act is silent on the removal of SEC Commissioners. Would the parties stipulate, as the parties did in *Free Enterprise*, that SEC Commissioners are removable only for cause, and, if so, would a future Court accept and rely on that stipulation? If there is no such stipulation or the Court declines to proceed on the basis of a stipulation, would the Court hold on its own analysis that Congress so intended despite its silence on the issue in enacting (and not amending) the Exchange Act? One can only speculate on these

233. 15 U.S.C. § 78d(a).

234. Free Enter. Fund v. Pub. Co. Accounting Oversight Bd., 561 U.S. 477, 487 (2010) (quoting Humphrey's Ex'r v. United States, 295 U.S. 602, 620 (1935)) ("The parties agree that the Commissioners cannot themselves be removed by the President except under the Humphrey's Executor standard of 'inefficiency, neglect of duty, or malfeasance in office,' . . . and we decide the case with that understanding.").

235. *Id.* at 545 (Breyer, J., dissenting) ("How can the Court simply assume without deciding that the SEC Commissioners themselves are removable only 'for cause?' . . . Unless the Commissioners themselves are in fact protected by a 'for cause' requirement, the Accounting Board statute, on the Court's own reasoning, is not constitutionally defective.").

236. Several commentators have questioned the Court's acceptance of a stipulation of law as the basis of the Free Enterprise decision. *See* Note, *The SEC Is Not an Independent Agency*, 126 HARV. L. Rev. 781, 793 (2013) (criticizing the Court for proceeding on the basis of a stipulation of the law and arguing that "interpreted in light of the text, prevailing rules of construction, and legislative history, the 1934 Act made SEC commissioners removable at will."); Gary Lawson, *Stipulating the Law*, 109 MICH. L. REV. 1191, 1195 (2011) (finding that the Court's acceptance of the parties' stipulation is acceptable, if not laudable, but concluding that "Justice Breyer and Samahon have a point," and asking "[i]sn't it the height of judicial activism to declare a federal statute unconstitutional based on quite possibly false assumptions about the state of the law?"); Tuan Samahon, *A Whopper of an Assumption in* Free Enterprise Fund v. PCAOB, CONCURRING OPINIONS (Mar. 8, 2010), https://concurringopinions.com/archives/2010/03/a-whopper-of-an-assumption-in-free-enterprise-fund-v-pcaob.html ("Since when can parties stipulate to different statutory language than that which was duly enacted and the Court go along with it?").

237. *Free Enter. Fund*, 561 U.S. at 492, 498.

questions, but it seems likely that the U.S. will not argue that SEC Commissioners are removable at will.

Let us assume, therefore, that the Court would conclude that SEC members are removable only for cause. Would there be any basis to differentiate the MSRB from the PCAOB? The MSRB has one mandatory function, rulemaking, and one permissive function, "establish[ing] information systems."[238] The PCAOB "promulgates auditing and ethics standards, performs routine inspections of all accounting firms, demands documents and testimony, and initiates formal investigations and disciplinary proceedings."[239] Does the breadth of the PCAOB's authority serve to distinguish it from the MSRB with respect to the application of the holding in *Free Enterprise* to the latter entity? It does not appear so, since the ratio decidendi in that case was limited to the conclusion that the two layers of for-cause removal constituted an unconstitutional limitation on the President's removal power and did not, on its face, depend on the nature or scope of the PCAOB's duties.[240]

But take note of this dictum, appearing immediately after the holding[241] in *Free Enterprise* that the removal provisions of the PCAOB statute are separable from the rest of the statute:

> It is true that the language providing for good-cause removal is only one of a number of statutory provisions that, working together, produce a constitutional violation. In theory, perhaps, the Court might blue-pencil a sufficient number of the Board's responsibilities so that its members would no longer be "Officers of the United States." Or we could restrict the Board's enforcement powers, so that it would be a purely recommendatory panel. Or the Board members could in future be made removable by the President, for good cause or at will. But such editorial freedom—far more extensive than our holding today—belongs to the Legislature, not the Judiciary. Congress of course remains free to pursue any of these options going forward.[242]

We cannot ignore this dictum, but it is not clear what to make of it. The Court speaks of "*a* constitutional violation," but the only constitutional violation found by the Court in *Free Enterprise* was the restriction on the President's removal power.[243] Do the recited statutory provisions offer additional bases, besides the restriction on the President's removal power,

238. 15 U.S.C. 78o-4(b)(3) (2018) (emphasis added).
239. *Free Enter. Fund*, 561 U.S. at 485.
240. *See id.* at 497–98.
241. *Id.* at 508–09.
242. *Id.* at 509–10.
243. *Id.* at 498 (emphasis added).

for finding the statute unconstitutional, and, if so, what are these bases? Or do they simply provide additional grounds for finding the restrictions on removal unconstitutional? It is difficult to answer these questions because of the nature of the cited provisions and the failure of the Court to explain their significance. Thus, the dictum raises the question of whether the MSRB members are "officers of the United States," as the parties in *Free Enterprise* agreed was the case with respect to the members of the PCAOB.[244] However, this issue has traditionally gone not to the removal power but to another issue raised by the petitioner in *Free Enterprise* (and rejected by the *Free Enterprise* Court) — the Appointments Clause of the Constitution,[245] which I discussed, above, in Part V. And of what import is the Court's comment that "we could restrict the Board's enforcement powers, so that it would be a purely recommendatory panel"[246] to the constitutional issue raised in *Free Enterprise* (the restriction on the power of the President to remove PCAOB members)? Logically it would appear none, yet it might bear on whether the MSRB statute violates the Appointments Clause.

In sum, although the MSRB has none of the PCAOB's authority to inspect, investigate and prosecute, these issues do not appear logically relevant to the holding in *Free Enterprise*, but the absence of any explanation for the passage containing this dictum leaves this question unanswered. On balance, it would appear that the holding in *Free Enterprise* would dictate a like result in the case of the MSRB.

VII. REMEDIES

A postscript to this analysis is an exploration of the appropriate remedy were the Court to find the MSRB statute unconstitutional in any respect. I believe that it is impossible to analyze this issue fully without presupposing the specific ground or grounds on which a holding of unconstitutionality might be based. Nonetheless, some tentative conclusions can safely be expressed.

The *Free Enterprise* Court held that the offending provisions could be stripped from the statute without invalidating the entire statute because "[t]he remaining provisions are not 'incapable of functioning independently,' and nothing in the statute's text or historical context makes it 'evident' that Congress, faced with the limitations imposed by the Constitution, would have preferred no Board at all to a Board whose members are removable at will."[247] The Court recognized that determining what Congress would have

244. *Id.* at 477.

245. *See* Buckley v. Valeo, 424 U.S. 1, 125 (1976).

246. *Free Enter. Fund*, 561 U.S. at 509.

247. *Free Enter. Fund*, 561 U.S. at 508–09 (quoting Alaska Airlines, Inc. v. Brock,

done had it not chosen a particular method of removing officials "can sometimes be elusive."[248]

In actuality, the analysis of the appropriate remedy when a statute has been declared unconstitutional is a bit more complicated than the straight-forward analysis described by the majority in *Free Enterprise*.[249] *Ayotte v. Planned Parenthood of N. New England*,[250] on which the Court relied in *Free Enterprise*,[251] involved a challenge to the constitutionality of a state statute requiring pre-abortion notice to the parents of a pregnant minor.[252] The lower courts found the statute unconstitutional for failure to adequately protect the health of the minor and enjoined the statute in its entirety.[253] The Court remanded the case to the Court of Appeals to determine the intent of the State Legislature: whether they intended that the courts could enjoin just the unconstitutional application of the statute and preserve the remaining portions of the statute.[254] The key finding in *Ayotte* was that "[o]nly a few applications of New Hampshire's parental notification statute would present a constitutional problem."[255] For this reason, the Court saw no need to throw out the entire statute, unless, of course, that was the way the legislature wanted it: thus, the remand.[256] Similarly, in *Buckley*, the Court found that portions of the PCAOB's duties did not mandate application of the Appointments Clause, in that they were, in effect, an adjunct to Congress'

480 U.S. 678, 684 (1987)).

248. *Id.* at 509 (quoting INS v. Chadha, 462 U.S. 919, 932 (1983)).

249. *Compare id.* at 508 (quoting Brockett v. Spokane Arcades, Inc., 472 U.S. 491, 504 (1932)) ("[T]he 'normal rule' is 'that partial, rather than facial, invalidation is the required course.'"), *with* Ayotte v. Planned Parenthood of N. New England, 546 U.S. 320, 329–30 (2006) (discussing three interrelated principles inform our approach to remedies: first, do not attempt to nullify more of a legislature's work than is necessary because unconstitutionality frustrates the legislative intent; second, because constitutional mandate and institutional competence are limited, the court is against rewriting state law to make the law constitutional in an effort to salvage it; and, third, remedy is about legislative intent, because a court may not grant a remedy to circumvent the intent of the legislature).

250. 546 U.S. 320 (2006).

251. *Free Enter. Fund*, 561 U.S. at 508.

252. *Ayotte*, 546 U.S. at 332 (holding that "either an injunction prohibiting unconstitutional applications or a holding that consistency with legislative intent requires invalidating the statute in toto should obviate any concern about the Act's life exception").

253. *See Ayotte*, 546 U.S. at 331 (agreeing with New Hampshire that the lower courts need not have invalidated the law wholesale).

254. *Ayotte*, 546 U.S. at 331.

255. *Id.*

256. *Id.*

own core duties.[257] By contrast, what MSRB powers would be left to carve out were the Court to hold that the creation of the agency was constitutionally infirm insofar as it related to the only mandatory authority — rulemaking — vested in the agency? This points to the conclusion that there would be no way to preserve the MSRB on the basis of such a finding.

Another relevant issue, not mentioned in *Free Enterprise*, is whether the statute in question contains a severability clause — stating that if any provision is declared invalid, the remainder remains in effect.[258] The absence of such a clause creates a presumption against severability.[259] The Exchange Act contains a severability provision, which provides: "If any provision of this chapter, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of the chapter and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected thereby."[260] This provision would not appear to reverse the presumption against severability, inasmuch as if the MSRB is held to be unconstitutional under any of the three potential sources of unconstitutionality discussed in this article, it does not appear possible to separate one "provision" of section 78o-4 from another. If the architecture of the MSRB violated the Constitution, then it would appear that the entirety of Congress' action must be voided.

Given that the exact ramifications of a decision that the creation of the MSRB or its architecture violates the U.S. Constitution cannot be predicted without knowing the grounds for such a decision, while I do not intend this summary to be dispositive of the severability issue, I assert that it is not far from a foregone conclusion that, given the differences between the MSRB and the PCAOB, the MSRB would survive under the current legislative scheme.

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257. *See supra* text accompanying notes 198–99.

258. *See* Exchange Act, 15 U.S.C. § 78gg (2018) (noting that the Exchange Act contains a severability provision stating that "if any provision of this chapter, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of the chapter and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected thereby"); *see also* Carter v. Carter Coal Co., 298 U.S. 238, 312 (1936) (determining a relevant issue, not mentioned in *Free Enterprise*, which is whether the statute in question contains a severability clause — stating that if any provision is declared invalid, the remainder remains in effect; ultimately, the Court held that the absence of such a clause creates a presumption against severability).

259. *See Carter*, 298 U.S. at 312 (stating the various ways to determine whether severability was intended including the non-statutory rule, where the burden is upon the supporter of the legislation to show the separability of the provisions involved and the statutory rule, where the burden is shifted to the assailant to show their inseparability).

260. 15 U.S.C. § 78gg.

VIII. CONCLUSION

A serious argument can be made that Congress acted unconstitutionally when it mandated the creation of the MSRB. First, it can be plausibly argued that vesting exclusive authority to promulgate rules in what is, ostensibly, a private entity, is a violation of due process (or, alternatively, a violation of a prohibition against vesting such authority in a private entity). Second, the fact that new members of the MSRB are appointed by its existing members strongly points to a finding of violation of the appointments clause. Third, the decision in *Free Enterprise* holding a "dual for-cause limitations on the removal of Board members" unconstitutional should dictate a comparable result. Finally, the consequences of a decision finding the statutory scheme unconstitutional on any of these three grounds include the very real possibility that the entire statute would be voided. All these issues await judicial interpretation, and, certainly, additional scholarly analysis.

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AMERICAN V. BRITISH RULE: THE IMPACT OF *JAMES G. DAVIS CONSTRUCTION CORP. V. HRGM CORP.* ON FEE-SHIFTING PROVISIONS IN THE MARYLAND AND D.C. AREA

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I. INTRODUCTION

In the United States alone, the legal services industry generated over $250 billion in revenue in 2013 and is projected to generate $280 billion in 2018.[1] Individuals, businesses, and governments pay a significant price in attorneys' fees to make themselves whole again or defend from outside claims.[2] Under the American Rule, win or lose, each party pays its own attorneys' fees.[3] However, under the British Rule, the losing party always pays the prevailing party's attorneys' fees.[4] The United States and Japan are the only countries that follow the American Rule, while the rest of the world follows the British Rule.[5]

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1. *Legal Services Industry in the US – Statistics & Findings*, STATISTA, https://www.statista.com/topics/2137/legal-services-industry-in-the-us/ (last visited Nov. 19, 2018).

2. *See* Christopher Hill, *Reminder: Construction Litigation is Expensive, Be Sure It's Worth It*, CONSTRUCTION L. MUSINGS – RICHMOND, VA (Aug. 19, 2013), http://constructionlawva.com/reminder-construction-litigation-expensive-be-sure-its-worth/.

3. *See, e.g.*, Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 281 (Md. 2008); St. Luke Evangelical Lutheran Church, Inc. v. Smith, 568 A.2d 35, 35 (Md. 1990).

4. *See* Fogerty v. Fantasy, Inc., 510 U.S. 517, 518 (1994); *see also* Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts*, 98 CORNELL L. REV. 327, 337 (2013) (stating that the British Rule may encourage lawsuits by optimistic parties).

5. Thomas D. Rowe, Jr., *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 651 n.1 (1982) (stating that Japan has many restrictions to the American Rule for the prevailing tort plaintiff).

The United States is one of two countries in the world that does not allow the prevailing party to recover attorneys' fees, although parties in the United States contract out of the American Rule sixty-percent of the time.[6] These clauses are known as "fee-shifting" provisions and are hotly debated before signing a contract.[7] Few exceptions apply to the American Rule, but one primary exception — contracting out of the American Rule — will be addressed throughout this comment.[8]

This Comment focuses on fee-shifting provisions in construction contracts and, primarily, on the decision in *James G. Davis Construction Corp. v. HRGM Corp.*[9] because this case deviates from the foundations of the American Rule.[10] This case became even more important after the decisions in *Hensel Phelps Construction Co. v. Cooper Carry Inc.*[11] and *Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Group Limited Partnership, LLLP*.[12] The aforementioned cases establish that when there are two indemnity provisions, one specifying third-party claims and one referring to "any and all claims," the unspecified "any and all" language now includes first-party claims.[13] However, if a defendant wishes to argue the intent of the contract, ambiguity must be found within the contract.[14] With no ambiguity, it is a simple question of fact, not a question of law, and the fact-finder will make the plain language determination of a contract's meaning.[15]

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6. Eisenberg & Miller, *supra* note 4, at 328, 332, 353 (stating that parties contract out of the American Rule more than any other dispute clause at a rate of sixty-percent, while parties contract into arbitration about eleven-percent of the time and contract out of a jury trial about twenty-percent of the time).

7. *See id.* at 330–31 (arguing that what a person does when he or she enters a contract sheds light on what public policy should be because entering into a contract is mutually beneficial and would therefore provide the most social welfare, and because people contract out of the American Rule sixty-percent of the time, maybe the American Rule is not necessary); *Fee-Shifting*, BLACK'S LAW DICTIONARY (10th ed. 2014).

8. *See generally Nova Research, Inc.*, 952 A.2d at 280 (stating that contract clauses allowing payment of the prevailing party's attorneys' fees are generally valid); *St. Luke Evangelical Lutheran Church, Inc.*, 568 A.2d at 39–40 (noting an exception to the American Rule).

9. 147 A.3d 332 (D.C. 2016).

10. *Id.* at 341 (holding for first-party fee-shifting without explicitly stating first-party in the contract provision).

11. 861 F.3d 267 (D.C. Cir. 2017).

12. 164 A.3d 978 (Md. 2017).

13. *See id.* at 979; *Hensel Phelps Constr. Co.*, 861 F.3d at 269; *James G. Davis Constr. Corp.*, 147 A.3d at 340–41.

14. *See* Merriam v. United States, 107 U.S. 437, 441 (1883) (stating that the contract's plain language controls unless there is ambiguity in the contract).

15. Wash. Props., Inc. v. Chin, Inc., 760 A.2d 546, 548 (D.C. 2000) (stating that

To understand fee-shifting provisions, it is necessary to begin with the basics of contract formation, negotiation, and interpretation.[16] It is also imperative to understand the context in which fee-shifting provisions are applied, in this case, within a Joint Venture Agreement ("JVA").[17] Although the D.C. Court of Appeals may have departed from traditional indemnity law jurisprudence, it is crucial to grasp the precedent to understand where courts may go in the future.[18] Finally, in the shadow of *James G. Davis Construction Corp.*, Maryland and D.C. ruled on subsequent cases: *Bainbridge St. Elmo Bethesda Apartments, LLC* and *Hensel Phelps Construction Co.*, portraying that it may not be necessary to explicitly state first-party claims in an indemnity provision to allow for first-party recovery.[19] Therefore, these three cases together provide guidance on indemnity law within Maryland and D.C.

