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TOWARDS SHAREHOLDER VOTE ON EQUITY ISSUANCES

NICCOLÒ CALVI*

New share issuances are capable of severe corporate governance consequences for the issuer and should be considered fundamental changes. Several recent Delaware cases confirm the severity of new share issuances, showing that the transactions have been used to affect the ownership structure of the firm, with the goal to either dilute or strengthen the participation of identified shareholders. U.S. law adopts a management-centric approach to the transaction, which is more focused on its economic side and seems consistent with the traditional view of public corporations with dispersed shareholders. However, this legal framework does not seem responsive to shareholders' interests anymore.

The institutionalization of the shareholder base of public firms has increased the average concentration of the ownership structures and the shareholders' powers. This Article identifies several instances of conflicts between the insiders and the outsiders, where shareholders carry a strong interest in avoiding the dilution of their voting power. Moreover, the entire fairness analysis proves to be flawed in that it fails to consider that the value of voting rights is highly subjective both for controllers and minority shareholders. Managers may take advantage of the tool, exploiting either the value or the voting rights of the existing shareholders. The claim of this Article is to increase the shareholders' power in U.S. law.

The comparative analysis helps identify possible tools. Namely, European legal systems set forth both the preemptive right and the requirement of the existing shareholders' approval. After having identified the flaws of the preemptive right provision — mainly due to the information asymmetry that affects outsider shareholders — this Article puts up a new framework requiring mandatory approval of new share issuances. Certain recent Italian cases witnessed a successful opposition

* Ph.D. Candidate, Bocconi University. LL.M. and Fellow of the Program on Corporate Governance, Harvard Law School. The author would like to express his sincere gratitude to Guhan Subramanian for his supervision and guidance. The author is also thankful for comments from Jesse M. Fried, Edward B. Rock, and Mark J. Roe.

by the outsider shareholders, who cast a negative vote and prevented the completion of the transaction. The value of the proposed rule in this Article declines depending on the presence of a controlling shareholder. Namely, while in non-controlled firms all the shareholders should be entitled to cast their vote, in controlled firms, the controller should vote only if the issuance does not strengthen her position, in order to avoid tunneling issues.

Authoritative studies debated the increase of shareholders' powers in public firms. Other essays focused on the issue of midstream recapitalizations and the protection of the minority shareholders in controlled firms. This Article analyzes a wide range of new share issuances both in controlled and in non-controlled firms, considering the possible incentives underlying the decision to enter into the transaction. The impact of the transaction is not trivial since, among other reasons, any debate on shareholder engagement and activism is frustrated as the insiders are empowered to easily dilute the "noisy" outsiders at will.

I. INTRODUCTION

The issuance of new shares is an immediate corporate way to raise additional equity capital. This statement is equally applicable to each case regardless of a firm's features such as the country of incorporation, the listing of its securities, the size and the governance, and transactions' features such as the purchasers' identity and the new share price. However, depending on the combination of these traits, an equity issuance may cause several additional effects. Namely, according to this Article, it is a fundamental change considering its potentially massive impact on the ownership structure and the governance of the issuer.

In February of 2013, Steel Partners Holdings, L.P. ("Steel Holdings") entered into a settlement agreement with the board of directors of ModusLink Global Solutions ("ModusLink"), after acquiring the public stocks of ModusLink since 2011, and reaching a stake granting 14.9 percent of the voting rights.[1] Pursuant to the agreement, ModusLink privately issued shares and warrants to Steel Holdings, which increased its ownership to 29.9 percent and, as of December 2016, owned approximately 35.62 percent of the outstanding shares.[2] In December of 2017, in order to fund an acquisition, the Special Committee and the Board of ModusLink approved a capital raise through the issuance of convertible preferred stocks to the alleged controller.[3] The initial conversion price was at a 31.5 percent premium over the previous day's closing price of the stock, significantly increasing Steel Holding's voting power from 35.62 percent to nearly half (*i.e.*, 46.76 percent).[4] The board further approved the issuance of the equity grants to three members affiliated with Steel Holdings, which, together with its affiliates, reached beneficial ownership equal to approximately 52.3

1. Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 WL 2714065, at *2 (Del. Ch. June 28, 2019).

2. *Id.* at *2.

3. *Id.* at *4.

4. *Id.*

percent.[5] Therefore, over the years, Steel Holdings achieved majority control of the issuer, taking advantage of both: (i) the 2013 private placement; and (ii) the 2017 equity financing transaction that was under review in the dispute.[6]

In July of 2014, in the context of the purchase of another company — Lorillard, Inc. ("Lorillard"), exchanged for both stocks and shares — Reynolds American, Inc. ("Reynolds American") issued new shares to its forty-two percent shareholder British American Tobacco PLC ("British American Tobacco"), preventing the latter from being diluted by the transaction.[7] While the issuance might facially seem to not affect the governance of the firm — in that the alleged controller does not increase its ownership stake — this is not the case. In fact, pursuant to the transaction entered into with Lorillard, the shareholders of the latter would own approximately fifteen percent of Reynolds American: due to the issuance (reserved to British American Tobacco), only the public shareholders of Reynolds American were affected by the entrance of Lorillard's shareholders into the ownership structure of the firm.[8] Therefore, the impact on the issuer's governance was not trivial.[9]

In May of 2017, Surgery Partners, Inc., a Delaware corporation with a concentrated ownership structure ("Surgery Partners"), and its controlling stockholder, H.I.G. Capital, LLC ("HIG"), entered into a series of interrelated transactions that provided, among other things, that: (i) HIG would sell its fifty-four percent common stock stake to an affiliate of Bain Capital Private Equity, LP ("Bain"); and (ii) Surgery Partners would issue to Bain newly created convertible preferred stocks in exchange for $310 million.[10] These preferred stocks voted with the common stock and provided for some tailored terms enabling Bain to further lock the control of the issuer. Namely, holding half of these newly issued preferred stocks (regardless of a possible dismissal of the common stocks) empowered Bain to prevent Surgery Partners from entering into a number of corporate governance and

5. *Id.* at *5.

6. *See id.* at *1–3 (detailing the background surrounding Steel Holdings' majority control status).

7. Corwin v. Brit. Am. Tobacco, PLC, 821 S.E.2d 729, 731 (N.C. 2018). Note that the ruling of the Supreme Court of North Carolina makes extensive use of Delaware case law.

8. *Id.* at 735.

9. *See id.* at 736 ("BAT's voting power did not increase, but it was allowed to remain constant at the sole expense of plaintiff and the other non-BAT stockholders, whose voting power significantly decreased.").

10. *See* Klein v. H.I.G. Capital, LLC, No. 2017-0862-AGB, 2018 WL 6719717, at *3 (Del. Ch. Dec. 19, 2018).

corporate finance transactions.[11] Also, the recapitalization allowed Bain to reach approximately sixty-six percent of the voting power of the issuer, combining the voting right of common stocks and preferred stocks.[12] Neither a special committee of independent directors was appointed for this purpose nor did the outsider public shareholders' vote on the transaction, which the controller approved by written consent.[13] Also, the structure of the transaction resulted in allegedly incentivizing HIG to underprice the preferred shares issued by the target in order to maximize the price at which Bain acquired HIG's shareholding.

In May of 2018, the Special Committee of the Board of CBS Corp., a dual-class Delaware corporation ("CBS"), entered into a series of actions that, if successful,[14] would have diluted the voting rights of the controlling shareholder,[15] National Amusements, Inc. ("NAI"), from eighty percent to seventeen percent through the issuance of a voting shares stock-dividend to the holders of both voting and non-voting classes of CBS shares.[16] The Special Committee claimed that its move was a response to a threat to the corporation by NAI, as the Special Committee had not recommended the approval of a business combination that the major shareholder had strongly suggested.[17] The Delaware Court of Chancery had to rule on NAI's alleged power to execute an amendment to CBS's corporate charter aimed at requiring a supermajority in order to approve a dividend, and therefore, empowering the controller to veto the transaction at hand.[18]

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11. *See id.* ("As long as Bain retains 50% of the shares of the Preferred Stock issued in the Bain Share Issuance, its affirmative vote is required before the Company can pay dividends other than dividends on the Preferred Stock; enter into a recapitalization, share exchange, or merger; increase its indebtedness; or modify any provision of the Company's organizational documents that would adversely affect the powers of the Preferred Stock, among other things.").

12. *Id.*

13. *Id.*

14. *See* CBS Corp. v. Nat'l Amusements, Inc., No. 2018-0342-AGB, 2018 WL 2263385, at *2 (Del. Ch. May 17, 2018) ("[T]he stock dividend would be conditional 'unless and until the Delaware Courts decide on a record whether it is legally and equitably permissible.'").

15. Ms. Redstone — the controller — was entitled to exercise either directly or indirectly (through her participation in NAI) the heavy majority of the voting rights (approximately 79.6 percent) without holding a proportional economic interest in the firm (approximately 10.3 percent of the economic stake). *Id.* at *1.

16. *Id.* at *2.

17. *Id.*

18. *Id.* ("NAI had executed and delivered consents to amend CBS's bylaws to, among other things, require approval by 90% of the directors then in office at two separate meetings held at least twenty business days apart in order to declare a dividend.").

These public firms' cases illustrate how new equity issuances may affect the ownership structure of a public corporation. U.S. law entrusts insiders with great flexibility in approving the transaction, provided that the price is fair to the corporation. This approach complies with the traditional view of the dispersed public corporation, whose shareholders are mainly (or only) concerned with the economic return of their investment rather than the firm's governance. However, this assumption is not accurate anymore with regard to the ownership base of several corporations. Several shareholders are concerned about dilution, and equity issuance is a powerful tool to address the conflict of interests between insiders and outsiders. Managers may employ this tool to dilute a noisy minority shareholder (*e.g.*, an activist hedge fund) in dispersed public firms or the controlling shareholder (if present) against her will. In a different scenario, should the controller be or have an influence over the decision maker, she may exploit the minority shareholders and strengthen her position in the firm.