II. FROM FORMATION TO JUDGMENT

A contract's creation, negotiation, performance, and conclusion are all equally important.[20] This section provides foundational elements of contract formation, contract interpretation by courts, JVAs, and indemnity and fee-shifting provisions. It also reviews the relevant Maryland and D.C. case law in the area of fee-shifting.

A. Formation of a Contract

To create a legally binding contract, there must be an offer, consideration, and acceptance of the offer.[21] An offer is defined as a manifestation of intent

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whether a contract is ambiguous is a question of law and the determination is outside that of a jury).

16. Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 283 (Md. 2008) (stating that the plain meaning of a contract is preferred to the court attempting to determine the intent of the parties).

17. *See James G. Davis Constr. Corp.*, 147 A.3d at 341 (stating that under a joint venture agreement parties wish to shift risk and attorney fee-shifting is part of the shifting of risk).

18. *See id.* at 334 (allowing first-party indemnification even though it was not explicitly called for in the contract).

19. *See* Hensel Phelps Constr. Co. v. Cooper Carry Inc., 861 F.3d 267, 269 (D.C. Cir. 2017); Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Grp. L.P., 164 A.3d 978, 979 (Md. 2017).

20. Cochran v. Norkunas, 919 A.2d 700, 708–09 (Md. 2007) (citing Teachers Ins. & Annuity Ass'n v. Tribune Co., 670 F. Supp. 491, 499–503 (S.D.N.Y. 1987)) (holding that all of these components are necessary to avoid an invalid contract).

21. *See id.* at 708; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 24 (AM. LAW INST. 1981) (stating that an offer to the terms of a contract invites the offeree to bind the offeror to the terms stated in the contract); *id.* § 50 (stating that an "[a]cceptance of an

to be bound to the terms of an agreement.[22] For valid consideration, the terms of the contract must be bargained for.[23] An acceptance of an offer may be done in any way specified by the offer,[24] but there must be mutual assent to the terms of the contract.[25]

Mutual assent is comprised of two main elements: (1) intent that parties be bound, and (2) the contract terms.[26] A contract does not require the intent to be bound to be legally binding, but expressly stating that a contract is not legally binding will prevent the formation of a contract.[27] A contract must specify the definiteness of the terms to the contract, meaning a contract must state what each party to the contract is responsible for accomplishing.[28] However, if the parties fail to agree on all of the contract's essential terms the contract may be void, especially if the parties did not intend to be bound until all essential terms of the contract were agreed upon.[29]

B. Contract Interpretation in Maryland and D.C.

Courts in Maryland and D.C. apply an objective interpretation to contracts: if no ambiguity exists in the contract, the court will apply the plain meaning of the contractual terms[30] and interpret the contract as a reasonably prudent person would.[31] Ambiguity does not arise because two parties differ on the meaning of a contract or a specific contract provision, but the court must decide whether a term or provision is subject to more than one reasonable interpretation.[32] To interpret a contract, courts will look to the

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offer is a manifestation of assent to the terms" of the contract).

22. *See* RESTATEMENT (SECOND) OF CONTRACTS § 24; *see id.* § 24 cmt. a (explaining that an acceptance of the offer will bind with offeree without further action).

23. *See id.* § 71 cmt. c (requiring both parties to benefit from the contract, but not necessarily to the same extent).

24. *Id.* § 30.

25. *See Cochran*, 919 A.2d at 713; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 18.

26. *Cochran*, 919 A.2d at 708.

27. RESTATEMENT (SECOND) OF CONTRACTS § 21.

28. *Cochran*, 919 A.2d at 708.

29. *See id.*; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 27.

30. Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 283 (Md. 2008) (citing Diamond Point Plaza L.P. v. Wells Fargo Bank, N.A., 929 A.2d 932, 951 (Md. 2007)) (stating that an objective interpretation of contracts applies the plain meaning of the contract terms when no ambiguity exists with the terms); Rivers & Bryan, Inc. v. HBE Corp., 628 A.2d 631, 635 (D.C. 1993).

31. *Cochran,* 919 A.2d at 710 (citing Walton v. Mariner Health, 894 A.2d 584, 594 (Md. 2006)).

32. *Diamond Point Plaza L.P.*, 929 A.2d at 952.

words of the contract in its entirety,[33] and the court will not sever any part of the contract unless no other course of action would be sensible.[34] Additionally, the court will not look outside the plain language of contract formation without ambiguity.[35]

If contract language is ambiguous, the courts must determine the intent of the parties.[36] A contract is ambiguous if, when looking at the plain language of the contract, a reasonable person could conclude more than one meaning of that contract.[37] If determined to be ambiguous, the contract will be interpreted against the drafter.[38] Additionally, industry specific and defined terms within a contract are given greater weight in contract interpretation than generic and general language.[39] When ambiguity arises, the courts must determine the intent of the parties and to do so, courts may look not only to the terms of the contract, but also to "the subject matter and surrounding circumstances."[40]

C. Joint Venture Agreements

A JVA is an agreement between two or more parties where the parties combine resources to achieve the terms of the contract.[41] Under the agreement, the total amount of property, money, or skill that is contributed by each party is generally split evenly, but different percentages can be determined by the agreement.[42] While a party may be contractually required to perform or provide for a certain percentage of a contract, it is impossible to determine the actual amount of property, money, or skill that was provided by a specific party.[43] While the duties of an agreement may be divided, each

33. *Nova Research, Inc.*, 952 A.2d at 283.

34. Sagner v. Glenangus Farms, Inc., 198 A.2d 277, 283 (Md. 1964) (explaining that, if a contract provision is illogical or senseless in the context of the entire contract, a court can read out that contract provision).

35. Dyer v. Bilaal, 983 A.2d 349, 354–55 (D.C. 2009).

36. *Id.* at 355.

37. Cochran v. Norkunas, 919 A.2d 700, 710 (Md. 2007).

38. Martin & Martin, Inc. v. Bradley Enters., Inc., 504 S.E.2d 849, 851 (Va. 1998) (stating that wherever ambiguity arises, it must be interpreted against the drafter of the contract).

39. RESTATEMENT (SECOND) OF CONTRACTS § 203(c) (AM. LAW INST. 1981).

40. Merriam v. United States, 107 U.S. 437, 441 (1883) (stating that surrounding circumstances can help shed light on the intent of the parties at the time the contract was entered into).

41. RICHARD W. MILLER, JOINT VENTURES IN CONSTRUCTION 1 (3d ed.) https://suretyinfo.org/pdf/JointVentures.pdf (last visited June 12, 2018) (stating that the resources the parties combine may include property, money, skill, or knowledge).

42. *Id.*

43. *Id.*

party to the joint venture is liable for the entirety of the contract; if one party defaults, the other parties must complete the project.[44]

Despite the potential liability arising from JVAs, they come with several advantages.[45] A JVA allows contractors to spread out risk, combine specialized abilities, and increase bid accuracy.[46] It may also allow a contractor to bid projects bigger than its capacity, and, most importantly, allow contractors to pool talent, resources, and financing.[47]

Three prominent types of JVAs include an integrated joint venture, non-integrated joint venture, and a combination joint venture.[48] An integrated joint venture is typically used when the parties involved have a strong relationship and the project is non-linear.[49] A non-integrated joint venture is typically used where there is a limited relationship between the parties and the work has a definite scope.[50] Slightly different in its creation, a combination joint venture is used when one party has more property, money, or skill than the other party or parties and where the project is large and complex.[51]

D. Indemnity and Fee-Shifting Provisions

Indemnity provisions are common in many contracts and shift the liability from one party to another.[52] Indemnification can generally cover two types of claims: first-party claims and third-party claims.[53] A first-party claim involves a claim from a party that is involved with the contract, while a third-party claim involves a party not privy to the base contract between the first

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44. *Id.*

45. *Id.*

46. Ms. Kale, V.V. et al., *Joint Venture in Construction Industry*, J. MECHANICAL & CIV. ENGINEERING, 60–61 (2017), http://www.iosrjournals.org/iosr-jmce/papers/sicete (civil)-volume3/36.pdf (last visited June 12, 2018).

47. *Id.*

48. *See id.* (presenting two other types of JVAs: (1) an equity joint venture where two or more parties create a new corporate entity, each gaining an owning portion of equity; and (2) a contractual joint venture where there is no equity participation between the parties and the agreement is completely governed by contracts).

49. *Id.* at 60.

50. *Id.*

51. *See id.* at 60–61 (stating that a combination joint venture agreement is appropriate when one party is particularly good at a certain aspect of the project and the other party is able to handle the general aspects of the project).

52. Peter Fabrics, Inc. v. S.S. Hermes, 765 F.2d 306, 316 (2d Cir. 1985) ("Indemnity obligations, whether imposed by contract or by law, require the indemnitor to hold the indemnitee harmless from costs in connection with a particular class of claims.").

53. Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 286 (Md. 2008) (citing Peter Fabrics, Inc. v. S.S. Hermes, 765 F.2d 306, 316 (2d Cir. 1985)).

parties.[54] Therefore, a first-party claim involves a claim with someone who has contract privity; while a third-party claimant does not have contract privity with both parties to the original contract.[55]

Fee-shifting provisions, or indemnification, may greatly impact pre-litigation decision-making because of the costs associated with litigation.[56] Therefore, there are six general theories surrounding fee-shifting provisions.[57] First, fee-shifting provisions provide fairness through the Rule of Indemnity.[58] Second, fee-shifting provisions provide compensation for the legal injury or the lawsuit.[59] Third, fee-shifting can be used punitively.[60] Fourth, private attorneys generally argue that lawsuits are for the benefit of society as a whole, and it should not matter who bears the cost of attorneys' fees because the lawsuit's outcome benefits the whole.[61] Fifth, involving the relevant strength of the parties involved, deals with cases that have one party with significantly more resources than the other party.[62] Sixth, the economic incentives theory deals with the decision making process to engage in litigation or settle the suit.[63] While there are many theories on fee-shifting provisions, the courts have adopted the American Rule; a policy decision to provide the greatest societal impact by having each party pay its attorneys' fees, unless otherwise provided for by contract.[64]

The two legal rules for fee-shifting provisions and attorney's fees indemnification are the American Rule and the British Rule.[65] Under the American Rule, the prevailing party may never recover attorneys' fees unless:

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54. *See id.* at 287–88.

55. *Id.* (claiming that a subcontractor is one example of a third-party claimant).

56. Rowe, *supra* note 5, at 653.

57. *Id.*

58. *Id.* at 653–54 (claiming that the prevailing party, having been in the right, should not have to pay to fees associated with the lawsuit).

59. *Id.* at 657–58 (stating that making the loser pay the winners attorneys' fees goes to putting the winner in the position they would have been in without the lawsuit).

60. *Id.* at 660 (stating that this fee-shifting is based on unjustifiable or undesirable behavior, and providing the prevailing party with attorneys' fees makes the undesirable behavior more expensive.).

61. *Id.* at 662 (providing that lawsuits that benefit society should be encouraged, and therefore the prevailing party should recover fees for such suits).

62. *Id.* at 663–64 (proposing the idea that leveling the playing field in litigation is sometimes necessary to come to a just outcome).

63. *Id.* at 665–66 (suggesting that economic incentives are necessary to increase or decrease the number of cases that are litigated).

64. Fogerty v. Fantasy, Inc., 510 U.S. 517, 533 (1994) (stating that parties are generally responsible for their own attorneys' fees).

65. Eisenberg & Miller, *supra* note 4, at 328–29.

> (1) [T]he parties to a contract have an agreement to that effect, (2) there is a statute that allows the imposition of such fees, (3) the wrongful conduct of a defendant forces a plaintiff into litigation with a third party, or (4) a plaintiff is forced to defend against a malicious prosecution.[66]

This is deeply rooted in the common law, and therefore, the United States Supreme Court will not deviate from the American Rule.[67] However, a court may award attorneys' fees at its discretion, as justice requires.[68] The American Rule stands in stark contrast to the British Rule.[69] Under the British Rule the court automatically awards attorneys' fees to the prevailing party.[70]

E. Prior Precedent — Redundant? Maybe Not

On October 6, 2016, in *Bainbridge St. Elmo Bethesda Apartments, LLC*, the D.C. Court of Appeals upheld the trial court's decision that an indemnity provision did not expressly call for the recovery of first-party attorneys' fees, but instead stated the terms "all claims," which the court interpreted to include first-party fees.[71] While the D.C. courts were interpreting Maryland law in *James G. Davis Construction Corp.*, Maryland later adopted D.C.'s *James G. Davis Construction Corp.* holding in *Bainbridge St. Elmo Bethesda LLC* and solidified it as good law.[72]

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66. St. Luke Evangelical Lutheran Church, Inc. v. Smith, 568 A.2d 35, 39 (Md. 1990); *see also* Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 281 (Md. 2008) (reinforcing the American Rule applied in *St. Luke Evangelical Lutheran Church, Inc.*).

67. Baker Botts L.L.P. v. ASARCO LLC, 135 S. Ct. 2158, 2164 (2015); Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247, 271 (1975) ("[The American Rule] is deeply rooted in our history and in congressional policy; and it is not for us to invade the legislature's province by redistributing litigation costs in the manner suggested by respondents and followed by the Court of Appeals.").

68. Hall v. Cole, 412 U.S. 1, 5 (1973) (stating that justice may require the awarding of attorneys' fees when opposing party has acted with the purpose of oppression or in bad faith).

69. Fogerty v. Fantasy, Inc., 510 U.S. 517, 518 (1994) (stating that under the American Rule each party is responsible for their own attorneys' fees while under the British Rule, the prevailing party recovers attorneys' fees).

70. *Id.*

71. James G. Davis Constr. Corp., v. HRGM Corp., 147 A.3d 332, 340 (D.C. 2016).

72. *See* Bainbridge St. Elmo Bethesda LLC v. White Flint Exp. Realty Grp. L.P., 164 A.3d 978, 979 (Md. 2017) (citing James G. Davis Constr. Corp., v. HRGM Corp., 147 A.3d 332, 340–41) ("[C]oncluding that the plain language of an indemnification provision containing an express reference to attorneys' [sic.] fees and an unqualified reference to any breach, allowed for first-party fee shifting." (internal quotations omitted)).

1. Atlantic Contracting & Material Co. v. Ulico Casualty Company

In *Ulico Casualty Company*[73] a surety was able to recover first-party attorneys' fees because the court found that, in the context of sureties, it is common practice to recover first-party attorneys' fees. Ulico Casualty Company ("Ulico"), a surety company, issued a performance and surety bond to Atlantic Contracting & Material Company ("Atlantic") guaranteeing Atlantic's performance on a road repair project.[74] Atlantic failed to pay for equipment repair from Clearwater Hydraulics and Driveshaft Services ("Clearwater"), and Clearwater, together with Ulico, filed a claim for payment.[75] Ulico filed a claim against Atlantic seeking all costs paid to Clearwater, as well as the attorneys' fees incurred pursuing the indemnification claim against Atlantic.[76] The indemnification agreement within the performance and surety bond read that Atlantic "indemnif[ied] [Ulico] from and against any and all Loss," and further defined loss to mean "any and all damages, costs, charges, and expenses of any kind" and allowed for the recovery of attorneys' fees.[77]

The Maryland Court of Appeals provided that "it is standard practice for surety companies to require contractors for whom they write bonds to execute indemnity agreements by which principals and their individual backers agree to indemnify sureties against any loss they may incur as a result of writing bonds on behalf of principals."[78] The court of appeals accepted the trial court's reasoning that "[i]ndemnity agreements of this kind are interpreted generally to *entitle the surety* to recover fees, costs, and expenses incurred in enforcing them."[79] Therefore, the court found that Ulico was entitled to reasonable attorneys' fees under the language in the indemnification agreement because, in the context of a surety, it would be senseless for a surety to enter into a contract in which the surety lacks the ability to make itself whole if a contractor defaults on the surety bond.[80]

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73. 844 A.2d 460 (Md. 2004).

74. *Ulico Cas. Co.*, 844 A.2d at 463; *see also id.* at 468 (stating that "a surety bond is a three-party agreement between a principal obligor, an obligee, and a surety," and that under this agreement a surety guarantees the obligee the performance of the contract if the principal fails to perform).

75. *Id.* at 463.

76. *Id.*

77. *Id.* at 469.

78. *Id.* at 468.

79. *Id.* at 478 (emphasis added).

80. *Id.* at 468, 479.

2. Nova Research, Inc. v. Penske Truck Leasing Co., L.P.

Nova Research, Inc. ("Nova Research") leased a tractor and trailer from Penske Truck Leasing Company ("Penske").[81] The rental agreement provided that Penske would provide liability insurance to Nova Research.[82] Nova Research further agreed to "indemnify, and hold harmless Penske, its partners, and their respective agents . . . from and against all loss, liability and expenses caused or arising out of [Nova Research's] failure to comply with the terms of this Agreement."[83] The agreement further defined loss as "[a]ny and all damages, costs, charges, and expenses of any kind, sustained or incurred by [the indemnified party] in connection with or as a result of: (1) the furnishing of any Bonds; and (2) the enforcement of this Agreement."[84]

On May 24, 2002, the rented truck was involved in a fatal car accident where both drivers were killed.[85] Nova Research breached the rental agreement because the person driving the truck was not a registered driver with Penske.[86] Therefore, Penske filed a claim, enforcing the agreement against Nova Research for all costs associated with the wrongful death claim.[87] The court held that Penske was not entitled to attorneys' fees for enforcing the agreement (the first-party claim), but was entitled to attorneys' fees for defending against the third-party wrongful death action.[88] The court declined to extend an exception to the American Rule when a contract reads "no express provision for recovering attorney's fees in a first-party action establishing the right to indemnity."[89] Allowing this exception would destroy the American Rule and the British Rule would quickly take over.[90]

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81. Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 278 (Md. 2008).

82. *Id.* (stating that the agreement provided that "[Penske] shall, at its sole cost, provide liability protection for Customer and any operator authorized by Penske, and no others. . . .").

83. *Id.* at 279 (explaining that Penske wished to provide insurance up to a certain point, but for Nova Research to indemnify Penske if Nova Research did not comply with the terms of the agreement).

84. *Id.* at 283.

85. *Id.* at 279.

86. *Id.* at 281.

87. *Id.* at 442.

88. *Id.* at 286 (holding that "a contract provision must call for fee recovery expressly for establishing the right to indemnity in order to overcome the application of the American Rule.").

89. *Id.* at 285 (citing Jones v. Calvin B. Taylor Banking Co., 253 A.2d 742, 748 (Md. 1969)).

90. *Id.* at 285 ("If we were to imply a fee-shifting provision for first party actions, even where the contract does not permit one expressly, the exception would swallow the

F. The New Wave of Indemnity

On October 6, 2016, the D.C. Court of Appeals upheld the trial court's decision that an indemnity provision included first-party fees even though it did not expressly call for the recovery of first-party attorneys' fees, but instead included the terms "all claims" which included first-party fees.[91] While the Court in *James G. Davis Construction Corp.* shifted away from the traditional American Rule, the courts in *Bainbridge St. Elmo Bethesda Apartments LLC* and *Hensel Phelps Construction Co.* solidified this shift away from the American Rule.[92]

1. James G. Davis Construction Corp. v. HRGM Corp.

The court in *James G. Davis Construction Corp.* allowed recovery of first-party attorneys' fees when the contract did not specifically call for the recovery of first-party attorneys' fees.[93] In August 2002, commercial construction companies James G. Davis Construction Company and HRGM Corporation entered a JVA to renovate McKinley Technical High School.[94] The agreement was set up as a combination joint venture, with Davis as the managing venturer.[95] The project was completed in 2006 and was valued at over $53 million.[96] HRGM raised several issues about Davis's management of the project and when Davis sent HRGM a letter stating that HRGM owed the joint venture over $100,000 in unpaid capital contributions, HRGM filed suit "alleging claims for breach of contract, breach of fiduciary duty, and a full and complete accounting."[97] The trial court found for HRGM.[98] The issue on appeal was whether the indemnification clauses in the JVA were contradictory, ambiguous or rather expressly stated for the recovery on first-

rule, and the presumption of the American rule disallowing recovery of attorney's fees would, in effect, be gutted.").

91. James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 334, 340, 342 (D.C. 2016).

92. Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Grp. L.P., 164 A.3d 978, 986 n. 6 (Md. 2017); Hensel Phelps Constr. Co. v. Cooper Carry Inc., 861 F.3d 267, 272 (D.C. Cir. 2017).

93. *James G. Davis Constr. Corp.*, 147 A.3d at 334.

94. *Id.*

95. *Id.* at 334 (stating that Davis was responsible for eighty percent of the project and eighty percent of the profits while HRGM was responsible for twenty percent of the project and twenty percent of the profits).

96. *Id.* at 335.

97. *Id.*

98. *See id.* at 335–36 (providing a standard punitive damages jury instruction, which allowed the jury to consider any attorneys' fees that have incurred in the case and which ultimately led the jury to award HRGM $5,056 in compensatory damages, $70,500 in punitive damages, $736,152.76 in attorneys' fees, and $39,344.67 in costs).

party claims. In a post-trial motion, HRGM requested $808,692.50 in attorneys' fees and $75,530.29 in costs based on Article XXI of the JVA.[99]

The two relevant indemnity provision sections were Articles XXI (contested) and XVI (uncontested).[100] Article XVI stated that the parties agreed to indemnify each other for the "loss or losses directly connected with the performance of the Construction Contract."[101] Both parties agreed that Article XVI only applied to the third-party claims.[102]

On appeal, the court held that Article XXI extended to first-party claims because of the unqualified language of "any breach" in Article XXI and the language of Article XVI applying only to third-party claims.[103] The court reasoned that this fact-pattern was more analogous to *Atlantic Contracting & Material Co.* than *Nova Research, Inc. v. Penske Truck Leasing Co.*[104] because (1) Article XXI included broad language; (2) Davis breached the JVA; and (3) the language "any and all" claims was included.[105] Therefore, the court held Davis responsible for the attorneys' fees.[106]

The trial court reduced HRGM's attorneys' fee request by $70,000 because the jury may have considered attorneys' fees in its punitive damages award. The goal in awarding punitive damages was to produce an award that would punish Davis's conduct.[107] Having found no reversible error, the court of appeals held that because the JVA used broad language and a specific third-party only provision, Davis was responsible for the attorneys' fees incurred by HRGM.[108]

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99. *Id.* at 336.

100. *Id.* at 341.

101. *Id.* at 340.

102. *Id.* at 341.

103. *Id.* at 340–41.

104. Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275 (Md. 2008).

105. *James G. Davis Constr. Corp.,* 147 A.3d at 348; *Nova Research, Inc.*, 952 A.2d at 275 (holding that a defendant may not be responsible for attorneys' fees when the plaintiff is establishing the right to indemnity); Atl. Contracting & Material Co. v. Ulico Casualty Co., 844 A.2d 460, 477 (Md. 2004) (stating that the breaching party may be responsible for attorneys' fees when the breaching party breaches the contract that included a provision for fees).

106. *James G. Davis Constr. Corp.*, 147 A.3d at 348.

107. *Id.* at 337, 339 (stating that Davis contended that the court erred in granting the post-trial motion because the jury considered attorneys' fees in the punitive damages award, and that HRGM was required to prove attorneys' fees as an element of damages and they failed to do so).

108. *Id.* at 340–41, 343, 348.

2. Hensel Phelps Construction Co. v. Cooper Carry Inc.

In *Hensel Phelps Construction Co.*, the D.C. Court of Appeals held that, because the JVA's indemnification provision did not specifically address first-party claims, the agreement did not encompass first-party claims.[109] D.C. applies an objective interpretation of a contract and the terms of the contract, if unambiguous, govern the rights of parties.[110] Therefore, a contract must be interpreted as a whole — "giving effective meaning to all its terms."[111] Specifically, the D.C. Court of Appeals applies a strict construction of indemnification clauses, as to avoid "any obligations which the parties never intended to assume" while still applying an objective interpretation to achieve the parties intent of the contract terms.[112]

HQ Hotels acquired all rights and responsibilities from Marriott, and entered into a design build agreement with Hensel Construction, which fully encompassed the original contract between Marriott and Cooper Carry.[113] The relevant fee-shifting provision — which Cooper Carry acknowledged — read:

> Marriott may sustain financial loss for which [Cooper Carry] may be liable if the Project or any part thereof is delayed because [Cooper Carry] negligently fail[ed] to perform the Services in accordance with this agreement, including, but not limited to, the Schedule.[114]

Cooper Carry also agreed to indemnify Marriott (including attorneys' fees) as "a result of, in connection with, or as a consequence of Cooper Carry's performance of the Services under this agreement."[115] Thus, Hensel was assigned the contract.[116]

The court reasoned that, even though the language of the indemnification provision was broad, it did not specifically include first-party claims or appear to intend first-party claims, and therefore the provision did not expand to first-party claims.[117] The court noted the holding in *James G. Davis Construction Corp.*:

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109. Hensel Phelps Constr. Co. v. Cooper Carry Inc., 861 F.3d 267, 275 (D.C. Cir. 2017).

110. *Id.*

111. *Id.* (citing Carlyle Inv. Mgmt. L.L.C. v. Ace Am. Ins. Co., 131 A.3d 886, 894–95 (D.C. 2016)).

112. Am. Bldg. Maint. Co. v. L'Enfant Plaza Props., 655 A.2d 858, 861 (D.C. 1995).

113. *Hensel Phelps Constr. Co.*, 861 F.3d at 270–71 (stating that the original contract was converted into a design build contract).

114. *Id.* at 270.

115. *Id.*

116. *Id.* at 270–71.

117. *Id.* at 275.

> [R]eading an indemnification clause covering 'any and all costs and expenses' to reach first-party claims by looking to a second indemnification clause protecting only against 'loss or losses directly connected with the performance of the Construction Contract' and reasoning the parties purposely chose a broader formulation for the clause at issue.[118]

The court, citing specifically to *James G. Davis Construction Corp.*, adopted *James G. Davis Construction Corp.*'s holding in the state of Maryland.

3. Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Group Limited Partnership, LLLP

The Maryland Court of Special Appeals held that the indemnity provision expressly provided for attorneys' fees in a first-party indemnification action.[119] The issue on appeal was whether the court undermined the clarity in *Nova Research* regarding the limited circumstances where a contractual indemnity provision is read as a first-party fee-shifting provision, overriding the American Rule.[120] The relevant indemnity provision stated:

> Bainbridge hereby indemnifies, and agrees to defend and hold harmless White Flint . . . from any and all claims, demands, debts, actions, causes of action, suits, obligations, losses, costs, expense, fees, and liabilities (including reasonable attorney's fees, disbursements, and litigation costs) arising from or in connection with Bainbridge's breach of any terms of this Agreement or injuries to persons or property resulting from the Work, or the activities of Bainbridge or its employees, agents, contractors, or affiliates conducted on or about the White Flint Property, including without limitation, for any rent loss directly attributable to any damage to the White Flint Property, caused by the construction of the Project, however Bainbridge shall not be liable for matters resulting from the negligence or intentional misconduct of White Flint, its agents, employees, or contractors. The indemnification obligations set forth herein shall service the termination of this Agreement indefinitely.[121]

The circuit court for Montgomery County read this agreement to include first-party claims because the indemnity provision called for specific damages that could only be first-party claims, and, therefore, all first-party

118. *Id.* (citing James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 340–41 (D.C. 2016)).

119. Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Grp. L.P., 164 A.3d 978, 979, 981 (Md. 2017) (relying on the list of claims in the contract that included claims that could only be first-party claims, e.g. rent loss).

120. *Id.* at 984–85; Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 287 (Md. 2008) (holding there is a significant difference between first- and third-party claims and the recovery of attorneys' fees under each).

121. *Bainbridge St. Elmo Bethesda Apartments, LLC*, 164 A.3d at 981.

claims must be included in interpreting the contract.[122] The court of appeals upheld the court of special appeals' holding and reiterated that this decision does not undermine the clarity provided in *Nova Research* because the indemnity provision in *Bainbridge St. Elmo Bethesda Apartments, LLC* contained express terms whereas the contract in *Nova Research* did not.[123] The court in *Bainbridge St. Elmo Bethesda Apartments, LLC* found that the indemnity agreement expressly provided for attorneys' fees and that payment of those fees was tied to the breach of contract.[124] Therefore, attorneys' fees were paid because there was a breach of contract.[125]

III. THE EXPANSION OF INDEMNITY

The D.C. Court of Appeals, in *James G. Davis Construction Corp.*, misapplied the exceptions to the American Rule that allows the prevailing party to recover attorneys' fees when it is explicitly stated in the contract.[126] The contract should have been interpreted to only include third-party claims because the indemnity provision did not explicitly call for first-party claims.[127] To make sure the court does not place an unintended burden on a party, "contractual attorney's fee provisions must be strictly construed to avoid inferring duties that the parties did not intend to create."[128] A broad interpretation of the provision would go against the well-established public policy that each party is responsible for their own attorneys' fees.[129] This concept is imperative because if courts begin applying contracts improperly,

122. *Id.* at 982 n. 3.

123. *See id.* at 983; *Nova Research, Inc.*, 952 A.2d at 286–88.

124. *Bainbridge St. Elmo Bethesda Apartments, LLC*, 164 A.3d at 986.

125. *Id.* at 983–84.

126. *See* Baker Botts L.L.P. v. ASARCO LLC, 135 S. Ct. 2158, 2164–65 (2015); Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 260 (1975); *Nova Research, Inc.*, 952 A.2d at 281 (stating that, under the American Rule, the prevailing party may never recover attorneys' fees unless: "(1) the parties to a contract have an agreement to that effect, (2) there is a statute that allows the imposition of such fees, (3) the wrongful conduct of a defendant forces a plaintiff into litigation with a third party, or (4) a plaintiff is forced to defend against a malicious prosecution."). *But see* James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 336 (D.C. 2016) (awarding first-party attorneys' fees when the contract did not specially state for the recovery of first-party attorneys' fees).

127. *See James G. Davis Constr. Corp.*, 147 A.3d at 336.

128. *Nova Research, Inc.*, 952 A.2d at 287 (citing ROBERT L. ROSSI, ATTORNEYS' FEES § 9:18 (3d ed. 2002, Cum. Supp. 2007) (stating that courts should not put duties into a contract that the parties did not actually intend when the contract was formed); *see also Baker Botts L.L.P.*, 135 S. Ct. at 2171 (2015) (stating that the Supreme Court will not deviate from the American Rule unless there a contract includes a specific and explicit provision agreeing to the British Rule).

129. *See Baker Botts L.L.P.*, 135 S. Ct. at 2164.

or implying unwarranted duties into the contract, the cost of basic goods and services will increase due to the inevitable litigation driven by the courts' inconsistent interpretations of indemnity provisions.[130] Parties will see an opportunity to either make themselves whole (a valid claim) or gain money or property above and beyond what they are contractually due (an invalid claim).[131]

The dispute resolution clause is important because it will likely impact the outcome of a settlement or litigation: "[s]erious consequences may result from a failure to negotiate the dispute resolution provision of a [JVA]. . . ."[132] Likely, the contractual terms were highly debated prior to signing, and should therefore be given the weight they deserve.[133]

A. Modern Cases Applied to Modern Cases: Confusion

1. James G. Davis Construction Corp. applied to Hensel Phelps Construction Co. v. Copper Carry and Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint

The D.C. Court of Appeals held in *James G. Davis Construction Corp.* that a prevailing party will be granted attorneys' fees, even without expressly calling for first-party fee-shifting, when one indemnity provision calls for awarding attorneys' fees for "any and all claims" and the other provision specifically calls for fee-shifting in third-party claims.[134] While this is a limited holding that narrowly fits within the confines of *Nova Research* the court in *James G. Davis Construction Corp.* moved closer to undermining the meaning of the American Rule by allowing first-party recovery even though first-party recovery was not expressly stated in the contract.[135]

The holding in *James G. Davis Construction Corp.*, applied to *Hensel Phelps Construction Co.*, would not allow fee-shifting for a first-party claim because in the Hensel Phelps-Cooper Carry agreement there was only one

130. *See, e.g.*, Eisenberg & Miller, *supra* note 4, at 335–36 (stating that the English rule increases the risk of additional costs to litigants).

131. *See id.* (stating that litigants could work to avoid paying litigation expenses).

132. Ian A. Laird & Randa Adra, *JV Agreements and the Dispute Resolution Clause: 5 Useful Points to Consider*, INSIDE COUNSEL, (Nov. 19, 2014) https://www.law.com/insidecounsel/2014/11/19/jv-agreements-and-the-dispute-resolution-clause-5/?slreturn=20180008225316.

133. RESTATEMENT (SECOND) OF CONTRACTS § 203(c) (AM. LAW INST. 1981) (stating that specific and exact terms of a contract are given greater weight than that of general terms).

134. James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 341 (D.C. 2016) (stating that if the parties wished to only include third-party claims, then the parties should have used the same language from the third-party only provision).

135. *See id.* at 342.

broad fee-shifting provision where Cooper Carry agreed to indemnify Hensel Phelps (including attorneys' fees) from anything in connection with Cooper Carry's performance of the contract.[136] The court in *Hensel Phelps Construction Co.* reasoned that, even though the indemnification provision was broad, a court could not imply first-party fee-shifting unless it is expressly stated in the contract.[137] This suggests that the two holdings are in conflict with each other. The court in *Hensel Phelps Construction Co.* further limited the holding in *James G. Davis Construction Corp.* when it stated that:

> [A]n indemnification clause covering "any and all costs and expenses" to reach first-party claims by looking to a second indemnification clause protecting only against 'loss or losses directly connected with the performance of the Construction Contract' and reasoning the parties purposely chose a broader formulation for the clause at issue.[138]

In its statement, the court in *Hensel Phelps Construction Co.* suggested that the "any and all" language used in the second indemnification provision in *James G. Davis Construction Corp.*, alone, would not allow for first-party recovery absent a separate indemnification provision that had significantly broader language than the other.[139]

While the contract in *Bainbridge St. Elmo Bethesda Apartments, LLC* provided a list of claims that included first and third-party claims, there was only one indemnification provision.[140] Therefore, the holding in *James G. Davis Construction Corp.* should not apply to *Bainbridge St. Elmo Bethesda Apartments, LLC* because the *Hensel Phelps Construction Co.* court limited the holding to apply only to cases where two indemnification contracts were present in the agreement.[141] However, the court in *Bainbridge St. Elmo Bethesda Apartments, LLC* reasoned that the *James G. Davis Construction Corp.* court held that "the plain language of an indemnification provision containing an express reference to 'attorney's fees' and an unqualified reference to 'any breach,'" [sic.] allowed for first-party fee-shifting."[142] Hence, the interpretations of *James G. Davis Construction Corp.* by the courts in *Hensel Phelps Construction Co.* and *Bainbridge St. Elmo Bethesda*

136. *See* Hensel Phelps Constr. Co. v. Cooper Carry Inc., 861 F.3d 267, 272 (D.C. Cir. 2017).