This Article studies the issuance of new equity in U.S. firms from a corporate governance perspective and discusses how the transaction affects the interests of existing shareholders. Since this Article focuses on listed companies, it mainly considers Delaware law,[19] although relevant rulings from other states will not be disregarded when dealing with public firms. The research uses a comparative method: U.S. legal framework — having a unique approach in dealing with shareholders' dilution with regard to both the allocation of powers and shareholders' rights — is compared to that of European countries.[20]

After explaining how the transaction may be used to achieve insiders' goals and arguing that the current U.S. legal framework does not adequately protect the outsiders' interests, Part V develops a normative narrative, taking advantage of the comparative experience. Namely, this Article analyzes the two main features (for the purposes of this transaction) of European Union ("EU") regulation — which maintains both the shareholders' vote and the preemptive right — and claims that U.S. law should set forth a voting mechanism to approve new share issuances.

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19. *See* DEL. DIV. CORPS., 2019 ANNUAL REPORT STATISTICS 1 (2019), https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2019-Annual-Report.pdf (showing that, among other things, 67.8 percent of all Fortune 500 companies are incorporated in Delaware and eighty-nine percent of U.S.-based IPOs in 2019 chose Delaware as the incorporation state).

20. Unless otherwise specified (*e.g.*, when refences will be made to the rules of law set forth by the European Union), the use of the adjective "European" throughout this Article is meant to cover not only the countries of the European Union but all the countries of the European area including, among others, the United Kingdom, whose approach to the transaction at hand will often be considered.

Recent legal scholarship has extensively analyzed all the transactions reallocating control rights in controlled public firms.[21] Other authors have studied the preemptive right in new share issuances, discussing its application and limits.[22] The scope of this Article is not related to the governance problems of a specific type of firm, but rather it focuses on a single transaction (*i.e.*, new share issuances) and extensively covers its application to both controlled and non-controlled firms. While the ultimate goal is to develop a comprehensive legal framework regulating this transaction as a whole, the voting mechanism that this Article suggests requires a different framing depending on the allocation of powers in the firm and who should be deemed outsiders in the transaction.

The remainder of this Article is divided as follows: Part II explains shareholders' concerns about the dilution resulting from the issuance of new shares; Part III positions the issue within the traditional corporate governance conflict between shareholders and managers; Part IV describes the current shareholder powers in the issuance of new shares and their limits; Part V proposes a new legal framework providing for increased powers; and Part VI concludes.

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21. *See generally* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016) [hereinafter Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*] (positing a new framework of corporate control that emphasizes control of entrepreneurs, which allows them to pursue their idiosyncratic vision); Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120 COLUM. L. REV. 941 (2020) [hereinafter Goshen & Hamdani, *Corporate Control, Dual Class*] (assessing the reallocation and valuation of control rights and suggesting a stronger reliance on the interpretation of the corporate charters with regard to the allocation of powers to approve such reallocations); Zohar Goshen & Assaf Hamdani, *Majority Control and Minority Protection*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) [hereinafter Goshen & Hamdani, *Majority Control and Minority Protection*] (contending that minority protection must be balanced with enabling entrepreneur-controllers to pursue their vision); Geeyoung Min, *Governance by Dividends*, 107 IOWA L. REV. (forthcoming 2021) (on file with author) (analyzing the impact of stock dividends on corporate control in dual-class companies from a policy perspective); Lefteri J. Christodulelis, Note, *Seizing the First-Mover Advantage: Resolving the Tension in Delaware Law Between Boards of Directors and Controlling Shareholders*, 120 COLUM. L. REV. 431 (2020) (examining the tension created from transferring control to shareholders).

22. *See, e.g.*, Marco Ventoruzzo, *Issuing New Shares and Preemptive Rights: A Comparative Analysis*, 12 RICH. J. GLOB. L. & BUS. 517, 518 (2013) (examining the differences between the United States and European countries in the limits applied to directors' power to issue new shares and regulate preemptive rights).

II. THE DILUTION ISSUE FROM SHAREHOLDERS' PERSPECTIVE

A plethora of economic literature has delved into the topic of the issuance of new shares, pointing out its genuine feature to be a valuable financing method to raise new equity capital.[23] However, the transaction, depending on its structure, may become a powerful tool for the firm's decision maker, strategically affecting the ownership structure of the issuer. This Part deals with the existing shareholders' perspective on the dilution: Section A focuses on the economic meaning of the term according to Delaware case law and literature; Section B positions the current U.S. legal framework regulating new stock issuances in the comparative context; and Section C suggests that the Delaware approach to dilution is not any more responsive to the concerns of a less dispersed ownership structure.

A. Dilution Meaning in Delaware Law

The term "dilution" should be split into two different, although connected, meanings depending on whether the focus is on financial or voting rights.

i. Economic Dilution

An existing shareholder is economically diluted whenever the overall value of the shares she holds before the issuance decreases because of the transaction. This effect occurs should both of the following requirements be met: (i) the price of the newly issued shares is lower than the market value of the outstanding shares before the transaction; and (ii) the shareholder does not purchase a fraction of the newly issued shares at least equal to the fraction of the shares she originally held (*i.e.*, she does not participate at least pro-rata in the new shares issuance). In fact, a claim for economic equity dilution must be factually based "on the theory that the corporation, by issuing additional stock for inadequate consideration, made the complaining stockholder's investment less valuable."[24]

ii. Voting Dilution

An existing shareholder experiences a voting power dilution whenever her fractional voting power declines because of the issuance. However, in this

23. *See generally* Woojin Kim & Michael S. Weisbach, *Motivations for Public Equity Offers: An International Perspective*, 87 J. FIN. ECON. 281 (2008) (studying the different industrial and financial reasons underlying the decision to issue additional equity).

24. Feldman v. Cutaia, 951 A.2d 727, 732 (Del. 2008); *see also* Cirillo Fam. Tr. v. Moezinia, No. 10116-CB, 2018 WL 3388398, at *16 n.153 (Del. Ch. July 11, 2018) (citing Feldman v. Cutaia, 956 A.2d 644, 655 (Del. Ch. 2007), *aff'd*, 951 A.2d 727 (Del. 2008)).

scenario, the transaction does not have to negatively affect the overall value of the stake that the existing shareholder held before the issuance. A shareholder's participation experiences a voting dilution when: (i) the price of the newly issued shares is equal to or above the market value of the outstanding shares; and (ii) the shareholder does not proportionally purchase the newly issued shares.[25]

Arguably, although the relationship is not reciprocal, the experience of economic dilution is conditioned upon the occurrence of voting dilution (*i.e.*, the transaction must negatively affect the fractional ownership of the shareholder in the firm). In fact, otherwise, in the event of an underpriced issuance, any loss in the value of the shareholder's existing stake is offset by the capital gain that she captures through the purchase of a proportional fraction of the new, underpriced issuance.[26]

Finally, in response to a claim by an allegedly diluted shareholder, a third kind of dilution has been theorized in the context of a Delaware case, the so-called "market price dilution":[27] this is the only supposed dilution scenario where a shareholder suffers a decline in the value of her participation without having her fractional voting rights reduced. In fact, such loss is identified by the fall of the market price of the already issued and publicly traded stocks of the company that occurs following the issuance. Reasonably, such alleged "dilution" is not a direct consequence of the issuance on the shareholder's participation, but of its impact on the market price of the securities. In other words, it does not result from the transaction itself but from the market's perception of its announcement. The court in its ruling explained the decline in the stock price as a consequence of the increase in the overall number of the issuer's shares offered on the market and explicitly endorsed the theory that the demand for the equity securities of a firm is "downward sloping and elastic."[28] Several scholars agreed on this intuition and some of them

25. *See* Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701, 708 (2011) [hereinafter Ganor, *The Power to Issue Stock*] (explaining voting right dilution and economic dilution); Ventoruzzo, *supra* note 22, at 517.

26. *See* Mike Burkart & Hongda Zhong, *Equity Issuance Methods and Dilution* 3 (Eur. Corp. Governance Inst., Working Paper No. 636/2019, 2019) (noting that the feature of preemptive rights is that as long as the existing shareholders fully exercise their rights, no dilution shall occur, and wealth transfers can be avoided); *see also infra* Section V.A (elaborating further on the statement in the context of the preemptive rights analysis).

27. *See* Ford v. VMware, Inc., No. 11714-VCL, 2017 WL 1684089, at *20 (Del. Ch. May 2, 2017) (suggesting the use of the label "market price dilution").

28. *Id.* (considering the decline in price as the consequence of (i) a "downward sloping and elastic" demand curve for the issuer's shares and (ii) an increase in the supply of the assets, which may occur even though the issued shares belong to a different class).

corroborated such a price-pressures hypothesis with empirical evidence.[29] Other studies argued that stock price reduction is the ultimate consequence of the market's perception that the issuance of shares arises from a board of directors' convincement that the stock is overpriced: in the context of asymmetric information, the market negatively reacts to the transaction.[30] While the scope of this Article does not cover the ultimate economic explanation of the decline in securities price following the stock issuance, it is useful to point out how this "market price dilution" shall not be considered within the dilution issues that this Article analyzes. In fact, taking advantage of the wording of the Delaware Court's reasoning, this "new" dilution concept does not meet the requirement that the company "issue equity that reduces the relative ownership or voting power of the pre-issuance holders."[31]

B. Dilution Protection in Delaware Law: A Comparative Perspective

New share issuances may adversely affect shareholders' interests in several ways, including by: (i) transferring wealth from existing shareholders to the purchasers of new shares; (ii) diluting voting power; and (iii) weakening managers' degree of accountability towards shareholders.[32] Reasonably, only the first item belongs to the category of the economic dilution since items *sub* (ii) and (iii) may result even from a non-underpriced issuance. As a general approach, corporate law is required to address the conflict between the need of the corporation to raise additional capital and the protection of the existing shareholders from dilution. From a policy perspective, a legal system may address this issue in two different ways depending on the nature of the tool that shareholders are granted. Under a

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29. *See, e.g.*, Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579, 589 (1986); Clifford G. Holderness & Jeffrey Pontiff, *Shareholder Nonparticipation in Valuable Rights Offerings: New Findings for an Old Puzzle*, 120 J. FIN. ECON. 252, 265 (2016) ("There is considerable evidence of downward sloping supply curves for shares of stock."); *cf.* Myron S. Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179, 207 (1972) (arguing that regressions support the substitution hypothesis against the selling-pressure hypothesis).