137. *Id.* at 275.

138. *Id.* (citing James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 341).

139. *Id.*

140. Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Grp. L.P., 164 A.3d 978, 987, 989 (Md. 2017).

141. *Hensel Phelps Constr. Co.*, 861 F.3d at 275 (D.C. Cir. 2017).

142. *Bainbridge St. Elmo Bethesda Apartments, LLC*, 164 A.3d at 986 n.6.

Apartments, LLC are conflicting and the meaning of the American Rule is in flux because each of these cases interprets the *James G. Davis Construction Corp.* holding differently.[143]

2. *Hensel Phelps Construction Co. applied to James G. Davis Construction Corp. and Bainbridge St. Elmo Bethesda Apartments, LLC*

The court in *Hensel Phelps Construction Co.*, in declining to expand the scope of the American Rule, interpreted the holding of *James G. Davis Construction Corp.* to mean that when "no clear and unequivocal intent to include first-party claims appears on the face of the instrument . . . [the agreement should be strictly construed]."[144] The court reasoned that, even though the indemnification was broadly constructed, it did not specifically call for first-party claims, and therefore fee-shifting in first-party claims would not be allowed.[145] This holding is clear and is consistent with the jurisprudence regarding indemnity and fee-shifting in the DC-Maryland-Virginia area.[146]

Hensel Phelps Construction Co.'s holding, applied to the facts of *James G. Davis Construction Corp.*, would not allow first-party attorneys' fees.[147] Even with two separate indemnity provisions in *James G. Davis Construction Corp.*, one specifically stated that it only applied to third-party claims and the other indemnity provision did not specifically call for first-party claims.[148] The language of the indemnification provision in *Hensel Phelps Construction Co.* is very similar and as all-inclusive as the indemnification provision at issue in *James G. Davis Construction Corp.*[149] For example, the provision in *Hensel Phelps Construction Co.* included the terms "claim, judgment, lawsuit, damage, liability, and costs and expenses," which is very similar to the "any and all" language in *James G. Davis Construction Corp.*, yet the court in *Hensel Phelps Construction Co.* did not

143. *See id.* at 987; *Hensel Phelps Constr. Co.*, 861 F.3d at 275.

144. *Hensel Phelps Constr. Co.*, 861 F.3d at 275.

145. *See id.*

146. *See* Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 282 (Md. 2008) (holding that unless the provision explicitly states first-party and attorneys' fees, fee-shifting in first-party claims will not be allowed); Atl. Contracting & Material Co. v. Ulico Cas. Co., 844 A.2d 460, 472–73 (Md. 2004) (holding that, in the surety context, indemnification clauses will be interpreted broadly).

147. *Compare Hensel Phelps Constr. Co.*, 861 F.3d at 275, *with* James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 341–42 (D.C. 2016).

148. *See James G. Davis Constr. Corp.*, 147 A.3d at 341–42.

149. *See Hensel Phelps Constr. Co.*, 861 F.3d at 275; *James G. Davis Constr. Corp.*, 147 A.3d at 340.

allow for the recovery of attorneys' fees in first-party claims.[150]

3. Hensel Phelps Construction Co. applied to Bainbridge St. Elmo Bethesda Apartments, LLC

Hensel Phelps Construction Co.'s holding, applied to the facts in *Bainbridge St. Elmo Bethesda Apartments, LLC*, would likely result in a different outcome as well. The indemnity provision in *Bainbridge St. Elmo Bethesda Apartments, LLC* provided "any and all" claims language and listed a series of claims that could both be first and third-party claims, without specifically referencing either first- or third-party claims.[151] Therefore, without specific reference to first-party claims, the *Hensel Phelps Construction Co.* court would have not broadened the exceptions to the American Rule and would have found that there should be no fee-shifting allowed in the first-party claim.[152]

The court in *Bainbridge St. Elmo Bethesda Apartments, LLC* held that first-party fee-shifting provisions were included in the provision because it listed both first- and third-party claims, and therefore all first- and third-party claims were covered.[153] The court further reasoned that because Bainbridge held all the risk, it was necessary for White Flint to be made whole if Bainbridge breached the contract.[154]

In applying the holding in *Bainbridge St. Elmo Bethesda Apartments, LLC* to *James G. Davis Construction Corp.*, it is unlikely the outcome would be different because the "any and all" language provided in Article XXI of the *James G. Davis Construction Corp.* contract would allow first- and third-party claims.[155] The rationale in *Bainbridge St. Elmo Bethesda Apartments, LLC* was simply that, because a first-party claim was listed, first-party attorneys' fees were allowed to be recovered regardless of whether the claim was specifically listed.[156] As "any and all" presumably includes first- and third-party claims, the recovery of attorneys' fees in a first-party claim would likely be granted.[157]

Similarly, in *Hensel Phelps Construction Co.*, the indemnification

150. *Compare Hensel Phelps Constr. Co.*, 861 F.3d at 270, *with James G. Davis Constr. Corp.*, 147 A.3d at 336.

151. Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Grp. L.P., 164 A.3d 978, 981 (Md. 2017).

152. *See Hensel Phelps Constr. Co.*, 861 F.3d at 275 (holding that objective analysis of the indemnification clause led to an interpretation only including third-party claims).

153. *Bainbridge St. Elmo Bethesda Apartments, LLC*, 164 A.3d at 987, 989.

154. *See id.* at 986.

155. *See James G. Davis Constr. Corp.*, 147 A.3d at 336.

156. *Bainbridge St. Elmo Bethesda Apartments, LLC,* 164 A.3d at 988.

157. *James G. Davis Constr. Corp.*, 147 A.3d at 332, 336.

agreement included broad terms, such as a "claim," which could be filed by either a first- or third-party.[158] Following the court's reasoning in *Bainbridge St. Elmo Bethesda Apartments, LLC*, the "claim" would include the recovery of attorneys' fees in a first-party claim because unqualified claims were covered by the indemnification provisions in the contract.[159] However, if *Bainbridge St. Elmo Bethesda Apartments, LLC*'s holding is read more narrowly — that specific first- and third-party claims were listed, and, therefore, all first- and third-parties could recover attorneys' fees — then the unqualified claim would likely not include first-party recovery of attorneys' fees.[160]

B. James G. Davis Construction Corp.: Ambiguity between Indemnity Provisions

In *James G. Davis Construction Corp.*, the D.C. Court of Appeals applied Maryland law and, therefore, it was unclear how the Maryland courts would interpret this decision.[161] However, the Maryland Court of Appeals cited to *James G. Davis Construction Corp.* in *Bainbridge St. Elmo Bethesda Apartments, LLC*, clarifying Maryland's interpretation.[162] The court limited the holding in *James G. Davis Construction Corp.* to include only express references to attorneys' fees and "any and all" language.[163] Though this clarification provides guidance for future contracts, it does not provide a rationale for deviating from requiring contracting parties to specifically include first-party claims in their fee-shifting provisions.[164]

While the court in *James G. Davis Construction Corp.* rejected *Nova Research, Inc.*, one of Maryland's fundamental cases regarding fee-shifting provisions, the court failed to provide reasoning for not connecting attorneys' fees to first-party claims when the connection was not specifically stating it in the contract.[165] Furthermore, the court continued to include first-

158. Hensel Phelps Constr. Co. v. Cooper Carry Inc., 861 F.3d 267, 275 (D.C. Cir. 2017).

159. *Compare Bainbridge St. Elmo Bethesda Apartments, LLC,* 164 A.3d at 980–81, 989 (stating that the reason for the recovery was the express provisions), *with Hensel Phelps Constr. Co.*, 861 F.3d at 275 (using a traditional interpretation of indemnification clauses to find that only third parties can recover).

160. *See Bainbridge St. Elmo Bethesda Apartments, LLC*, 164 A.3d at 989; *Hensel Phelps Constr. Co.*, 861 F.3d at 275.

161. *James G. Davis Constr. Corp.*, 147 A.3d at 340.

162. *Bainbridge St. Elmo Bethesda Apartments*, *LLC*, 164 A.3d at 986 (citing James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 340–41) (clarifying how Maryland law would interpret the decision).

163. *Id.* at 986 n.6.

164. *Id.*

165. *See James G. Davis Constr. Corp.*, 147 A.3d at 332 (addressing whether or not

party recovery without the JVA expressly stating "first-party" even after it acknowledged that courts have typically erred on the side of caution by not including first-party recovery when it is called into question.[166] The court reasoned that *Nova Research* does not bar the recovery of attorneys' fees when "attorneys' fees" are specifically listed in the agreement.[167] However, the court failed to consider the effect of allowing fees recovery in this situation and should not have extended first-party recovery.[168] In allowing the recovery of attorneys' fees in these types of situations, the court gutted the meaning of the American Rule because the intent to include first-party fees was not expressly stated in the contract.[169]

The *James G. Davis Construction Corp.* court's reasoning is logically sound, but not legally rational; both parties agreed that Article XXI only applied to third-party claims, so the court reasoned that broad language included first-party claims, barring any ambiguity.[170] However, the court failed to apply the precedent and proceeded to allow a new exception to the American Rule.[171] The court stated that because Article XVI specifically stated third-party claims and Article XXI listed "any and all claims," the contract therefore allowed attorneys' fees recovery for first-party claims.[172] The court further stated that if the parties wanted Article XXI to include only third-party claims, the parties should have used language similar to that in Article XVI, specifically stating third-party recovery.[173] However, a court cannot infer parties' intents and grant attorneys' fees to the prevailing party unless the language is unmistakably clear.[174] At the very least, the court should have rendered Article XXI ambiguous because, without specifically calling for the recovery of attorneys' fees in first-party claims, the court

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first-party fee-shifting can take place without expressly stating for the recovery of attorneys' fees in the contract).

166. *Id.* at 341–42 (citing Atl. Contracting & Material Co. v. Ulico Casualty Co. as the only other case where first-party recovery was allowed without explicitly stated in the contract); *see also* Atl. Contracting & Material Co. v. Ulico Cas. Co., 844 A.2d 460, 469 (Md. 2004) (allowing for a first-party surety to recover fees because in the surety context, contracts are generally interpreted to allow the surety to recover fees and costs).

167. *James G. Davis Constr. Corp.*, 147 A.3d at 341–42.

168. *See id.* at 342 (stating that Nova Research did not have the opportunity to address whether first-party fees could be limited if the contract addresses attorneys' fees in first-party claims).

169. *Id.*

170. *See James G. Davis Constr. Corp.*, 147 A.3d at 341.

171. *See id.* at 345–46; Nova Research, Inc. v. Penske Truck Leasing Co., L.P., 952 A.2d 275, 285 (Md. 2008).

172. *James G. Davis Constr. Corp.*, 147 A.3d at 341.

173. *Id.*

174. Oscar Gruss & Son, Inc. v. Hollander, 337 F.3d 186, 199 (2d Cir. 2003).

could not simply imply the intent of the parties. Additionally, the court should have looked to the parties' intent at time of agreement.[175]

The court erred in relying on the plain meaning of the contract and finding no ambiguity in Article XXI.[176] However, if ambiguity did exist and a reasonably prudent person could find different meanings in the contract terms, the intent of the contract could have been found in the interest of justice.[177] When ambiguity does exist, the parties' intents are imperative and the circumstances surrounding the agreement must be investigated or the costs of attorneys' fees associated with the suit would fall on one party, even if the parties intended to pay their own attorneys' fees.[178] While the conclusion would likely have been the same because first-party indemnity provisions are usually included in JVAs,[179] the rationale would have limited the effect of the holding on current and future contracts in that the court could have limited the holding to the facts of the case.[180]

C. Interpreting a Contract Within the Context of the Industry

The holding in *James G. Davis Construction Corp.* is analogous to the holding of *Atlantic Contracting*, which allowed the surety to recover fees and costs by a first-party action because "these types of agreements" typically allow recovery, even though "attorneys' fees" were not specifically referred to in the contract when dealing with a surety.[181] Similarly, the contract in *James G. Davis Construction Corp.* should be interpreted within

175. Dyer v. Bilaal, 983 A.2d 349, 354–55 (D.C. 2009) (stating that a court will not look to the intent of the parties at contract formation unless there is some ambiguity with the contract); Diamond Point Plaza L.P. v. Wells Fargo Bank, N.A., 929 A.2d 932, 952 (Md. 2007) ("A contract is not ambiguous simply because, in litigation, the parties offer different meanings to the language. It is for the court, supposing itself to be that reasonably prudent person, to determine whether the language is susceptible of more than one meaning.").

176. *James G. Davis Constr. Corp.*, 147 A.3d at 341.

177. Cochran v. Norkunas, 919 A.2d 700, 709–10 (Md. 2007) (stating that courts will not look to the intent of the parties without ambiguity).

178. *See* Merriam v. United States, 107 U.S. 437, 444 (1883) (holding that contracts should be construed using the contract's language if the contract is ambiguous due to surrounding circumstances); Martin & Martin, Inc. v. Bradley Enters. Inc., 504 S.E.2d 849, 851 (Va. 1998) (stating that wherever ambiguity arises, it must be interpreted against the drafter of the contract so the result may have been the same in *James G. Davis Construction Corp.*).

179. MILLER, *supra* note 41.

180. *See generally James G. Davis Constr. Corp.*, 147 A.3d 332 (providing a broad holding because attorneys' fees were not granted in the interest of justice, but because the court stated the contract expressly provided for attorneys' fees).

181. *Id.*; Atl. Contracting & Material Co. v. Ulico Cas. Co., 844 A.2d 460, 469 (Md. 2004).

the context of the construction industry to truly understand the meaning of the contract and the intent of the parties.[182] Once determined to be ambiguous, the court may look to the surrounding circumstances to determine the intent of the parties.[183] Under the intent of the parties theory, there are two relevant and prevalent circumstances: (1) this contract is within a JVA and (2) this contract is a JVA within the construction industry.[184]

Typically, JVAs include first-party and third-party fee-shifting provisions because one party is jointly and severally liable for all actions taken by the other venturer.[185] However, not every JVA includes first-party and third-party fee-shifting.[186] Additionally, defendants may believe the cost of litigation is the only deterrent to meritless lawsuits and harassment.[187] Therefore, courts generally apply a strict interpretation of indemnity provisions because it is in the best interest of both parties and serves as a deterrence against frivolous claims in the future as the cost associated with the suit may increase or decrease based on the indemnity provision.[188] However, because this contract is a JVA and because Davis was responsible for eighty percent of the profits and potential liability, it is likely that Article XXI could have been explicitly restricted to first-party claims because Davis could have written "first-party" into the contract if that was Davis'

182. *James G. Davis Constr. Corp.*, 147 A.3d at 332.

183. *Merriam*, 107 U.S. at 441 (stating that the court may look to the subject matter and the surrounding circumstances to determine the parties' intent at the contracts inception).

184. Pacific Indem. Co. v. Interstate Fire & Cas. Co., 488 A.2d 486, 488 (Md. 1985) (stating that courts should looking at the character, the purpose, and the facts and circumstances of the contract at the time of the contract's execution to determine the intention of the parties).

185. *See generally,* Vincent Rowan, *Working With a Joint Venture or Consortium Contractor: Getting the Best Out of the Relationship*, REED SMITH (Dec. 13, 2011), https://www.reedsmith.com/en/perspectives/2011/12/working-with-a-joint-venture-or-consortium-contrac (providing an overview of typical JVAs and the implications of joint and several liability in such agreements).

186. *See* MILLER, *supra* note 41.

187. *See* D. Hull Youngblood, Jr. & Peter N. Flocos, *Forget About Copy and Paste. The Best Indemnification Provisions Start With the Details of the Transaction*, THE PRAC. L., at 24 (Aug. 2010), http://www.klgates.com/files/Publication/4fff23f1-3315-4425-b6ad-56e54bea55f0/Presentation/PublicationAttachment/fba1faaa-91de-4849-8a8f-6678e1cad2b2/Youngblood_Flocos_PracticalLawyer.pdf ("Defendant may perceive that only the cost of litigation stands between the defendant and harassment by a plaintiff asserting meritless claims.").

188. *See* Am. Bldg. Maint. Co. v. L'Enfant Plaza Props., 655 A.2d 858, 861 (D.C. 1995) (stating that the D.C. Court of Appeals applies a strict construction of indemnification clauses, as to avoid "any obligations which the parties never intended to assume.").

intention.[189]

Generally, private parties contract out of the American Rule about sixty-percent of the time,[190] which allows a general contractor to reduce the overall risk associated with a construction project.[191] The most common indemnity provision used in construction contracts can be found in American Institute of Architects document 201A and "it identifies the contractor as the one responsible for protecting [its] subcontractors, and other parties involve[ed] in the contract, including agent, employees or any other related party against claims, damages, losses, and expenses, including but not limited to attorneys' fees."[192] Being that the most popular indemnity provision does not include first-party indemnification, it is not industry standard to include first-party indemnifications in construction contracts.[193]

While JVAs do allow for the combination of resources by two separate companies, a combination JVA presents a unique issue.[194] Having more responsibility over the project, Davis likely wanted as much control as possible to limit its possible liability. At the same time, as HRGM was only receiving twenty-percent of the profit, it would want to limit its liability for such a small profit.[195] Furthermore, because Davis was responsible for eighty-percent of the contract and drafted the contract, it therefore had more negotiating power.[196] If the court found ambiguity within the contract, it

189. James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 334, 348 (D.C. 2016).

190. *See* Eisenberg & Miller, *supra* note 4, at 331 (adding that parties contract into arbitration about eleven percent of the time and contract out of a jury trial about twenty-percent of the time).