30. *See* Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61, 62 (1986) (reviewing and summarizing several theories on the point debated as of the date of their essay); Massimo Massa et al., *Rights Offerings, Trading, and Regulation: A Global Perspective* 3 (INSEAD, Working Paper No. 2013/120/FIN, 2013); Holderness & Pontiff, *supra* note 29, at 264–66 (exposing further findings concerning the stock price reaction and the negative information that the market infers about the narrower case of a nontransferable rights offering).

31. *Ford*, 2017 WL 1684089, at *20.

32. *See* EILÍS FERRAN & LOOK CHAN HO, PRINCIPLES OF CORPORATE FINANCE LAW 105 (2d ed. 2014).

property rule protection, shareholders may not be expropriated of their assets without their consent, regardless of the consideration that they receive; therefore, they cannot be deprived of their voting rights absent their vote as a class.[33] By contrast, the liability rule protection consists of a deal-oriented approach that enables the decision maker to expropriate the shareholders as long as they receive a fair price in exchange.[34] Although the majority of the legal scholarship has addressed the dichotomy in the context of the conflicted transaction, it is also arguably applicable to new equity issuances, as the comparative analysis between different countries confirms.

The U.S. legal framework — adopting a liability rule — is more focused on protection from the economic dilution rather than from the voting one.[35] To begin with, U.S. rules generally empower directors with the decision to issue new shares and seldom require the approval of the shareholders.[36] Also, existing shareholders are generally not granted the right to participate in the new issuance: in fact, the preemptive right is not either a mandatory or a default provision, and its adoption is very rare in public firms.[37] Namely, the most effective limit on managers' discretion and the most powerful protection of shareholders' interests relies on the application of directors'

33. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV 1089, 1092 (1972) ("An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller."); *see also* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 398 (2003) [hereinafter Goshen, *The Efficiency of Controlling Corporate Self-Dealing*] (applying the notion of property rules to group rights and the corporate organization); Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 601 (analyzing the property rule protection from the controlling shareholder's perspective).

34. Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 398 ("A liability rule allows transactions tainted with self-dealing to be imposed on an unwilling minority but ensures that the minority is adequately compensated in objective market-value terms.").

35. FRANKLIN A. GEVURTZ, CORPORATION LAW 134 (2d ed. 2010) ("[T]he more frequent concern is the potential dilution of the economic worth of the existing shares.").

36. *E.g.*, *In re* Nine Sys. Corp. S'holders Litig., No. 3940-VCN, 2014 WL 4383127, at *28 (Del. Ch. Sept. 4, 2014) ("Delaware law endows the board — not a controller — with the exclusive authority to manage and direct the corporation's business affairs, the foremost example of which is the power to issue stock."); Grimes v. Alteon, Inc., 804 A.2d 256, 261 (Del. 2002) ("Taken together, these provisions confirm the board's exclusive authority to issue stock and regulate a corporation's capital structure."). See *infra* Part IV for a discussion of the main cases triggering the shareholder vote.

37. ROBERT CHARLES CLARK, CORPORATE LAW § 17.1.4 (1986); *see* Edward Rock et al., *Fundamental Changes*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 171, 182 (3d ed. 2017) [hereinafter Rock et al., *Fundamental Changes*].

fiduciary duties to the transaction.[38] By contrast, the default rules of other legal frameworks, including those of EU countries, provide for a two-fold interaction with the shareholders' meeting in that they set forth both the shareholders' vote and the preemptive right.[39] This broader autonomy that U.S. rules grant to the managers is consistent with the overall approach to corporate law: as a seminal comparative corporate law study has pointed out, "EU law and, to some extent Japanese law, accord more attention to [the] management-shareholder conflict in regulating corporate decisions than does the law of U.S. jurisdictions."[40]

However, this manager-friendly attitude proves to have some flaws. Namely, the entire fairness standard is the highest burden that the issuance of new shares currently may have to meet, should the business judgment rule not apply to the transaction, and it mainly consists in an ex-post analysis that the courts carry out on the transaction consideration.[41] Although this rule might seem effective in incentivizing managers to set an issuance price that is fair to the corporation, two different issues may arise.

First, courts apply the entire fairness standard only if they find the transaction to be self-dealing.[42] This approach assumes that absent a conflict of interest, the issuance price is fair. However, satisfying the burden of proof that the transaction is self-dealing is often a problematic task and even a non-self-dealing transaction might harm (certain) shareholders.[43] The above-mentioned case *Corwin v. British American Tobacco PLC*[44] witnessed

38. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 183 (arguing that the duty of loyalty can be at least as effective as preemptive rights, provided that private enforcement institutions are effective); Ventoruzzo, *supra* note 22, at 527 (pointing out the power and flexibility of the fiduciary duties in limiting managers' discretion in the issuance of shares).

39. *See* Directive 2017/1132, of the European Parliament and of the Council of 14 June 2017 Relating to Certain Aspects of Company Law, 2017 O.J. (L 169) 80 ("[D]ecision by the general meeting on the increase of capital"); *id.* at 81 ("Increase in capital by consideration in cash").

40. Rock et al., *Fundamental Changes*, *supra* note 37, at 202.

41. *See* Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 403 ("The fairness-test protection is no more than a guarantee that the transaction will be fair . . . ."); Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 950 (explaining that the entire fairness review is a two-fold scrutiny test concerning both the process underlying the transaction ("fair dealing") and the transaction price ("fair price")).

42. *See* Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 397; Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 975 (explaining how the entire fairness standard governs self-dealing).

43. *See* Min, *supra* note 21 (manuscript at 43) (noting that the majority of the cases of directors amending the governance structure of the firm through the distribution of dividends did not witness an express conflict of interest).

44. 821 S.E.2d 729 (N.C. 2016).

similar circumstances.[45] In fact, not only did public shareholders incur a dilution of their voting rights as a result of the issuance but also the economic terms of the transaction seemed to favor the subscriber (and alleged controller) British American Tobacco, which was able to purchase the new shares at a price cheaper than the closing price of the issuer's trading price on the day before the signing of the transaction[46] at a "negative 4.8% premium."[47] Therefore, when the transaction closed, British American Tobacco — due to the further rise in the stock's market price — secured a profit equal to approximately $920 million, which it did not share with the other shareholders.[48] However, Reynolds American's public shareholders failed to prove breach of fiduciary duties in the transaction by either the board of directors or British American Tobacco. Namely, both the North Carolina Business Court and the Court of Appeals dismissed the action against Reynolds American managers, respectively, on the merits and due to lack of standing.[49] With regard to British American Tobacco, the Supreme Court of North Carolina stated that it was not a de facto controlling shareholder[50] in spite of, among other things, its forty-two percent shareholding veto power over the board and role as the main source of equity financing for the issuer; furthermore, it had allegedly behaved aggressively towards the managers in the context of the transaction.[51]

Second, even if the court found the transaction to be self-dealing, there are instances when a fair issuance price does not prevent the transaction from discriminating within the shareholders' class and undermining certain shareholder interests.[52] Indeed, it has been argued that a troublesome situation arises — and the shareholders' protections prove to be insufficient — in the event of a selective sale of the new shares to some existing or new shareholders, provided that the issuance price is fair to the corporation.[53] To this extent, under Delaware law, the firm's decision maker is empowered to effectively issue new shares (to herself or sympathetic investors) and shift the control of the firm, without dealing or negotiating with the minority

45. *Id.* at 733; *see also supra* text accompanying notes 7–9.

46. *Corwin*, 821 S.E.2d at 742.

47. *Id.* at 751 (Hudson, J., dissenting).

48. Corwin v. Brit. Am. Tobacco, 796 S.E.2d 324, 328–29 (N.C. Ct. App. 2016).

49. *Id.* at 338.

50. *See Corwin*, 821 S.E.2d at 743.

51. *Id.* at 753–54 (Hudson, J., dissenting).

52. *See infra* Section II.C.

53. *See* Ventoruzzo, *supra* note 22, at 528 (mentioning other problematic cases, such as the issuance of new "shares to themselves at a fair price" or of the offer to existing shareholders exploiting those who lack funds, although in such cases, a possible and adopted solution consists of requiring a business purpose for the transaction).

shareholders (nor the independent directors), but only the court scrutinizes the fairness of the transaction's price.[54] On a firm level, it has been pointed out that the valuation of a corporation is a problematic task for courts due to the lack of a universal method applicable to all the cases.[55] Furthermore, on a shareholder level, as the following Parts further explain, certain existing or prospective shareholders are willing to subscribe new shares even at a price above the fair market value.[56] Authoritative professors recently addressed the issue, claiming that the entire fairness standard — usually applied to self-dealing transactions — should not be applied to a transaction reallocating control rights since, among other things, the value of control rights is highly subjective.[57] Accordingly, economic models that help courts assess the fair price of the reallocation of control rights "do not exist" differently from what happens in the case of a sale and purchase of assets or entire firms.[58] Arguably, the same reasoning should apply to strategic issuances, which shift the voting rights regardless of whether the ownership structure of the firm is controlled or dispersed and the transaction entails a transfer of control. A decline in the voting power may be a harm by itself even if the firm allegedly receives a fair price; therefore, applying the entire fairness standard to a dilutive issuance of shares that alters the ownership structure of the firm is an inaccurate remedy. This claim is consistent with the argument of recent research that points out how different shareholders value their voting rights, distinguishing between dispersed retail shareholders who seldomly cast their vote and active ones who accumulate them in order to seek corporate changes.[59]

As mentioned above, this feature of the rules governing the issuance of new shares flags a material difference between the United States and several other countries, including the European ones. Multiple explanations might

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54. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 975–77 (addressing the case of the controller engaging in self-dealing transactions). Arguably, the argument applies to all the cases where the decision maker of the firm or the person controlling it engages in similar transactions.

55. *See* Yu-Hsin Lin, *Controlling Controlling-Minority Shareholders: Corporate Governance and Leveraged Corporate Control*, 2017 COLUM. BUS. L. REV. 453, 496 (2017) (applying the reasoning to appraisal proceedings).

56. *See infra* text accompanying notes 170–88.

57. *See generally* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21 (discussing how a test determining which reallocations are allowed and not allowed will eventually revert back to business judgment review).

58. *Id.* at 946.

59. *See* Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 695 (2019) [hereinafter Lund, *Nonvoting Shares*] (using the argument as a ground to advocate a governance system that efficiently distributes voting rights).

be given to the point. In the context of a massive and detailed report carried out on behalf of the United Kingdom government on the topic of new equity issuances ("Myners Report"), it has been indicated that in the United States, the main interest is public firms' access to equity capital rather than protecting shareholders from dilution risk.[60] Arguably, in the United States, the philosophies underlying the nature and the role of the public firm's shareholders are different from that of EU countries. In fact, there appears to be a stronger conception of *purchase* of the equity securities[61] rather than of *subscription* of shares: while the latter commits the shareholders to the execution of the corporate contract, the former shows a mere economic interest in the corporation. The Myners Report found that in the United States, "investors have the limited role of buying and selling without any particular commitment to the governance or long-term strategy of the companies in which they invest."[62] To this extent, EU laws tend to protect the property rights of shareholders through mandatory rules, undermining the flexibility of the managers in amending the financial structure of the firm.[63] A comparative study on freeze-outs pointed out similar differences between the two conceptions and underlined the dichotomy between mere financial and voting rights in the U.S. approach and the "pure 'untouchable' right of property."[64] While the freeze-out transaction is indisputably different from new equity issuances in that its application is limited to controlled companies and is an extreme change to the ownership structure of public firms, the argument can be transposed. Namely, the bottom line is that the U.S. legal system allows greater flexibility in the composition of the shareholders' base as long as the economic value of the shareholders is not exploited.[65]

The described attitude might come from either a cultural and political background or an economic landscape, where the majority of the public companies used to have a fragmented ownership structure.[66] To this latter

60. PAUL MYNERS, PRE-EMPTION RIGHTS: FINAL REPORT 17 (2005), https://webarchive.nationalarchives.gov.uk/20060213221519/http://www.dti.gov.uk/cld/public.htm.

61. *Id.* at 16 (explaining that in the United States, "investors have the limited role of buying and selling without any particular commitment to the governance or long-term strategy of the companies in which they invest").

62. *Id.*

63. *See* Ventoruzzo, *supra* note 22, at 542.

64. Leonardo Pinta, Note, *The U.S. and Italy: Controlling Shareholders' Fiduciary Duties in Freeze Out Mergers and Tender Offers*, 7 N.Y.U. J.L. & BUS. 931, 936 (2011).

65. *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 413 (2006) (listing economic rights as one of four "fundamental rights" shareholders have under current law).

66. *See* Ventoruzzo, *supra* note 22, at 542 (suggesting the theory as one of the possible explanations for the different approaches to preemptive rights in the United

extent, the paradigm of the so-called Berle-Means corporation — as defined by Professor Roe — is a public company with dispersed public shareholders.[67] This model results in two main consequences: (i) the power of the managers is strong; and (ii) given that the legal system and the market tend to develop together, the former sets forth provisions protecting the dispersed public shareholders from the managers, based on what were perceived as their main concerns.[68] The U.S. approach perfectly complies with the perception of the so-called Berle-Means corporation, treating the shareholders as investors with the underlying assumption that they do not consider protection from dilution of their respective fractional voting rights a critical priority. This seems to fit within the definition of fragmented dispersed shareholders, who are concerned about the exploitation of the value of their respective investment and likely deem less problematic the reduction in the strength of their respective voting power since, individually, each shareholder is capable of having only a trivial effect on the vote of the shareholders as a class. Section II.C, however, exposes how this model is not any more representative of the majority of U.S. public firms.

While the reason underlining the peculiar and flexible approach of U.S. corporate law to new share issuances is debatable, the potential impact of this transaction on the core corporate governance issues seems to be undisputed. As a final remark, the Myners Report, dated 2005, suggested a connection between the differences in the rules on new equity issuances between the United Kingdom and United States and the features of their respective markets, especially the degree of the shareholders' involvement

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States and Europe; in fact, in EU jurisdictions, shareholders have preemptive rights in new share issuances as a default rule). Note that the Author does not find the explanation fully convincing since it does not apply in the context of close corporations even if the difference between the two systems persists. However, for the purpose of this Article, the argument may still be valid. Indeed, the focus of this Article is on the overall attitude towards new share issuances and the possible interests of public shareholders in avoiding the dilution, rather than on the specific issue of the mandatory preemptive right provision. To this extent, it does not seem unreasonable to explain the traditionally different approach between the two jurisdictions with the different ownership structure of the respective firms and the overall lack of interests of the Berle-Means corporation's public shareholders in keeping their voting power. *See* ROBERT W. HAMILTON, THE LAW OF CORPORATIONS 196 (5th ed. 2000) (reporting frequent implementation of the preemptive right in close corporations, therefore corroborating the intuition that a less dispersed ownership structure might increase the interest in antidilution protections).

67. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 12 (1991); Brian R. Cheffins, *The Rise and Fall (?) of the Berle-Means Corporation*, 42 SEATTLE U.L. REV. 445, 464–70 (2019) (extensively reviewing the reasons underlying the development of the Berle-Means corporation and its evolution).

68. *See* Cheffins, *supra* note 67, at 466–68 (reviewing the of evolution of the U.S. legal system on the point).

in the governance of the public firm.[69] Indeed, it was claimed that the stronger powers and responsibilities of the institutional investors in the United Kingdom, as well as their more active involvement in the governance of the participated firms and the set of long-term goals, enhanced their interest in avoiding dilution.[70] The following Section seeks to undermine the premise of this statement — as far as it concerns the current scenario in the United States — and point out that existing shareholders, given their features and sophistication, carry an interest in avoiding dilution.

C. The New Ownership Structure of the Public Firm and the Enhanced Shareholders' Interests in Effective Anti-Dilution Protections

This Article claims there should be a distinction between the issuance of new shares and other corporate deals such as the sale or purchase of corporate assets.[71] Namely, assessing an equity issuance in the same way as any other possibly overpaid transaction, with the goal of understanding whether the company received too little in exchange for its stocks, seems an oversimplification. Regardless of the fairness of the price, each share carries a value that is beyond its capacity as a tradable security.[72] Therefore, an issuance of new shares is capable of material impacts at the shareholder level, even in a public company.[73] Any equity issuance may affect the position of the individual shareholder within the corporate entity, regardless of the consideration that she receives. Arguably, the shareholders of public corporations have an interest in restricting the flexibility of the managers and downsizing the risk that they affect the ownership structure of the firm, with the ultimate goal of either reducing the voting power of some shareholders or strengthening their insulation.[74]

The analysis of the adverse positions and the incentives of, respectively,

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69. *See* MYNERS, *supra* note 60, at 16–17 (describing the influence shareholders can have in the United States).

70. *See id.* at 17.

71. *See* Min, *supra* note 21 (manuscript at 12, 13) (exposing a similar reasoning with regard to dividend distribution and stressing the "stock's unique and powerful trait," since "stock comes with voting and other rights").

72. *See* Robert Charles Clark, *Vote Buying and Corporate Law*, 29 CASE W. RSRV. L. REV. 776, 778 (1979) ("[O]ne who buys common shares of a company is in fact purchasing not only a residual economic interest in the company, but also a share of the voting power.").

73. *See* Carsanaro v. Bloodhound Techs., Inc., 65 A.3d 618, 655–56 (Del. Ch. 2013) (endorsing the principle that the impact of a new issuance is "felt primarily by the shareholders"). Note that since the case involved a private corporation and the argument was used to broaden the application of the *Gentile* ruling, stating that it is the majority view of Delaware case law would be, at least, questionable.

74. *See supra* text accompanying note 32.

shareholders and managers of the public company requires a *caveat* in order to clarify the use of the terms. The main corporate tension, in the context of an issuance of new shares, concerns that between the issuer's constituencies which, respectively: (a) are empowered to approve the issuance or can substantially influence the decision (*i.e.*, the insiders); and (b) have a passive position in the decision and are exposed to the risk to have their own interests negatively affected in any of the mentioned ways (*i.e.*, the outsiders). To this extent, the directors and officers of the firm will be considered together within the corporation's management in the category *sub* (a).[75] All the shareholders not exercising control in the firm are part of the category *sub* (b). The most problematic task is the allocation of the controlling shareholders in either of the two groups: although one would be tempted to consider the controllers within the decision makers *sub* (a),[76] this Article also considers the case of a conflict between the board and the controlling shareholder, with the former diluting (or trying to dilute) the latter against her will.[77] This Article advocates focusing on the specific transaction and tries to distinguish the position that the controller — if existing in the firm's ownership structure — may have in order to assess whether she should be considered part of the insider managers or of the outsider shareholders.

To begin with, the paradigm of the public corporation as an entity, whose ownership structure is widely fragmented and whose governance mainly witnesses an agency tension between the interests of the dispersed shareholders and managers, is not accurate anymore.[78] The massive presence of institutional investors in the shareholder base has significantly

75. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005) [hereinafter Bebchuck, *The Case for Increasing Shareholder Power*] (adopting this division while warning that within the broad category of the manager, the interests of officers and independent directors sometimes differ and pointing out that the increase in power of independent directors has been a salient corporate governance topic throughout the years).

76. *See, e.g.*, FERRAN & HO, *supra* note 32, at 205 (adopting this approach for the purpose of the transaction at hand).

77. *See infra* text accompanying notes 192–203.