191. *See* Juan Rodriguez, *Indemnity Clauses in Construction Contracts*, THE BALANCE SMALL BUS. (Oct. 12, 2017), https://www.thebalance.com/indemnity-agreements-844985 (stating that an indemnity provision allows a contractor to divert the risk of the other first- or third-party claims because if anything were to happen, it would only take time and not additional money to make the company whole again).

192. *Id.* (stating that this provision requires a subcontractor to indemnify the contractor of any and all costs that arise from anything that subcontractor is in control over).

193. *See id.* (providing that the most popular provisions do not include first-party fee-shifting provisions because it is necessary for the parties to craft their own).

194. *See* Ms. Kale, V.V. et al., *supra* note 46, at 60–61 (stating that a combination joint venture takes place when one party has more money or property and therefore has provides more to the project and in turn receives a larger percentage of the profits and liability); *see also supra* Part IIC.

195. *See* James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 334, 348 (D.C. 2016) (declaring that the trial court found that HRGM achieved its business reputation goals).

196. *See id.*

would have been interpreted against Davis as the drafter of the contract.[197] Likely, regardless of the court's holding, the contract would likely have been interpreted against Davis and in favor of HRGM because Davis drafted the contract.[198]

While broad language is difficult to maneuver around — for example, the "any and all" language in Article XXI of the JVA — the D.C. Court of Appeals veered away from precedent regarding first-party recovery of attorneys' fees.[199] While similar to the indemnification provision in *Nova Research*,[200] the court in *James G. Davis Construction Corp.* found *Nova Research*'s holding inapplicable because attorneys' fees were explicitly referred to within Article XXI of the agreement and Article XXI did not specifically call for the recovery of first-party attorneys' fees.[201]

With *Bainbridge St. Elmo Bethesda Apartments, LLC* clarifying *James G. Davis Construction Corp.*'s holding, the conclusion is not as undefined as it once was; any language indicating "any and all" in reference to claims where attorneys' fees could be recovered is a death trap for the failing party to a claim because the failing party would be responsible for the oppositions attorneys' fees.[202] Article XXI of the Davis and HRGM Joint Venture Agreement stated: "[e]ach Venturer shall indemnify and save harmless the other Venturer and its affiliates, directors, employees and officers from and against any and all claims . . . (including but not limited to reasonable attorneys' fees)."[203] However, with attorneys' fees included in Article XXI, the Davis contract could have met the requisite specificity to impose attorneys' fees on the losing party.[204] Therefore, the court likely provided a sufficient and subtle distinction between the recovery and attorneys' fees and

197. *Id.* at 341.

198. Martin & Martin, Inc. v. Bradley Enterprises, Inc., 504 S.E.2d 849, 851 (Va. 1998) (stating that wherever ambiguity arises, it must be interpreted against the drafter of the contract).

199. *James G. Davis Constr. Corp.*, 147 A.3d at 336.

200. 952 A.2d 275, 285 (Md. 2008) (presenting the top 400 contractors, by revenue, in the United States).

201. *Id.* ("Where the contract provides no express provision for recovering attorney's fees in a first-party action establishing the right to indemnity, however, we decline to extend this exception to the American rule, which generally does not allow for prevailing parties to recover attorney's fees.").

202. Bainbridge St. Elmo Bethesda Apartments, LLC v. White Flint Express Realty Grp. L.P., 164 A.3d 978, 986 n.6 (Md. 2017) (citing *James G. Davis Constr. Corp.*, 147 A.3d at 340–41).

203. *James G. Davis Constr. Corp.*, 147 A.3d at 336.

204. *See id.* at 336; Zissu v. Bear, 805 F.2d 75, 79 (2d Cir. 1986) (providing an example of a case that did not meet the necessary level of scrutiny).

the American Rule by including the "any and all" language.[205]

As the court provided in a footnote in *Bainbridge St. Elmo Bethesda Apartments, LLC*, a subtle distinction arose:

> [G]iven the *language and structure* of the clause and what it covers specifically in terms of damages, some of them, not all of them, are only first-party damages. It would make no sense . . . in the same provision to say, we're going to give your first-party type damages, but this clause doesn't apply.[206]

If allowing the recovery of first-party fees was allowed without being specifically stated within the contract, courts might as well adopt the British Rule and award the prevailing party with any incurred attorneys' fees.[207] *James G. Davis Construction Corp.*, *Hensel Phelps Construction Co.*, and *Bainbridge St. Elmo Bethesda Apartments, LLC* illustrate that even though many parties contract out of the American Rule, the default is moving closer and closer to the British Rule, allowing parties to recover attorneys' fees without specific contract provisions.[208]

D. What if there was only one Indemnity Provision?

In *Hensel Phelps Construction Co.*, the D.C. Court of Appeals cited to the holding in *James G. Davis Construction Corp.* to demonstrate that "any and all" language alone may not allow for first-party recovery, stating that:

> [R]eading an indemnification clause covering "any and all costs and expenses to reach first-party claims by looking to a second indemnification provision clause protecting only against 'loss or losses directly connected with the performance of the Construction Contract' and reasoning the parties purposely chose a broader formulation for the clause at issue" and therefore no ambiguity exists because of the parties deliberately used the language in the contract.[209]

However, in *Bainbridge St. Elmo Bethesda Apartments, LLC*, the Maryland court, disagreed with *James G. Davis Construction Corp.*'s holding,[210]

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205. *See James G. Davis Constr. Corp.*, 147 A.3d at 336.

206. *Bainbridge St. Elmo Bethesda Apartments, LLC,* 164 A.3d at 982 n.3 (relying on the list of claims in the contract that included claims that could only be first-party claims, e.g. rent loss and because one first-party claim is included in the list, the indemnity provision intended to include the recovery of attorneys' fees in first-party claims).

207. *See* Fogerty v. Fantasy, Inc., 510 U.S. 517, 533 (1994); *see also* Eisenberg & Miller, *supra* note 4, at 327 (stating that the British Rule may encourage lawsuits by optimistic parties).

208. *See Fogerty*, 510 U.S. at 533; Eisenberg & Miller, *supra* note 4, at 327.

209. Hensel Phelps Constr. Co. v. Cooper Carry Inc., 861 F.3d 267, 275 (D.C. Cir. 2017).

210. *See James G. Davis Constr. Corp.*, 147 A.3d at 340 (stating that Maryland law governs the contract).

"conclude[d] that the plain language of an indemnification provision containing an express reference to 'attorney's fees' and an 'unqualified reference to 'any breach,' allowed for first-party fee-shifting."[211] This suggests that two jurisdictions who generally look to each other for guidance have different interpretations of the holding in *James G. Davis Construction Corp.*; D.C. would likely not allow for the recovery of first-party claims with "any and all" language in the contract, whereas Maryland would likely allow for the recovery of first-party claims.[212] D.C., the jurisdiction in which the case was decided, limited the *James G. Davis Construction Corp.* holding to "all," which only includes first-party recovery when there is another provision that specifically refers to third-party recovery.[213] However, Maryland, in interpreting a D.C. case that interpreted Maryland law, suggested that the holding is actually more broad than D.C. wishes to acknowledge and the "any and all" language, in reference to attorneys' fees, includes the recovery by first-parties, regardless of a second provision explicitly allowing recovery by third-parties.[214]

Without the court finding that, as a matter of law, there was ambiguity in the contract, the plain meaning must be interpreted and the question must be presented to the fact-finder.[215] Therefore, at the outset of litigation, ambiguity within the contract and the intent of the parties must be determined for a court to provide an accurate ruling on the contract terms.[216] Without ambiguity, the plain language will be read and interpreted.

IV. HOW TO DRAFT AN INDEMNITY PROVISION

If *James G. Davis Construction Corp.* sets the new standard, it is necessary to reevaluate fee-shifting provisions and contracts generally. Fee-shifting provisions are not the only essential elements of receiving or paying attorneys' fees if the lawsuit is won or lost, respectfully; but it is necessary to read the entire contract to determine if there is any possible plain language

211. *Bainbridge St. Elmo Bethesda Apartments, LLC,* 164 A.3d at 486 n.6.

212. Barbara Bintliff, *Mandatory v. Persuasive Cases*, PERSPS.: TEACHING LEGAL RES. AND WRITING, Winter 2001, https://info.legalsolutions.thomsonreuters.com/pdf/perspec/2001-winter/winter-2001-7.pdf (last visited Apr. 13, 2019) (stating that "because demographic, geographic, or historic similarities may have led to the development of similar legal doctrines among neighboring states.").

213. *Hensel Phelps Constr. Co.*, 861 F.3d at 275.

214. *Bainbridge St. Elmo Bethesda Apartments, LLC,* 164 A.3d at 989.

215. Washington Props, Inc. v. Chin, Inc., 760 A.2d 546, 548 (D.C. 2000) (stating that whether a contract is ambiguous is a question and the determination is outside that of a jury).

216. Merriam v. United States, 107 U.S. 437, 444 (1883) (stating that the intent of the parties is only necessary where ambiguity exists).

that could give the court any reason to infer that first-party claims are included in the agreement.[217] A contract should not have frivolous language; an irrelevant provision can raise questions or change the meaning of another contract provision.[218] Therefore, it is necessary to view the contract as a whole, use consistent language, and determine what the client wants at the outset.[219]

Indemnity provisions can act as a savior on one hand, but a death sentence on the other. Once the client is aware of the problems that may arise with including or not including first-party indemnity that includes attorneys' fees, it is necessary to move forward with caution.[220] If the client wishes to include first-party recovery of attorneys' fees, it is necessary to make sure that they are explicitly called for or that attorneys' fees are referenced with respect to "any and all" claims.[221]

Additionally, it would be prudent to explicitly state that a provision includes, or does not include, first-party claims. When this is not possible, one must look for language in the contract that may give the court reason to include first-party claims. At this point, it is unclear whether courts are trying to expand the exceptions under the American Rule, but it appears they are. If part of an indemnity provision may only apply to first-party claims, it should be removed or further specified to only include third-party claims. If there is more than one provision that applies to indemnification, it must be clear that first-party claims are not included. This can be achieved by intentionally leaving out first-party claims (including breach of contract, which can only be a first-party claim). Though the American Rule still applies in Maryland and D.C., courts are becoming more likely to increase their definitions of 'expressed' by reading "any and all" language to include first-party claims.

Indemnity provisions are in many contracts and the intent of the parties should be understood by the plain reading of a contract whenever possible because indemnity provisions could determine whether a lawsuit is brought

217. Nova Research, Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 283 (Md. 2008) (presenting that a court must look at the contract in its entirety, therefore in determining how a court will look at a contract, attorneys must look to the entire contract document).

218. *See id.* at 283 (stating that a court will read the contract in its entirety to determine its meaning); Sagner v. Glenangus Farms, Inc., 198 A.2d 277, 286 (Md. 1964) (stating that the court will not read out any part of the contract).

219. *Nova Research, Inc.*, 952 A.2d at 283.

220. MILLER, *supra* note 41.

221. James G. Davis Constr. Corp. v. HRGM Corp., 147 A.3d 332, 336 (D.C. 2016) (holding that any and all language in reference to claims and attorneys' fees will hold a losing first-party responsible for reasonable attorneys' fees).

or whether a settlement is the more practical business decision.[222] However, what is rarely understood is that the decision is made far before the time to file suit and, therefore, the client must be aware of the seriousness of the decision to include first- or third-party indemnity provisions. Once the client has determined which path they wish to take, the safest option is to ensure that the plain language of the contract supports the client's intent.

V. CONCLUSION

For the aforementioned reasons, the D.C. Court of Appeals likely expanded the jurisprudence regarding first-party recovery of attorneys' fees. However, currently this is the new standard and if the holding is not further limited, it is necessary to increase the specificity of indemnity provisions in contracts. Without specificity in contract terms that are consistent throughout the entire contract, one term can alter the intent of the parties and the plain language interpretation of the contract.

The construction industry is a relatively low percentage profit industry and, therefore, the allocation of risk is important to control companies' bottom lines. In many cases, especially large construction project claims, attorneys' fees may be incredibly high. HRGM acquired over $800,000 in fees and costs and the company was only responsible for twenty percent of a $53 million project, roughly 10.6 percent of the revenue generated by the contract.[223] Therefore, the importance of fee-shifting provisions in contracts cannot be overlooked.

222. *See* Eisenberg & Miller, *supra* note 4, at 333–34.

223. *Id.*

VALUEACT PARTNERS AND HART-SCOTT-RODINO: ENDING THE COMPETITION BETWEEN INVESTOR INTEREST AND ANTITRUST LAW

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I. INTRODUCTION

While hedge fund activism has exploded in frequency and debate in recent decades, the financial regulatory world is still adapting to the phenomenon.[1] Designed to be subject to minimal oversight, hedge funds came under fire in the aftermath of the 2008 financial crisis and new rules required additional disclosures to the Securities and Exchange Commission ("SEC").[2] Scholarship on this topic often advocates for more effective reporting mechanisms to disclose hedge fund acquisitions and holdings.[3] But few commentators consider that the disclosure requirements imposed by regulations, particularly those pertaining to antitrust goals, are no longer compatible with the reigning legal framework.[4] A particularly stark example of the failure of corporate law to keep up with activist investors is evident when comparing the freedom the SEC permits hedge "wolf packs" with the limitations the Federal Trade Commission ("FTC") imposes on all activist investors; the latter nullifying the benefits of the former. The 2016 enforcement of the Hart-Scott-Rodino Antitrust Improvements Act ("Hart-Scott-Rodino") against hedge fund ValueAct Partners ("ValueAct") has spooked many activist funds and prompted a discussion of the limits of their abilities within the law.[5] This Note argues that the District Court for the

1. *See* Wulf Kaal & Dale Oesterle, *The History of Hedge Fund Regulation in the United States*, COLUM. L. SCH. BLUE SKY BLOG (Feb. 29, 2016), http://clsbluesky.law.columbia.edu/2016/02/29/the-history-of-hedge-fund-regulation-in-the-united-states/ (detailing the advent of hedge funds as an exception to certain securities regulation and the attempts since the 1980s hold them accountable to oversight rules).

2. *Id.* (outlining the new requirements imposed on hedge funds by Dodd-Frank including disclosure of firm performance, risk metrics, and positions).

3. *See* Joel Slawotsky, *Hedge Fund Activism in An Age of Global Collaboration and Financial Innovation: The Need for a Regulatory Update of United States Disclosure Rules*, 35 REV. BANKING & FIN. L. 275, 330 (2016) (recommending a lower share purchase threshold to trigger hedge fund disclosure).

4. *But see* Dissenting Statement of Commissioners Maureen K. Ohlhausen & Joshua D. Wright at 3, United States v. Third Point Offshore Fund, Ltd., 1:15-cv-01366 (D.D.C. Aug. 24, 2015), 121-0019, [hereinafter Ohlhausen & Wright Statement] https://www.ftc.gov/system/files/documents/public_statements/777351/150824thirdpointohlhausen-wrightstmt.pdf (suggesting that the FTC not require passive or activist investors to provide notice and seek approval before purchasing ten percent or less of a company's shares); BILAL SAYYED, A "SOUND BASIS" FOR REVISING THE HSR ACT'S INVESTMENT-ONLY EXEMPTION, THE ANTITRUST SOURCE 1–2 (2013) (arguing that the Hart-Scott-Rodino "investment-only" exemptions be replaced with a less burdensome, less inclusive reporting threshold that more effectively screens actual anticompetitive risks).

5. *See* Final Judgment at 4, United States v. VA Partners I, LLC, No. 16-cv-01672 (WHA), 2016 U.S. Dist. LEXIS 163605 (N.D. Cal. Nov. 1, 2016) (holding that the defendants were enjoined from making a covered acquisition without filing and observing the waiting period as required by Hart-Scott-Rodino).

Northern District of California incorrectly approved the ValueAct consent decree because it failed to consider the supremacy of securities law over antitrust law in investor disclosure.[6]

II. THE SAME INFORMATION, DIFFERENT STANDARDS: ANTITRUST LAW COMPETES WITH SECURITIES LAW

A. Hedge Fund Disclosures under the Williams Act and the Hart-Scott-Rodino Act

The Williams Act, enforced by the SEC, governs public disclosures required by institutional investors, most notably 13(d) and 13(g) filings.[7] The Williams Act was passed in 1968 and amends the 1934 Securities Exchange Act ("Exchange Act").[8] Within ten days of acquiring five percent or more of a company's stock, investors are required to file a 13(d) disclosure statement.[9] Under 13(d), investors must also disclose whether they acquired the securities as a member of a group.[10]

Investors who do not intend to influence the decisions or direction of a company, known as passive investors, are permitted to file a 13(g) when acquiring more than five percent (but less than twenty percent) of a company's stock.[11] The intent of the Williams Act is to update investors on holdings that could potentially impact a company.[12] Since passive investors are only holding the stock for purposes of investment and may not shape corporate behavior, the 13(g) form requires less information.[13] However,

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6. *Id.* at 7.

7. 17 C.F.R. § 240.13d-1 (2018).

8. *Id.*; *see* 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 11:2 (2018) (providing an overview of the Williams Act).

9. 17 C.F.R. § 240.13d-1(e)(1).

10. *See id.* § 240.13d-1(b)(1)(iii) (citing 15 U.S.C. § 78m(d)(3) (2018)) ("[A group occurs] when two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer.").

11. *Id.*; *see also* Ethan A. Klingsberg et al., *Active vs. Passive Investing: The Struggle of 2 Agencies,* LAW360 (July 27, 2016, 1:13 PM), https://www.law360.com/articles/821838/active-vs-passive-investing-the-struggle-of-2-agencies (noting that "passive" investors qualifying for 13(g) status may still engage an issuer on certain corporate governance issues when the investor is also engaging other issuers in its portfolio on the same topics).