78. *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 498–99 (2018) [hereinafter Lund, *The Case Against Passive Shareholder Voting*] (describing the fall of the Berle-Means corporation and the increasingly concentrated shareholder bases); *see also* Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 92 (2017) [hereinafter Bebchuk, *The Agency Problems of Institutional Investors*] (corroborating the argument of the increased concentration with robust empirical evidence concerning the largest twenty U.S. public corporations as of June 30, 2016); Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 365–67 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) [hereinafter Rock, *Institutional Investors in Corporate Governance*] (exposing the transformation and the concentration of institutional ownership in U.S. public firms over the last few decades).

increased its average degree of sophistication and concentration.[79] Authoritative scholars relied on such empirical data to claim the need for a new set of corporate governance theories tailored to the current ownership structures.[80]

While such institutional investors are not necessarily actively involved (or according to some scholars, not enough[81]) in the governance of the firm, it has been observed that they vote on core corporate governance matters and often debate with the firm's management on such issues.[82] Recent studies describe the business model of the institutional investors and point out how the size of the stake they usually hold results in an interest in not missing the opportunity to cast their determinative vote in an informed way in order to beneficially impact the firm's performance.[83] Accordingly, the massive economic value of their stake — coupled with a reputational argument to attract additional assets under their management due to their "superior

79. *See* Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 973 (2019) [hereinafter Hamdani & Hannes, *The Future of Shareholder Activism*] (exposing that "institutional investors today collectively own 70–80% of the entire U.S. capital market" and that in an average large public firm, there are "between three to five money managers, each holding approximately 5–10% of the corporation's stock. Other institutional investors . . . hold smaller percentages, comprising together up to an additional 50% of the corporation's shares"); Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 304 (2019) [hereinafter Goshen & Hannes, *The Death of Corporate Law*] (arguing that the shift from retail investors to large, sophisticated ones has resulted in a decline of the use of Delaware courts).

80. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 864 (2013) ("The canonical account of U.S. corporate governance, which stresses the tension between dispersed shareholders and company managers in large public firms, has become factually obsolete and now provides a misleading framework for contemporary corporate governance theorizing.").

81. *See generally, e.g.*, Bebchuk, *The Agency Problems of Institutional Investors*, *supra* note 78 (claiming a lack of incentives for institutional investors in adequately investing in the corporate governance of the participating firms).

82. *See* Gilson & Gordon, *supra* note 80, at 887; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 501–02 (pointing out the influence that institutional investors have on the governance of firms but also carefully distinguishing between active institutional investors and passive institutional investors, arguing that only the former are effective governance players).

83. *See, e.g.*, Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 979–83 ("[T]he increase in size of the stakes owned by large institutional investors suggests that money managers may capture substantial gains from improved share value at portfolio companies."); Lund, *Nonvoting Shares*, *supra* note 59, at 717 (noting how institutional investors that hold the majority of shares of U.S. public firms "have the resources and sophistication to exercise their votes intelligently, as well as a financial incentive to invest in monitoring and stewardship," although excluding passive funds from this group).

returns" and recognize "faithful efforts" — creates an incentive in retaining the voting power and participating in the corporate decisions even for the passive funds, which charge the lowest fees.[84] This trend is expected to continue in the future. On the point, BlackRock's CEO, in his 2018 letter to the CEOs of the firms in their portfolio, committed to an increasingly intense involvement in the engagement activity with the participated issuers since, among other things, they may not easily dismiss their participation in managing their index funds, contrary to what occurs in the active funds' practice.[85] The 2019 edition of the same annual letter pointed out the materiality of "corporate strategy and capital allocation" as engagement priorities,[86] signaling that the institutional investors are increasingly seeking a voice in business matters, not only in governance matters.[87] A recent study indicated that the increasing percentage of shares of the public companies that index funds — a subgroup within the institutional investors — is attributable to those index funds leaning towards shareholder empowerment.[88] The statement is consistent with the findings of an empirical analysis, which pointed out the unprecedented rise in shareholders' powers that the recent corporate governance charter amendments have caused.[89] This study and evidence, overall considered, suggests that such

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84. *See* Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 981; Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 12 (N.Y.U. Sch. L., Working Paper No. 18–39, 2019) [hereinafter Kahan & Rock, *Index Funds and Corporate Governance*] (pointing out the relationship between the size of the stake that index funds have and their incentive in voting); *id.* at 31 (explaining how reputational incentives work in index funds' structures in order to gather the necessary information and properly vote).

85. Letter from Larry Fink, Chairman and Chief Exec. Off., BlackRock, to CEOs (2018), https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/; *cf.* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 516–17 (explaining her skepticism about the commitment of the so-called "Big Three" to be increasingly involved in the governance of the participated firms and corroborating her view with economic data analysis on costs and staffing resources).

86. Letter from Larry Fink, Chairman and Chief Exec. Off., BlackRock, to CEOs (2019), https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter.

87. Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 976.

88. *See* John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 1 (Harv. Pub. L., Working Paper No. 19–07, 2018) ("Against that real-world benchmark, indexation represents a significant shift towards more shareholder power, not less."); William B. Bratton & Simone M. Sepe, *Corporate Law and the Myth of Efficient Market Control*, 105 CORNELL L. REV. 675, 677 (2020) ("The rise of hedge funds and other activist investors has brought an unprecedented shift in power from managers to shareholders, who are now empowered to determine business decisions at publicly traded companies."); *cf.* Cheffins, *supra* note 67, at 447 (claiming that the overall paradigm of the public corporation has not changed so materially that it has changed the passivity of the shareholders).

89. Geeyoung Min, *Shareholder Voice in Corporate Charter Amendments*, 43 J.

empowered and relatively more involved shareholders do not lack interests and incentives in limiting managers' power to dilute their voting influence at will.[90] Namely, the several claims for an improved set of corporate governance principles addressing the change in the status of the public shareholders should not undermine the possible effects of the managers' amendments to the ownership structure itself. In fact, any increase in — or any claim to increase — the shareholders' powers and their engagement in the public companies' governance should not disregard the importance of a fundamental transaction, such as the issuance of additional shares, where the ultimate impact is similar to the creation and purchase of votes.[91] To this extent, fundamental transactions are the premise of any case of shareholder involvement in the governance of the firm.

As a general remark, several of the established powers of common equity shareholders have a direct and proportional relationship to the size of the voting stake that the shareholder holds, including: the right to vote on directors' elections and mergers, to start a proxy fight, or to propose a governance action, as well as to threaten any of these in order to capture managers and directors.[92] On the point, it has been indicated how a share equal to at least twenty-five percent of the issuer's stock would empower the holder to block "empire-building" acquisitions and to exercise a strong influence over the management of the firm and, in extreme circumstances, remove the managers.[93] It has been pointed out that, when informed and motivated institutional investors hold voting shares, they are usually able to achieve a certain degree of influence over the management of firm, despite their belonging to the minority; however, the large majority of their tools build on their voting rights.[94] Therefore, minority shareholders with a significant stake in the context of new share issuances might fear losing their blocking rights and seek to aggressively purchase additional shares.[95]

CORP. L. 289, 303–05 (2018).

90. *See generally* Ganor, *The Power to Issue Stock*, *supra* note 25 (discussing multiple powers of shareholders and their ability to protect their interests so that their voting rights are not diluted).

91. *See id.* at 733.

92. *See* Coates, *supra* note 88, at 6 (exposing the rights that common equity shareholders enjoy).

93. Roe, *supra* note 67, at 12–13.

94. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 741 (mentioning, among other things, the submission of a shareholder proposal, the "vote against board nominees or executive compensation," and the veto of a fundamental change).

95. Jesse M. Fried & Holger Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, 137 J. FIN. ECON. 353, 363 (2020) [hereinafter Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*].

However, this is not always possible, at least in a cost-effective way.[96] The intuition of the shareholders' interests in avoiding voting dilution is supported by the results of a relatively recent economic analysis, which found that shareholders holding more than five percent of the voting rights of a public firm fear dilution of their voting influence that may occur because of the issuance.[97] Note that the case of shareholders whose voting rights exceed five percent captures not only the controlling shareholders but also the significant minority ones.

The bottom line is that there are two main instances when a public corporation's shareholders are concerned about the dilution of their fractional voting power. The first instance involves shareholders who are concerned about dilution are controlling shareholders or, broadly, shareholders who seek to pursue control of the firm. The second and more problematic instance is where one of the shareholders does not seek control but rather aims to exercise influence over the managers without pursuing control. Professors Armour and Cheffins pointed out the distinction between investors seeking influence and those seeking control and their respective business models.[98] Namely, investors seeking influence usually purchase a block that, although does not grant the control of the corporation, enables the investor to exercise pressure over management to achieve changes that are ultimately oriented at increasing the shareholders' value.[99] According to an article within this category, hedge funds seek broader influence than the influence usually exercised by institutional investors.[100] Thus, the position of hedge funds is in a sort of grey area between plain influence and "actual legal control."[101] The development of the market for influence — which investors that "use the influence that accompanies their large ownership positions to discipline management" mainly participate — led to the broadening of the spectrum of the shareholders carrying an interest in retaining their voting power in order to influence the managers, even if such influence is not strong enough to impose any decision (as otherwise is the

96. *See, e.g.*, *infra* text accompanying notes 140–48, 170–88.

97. Thomas Poulsen, *Corporate Control and Underinvestment*, 17 J. MGMT. & GOVERNANCE 131, 132 (2013).

98. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58–59 (2011).

99. *See id.* at 58.

100. *See* Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUD. 1, 14 (2019) (explaining how these investors usually seek to actively change the target company either through a proxy context or obtaining a seat on the board of directors).

101. *Id.*

case for controlling shareholders).[102]

In conclusion, although the longer-term interest is often connected to the financial reward, this Section claims that in the context of the public firms' equity issuances, several shareholders carry an additional interest in retaining their fractional voting power. To this extent, it supports the theory of Section B[103] that the entire fairness standard is not an appropriate standard for transactions reallocating voting rights. In addition, a new share issuance may carry the strongest corporate governance implications through the impact on the fractional voting power of selected shareholders. Neutralizing these impacts is the best way to reconcile the issuance of new shares with the corporation's original business purpose to raise additional equity capital.

Therefore, since the interest of the outsider shareholders to not experience economic dilution is well-established and does not require any further explanation, this Article analyzes the transaction considering either type of dilution that the shareholders may experience. Part III focuses on the opposite side of the transaction and describes the different incentives that managers may carry in abusing their broad power of strategic issuances.

III. THE INCENTIVES OF THE MANAGERS

Opportunistic behaviors may influence managers' decisions to approve a new equity issuance. A seminal study indicated how this is a powerful tool to bypass shareholders' will through the dilution of their voting power and perpetuate the interests of the managers: indeed, from their perspective, the transaction may prove to be a useful tool to "build empires, entrench managers, and dilute shareholder influence."[104]

Arguably, the self-interest that managers might prioritize through equity issuances belongs to the broader class of agency issues in public companies.[105] While articles dating back to the end of the twentieth century assumed that in the specific context of equity issuances managers act in the best interest of the existing shareholders,[106] a recent finding suggests that

102. *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 494–95 (including within the list of participants in this market both institutional investors and hedge funds).

103. *See supra* text accompanying notes 41–59.

104. Rock et al., *Fundamental Changes*, *supra* note 37, at 180.

105. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976), *reprinted in* MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS (2000) (exposing the analysis of agency costs).

106. *See, e.g.*, Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information the Investors Do Not Have* ,13 J. FIN. ECON. 187, 188 (1984); Merton H. Miller & Kevin Rock, *Dividend Policy Under*

new share issuances are not exempt from agency tensions and supports the theory with empirical evidence.[107] A previous empirical analysis in the same field already flagged the case of managers seeking to sell new shares to sympathetic investors through private placements with the ultimate purpose of entrenching themselves.[108] Furthermore, the heterogeneity of interests within the shareholders' class should not be undermined in light of the well-established majority-minority conflict in the public firm, which seems to be even stronger in the context of this specific transaction. In order to point out the incentives that might lead managers to approve strategic issuances to affect the shareholders' voting power, it is critical to understand the different agency tensions that possibly arise between the managers and the shareholders. Namely, this Section addresses separately — following the established pattern in corporate governance literature — managers' incentives in public corporations whose control is contested (Section III.A) and those in controlled public corporations (Section III.B).[109]

A. Non-Controlled Corporation

The non-controlled public corporation is the traditional background of agency issues and of conflicts between shareholders and managers.[110] Although there are several cases of equity issuances merely in the best business interests of the corporation, this Section focuses on the incentives possibly underlying strategic transactions that managers enter into to exploit either value or the voting rights of certain shareholders.

First, the competency to issue additional shares is a powerful tool in the takeover context. The most famous strategic issuance in this scenario is the poison pill, a defensive measure against hostile takeovers.[111] Arguing in

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Asymmetric Information, 40 J. FIN. 1031, 1034 (1985).

107. *See* Clifford G. Holderness, *Equity Issuances and Agency Costs: The Telling Story of Shareholder Approval Around the World*, 129 J. FIN. ECON. 415, 433–34 (2018).

108. *See* Michael J. Barclay et al., *Private Placements and Managerial Entrenchment*, 13 J. CORP. FIN. 461, 481 (2007).

109. *See, e.g.*, Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 564 (noting how the governance issues are different between controlled and non-controlled corporations).

110. *See id.* at 589 (framing the allocation of powers and cashflow rights in a dispersed-ownership structure and summarizing the agency concerns that apply to the case since the tiny fraction of residual cash flows assigned to managers "exposes investors to management agency costs, which are curbed by shareholders' control rights; that is, their ability to terminate management"). *See generally* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007) [hereinafter Bebchuk, *The Myth of the Shareholder Franchise*] (arguing that shareholders are prevented from effectively exercising their control powers).

111. Ganor, *The Power to Issue Stock*, *supra* note 25, at 703.

favor of, or against, the poison pill is beyond the scope of this Article and prominent legal scholars have extensively addressed the topic during the last few decades.[112] The bottom line is that through the issuance of new shares, the managers may disregard the will of shareholders and prevent the sale of control of the corporation if they either deem it the best solution to maximize the interests of the corporation or — building on the several studies on agency tensions in public corporations — their own interests.[113] Along the same line of reasoning and with similar issues, managers may issue new shares to favor the sale of control of the firm and avoid shareholder opposition. The suitable tool would be the top-up option and, again, the ultimate purpose might (although obviously does not have to) be to extract personal benefit from the sale.[114] In addition, future new shares have been massively used in the context of merger and acquisition deals as a side agreement to lock the transaction. Namely, extensive research on deal protections illustrates that in recent public acquisitions, the acquirer has often granted the target a loan that is convertible into common shares in the event that the target's board eventually decides to pursue another (more rewarding) opportunity in the period between the announcement and the closing of the deal, the so-called market canvass.[115]

Second, managers may find that equity issuances are a powerful tool to dilute shareholders even in a non-control-acquisition context. Any shareholder eventually interested in taking part in a serious and effective

112. Among the multiple studies on the poison pill, see Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 904–07 (2002), for a description of the poison pill and endorsing a takeover-oriented position, Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 733–34 (2007), and Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1735–36 (2006), which advocates in favor of the poison pill. *See also* Goshen & Hannes, *The Death of Corporate Law*, *supra* note 79, at 266–69, 277–80 (carrying out an extensive review of the historical evolution of the case law related to the poison pill).

113. *See* Alan K. Koh et al., *Land of the Falling "Poison Pill": Understanding Defensive Measures in Japan on Their Own Terms*, 41 U. PA. J. INT'L L. 687, 694–702 (2020) (providing a detailed review of U.S. literature on the topic); Michael Klausner, *The Empirical Revolution in Law: Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1350–52 (2013).

114. *See* Ganor, *The Power to Issue Stock*, *supra* note 25, at 704, 717–20 (defining the top-up option as a call option that the board of directors of the target grants the bidder in the context of a takeover in order to allow the latter to eventually complete a freeze-out short form merger and pointing out the agency issues possibly affecting the transaction).

115. *See* Fernán Restrepo & Guhan Subramanian, *The New Look of Deal Protection*, 69 STAN. L. REV. 1013, 1043–1048 (2017) (noting that in one case, the conversion would have allowed the prospective acquirer to hold 23.8 percent of the fully diluted shares of the target).

engagement activity is a potential threat to the incumbent managers, should her agenda not overlap with management's business plan. As already mentioned, the legal literature agrees about the increased sophistication of shareholders in the current framework of the U.S. public firm.[116] A recent essay described institutional shareholder engagement as a way to influence the long-term strategies of the firm: while the essay pointed out how this attitude differs from the more aggressive and, allegedly, short-termist approach of the activist hedge funds, it also indicated engaged shareholders' expectations concerning the board's accountability and the firm's accomplishment of their goals.[117] In addition, Professor Coates recently argued that index fund managers — because of the indexation of ownership, which has determined a rise in shareholders' powers — now exercise a strong pressure to influence the managers of a wide range of public corporations.[118] Professor Coates's research indicated that there was increased engagement of shareholders who connect with the board of directors in order to disclose their policies and share their feelings about managers and corporate activity.[119] BlackRock itself, an investment management corporation that has publicly committed to a model of shareholders' engagement based on an enhanced interaction with the board for a few years,[120] warned that if the expectations and the ideas that the BlackRock Investment Stewardship team shared in the context of engagement activity were not fulfilled, the team would not hesitate to vote against management's recommendations as a last resort tool.[121] Not only do

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116. *See supra* text accompanying notes 78–91.

117. *See* Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 392 (2016).

118. Coates, *supra* note 88, at 19 ("The bottom line of this influence is very different than what the term 'passive' investment implies. Rather than blindly choosing stocks in their index and then ignoring them, index fund managers have and are increasingly using multiple channels to influence public companies of all sizes and kinds. Their views on governance issues, their opinions of CEOs, their desires for change at particular companies, their response and evaluations of restructuring or recapitalization proposals from hedge fund activists — all of these matter intensely to the way the core institutions in the U.S. economy are operating."); *see also* Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. REV. 915, 940 (2019) [hereinafter Kahan & Rock, *Anti-Activist Poison Pills*] ("[O]ver the last two decades, as the trend towards increasing institutionalization of shareholding has continued, the largest institutions have awakened to their power.").

119. *See* Coates, *supra* note 88, at 16; Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 381 ("[I]nstitutional investors are engaging with management in a much more active way than ever before.").

120. *See, e.g.*, *BlackRock: Ebb and Flow*, FIN. TIMES (Apr. 12, 2018), https://www.ft.com/content/ee2cd1d6-3e6e-11e8-b9f9-de94fa33a81e.

121. *See* BLACKROCK, THE INVESTMENT STEWARDSHIP ECOSYSTEM 7 (2018), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-steward

these findings corroborate the argument that shareholders carry an interest in avoiding dilution of their voting rights but also — and more importantly for the purpose of this paragraph — this attitude is likely to make management subject to duties of accountability and responsiveness towards sophisticated shareholders, undermining its autonomy and possibly increasing its incentive to approve dilutive equity issuances. Should the incumbent managers be or feel threatened that such engaging shareholders support different management in the medium/long-term, the incentive is amplified. On that point, authoritative scholars have recently explained that the enhanced powers of institutional investors in public firms' governance have weakened the position of managers who increasingly value any tool that empowers them to affect the corporation's ownership structure to insulate themselves.[122] The larger the stake the institutional investors have, the more likely they are to have the power to replace the board of directors.[123] The case is further corroborated by the argument that when institutional investors engage with the management of a company, the latter is aware that should an activist campaign start in the future, the institutional investors have a critical role in determining its outcome, and are likely to base their votes on whether the firm had fulfilled the shareholders' agenda.[124]

Many prominent practitioners and legal scholars have claimed that shareholders with long-term targets are beneficial to the firm.[125] From an

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ship-ecosystem-july-2018.pdf (corroborating the report in some cases when BlackRock effectively voted against management's recommendation). Note that in all the instances where BlackRock voted on a proposal against management's recommendation, such proposal was approved with a majority below seventy percent. *See id.* at 9. Therefore, even a tiny dilution of the voting power might have fulfilled an assumed goal of the managers to entrench themselves.

122. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 992 (applying the reasoning — in order to explain the creation of dual class structures — to the case of the controller-manager fearing that she might fail to pursue her idiosyncratic vision).

123. *See* Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 983 ("[C]orporate managers might become the ones that cannot risk their relationship with the mutual funds complex, especially when all funds of the same fund family tend to vote together.").

124. *See* Coates, *supra* note 88, at 17; *see also* Gilson & Gordon, *supra* note 80, at 896 (pointing to the pivotal role of institutional investors in activist campaigns and, more broadly, the necessary interaction of activists and institutional investors in the current ownership structure of public firms).