12. *See* Lloyd S. Harmetz, *Frequently Asked Questions About Section 13(d) and Section 13(g) of the Securities Exchange Act of 1934*, MORRISON & FOERSTER LLP 1 (2017), https://media2.mofo.com/documents/faqs-schedule-13d-g.pdf (articulating that disclosures provide transparency on potential changes in corporate control).

13. *Id.* at 3; *see* R. Christopher Small, *Passive Investors, Not Passive Owners*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 21, 2015), https://corpgov.law.har

like the 13(d) form, the 13(g) form must be submitted by passive investors within ten days of the acquisition.[14] Schedules 13(d) and 13(g) when filed are made publicly available by the SEC.[15]

The Hart-Scott-Rodino Act amended the Clayton Antitrust Act of 1914.[16] Investors are impacted by the Hart-Scott-Rodino Act when acquiring securities deemed sufficiently significant; they must notify the FTC of their intent to purchase these securities and await FTC approval before purchasing.[17] Filings made to the FTC are not made public until approved, unless an investor requests expedited review of securities acquisition requests.[18] The investigation period prior to approval generally lasts thirty-days, although it could take longer if the FTC requests additional information.[19] Investors seeking to acquire ten percent or less of a company's stock solely for the purposes of investment are exempt from Hart-Scott-Rodino approval prior to purchase.[20]

While not codified, the FTC confines the "investment-only" exemption to shareholder "passivity."[21] Passive investors are only allowed to engage in a narrow scope of activity before the FTC approves their securities purchase.[22]

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vard.edu/2015/01/21/passive-investors-not-passive-owners-2/ (explaining that, officially, a passive investor can shape governance issues only in a very limited sense, but that the effects of passive investors on corporate governance issues need further investigation).

14. Harmetz, *supra* note 12, at 4.

15. 17 C.F.R. § 240.13d-1 (2018); FEDERAL SECURITIES ACT OF 1934 § 7A.02 (A.A. Sommer Jr. June 2018 ed. 2018).

16. 15 U.S.C. § 18a (2018).

17. Revised Jurisdictional Thresholds for Section 7A of the Clayton Act, 82 Fed. Reg. 8524 (Jan. 26, 2017) (articulating the FTC's obligation to update reporting thresholds as a percentage of an issuer and in dollar amount annually based on changes in gross domestic product).

18. Lisl Dunlop & Shoshana Speiser, *Merger Control in the United States: Overview*, THOMPSON REUTERS PRAC. L. (June 1, 2017), https://content.next.westlaw.com/Document/Ieb49d8761cb511e38578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1.

19. *Premerger Notification and the Merger Review Process*, FED. TRADE COMM'N, https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/mergers/premerger-notification-merger-review (last visited Feb. 14, 2019).

20. 15 U.S.C. § 18a(c)(9).

21. *Id.*; *see* Debbie Feinstein et al., *"Investment-only" Means Just That*, FED. TRADE COMM'N (Aug. 24, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just (explaining that the "investment only" exemption applies only to "purchasers who intend to hold the voting securities as passive investors").

22. Rules, Regulations, Statements and Interpretations Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 43 Fed. Reg. 33,450, 33,465 (July 31, 1978) (noting in background that while voting securities will not preclude an investor from claiming "investment-only" exemption, the following behaviors will: "(1) Nominating a candidate

Investors have long complained that the government's passivity definition is unclear.[23]

In every case that the Department of Justice ("DOJ") or FTC has pursued involving the violation of the Hart-Scott-Rodino Act "investment-only" exemption, the subject of the allegations settles in the form of a consent decree.[24] These consent decree settlements follow procedures set by the Antitrust Procedures and Penalties Act, also known as the Tunney Act.[25] Litigating under the Tunney Act is rarely a viable option for defendants given the time commitment and the time sensitivity of securities purchases.[26] Further, the risk of the steep fines should the defendant lose in court often plays a coercive role in the defendant's decision to settle.[27]

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for the board of directors of the issuer; (2) proposing corporate action requiring shareholder approval; (3) soliciting proxies; (4) having a controlling shareholder, director, officer, or employee simultaneously serving as an officer or director of the issuer, (5) being a competitor of the issuer, or (6) doing any of the foregoing with respect to any entity directly or indirectly controlling the issuer.").

23. *See* Barry A. Nigro, Jr., *ValueAct Settlement: A Record Fine for HSR Violation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 19, 2016), https://corpgov.law.harvard.edu/2016/07/19/valueact-settlement-a-record-fine-for-hsr-violation/ (explaining that there is no case law on the "investment-only" exemption so investors must rely on guidance from settlements, speeches, and informal interpretations, and noting that the broader application of the ValueAct settlement remains uncertain since the government relies on the "totality of the circumstances" of investor behavior to determine whether a violation has occurred).

24. *See* Scott E. Gant et al., *The Hart-Scott-Rodino Act's First Amendment Problem*, 1 CORNELL L. REV. ONLINE 1, 12 (2017). *See generally* ORG. FOR ECON. CO-OPERATION AND DEV., COMMITMENT DECISIONS IN ANTITRUST CASES 3 (2016), https://www.ftc.gov/system/files/attachments/us-submissions-oecd-other-international-competition-fora/1606commitment_decisions-us.pdf (explaining the consent decree process of settling antitrust cases, which culminates in an agreement between parties, and "begins with the filing of a complaint by DOJ in federal district court that alleges the theory of harm and the relevant markets, along with a Competitive Impact Statement and a proposed final judgment that the Division will ask the court to enter after the public comment period.").

25. 15 U.S.C. § 16; *see also The Enforcers*, FED. TRADE COMM'N, https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/enforcers (last visited Feb. 14, 2019) (noting that both FTC and DOJ have complementary jurisdiction in antitrust enforcement and divide investigations depending on the industry).

26. *See* William J. Kolasky, Jr. & James W. Lowe, *The Merger Review Process at the Federal Trade Commission: Administrative Efficiency and the Rule of Law*, 49 ADMIN. L. REV. 889, 891–92 (1997) (arguing that firms usually settle by consent decree because litigation costs too much and takes too long given that securities purchases are time sensitive).

27. *See* Philip Goldstein, *A Critique of the ValueAct Settlement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 5, 2016), https://corpgov.law.harvard.edu/2016/08/05/a-critique-of-the-valueact-settlement/ (citing the severe increase in civil penalties as the reason why ValueAct agreed to a consent decree, but does not concede DOJ's allegations).

The settlements are called consent decrees, and require the DOJ and the FTC to publish a Competitive Impact Statement which details the DOJ's views on the enforcement.[28] The DOJ and the FTC must technically allow for a sixty-day public comment period before a district court may enter judgment on a consent decree.[29] Judges publish a decision on consent decrees based on a public interest standard of review.[30] This benchmark is highly contentious for its alleged lack of clarity.[31]

Though judges overseeing Tunney Act proceedings rarely disapprove of a proposed consent decree, they are permitted to exercise their discretion in evaluating 1) the decree's competitive impact, and 2) the impact of the decree "upon the public generally and individuals alleging specific injury."[32] While the courts typically give extreme deference to the DOJ or FTC, the intent of the 2004 revisions to the Tunney Act was to give judges little flexibility.[33]

B. Williams Act & Wolf Packs

The Williams Act created a loophole where shareholders can collaborate without disclosing their holdings or united efforts.[34] As long as investors do not conspire to create formal agreements with other shareholders to act

28. 15 U.S.C. § 16(b).

29. *See* Ben James, *Senators Say DOJ Is Ignoring the Tunney Act*, LAW360 (Sept. 28, 2006, 12:00 AM), https://www.law360.com/articles/10947 (citing a letter from members of Congress alleging that the DOJ allows mergers to go forward before the formal completion of the Tunney Act process culminating in the sixty day review period wherein the public may comment and the courts officially approve of the consent decree).

30. 15 U.S.C. § 16.

31. *See* Lawrence M. Frankel, *Rethinking The Tunney Act: A Model for Judicial Review of Antitrust Consent Decrees*, 75 ANTITRUST L. J. 549, 550, 570 (2008) (explaining that the purview of a judge when evaluating a Tunney Act consent decree is vague despite a 2004 amendment that attempted to solidify a judge's evaluative framework).

32. 15 U.S.C. § 16(e); *see also* Rachel Frank, Comment, *Still Mocking Judicial Power?: Determining Deference Accorded to the Justice Department in Reviewing Consent Decrees in Horizontal Mergers*, 9 ELON L. REV. 171, 204 (2017) (noting that while district court rulings on Tunney Act consent decrees do not have force of law they still have some influence on precedent and provide direction to DOJ).

33. 15 U.S.C. § 16(g); *see* ORG. FOR ECON. CO-OPERATION AND DEV., *supra* note 24, at 4 (stating that when considering a Tunney Act consent decree courts may not "substitute its opinion on the best way to resolve the government's claims. . . .").

34. 17 C.F.R. § 240.13d-1(b)(ii)(k) (2018); *see* David A. Katz, *Section 13(d) Reporting Requirements Need Updating*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Apr. 12, 2012), https://corpgov.law.harvard.edu/2012/04/12/section-13d-reporting-requirements-need-updating/ (citing a 2011 petition to the U.S. Securities and Exchange Commission that advances a ten-day disclosure window which would allow investors to acquire a significant portion of stocks discretely).

collectively and as long as an individual holds less than five percent of a company's shares, investors can dodge group disclosures.[35] This phenomenon, known as a "wolf pack," is defined as "a loose network of activist investors that act in a parallel fashion but deliberately avoid forming a 'group' under section 13(d)(3) of the [Exchange Act]."[36] These packs are often driven by a "lead wolf" who sets the action plan for other shareholders to follow; hedge funds often fill this lead role.[37]

Though not explicitly regulated in SEC rules, the United States Court of Appeals for the Second Circuit authorized wolf packs so long as they do not collude for the acquisition of stock.[38] John Coffee and Darius Palia, leading experts on the wolf pack tactic and its evolution, analyzed recent court rulings and found judges reluctant to find the existence of a group even when a shareholder block clearly pushed the boundaries of prohibitions against collectively acquiring and voting shares.[39] Wolf packs are a highly controversial vehicle that many stakeholders think cheat the Williams Act instead of complying with it.[40] Though the SEC is well aware of the complaints about its reporting process, which is alleged to facilitate wolf pack behavior, it has yet to change those disclosure rules.[41]

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35. *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 568 (2016) (explaining how wolf packs escape disclosure because the SEC sees "parallel action by like-minded activist investors, even when accompanies by discussions among them, does not, without more, give rise to a group for purposes [of disclosure].").

36. *Id.* at 562.

37. *See* Slawotsky, *supra* note 3, at 298–99 (explaining that a lead investor will acquire five percent or more of a company and in the ten-day period before they must publicly disclose their purchase will both continue to acquire stock and also let other investors know of their activist plans; the end result is an informal shareholder block which is aligned in activist intent but has not formed a formal agreement).

38. 17 C.F.R. § 240.13d-1(b)(ii)(k); CSX Corp. v. Children's Inv. Fund Mgmt. LLP, 654 F.3d. 276, 282–83 (2d Cir. 2011).

39. *See* Coffee & Palia, *supra* note 35, at 568 (listing the following types of shareholder blocks that were found not to be a "group": (1) "two Schedule 13D filers and a Schedule 13G filer . . . 'where one was a well-known raider and all three discussed among themselves how to improve the value of the target company'"; and (2) "a joint slate of directors proposed by the investors").

40. 17 C.F.R. § 240.13d-1(b)(ii)(k); *see Comments on Rulemaking Petition: Request for Rulemaking Regarding the Beneficial Ownership Reporting Rules Under Section 13 of the Securities Exchange Act of 1934*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/comments/4-624/4-624.shtml (last visited Feb. 14, 2019) [hereinafter *Comments on Rulemaking Petition*] (discussing a 2011 petition to the SEC to revise 13(d) disclosure timelines so that wolf packs have less of an advantage to quietly accumulate stock).

41. *See Comments on Rulemaking Petition, supra* note 40 (considering petitions but not listing any official revisions to 13(d) disclosures).

C. Credit Suisse v. Billings

Securities and antitrust law are often at odds in questions of corporate noncompliance.[42] In *Credit Suisse Securities (USA) LLC v. Billing*,[43] the Supreme Court questioned not whether securities or antitrust laws were broken, but if they were reconcilable.[44] Respondents brought a claim against Credit Suisse arguing that the brokers colluded to drive up securities prices.[45]

Antitrust and securities law came into conflict because, while initial public offerings ("IPOs") are governed by securities law, the petitioners brought an antitrust suit.[46] The Court applied a four-part test to determine whether antitrust law should not be enforced: 1) the issue is "squarely within" securities regulations; 2) the SEC wields authority; 3) the SEC is actively regulating; and 4) there exists "serious conflict" between the antitrust and securities regulatory bodies.[47] In holding that the antitrust laws did not apply, the Court ruled that "antitrust action in this context is accompanied by a substantial risk of injury to the securities markets and by a diminished need for antitrust enforcement to address competitive conduct."[48]

D. Hart-Scott-Rodino Act Enforcement Against ValueAct Partners

In 2016, the DOJ issued a Hart-Scott-Rodino Act enforcement against the hedge fund ValueAct for failure to qualify for the "investment-only" exemption.[49] This enforcement was not only the largest Hart-Scott-Rodino "investment-only" penalty to date, but also the most stringent governmental interpretation of passivity.[50]

The *ValueAct* complaint cited the fund's accumulation of stock in both Baker Hughes and Halliburton, following the announcement of the planned

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42. *Is There Life After Trinko and Credit Suisse? The Role of Antitrust in Regulated Industries: Hearing Before the H. Comm. on the Judiciary*, 111th Cong. 5 (2010) (statement of Howard Shelanski, Deputy Director for Antitrust, FTC) (detailing a long history of litigation to determine when antitrust law applies to regulated industries, such as securities).

43. 551 U.S. 264 (2007).

44. *Id.* at 267.

45. *Id.* at 269–270.

46. *Id.* at 268–269.

47. *Id.* at 274.

48. *Id.* at 284.

49. United States v. VA Partners, LLC, No. 16-cv-01672, 2016 U.S. Dist. LEXIS 163605, at *1 (N.D. Cal. Nov. 1, 2016).

50. *See* Nigro, *supra* note 23 (noting that ValueAct penalty was close to twice as large as the largest ever prior Hart Scott Rodino settlement); Klingsberg et al., *supra* note 11 (citing the ValueAct settlement as the potential spark of a new direction in shareholder activism because the enforcement targeted communication between investors and companies that is common practice).

merger between the two companies.[51] The DOJ alleged ValueAct broke the law by not 1) providing the government with notice of its intent to acquire the stock, nor 2) observing the waiting period during which the government would approve or deny ValueAct's request for purchase.[52] According to the DOJ, ValueAct did not meet the "investment-only" exception because it intended at the outset to become involved in decision making at Baker Hughes and Halliburton.[53] The consent decree that the DOJ reached with ValueAct required ValueAct to abstain from a long list of communications with entities in which they invested prior to government approval.[54]

III. DISCLOSURE BEFORE VS. DISCLOSURE AFTER: ANTITRUST & SECURITIES LAWS COMPETE

The *ValueAct* court made two fundamental errors in its judgment against the hedge fund to allegedly violate the Hart-Scott-Rodino Act.[55] First, it failed to recognize that Hart-Scott-Rodino interferes with the administration of securities law by imposing a preemptive disclosure requirement on investors who would otherwise be able to discretely make purchases under the Williams Act.[56] Securities law values the ability of investors to disclose investments only after completion, as evidenced by the Williams Act and the evolution of wolf packs which legally push the Williams Act's boundaries.[57] The *ValueAct* court should have applied the test established by *Credit Suisse* to find that Hart-Scott-Rodino cannot force investors to comply with

51. Complaint ¶¶ 3–4, United States v. VA Partners, LLC, 2016 U.S. Dist. LEXIS 163605 (N.D. Cal. Nov. 1, 2016) (No. 3:16-cv-01672).

52. *Id.* ¶ 19.

53. 15 U.S.C. § 18 (2018); Complaint ¶¶ 4, 12, 13, 16, *VA Partners, LLC*, 2016 U.S. Dist. LEXIS 163605 (No. 3:16-cv-01672) (arguing among the factors amounting to ValueAct's failure to meet the exemption was their brand as an activist investor, and communications with its partners and investors about plans to facilitate the Baker Hughes-Halliburton merger).

54. *See VA Partners, LLC*, 2016 U.S. Dist. LEXIS 163605 at *4–5 (prohibiting ValueAct from the following investor actions without government approval: 1) suggesting a merger or acquisition; 2) suggesting a merger or acquisition in which ValueAct holds a stake; 3) developing the terms of a public merger or acquisition; 5) suggesting to the company modifications of corporate structure subject to shareholder approval; and 6) becoming involved in strategy development pertaining to pricing or production).

55. 15 U.S.C. § 18; *VA Partners, LLC*, 2016 LEXIS 163605, at *1.

56. *Compare* 17 C.F.R. § 240.13d-1 (2018) (requiring disclosure of securities acquisitions after purchase), *with* 15 U.S.C. § 18(a) (requiring disclosure of securities acquisitions prior to purchase and observation of a waiting period for FTC approval).