125. *See, e.g.*, Martin Lipton, *It's Time to Adopt the New Paradigm*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 11, 2019), https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm/ (encouraging a proactive dialogue between the firms and their long-term shareholders, who should also share their concerns and expectations about the corporation, and arguing that the engagement between the parties should also be sought before the submission of a shareholder's proposal); Mallow & Sethi, *supra*

ex-ante perspective, the risk of such dilution is likely to discourage shareholder engagement. Among the different views of corporate governance involvement that institutional investors have and should have, a consensus developed over the significant investment of time, money, and skills that engaged governance requires for a specific corporation.[126] The risk to be unduly diluted, should such effort result in an engagement not complying with management's plans, is not attractive. The argument is even more applicable to any shareholder with a long-term view, given that she has no certainty that in the future she will be able to keep her fractional voting power in the event of a disagreement with management. In addition, from an *ex-post* perspective, the effort of such engagement activities would be pointless not only for the specific shareholder but for the corporation itself. Namely, if the agenda of the engaged shareholder overlaps with management's expectations, the utility of the effort is marginal; by contrast, should the activity result in a disagreement with the managers, the latter might dilute the shareholder with no benefit for the corporation. In an oversimplified way, the extreme scenario is that the board decides to "fire" the shareholders through a dilutive issuance.

A similar reasoning applies, and its impact amplifies, if an activist shareholder is in the ownership structure of the corporation.[127] In such a context, the incentives of the managers to dilute the incoming activist are increased and reach their peak when the activist is reasonably confident of success in a prospective proxy fight due to the support of some institutional investors.[128] Authoritative legal scholars have pointed out the importance of a relationship between institutional shareholders and activist hedge funds: while the activist hedge fund acts as the voice of the institutional shareholders, the institutional shareholders are passive with regard to the

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note 117, at 389–90 (providing a detailed definition of engagement); Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 371 (describing the efforts of legal scholars and regulators aimed at addressing the lack of adequate shareholder engagement).

126. According to many prominent scholars, the need for extensive resources prevents many institutional investors from being more actively involved or effectively involved, depending on the voices, in the corporate governance of the firms in which they participate. *See* Gilson & Gordon, *supra* note 80, at 872–73; Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2043–75 (2019) [Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance*] (developing an extensive analysis of the costs incurred by index funds).

127. *See, e.g.*, Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 382 (exposing the differences between hedge funds and "traditional" institutional investors).

128. *See supra* text accompanying notes 78–91 (describing the institutionalization of the shareholder base of public firms).

corporate governance proposals but keener on exercising their voting rights over the activist hedge fund.[129] The hedge fund's activist campaign may originate from the dissatisfaction of institutional investors due to the failure of management to address their priorities.[130] In such a scenario, if the managers fear defeat in the campaign, they might decide to dilute the hedge funds' shares, and the shareholders will be expected to support its campaign through a material share issuance. Based on the usual business pattern of the activists — which need to collect voting shares in order to claim corporate changes that reward their initial investment[131] — a decline in the voting power negatively affects the activist's odds of success. Managers may use poison pills with lower thresholds as a weapon against the activist hedge fund.[132] Both *Yucaipa American Alliance Fund II, L.P. v. Riggio*[133] and *Third Point LLC v. Ruprecht*[134] witnessed the adoption of a shareholders' rights plan triggered at thresholds significantly below the majority control — respectively twenty percent and ten percent — and tailored[135] against the activist possibly seeking to target the issuer with a proxy contest. In both cases, the courts evaluated the threats posed by the activist and the proportionality of the reaction and emphasized the risk of an underpriced acquisition of a controlling issuer.[136] Even if shareholders' rights plans are

129. *See* Gilson & Gordon, *supra* note 80, at 866–67; Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 505 (pointing out that the consensus-seeking hedge funds, in order to increase their odds of success in their campaign, often tailor their agenda to the institutional shareholders' priorities); Rock, *Institutional Investors in Corporate Governance*, *supra* note 78, at 381 (exposing the change in the behavior of institutional investors, who are now willing to support value-enhancing intervention by the hedge funds rather than deferring to managers); Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 940 (flagging that institutional investor support is an indispensable condition for the activists' success).

130. Hamdani & Hannes, *The Future of Shareholder Activism*, *supra* note 79, at 988.

131. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 695.

132. *See* Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 935; *see also* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069 (2007) [hereinafter Kahan & Rock, *Hedge Funds in Corporate Governance and Corporate Control*].

133. 1 A.3d 310 (Del. Ch. 2010).

134. No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).

135. *See id.* at *20 (explaining the two-tiered structure of the pill, which was triggered at a lower threshold if the purchaser sought to influence the control of the issuer); *Yucaipa*, 1 A.3d at 321 (granting an exemption to the company's founder, whose beneficial ownership was above the threshold triggering the pill).

136. *See Third Point*, 2014 WL 1922029, at *17 ("I cannot conclude that there is a reasonable probability that the Board did not make an objectively reasonable determination that Third Point posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium."); *Yucaipa*, 1 A.3d at 331 ("[T]he board's motivation was to protect Barnes & Noble from the threat of being

not technically traditional issuances of new shares (in the form of rights offering), their effects are substantially similar in that, rather than diluting a shareholder, shareholders' rights plans prevent a shareholder from increasing her voting power by threatening a dilution. To this extent, it has been pointed out how the power to issue shares is often undermined in any discussion concerning poison pills, in spite of being a critical part of it.[137] Although these plans are unlikely to be held as primarily aimed at interfering with the shareholders' franchise,[138] their impact on the shareholders' powers is material. Note that in *Third Point v. Ruprecht*, other institutional shareholders joined the hedge fund as plaintiffs, corroborating the theory that at least some shareholders deem it critical to have a voice on these issues.[139]

Since this Article concerns corporations with publicly traded shares, the immediate objection to this point seems that the "activists' team" could easily increase its stake and restore its pre-issuance voting power on the market. Therefore, the equity issuance would prove to be ineffective. However, Professors Gordon and Gilson's analysis illustrates the flaw of this response.[140] To begin with, activist hedge funds seek an economic reward from the increase in the issuer's share price after their intervention.[141] Empirical analysis found that as soon as an activist hedge fund discloses to the public its purchase of a stake in a listed corporation, the trading price of the issuer's shares increases because the market moves forward and incorporates a significant part of the purported beneficial effects of the activist campaign into the short-term trading price.[142] Therefore, it is critical for hedge funds to be able to purchase a reasonably large stake ahead of the trigger of the mandatory disclosure obligation.[143] If the firm issues new equity after the activist's disclosure, the price of the new shares issuance is

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subject to inordinate influence or even control by a bloc that emerged without paying a fair price for that control. The effect on electoral rights was an incident to that end.").

137. *See* Ganor, *The Power to Issue Stock*, *supra* note 25, at 703.

138. *See Third Point*, 2014 WL 1922029, at *16, *18.

139. *Id.* at *1 ("The other plaintiffs in this litigation are institutional stockholders who purport to represent the interests of the corporation's stockholders other than the hedge funds.").

140. *See* Gilson & Gordon, *supra* note 80, at 902–06 (explaining the business model of the activist investors).

141. *See, e.g.*, Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 920, 923–24 (providing a detailed analysis of the business model of activist hedge funds and a description of their concern in avoiding either type of dilution).

142. Gilson & Gordon, *supra* note 80, at 903 n.138, 903–05.

143. *See id.* at 904 (using the argument to challenge a proposed securities regulation aimed at amending the disclosure obligation rule, both broadening its scope of applicability and shortening the time for the investor to comply with the disclosure obligation).

likely to reflect such increase in the stock's trading price.[144] It is therefore an obvious remark that, should the activist be willing to purchase on the market, it purchases the shares at the new increased price, increasing the overall average price per share of its stake. In other words, the activist's goal to secure a large position before filing the disclosure would be frustrated. The described scenario undermines the investor's action, forcing her to either purchase additional shares at the increased price after the disclosure or, reasonably, give up on her campaign.

In addition, since the activists are usually risk-averse and allocate a set amount of funding, incurring an additional purchase is problematic even absent an increase in the price per share.[145] The argument that hedge funds typically tend to avoid putting "too many eggs . . . in one investment basket" supports that statement since an additional investment becomes necessary to retain the significant minority shareholding that they need in order to be effective when approaching the management of the corporation.[146] This argument on one side corroborates the case that hedge funds carry an interest in not having their voting power diluted and, on the other, undermines their potential willingness to increase their economic investment to retain their fractional stake in the post-issuance ownership structure. Note that, since in the scenario that this Section addresses, the purpose of the strategic transaction is to generally dilute a specific shareholder or a block of them, the managers do not need to issue shares to a specific investor, a so-called "white squire."[147] Arguably, although the case of an equity issuance in favor of sympathetic (with management) investors further strengthens the position of the latter, even an issuance to investors in the general public is likely to be effective in lowering the chances and increasing the costs of the to-be-diluted shareholder's ability to keep a significant stake and be successful in its campaign. This feature not only avoids the difficulty of searching for a white squire willing to incur a significant investment but also makes an

144. *Id.* at 903 (discussing how the price of the shares increases once an activist discloses its purchase of stocks in a certain target).

145. *See id.* at 909–10.

146. Cheffins, *supra* note 67, at 487 (using the argument in order to explain the relatively small presence of hedge funds in very large public firms and suggesting the reason is they would need an excessive investment in a single company in order to "buy up a minority stake sufficiently sizeable to capture management's attention and to yield meaningful profits in the event of success").

147. The white squire is a tool used by managers who, seeking to secure their entrenchment, selectively issue a block of shares to a sympathetic investor willing to support them. *See* Ganor, *The Power to Issue Stock*, *supra* note 25, at 731–32; Paul Davies et al., *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 205, 214 (3d. 2017) (explaining the white squire's action, also called "white knight").

important argument in order to avoid the requirement of the shareholders' approval that stock exchange rules set forth in the event of highly dilutive equity issuances.[148]

In addition, the threat of such a dilutive issuance might be effective not only in frustrating the result of an activist's campaign but also, from an ex-ante perspective, in discouraging their intervention at all. This Section does not intend to take a position in favor of, or against, shareholder activism or shareholder engagement.[149] Contrarily, the purpose is to point out where the incentives of managers to use the equity issuances to affect the ownership structure of a dispersed public corporation lie and how such corporate transactions are an effective and powerful means to achieve goals other than the raising of funds for the corporation.