57. *See* CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 654 F.3d. 276, 278–79 (2d Cir. 2011) (holding that wolf packs may form without disclosure).

disclosure requirements that undermine securities markets.[58]

The court's second error was the failure to find that the DOJ's proposed consent decree was not in the public interest and, therefore, should not have been enforced. But for the confines of the Tunney Act,[59] the *ValueAct* court might have recognized that activist investors are an asset to antitrust enforcement as well as corporate governance and performance, and consequently would not have punished ValueAct's activism.[60]

A. The Credit Suisse Test Part I: Hart-Scott-Rodino Interferes with the Markets

Credit Suisse established that, when evaluating whether securities law and antitrust law conflict, courts must analyze whether antitrust enforcement is "accompanied by a substantial risk of injury to the securities markets and by a diminished need for antitrust enforcement to address anticompetitive conduct."[61] Looking at both *ValueAct* and Hart-Scott-Rodino through the lens of *Credit Suisse*, a court would find that Hart-Scott-Rodino interferes with securities law and market operations, and so is improperly applied to pre-merger antitrust disclosure given its incompatibility with securities disclosures.[62] Further, early disclosure prompted by Hart-Scott-Rodino interrupts market operations by diminishing market returns.[63] Comparing the freedom of wolf packs, at the extreme end of the permitted activity under the Williams Act, with the oppressiveness of Hart-Scott-Rodino on all activist investors highlights the market obstruction imposed by this particular antitrust regulation on investors.[64] Hart-Scott-Rodino systematically

58. *See* Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 279 (2007) (holding that securities law preempts antitrust law when the two conflict).

59. 15 U.S.C. § 18(a).

60. *See* José Azar et al., *Anti-Competitive Effects of Common Ownership*, 73(4) J. FIN. 1513, 1541(2018) (discussing the positive antitrust behavior of activist hedge funds); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (finding that hedge funds provide benefits to shareholders through their ability to influence and hold management accountable).

61. *Credit Suisse*, 551 U.S. at 284.

62. *See* 15 U.S.C. § 18(a) (requiring government approval and disclosure before purchasing securities of a certain threshold); *Credit Suisse*, 551 U.S. at 284 (finding antitrust law incompatible with securities law and thus inapplicable when enforcing the antitrust law poses "a substantial risk of injury to the securities markets").

63. *See Credit Suisse*, 551 U.S. at 283–84 (holding that antitrust law cannot interfere in the "efficient functioning of the securities markets" when securities law also governs).

64. *See* Leonard Chazen & Jack Bodner, *Conscious Parallelism May Justify a Wolf Pack Pill,* LAW360 (May 27, 2014, 9:45 PM), https://www.law360.com/articles/540818/conscious-parallelism-may-justify-a-wolf-pack-pill (acknowledging that wolf packs are a powerful tool which can help mitigate a target company's defenses against governance reform).

undermines the benefits afforded to investors by the Williams Act.[65]

Though the courts have never revisited *Credit Suisse*, its framework easily applies in evaluating the Hart-Scott-Rodino Act given the contrast between the SEC's intent[66] and Hart-Scott-Rodino's oppressive impact.[67] The Court held in *Credit Suisse* that the IPO process constitutes an activity "central to the proper functioning of well-regulated capital markets."[68] It seems straightforward to draw this conclusion when analyzing ValueAct's securities activities or when one considers that *Credit Suisse* gave deference to the IPO underwriters' marketing activities. Both of these actions are analogous to communications between issues and investors, as regulated by Hart-Scott-Rodino.[69]

Regarding purchase timing, a key element of securities markets, Hart-Scott-Rodino deprives funds the stealth that the Williams Act affords wolf packs and other investors; inopportune disclosure to the issuer can be a significant disadvantage to investors.[70] When filing a Hart-Scott-Rodino disclosure, investors must choose whether they want to purchase securities earlier, potentially when the market price and influence opportunity is ideal, or wait and enjoy covert acquisition lest a public disclosure increase the stock price and disrupt the firm's strategy.[71] A court would find that, in this

65. *See* 15 U.S.C. § 18(a) (requiring investors to disclose before purchase); 17 C.F.R. § 240.13d-1(a) (2018) (allowing investors to disclose after purchase); Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activism Investors: Evidence and Policy*, 39 J. CORP. L. 1, 17 (2013) (citing data which indicates that early disclosure causes lower returns to investors).

66. *See* Robert G. Vanecko, Comment, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 NW. U. L. REV. 376, 383 (1992) (explaining the Congressional intent of the Exchange Act, which the Williams Act amends, is to protect investors by requiring disclosures by market participants).

67. *See* 15 U.S.C. § 18(a) (preventing investors from making a stock purchase at the time of their choice, without issuer notification, and without government approval).

68. *Credit Suisse*, 551 U.S. at 265.

69. *Id.* at 276 (stating the importance of marketing in the administration of an IPO, governed by securities regulation, should not be obstructed by conflicting antitrust laws).

70. *See* Joe Sims & Deborah P. Herman, *The Effect of Twenty Years of Hart-Scott-Rodino on Merger Practice: A Case Study in the Law of Unintended Consequences Applied to Antitrust Legislation*, 65 ANTITRUST L.J. 865, 886 (1997) (arguing that investors following Hart-Scott-Rodino and waiting for government approval of their transactions "may also forgo other strategic opportunities—opportunities that may be lost forever, even if the current transaction is ultimately abandoned."); SAYYED, *supra* note 4, at 15–16 (noting that among the costs to investors imposed by Hart-Scott-Rodino "include (i) the delayed implementation of efficiencies associated with an acquisition [and] (ii) interference with the market for corporate control.").

71. *See* 15 U.S.C. § 18(a) (requiring investors to seek government approval before securities purchases of a certain size); *see also* Andrew Ross Sorkin, *One Secret Buffet Gets to Keep*, N.Y. TIMES (Nov. 14, 2011, 9:24 PM), https://dealbook.nytimes.com/2011/11/14/one-secret-buffett-gets-to-keep/?mcubz=0&_r=0 ("[T]he simple disclosure of an

instance, antitrust law quashes the securities law advantage not only in conflict but "overly deter[s] . . . practices important in" the securities purchasing process.[72]

By comparison, the SEC recognizes the importance of investor freedom by only mandating disclosure after stock purchases are complete, and by giving a broader definition to "passive" investors which allows more investor-issuer engagement without disclosure.[73] As exemplified by its minimal speech regulation in proxy contests, the SEC has further prioritized the liberation of investor-issuer communication.[74] Under the Williams Act, any investor is allowed to communicate with other shareholders and the issuer, whereas the same investors under Hart-Scott-Rodino may not even manifest the intent to influence the issuer, let alone communicate that intent.[75] Given that the SEC has specifically addressed the flexibility it allows in disclosure as compared to Hart-Scott-Rodino, a court would find the Williams Act and Hart-Scott-Rodino Act in conflict.[76]

The Hart-Scott-Rodino Act requires investors to give issuers notice of their intent to purchase shares.[77] Consequently, the law diminishes

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investment would cause the price to rise so much as to scuttle [investors'] strategy.").

72. *Credit Suisse*, 551 U.S. at 285; *see* Ohlhausen & Wright Statement, *supra* note 4 (expressing concern that enforcement of Hart-Scott-Rodino against funds chills shareholder advocacy).

73. *Compare* 15 U.S.C. § 18(a) (mandating disclosure and a waiting period before securities purchases), *with* 17 C.F.R. § 240.13d-1(a) (2018) (requiring disclosure after securities purchases without a waiting period before purchasing). *See generally* Peter Jonathan Halasz et al., *Activism and Passivity: HSR Act and Section 13(d) Developments for Investors*, SCHLUTE ROTH & ZABEL (July 18, 2016), https://www.srz.com/images/content/1/4/v2/146491/072816-Activist-Investing-Update-HSR-Act-and-Section-13d-Develop.pdf (explaining that shortly after the *ValueAct* enforcement was announced, the SEC published guidance specifically articulating that failure to qualify as a passive investor under Hart-Scott-Rodino will not necessarily preclude an investor for qualifying as passive and thus eligible for 13(g) status under the Williams Act).

74. *See* Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 687 (2007) (describing the SEC's view of proxy contests, among the most important tools in shareholder activism, citing significant flexibility among investors in how much they must disclose to the SEC and when, which gives shareholders immense freedom in communication).

75. *See* 17 C.F.R. § 240.13d-1 (refraining from imposing communications limitations between issuers and investors prior to securities purchases); Feinstein et al., *supra* note 21 (warning investors that expression of intent could jeopardize an investors' claim of exemption under the "investment-only" rule).

76. *See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm (last updated July 14, 2016) (providing guidance on 13(g) filing requirements, and allowing a broader spectrum of "passive" shareholder behavior without disclosure than Hart-Scott-Rodino).

77. Richard B. Holbrook, Jr. et al., *Over a Barrel: Strategic Considerations for*

securities enforcement as laid out in the Williams Act[78] because it disrupts activist hedge funds, widely recognized to be an asset to corporate governance and market performance,[79] giving issuers time to prepare defenses against investor fund activism.[80] In 2015, the SEC provided further evidence of its interest in maintaining investor advantages by declining to shorten the disclosure timelines for companies making threshold stock purchases pertinent to the Williams Act.[81] The SEC seems to recognize that not only do shareholders lose investment opportunities when forced to disclose their intent to purchase under Hart-Scott-Rodino,[82] but Hart-Scott-Rodino deters the type of investors who enhance market returns.[83]

A court would also find a "clear repugnancy" between the timing of communication that is allowed to investors as protected by the Williams Act but undermined by Hart-Scott-Rodino.[84] Whereas Hart-Scott-Rodino prohibited ValueAct from communication about strategic goals with its clients and even internal communications without FTC approval, courts have held that shareholders holding a larger percentage of shares may freely communicate and band together for a common goal, acting as a group of theoretically unlimited size.[85] Further, under the Williams Act, investors

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Investment Funds at the Crossroads of Antitrust and Securities Law, BLOOMBERG BNA (Dec. 21, 2012), https://www.bna.com/over-a-barrel-strategic-considerations-for-investment-funds/?amp=true.

78. *See* 17 C.F.R. § 240.13d-1(a) (giving investors time in between a securities purchase and the issuer's inevitable discovery).

79. Holbrook et al., *supra* note 77; Brav et al., *supra* note 60, at 1730.

80. Holbrook et al., *supra* note 77.

81. Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39; *see* Andrew E. Nagel et al., *The Williams Act: A Truly "Modern" Assessment*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. 1 (Oct. 22, 2011), https://corpgov.law.harvard.edu/2011/10/22/the-williams-act-a-truly-modern-assessment/ (discussing reluctance to amend the Williams Act disclosure timelines for fear that it would interrupt shareholder manager accountability power).

82. *See* Bebchuk et al. *supra* note 65, at 17 (citing data which indicates that early disclosure causes lower returns to investors).

83. *See* Bebchuk & Jackson, *supra* note 81, at 49–50 (arguing that shortening disclosure timelines will reduce the number of block shareholders which in turn will reduce stock returns); Slawotsky, *supra* note 3, at 279 (noting that activist hedge funds "gravitate towards badly managed companies, and without such activists, smaller shareholders are powerless to remedy the situation.").

84. *See* Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 275 (2007) (holding that when there is a clear repugnancy between securities and antitrust law, securities law supersedes); Complaint ¶¶ 1–6, United States v. VA Partners, LLC, No. 16-cv-01672, 2016 U.S. Dist. LEXIS 163605, at *1 (N.D. Cal. Nov. 1, 2016) (No. 3:16-cv-01672) (finding that communication with an investor of a certain threshold and the issuer without government approval or disclosure violates the Hart-Scott-Rodino Act).

85. *See* CSX Corp. v. Children's Inv. Fund Mgmt. LLP, 654 F.3d 276, 309 (2d Cir.

may engage with a company free of disclosure as long as they hold less than five percent of its shares.[86]

The *Credit Suisse* Court also noted that securities law preempts antitrust laws when the securities law provides a "diminished need for antitrust enforcement to address anticompetitive conduct."[87] Critics of Hart-Scott-Rodino point out that it rarely has a significant impact on preventing its stated claim — anticompetitive behavior.[88] If a court applied *Credit Suisse*'s emphasis on preventing antitrust litigation that interferes with the securities markets, it would find that Hart-Scott-Rodino obstructs market efficiency by giving companies opportunities to block activist shareholders that securities law does not provide.[89] A court would also be moved by the same fear articulated by the *Credit Suisse* Court: "chilling" permissible securities behavior due to a fear of antitrust violations.[90] The repugnancy is most clear when comparing the freedoms allowed to a wolf pack and the restrictions on an individual investor such as ValueAct.[91]

B. Credit Suisse Test Part II: The Four Factors Applied to ValueAct

Had the *ValueAct* court properly shed the Tunney Act confines, it would have applied the long-held precedent that securities law preempts antitrust law when the two conflict.[92] The *Credit Suisse* test aptly applies to

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2011) (deregulating group formation for purposes of 13(d) disclosure).

86. *See* 17 C.F.R. § 240.13d-1 (2018) (requiring disclosure only after the purchase of five percent or less of an issuer's securities and without restriction on communications between issuer and shareholder either before or after acquisition).

87. *Credit Suisse*, 551 U.S. at 284.

88. 15 U.S.C. § 18a(a) (2018); *see* SAYYED, *supra* note 4, at 15–16, 18 (discussing the disproportional use of agency energy on Hart-Scott-Rodino filing review when most filings present no anticompetitive potential, and only three percent of filings give the FTC pause for further review, which is not to say those applications are not later decided to be nonthreatening and approved).

89. *Credit Suisse*, 551 U.S. at 282 (holding that the antitrust claims against securities underwriters were incompatible with securities laws and thus inapplicable because the antitrust laws "forbid[] . . . a wide range of joint conduct that the securities law permits or encourages. . . .").

90. *Id.* at 283.

91. *Id. Compare* CSX Corp. v. Children's Inv. Fund Mgmt. LLP, 654 F.3d 276, 309 (2d Cir. 2011) (holding informal shareholder group coordination is permissible under securities law), *with* United States v. VA Partners I, LLC, No. 16-cv-01672 (WHA), 2016 U.S. Dist. LEXIS 163605, at *1 (N.D. Cal. Nov. 1, 2016) (holding that investors who own a certain threshold of an issuer's stock may not communicate with the issuer without prior government approval).

92. *See* William T. Reid IV, Comment, *Implied Repeal of the Sherman Act Via the Williams Act:* Finnegan v. Campeau Corp., 65 ST. JOHN'S L. REV. 965, 971, 976 (1991) (describing court history of antitrust preemption conditions with examples *Silver v. Stock Exchange*, a 1963 case where the Supreme Court decided that "antitrust law could coexist

ValueAct's behavior and sufficiently nullifies the prosecution under the Hart-Scott-Rodino Act's "investment-only" exception.[93] ValueAct's disclosures were "squarely within" the SEC's purview since ValueAct would be required to report relevant purchases in its 13(d) filing.[94] The SEC would penalize ValueAct for failure to report mandatory disclosures, as the one of the Commission's primary functions is "actively" regulating disclosures.[95] Further, the SEC has primary authority in investor-company communication and over communications where an investor may purchase securities, which are the two primary limitations imposed on investors under Hart-Scott-Rodino.[96] Applying this to the *ValueAct* case, a court would likely find significant conflict between antitrust and securities laws since the fund would have been entitled to purchase without observing an approval waiting period, and could have also begun engaging with other shareholders, at any time before or after acquisition, without a company disclosure.[97] The latter element is particularly crucial

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provided that the imposition of the former did not render the workings of the latter ineffectual" and *Finnegan v. Campeau Corp.*, a 1990 case where the Second Circuit held "that applying antitrust laws to tender offers would upset the equilibrium of neutrality among bidders, shareholders, and management that the Williams Act seeks to achieve.").

93. *Credit Suisse*, 551 U.S. at 282 (stating that the involvement of antitrust courts in securities matters "mean that the securities-related costs of mistakes is unusually high.").

94. *See* 17 C.F.R. § 240.13d-1(a) (2018) ("Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (i) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13(d)." (emphasis added)).

95. *See* Press Release, Sec. & Exch. Comm'n, SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings (Sept. 10, 2014), https://www.sec.gov/news/press-release/2014-190 ("These reporting requirements under . . . Section 13(d) or (g) of the Exchange Act apply irrespective of profits or a person's reasons for acquiring holdings or engaging in transactions. The failure to timely file a required beneficial ownership report, even if inadvertent, constitutes a violation of these rules.").

96. *See* 15 U.S.C. § 18(a) (2018) (limiting interactions between investors and issuers prior to securities purchase approval, also limiting the timing of an investor's securities purchase); Mary Jo White, Chair, Soc'y of Corp. Sec'ys & Governance Prof'ls, Building Meaningful Communication and Engagement with Shareholders (June 25, 2015), https://www.sec.gov/news/speech/building-meaningful-communication-and-engagement-with-shareholde.html (ascribing the proxy process, which falls under the SEC's regulatory authority, as one of the most important communication outlets between shareholders and companies); *What We Do*, U.S. SEC. & EXCH. COMMISSION, https://www.sec.gov/Article/whatwedo.html (last updated June 10, 2013) (describing the SEC's authority over communication between investors and shareholders as well as the conditions under which investors may purchase).

97. *Compare* United States v. VA Partners I, LLC, No. 16-cv-01672 (WHA), 2016 U.S. Dist. LEXIS 163605, at *7–9 (N.D. Cal. Nov. 1, 2016) (holding that an issuer may

because ValueAct was denied the speech privileges under antitrust law when the Exchange Act and SEC regulations clearly permit the same type of communication.[98]

The Supreme Court in *Credit Suisse* emphasized that antitrust and securities laws are clearly repugnant when they "produce conflicting guidance, requirements, duties, privileges, or standards of conduct."[99] Under SEC regulations, but not FTC regulations, ValueAct can purchase stock at the opportune moment of their choosing and influence management.[100] If a court evaluated a case with similar facts to *ValueAct* and applied *Credit Suisse*, it would likely find that a hedge fund's ability to engage in activist behavior "is central to the proper functioning of well-regulated capital markets."[101]

C. ValueAct's Competitive Impact

The Northern District of California wrongly decided *ValueAct* because it neglected to properly consider the competitive impact of activist shareholders.[102] Hart-Scott-Rodino requires disclosure of securities purchases above a certain threshold by non-passive investors, implying that Congress believes active investors are more likely to stimulate anticompetitive behavior.[103] Pre-merger disclosure by activist investors is a

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not even manifest intent to engage an issuer on management issues, let alone act on that intent without government approval and disclosure of a securities purchaser), *with* 17 C.F.R. § 240.13d-1(b) (imposing only disclosure following a securities acquisition, refraining from regulating investor-issuer speech prior to purchase).

98. *Compare* Complaint ¶ 26, *VA Partners I, LLC*, 2016 U.S. Dist. LEXIS 163605, (No. 3:16-cv-01672) (citing meetings between securities acquirer and issuer without government approval or disclosure as evidence of Hart-Scott-Rodino violation), *with* 17 C.F.R. § 240.13d-1 (mandating securities disclosure only after purchase, and does not require issuer-investor communication preapproval).

99. *See* Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 264 (2007) (arguing that antitrust law as applied in this case would chill "legitimate [securities] conduct" for fear of antitrust lawsuits which would negatively impact the securities market).

100. *See* 15 U.S.C. § 18(a) (requiring securities purchasers to obtain approval before the purchase is complete); 17 C.F.R. § 240.13d-1 (requiring securities disclosure only after acquisition).

101. *Credit Suisse*, 551 U.S. at 276.

102. 15 U.S.C. § 16(b); *see* Competitive Impact Statement at 10, *VA Partners I*, *LLC*, 2016 U.S. Dist. LEXIS 163605 (No. 3:16-cv-01672) (reiterating the standard which the district court was required to evaluate the *ValueAct* consent decree, including "the impact of entry of such judgment upon competition in the relevant market or markets, upon the public generally and individuals alleging specific injury from the violations set forth in the complaint including consideration of the public benefit, if any, to be derived from a determination of the issues at trial.").

103. *See* Regulations, Statements, and Interpretations Under the Hart-Scott-Rodino Antitrust Improvements of 1976, 43 Fed. Reg. 33,450 (July 31, 1978) (stating that the

misguided attempt to enforce antitrust principles as demonstrated by the *ValueAct* case which imposed significant consequences upon an investor who did not pose an anticompetitive threat.[104]

Recent scholarship indicates that horizontal shareholding among large institutional investors as opposed to activist hedge funds poses a significant problem in antitrust.[105] This emphasizes the absurdity of requiring activists to seek permission before acquiring securities when passive investors do not need pre-approval and are a greater threat to anticompetitive behavior.[106] Research shows that the anticompetitive effects of horizontal shareholding emerge without communication between shareholders and management, again underscoring the purposelessness of restricting ValueAct's discussions with Baker Hughes and Halliburton.[107]

The government's allegations that ValueAct was attempting to facilitate the merger of Baker Hughes and Halliburton remain unproven because,

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Hart-Scott-Rodino premerger system "provides the enforcement agencies with advance notice of, and information about, certain transactions, and with an opportunity to seek a preliminary injunction in Federal district court to prevent consummation of any such transactions which may, if consummated, violate the antitrust laws."); Feinstein et al., *supra* note 21 (noting that only non-passive investors as opposed to passive investors are targeted for compliance with Hart-Scott-Rodino antitrust disclosure).

104. *VA Partners I, LLC*, 2016 U.S. Dist. LEXIS 163605, at *1; *see* 15 U.S.C. § 16(b)(2)–(3) (requiring the government to provide an explanation of the anticompetitive effect of entities it pursued for violation of antitrust laws); Martin C. Schmalz, *How Passive Funds Prevent Competition*, ERIC POSNER BLOG (May 18, 2015), http://ericposner.com/martin-schmalz-how-passive-funds-prevent-competition/ (contrasting an activist hedge fund's advocacy for strategies increasing DuPont's competitiveness with passive shareholder funds who voted against effort, presumably because competition did not benefit them).

105. *See* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1274 (2016) (synthesizing research which proves "anticompetitive effects arise from the fact that interlocking shareholdings diminish each individual firm's incentives to cut prices or expand output by increasing the costs of taking away sales from rivals.").

106. *See* Noah Smith, *Passive Investing Might Not Be Great for Growth*, BLOOMBERG (July 10, 2017, 6:30 AM), https://www.bloomberg.com/view/articles/2017-07-10/passive-investing-might-not-be-great-for-growth (citing researcher Antoinette Schoar who argues that large diversified funds who are common owners are not a risk to antitrust precisely because activist investors will rise above the larger funds and force companies to focus on competition).

107. *See* Complaint ¶ 26, United States v. VA Partners I, LLC, 2016 U.S. Dist. LEXIS 163605 (N.D. Cal. Nov. 1, 2016) (No. 3:16-cv-01672) (stating that ValueAct's meetings with Halliburton and Baker Hughes without disclosure and government approval evidenced ValueAct's violation of Hart-Scott-Rodino); Elhauge, *supra* note 105, at 1274 (explaining that managers understand through publicly available information that their shareholders also hold stock in competitors and make management decisions that benefit horizontal shareholders because managers believe it is in their own best interest to heed shareholder will; this is accomplished without coordination between managers and investors).

while ValueAct did purchase stocks in competing firms, there was no trial.[108] But, even if ValueAct had discussed the merger with both companies, the proportion of its role as an influencer in a merger decision compared with the burden of applying for securities acquisition does not justify the latter.[109] Further, activist funds like ValueAct are more likely than passive index funds to spur a company to be more competitive.[110]

In ValueAct, the FTC had the opportunity to review the antitrust implications and rejected the Baker Hughes-Halliburton merger before it was complete.[111] But with little connection between its antitrust goals and ValueAct, the FTC still fined them — a single investor in billion-dollar companies — $11 million for possibly having discussions about a potential merger.[112] If the district court had properly analyzed the competitive impact of *ValueAct*, it would have recognized that the consent decree did not sufficiently demonstrate ValueAct's antitrust competitive impact.[113] Further, the consent decree was not in the public interest because it inhibited the means by which activist shareholders bolster competition and market

108. *VA Partners I, LLC*, 2016 U.S. Dist. LEXIS 163605, at *1; *see* Nigro, *supra* note 23.

109. *See* David Benoit, U.S. v. ValueAct*: A Lawsuit to Define Activism*, WALL ST. J. (Apr. 4, 2016, 7:03 PM), https://www.wsj.com/articles/justice-department-sues-value act-over-baker-hughes-halliburton-disclosures-1459794637 (noting that as of its last regulatory filings close to the time of DOJ's complaint against it, ValueAct only owned 5.3% of Baker Hughes and roughly 1.9% of Halliburton).

110. *See* 15 U.S.C. § 18 (2018) (implying that active firms pose a greater risk to antitrust than passive firms since the two only passive investors are exempt from premerger disclosure); Azar et al., *supra* note 60, at 7 (arguing that activist hedge funds steward the competitive efforts of their issuers, finding that large institutional investors have the opposite effect even if they are "entirely 'passive' in terms of corporate governance (other than voting)").

111. *See* 15 U.S.C. § 46(a) (authorizing the FTC to investigate any business for compliance with antitrust laws); *id.* § 45(a)(1) (authorizing the FTC to prevent companies from "using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce."); Matt Levine, *Sometimes It's Hard for Owners to Talk to Companies,* BLOOMBERG (July 13, 2016, 2:38 PM), https://www.bloomberg.com/view/articles/2016-07-13/sometimes-it-s-hard-for-owners-to-talk-to-companies (arguing that Hart-Scott-Rodino may be helpful to the government's antitrust agenda but it was unnecessary to apply it to ValueAct since it ultimately blocked the Baker Hughes-Halliburton merger for reasons that had nothing to do with ValueAct's communication with either company).

112. *See VA Partners I, LLC*, 2016 U.S. Dist. LEXIS 163605, at *1 (alleging no actual antitrust violations against ValueAct but only finding them liable for failure to file a disclosure form).

113. *See* 15 U.S.C. § 16(e)(1)(a) (requiring the court to consider a consent decree in light of its alignment with the public interest and impact on competition in relevant markets).

returns.[114]

D. Correcting Course with Credit Suisse and the Public Interest Standard

In the absence of the Tunney Act, the ValueAct court may have correctly applied *Credit Suisse* to Hart-Scott-Rodino's impact on the timing of securities purchase disclosures and found that it improperly interfered with securities regulation.[115] The system through which the government lodges Hart-Scott-Rodino complaints gives the DOJ and the FTC an oppressive amount of power so that companies almost always settle through consent decrees.[116] The courts' "rubber stamp" authority under the Tunney Act has created two legal obstacles in Hart-Scott-Rodino adjudication.[117] First, a judge has never had the opportunity to offer a clear and consistent definition of "passive investor."[118] Secondly, a judge has never applied *Credit Suisse* to Hart-Scott-Rodino cases involving alleged non-passive investors.[119]

However, if the public interest standard (as dictated by the Tunney Act) must be applied, the district court in *ValueAct* should have recognized that communication between shareholders and issuers is in the public interest because it increases corporate oversight and competition.[120] In fact, one of

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114. *See id.* § 16(e)(1) (requiring judges to determine whether a DOJ consent decree is in the public interest); *VA Partners I, LLC*, 2016 U.S. Dist. LEXIS 163605, at *1; *see also* Azar et al., *supra* note 60, at 7 (finding activist shareholders benefit competition).

115. *See also* Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 285 (2007) (holding that securities law preempts antitrust law when they conflict). *See generally* 15 U.S.C. § 16 (limiting judicial discretion of DOJ consent decrees).

116. *See* JOSEPH G. KRAUSS ET AL., THE TUNNEY ACT: A HOUSE STILL STANDING, THE ANTITRUST SOURCE 2 (2007), https://www.americanbar.org/content/dam/aba/publishing/antitrust_source/Jun07_Krauss6_20f.authcheckdam.pdf (stating that the 2004 update to the Tunney Act was meant to broaden the judicial standard beyond the previous evaluative benchmark that judges simply ensure that decrees do not mock judicial power).

117. 15 U.S.C. § 16; KRAUSS ET AL., *supra* note 116, at 1.

118. *See Further Guidance on the HSR Act Investment-Only Exemption for Seemingly "Passive" Investors Engaging with Management*, CADWALADER (Nov. 2, 2016), http://www.cadwalader.com/resources/clients-friends-memos/further-guidance-on-the-hsr-act-investment-only-exemption-for-seemingly-passive-investors-engaging-with-management (noting that because the ValueAct settlement does not offer perfect guidance to investors, investors who identify as passive should reevaluate their approach lest it unintentionally contradict the new precedent).

119. *See* Gant et al., *supra* note 24, at 12–13 (stating that an "investment-only" allegation against an investor under Hart-Scott-Rodino has never been adjudicated in trial).

120. *See* Ohlhausen & Wright Statement, *supra* note 4 (responding to the FTC's enforcement against hedge fund Third Point for violating the "investment-only" Hart-Scott-Rodino exemption saying, "we believe such a narrow interpretation of the

the world's most powerful activist shareholders, Third Point, fought for more competition during the Dow and DuPont negotiations which represented the most significant merger in recent years and a big concern among antitrust watchdogs.[121] The *ValueAct* court was incorrect in finding that ValueAct's communication with its stock issuers was not in the public interest and thus further subverted public interest by failing to revise the passive investor definition to reflect the positive impact of hedge fund activism.[122] The more accurate determination by the court is that the narrow definition of "passive investor," as outlined by DOJ, has the potential to chill investor communication with shareholders, which the court in *Credit Suisse* sought to avoid.[123] This is against the public interest as activist shareholders provide an effective corporate oversight function which has anticompetitive spillover effects and actually help the FTC in its antitrust goals.[124]

IV. READJUSTING THE BURDEN AND ACTUALLY ENFORCING ANTITRUST

While the DOJ may consider the ValueAct enforcement to be a boon in catching anticompetitive behavior before it begins, its impacts have far more negative results than positive.[125] Congress should eliminate all pre-

'investment-only' exemption is not in the public interest" given that "the type of shareholder advocacy pursued by [Third Point] here often generated well-documented benefits to the market for corporate control.").

121. *See* Jack Kaskey, *Third Point's Loeb Suggests Carving DowDuPont Into Six Companies*, BLOOMBERG (May 24, 2017, 1:31 PM), https://www.bloomberg.com/news/articles/2017-05-24/third-point-s-loeb-suggests-carving-dowdupont-into-six-companies (describing Third Point's efforts to persuade Dow and DuPont to split into six entities instead of three upon merging).

122. *See* Sims & Herman, *supra* note 70, at 885–86 (explaining that the transaction delays caused by the Hart-Scott-Rodino disclosure process can negatively impact the economy); *see also* Bebchuk & Jackson, *supra* note 81, at 18–19 (citing evidence that investors who hold blocks of shares, such as activist hedge funds, provides a critical oversight function which enhances corporate governance).

123. *See* Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 283 (2007) (holding that antitrust laws may be inapplicable when they could potentially prohibit behavior otherwise legal under securities law); *see also* Howard A. Shelanski, *The Case for Rebalancing Antitrust and Regulation*, 109 MICH. L. REV. 683, 706–07 (2011) (articulating that the *Credit Suisse* decision was based on the Supreme Court's concern that lower courts, when confronted with an antitrust claim, would not have the proper securities law expertise and thus legal securities behavior will be deterred for fear of antitrust challenges).

124. *See* 15 U.S.C. § 16 (2018) (articulating Hart-Scott-Rodino's purview to intervene in anticompetitive behavior); *see also* Hadiye Aslana et al., *The Product Market Effects of Hedge Fund Activism,* 119 J. FIN. ECON. 226, 227 (2016) (finding that companies react to the shareholder activism within rival companies by "not only by reducing prices but also by improving their own productivity, cost and capital allocation efficiency, and product differentiation").

125. *See* Sims & Herman, *supra* note 70 (detailing the discrepancy in costs to

investment disclosure requirements from the Hart-Scott-Rodino Act and amend Hart-Scott-Rodino to serve instead as a consent doctrine whereby investors understand that, with acquisition of stock, they will be subject to antitrust scrutiny.[126] Consequently, Congress would remove the FTC's authority to review and reject securities purchases prior to completion. Instead of pursuing proactive securities acquisition disclosures, Congress should empower the FTC to perform reactive monitoring on acquisitions. This new approach should parallel the approach taken by the SEC in insider trading cases.[127] An amended Hart-Scott-Rodino should require the FTC to analyze 13(d) disclosures and utilize big data capabilities to detect unusual trading behavior that could have anticompetitive impacts.[128] The FTC can use this information to employ advanced antitrust enforcement mechanisms and focus agency resources on the entities merging, rather than on the investors involved.[129]

V. CONCLUSION

The DOJ and United States District Court for the Northern District of California, were incorrect in issuing the decision against ValueAct; the District Court should have properly restrained the DOJ from applying overly-restrictive limitations on investor communication which conflict with securities laws.[130] The Hart-Scott-Rodino Act interferes with investment strategy and is incompatible with securities law, as exemplified by the existence of wolf packs, in contrast to the FTC's restrictions on activist investors. The *ValueAct* decision demonstrates the failures of the Hart-Scott-

investors in Hart-Scott-Rodino compliance compared to the actual antitrust results produced).

126. *See* 15 U.S.C § 18 (prohibiting securities acquisitions of a certain threshold without government pre-approval, subject to a discrete list of exemptions).

127. *See* Daniel M. Hawke, *The SEC's "Trader-Based" Approach to Insider Trading Enforcement*, ARNOLD & PORTER (Sept. 13, 2006), https://www.apks.com/en/perspectives/publications/2016/09/the-secs-trader-based-approach-to-insider (detailing the SEC's two approaches to insider trading investigations: the "security based" approach which relies on news reports, tips, and events to identify trades made immediately before, and the "trader based" approach which analyzes trading patterns in individual and institutional investors).

128. *See* Reuters, *Here's How the SEC is Using Big Data to Catch Insider Trading*, FORTUNE (Nov. 1, 2016), http://fortune.com/2016/11/01/sec-big-data-insider-trading/ (describing the SEC's sophisticated trading analytical capabilities).

129. *See How Mergers are Reviewed*, FED. TRADE COMM'N, https://www.ftc.gov/news-events/media-resources/mergers-and-competition/merger-review (last visited Feb. 14, 2019) (outlining the merger review process wherein companies seeking a merger over a certain dollar threshold must get approval before culmination).

130. United States v. VA Partners I, LLC, No. 16-cv-01672, (WHA), 2016 U.S. Dist. LEXIS 163605, at *1 (N.D. Cal. Nov. 1, 2016).

Rodino review structure to properly adjudicate alleged violations.[131] Therefore, it should be revised to minimize opportunity costs to shareholders and align with the freedoms granted by securities law.[132]

131. 15 U.S.C. § 16.

132. *See generally* 17 C.F.R. § 240.13d-1 (2018) (providing investors an advantage in securities disclosure).

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