Finally, an equity issuance in a public firm whose control is contested is a powerful tool regardless of the considerations on shareholder activism and engagement. The above-mentioned case *Reith v. Lichtenstein*[150] witnessed the acquisition of majority control by a shareholder throughout the years. The 2013 settlement agreement — which enabled Steel Holdings to be issued new shares that, together with the warrants it was granted in the same circumstances, approximately doubled its stake from 14.9 to 29.9 percent — had a strong impact on the ownership structure of the firm.[151]

A last caveat is necessary. This Section did not analyze the hypothesis of the quasi-controller who seeks the support of the board of directors in order to pursue control of the corporation through the equity issuance, although it formally pertains to the scenario of the public corporations whose controller is contested. The next Section addresses this case.[152]

B. Controlled Corporations

Controlled corporations are becoming increasingly important in the U.S. market,[153] which has historically been different from the European one,

148. *See infra* Section IV.B.

149. *See* Lund, *The Case Against Passive Shareholder Voting*, *supra* note 78, at 502–03, 503 n.41 (reviewing the literature on this debate); *see also* Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 918 n.6 ("The effects of activism are likely to differ systematically depending on the style of the activist; the type of target; the year the activism took place; and, most importantly, the skills of a particular activist and quality of the business plan it wants to pursue.").

150. No. 2018–0277-MTZ, 2019 WL 2714065 (Del. Ch. June 28, 2019); *see supra* text accompanying notes 1–6.

151. *Reith*, 2019 WL 2714065, at *2, 3.

152. *See infra* Section III.B.i.

153. *See* Da Lin, *Beyond Beholden*, 44 J. CORP. L. 515, 520 (2019) ("According to a 2014 study by the law firm Davis Polk & Wardwell LLP, 54 of the 100 largest initial public offerings between September 2011 and October 2013 were of companies with one

where the percentage of controlled listed firms has always been large. The definition of controlling shareholder encompasses not only (i) a shareholder who owns more than fifty percent of the voting power of the corporation (*i.e.*, the so-called de jure control) but also (ii) a shareholder who owns less than fifty percent of the voting power of the corporation but exercises control "over the business affairs" of the corporation (*i.e.*, the so-called de facto control).[154] While the concept of control over the business affairs of the corporation has subsequently been refined and transposed to control over the directors,[155] the fractional voting power that a shareholder should retain in order to qualify as a controller is still unclear.[156] The class of controlled corporations covers the cases of both concentrated ownership[157] and dual-class structure: although this Article generally tends to consider the position of the controlling shareholder regardless of the proportion between the percentages of, respectively, the voting rights and the financial rights she holds, this Article will occasionally distinguish between the two situations.

Generally, the presence of a controller in the ownership structure of the

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shareholder holding more than 50% of the voting power. As of 2015, seven percent of companies in the S&P 1500 index have one shareholder or group holding more than 30% of the company's voting shares."); Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 594–95 (2017) [hereinafter Bebchuk & Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*] (reporting, among other things, that as of July 2016, dual-class controlled companies in the U.S. economy had "an aggregate market capitalization exceeding $3 trillion"); Jesse M. Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 79, 79 (Luca Enriques & Tobias H. Troger eds., 2019) [hereinafter Fried, *Powering Preemptive Rights with Presubscription Disclosure*].

154. Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113–14 (Del. 1994) (citing Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)); *see Reith*, 2019 WL 2714065, at *21–23 (carrying out an analysis of the minority controlling status); Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 953 ("Control rights are, broadly stated, rights to decide on the business direction of a company, ranging from day-to-day operational to strategic management decisions.").

155. *See In re* Tesla Motors, Inc. S'holder Litig., No. 12711-VCS, 2018 WL 1560293, at *12–13 (Del. Ch. Mar. 28, 2018) (reviewing the case law and applying the criterion).

156. *See* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 449, 449 n.1 ("In the United States, Delaware Courts have declined to quantify the precise percentage of stock necessary to constitute an 'effective majority' [of the voting rights], choosing instead to engage in a factual inquiry of the exercise of actual control in each case."); *see also* Ann M. Lipton, *After* Corwin*: Down the Controlling Shareholder Rabbit Hole*, 72 VAND. L. REV. 1977, 1990 (2019) (carrying out an analysis of the most recent case law and noting that "no particular level of voting power is determinative" to assess the control status).

157. *See* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 449 (providing a definition of concentrated ownership structure as the firms where the controller "holds an effective majority of the firm's voting and equity rights" and therefore flagging a material difference with the case of dual-class firms).

firm has a sizeable impact on the corporation's decisions.[158] This makes the statement that the main goal of corporate law in controlled corporations is to protect minority shareholders largely shared and relatively undisputed.[159] Controlling shareholders are generally subject to fiduciary duties as much as the board of directors: transactions involving controlled companies trigger the entire fairness standard if they are deemed to be conflicted, *i.e.*, the controller stands on both sides of the transaction and gets a "unique benefit" from it.[160] However, focusing on the issuance of new shares, it seems reasonable to value the shareholder's influence over the decision maker (*i.e.,* the board of directors) with regard to the specific transaction. The ultimate distinction is between the cases of: (i) the controller purchasing the newly issued shares; and (ii) the controller not participating in the issuance. In fact, the distinction determines whether the case falls in, respectively, the majority-minority or the director-shareholder conflict. Notwithstanding the different labels, it is critical to understand *who* the outsider shareholders that the managers may seek to dilute are (*i.e.*, whether the controller or the minority shareholders) and who, if anyone, the managers have incentives to favor. Arguably, since management is empowered to approve the issuance, corporate law should broadly protect the shareholders who are not related to the decision maker and whose stakes may incur a dilution because of the issuance.

This Section aims to point out some of the possible incentives that may lead the managers of a controlled corporation to use the issuance of new equity as a tool to exploit either the financial or economic rights of the outsider shareholders. Namely, this study covers both underpriced and non-underpriced issuances, claiming that even the latter may prove to be a powerful tool for the managers to perpetuate self-interests.[161] Section III.B.i

158. There is an extensive debate in the literature concerning whether the presence of a controller is beneficial or detrimental to the corporation, especially in the case of dual-class structure. *See, e.g.*, Bebchuk & Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, *supra* note 153, at 596–99, 609–13 (extensively exposing the policy debate on the topic and claiming that the potential benefits of the structure decline throughout the years); Young Ran (Christine) Kim & Geeyoung Min, *Insulation by Separation: When Dual-Class Stock Met Corporate Spin-Offs*, 10 U.C. IRVINE L. REV. 1, 27–28 (2019) (reviewing the literature debate on the upsides and downsides of the dual-class structures).

159. *See, e.g.*, Jesse M. Fried et al., *The Effect of Minority Veto Rights on Controller Pay Tunneling*, 138 J. FIN. ECON. 777, 778 (2020) [hereinafter Fried et al., *The Effect of Minority Veto Rights*] ("[A] key governance objective is protecting minority shareholders from tunneling by the controller.").

160. *See, e.g.*, IRA Tr. FBO Bobbie Ahmed v. Crane, No. 12742-CB, 2017 WL 7053964, at *6 (Del. Ch. Dec. 11, 2017).

161. However, when proposing the adoption of a new rule, the policy approaches in the case of firms having concentrated ownership or a dual-class structure may be slightly

analyzes the more customary case of the controller purchasing shares, resulting in a potential harm to minority shareholders, while Section III.B.ii addresses the case of the controller not subscribing the new shares.

i. The Purchasing Controller

The case of this Section is that the controller purchases more than her ratable part of the newly issued shares and therefore increases her fractional stake in the firm. To this extent, she should be allocated to the category of the firm's managers, and the involved agency tension presumably opposes the controller-manager to the outside minority shareholders. Also, the incentives of the managers in using the equity issuance to perpetrate abuses are significantly different: in the analyzed hypothesis of the non-controlled corporation, the managers were assumed to have the goal to entrench themselves, build empires or, more broadly, retain their independence and lack of accountability to shareholders. While the purpose of building empires would still be valuable for the controller-manager,[162] this case carries a material difference since the board of directors is already under the influence of the controlling shareholder and it acts in conjunction with her in the customary majority-minority conflict.[163] The controller-manager may seek economic benefits as, respectively, a direct or indirect consequence of the transaction, depending on the issuance price. This leads to the analysis of two different scenarios, both of which involve the exploitation of value from minority shareholders that the legal scholarship addresses as "tunneling."[164]

a. Cheap-Issuance Tunneling

The immediate way to shift value from minority shareholders to the controller is achieved through the issuance of shares to the latter in exchange for a low price, the so-called "cheap stock tunneling."[165] The case is very

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different.

162. *See* Sang Yop Kang, *Re-Envisioning the Controlling Shareholder Regime: Why Controlling Shareholders and Minority Shareholders Often Embrace*, 16 U. PA. J. BUS. L. 843, 869–70 (2014) (indicating both pecuniary and non-pecuniary benefits of empire building from the perspective of the controller).

163. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 355 (assuming management is under the influence of the controllers and seeks to enhance their interests against those of the other investors).

164. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 571 n.32 ("The term tunneling refers to transactions, especially within a business group or a pyramidal ownership structure, on terms aimed at favoring the controlling shareholder."). *See generally* Vladimir A. Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011) (providing for an extensive review and taxonomy of the tunneling).

165. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra*

straightforward since the transaction provides the controller with a direct economic gain. She is enabled to increase her financial and voting rights in the firm, in exchange for a price per share below its market value. The harmed parties are those who fail to participate (at least) pro-rata in the issuance and are therefore diluted from both economic and voting right perspectives. Arguably, the structure of the deal of *Corwin v. British American Tobacco* meets these features.[166] Namely, there is a reasonable ground to claim that the issuance was cheap, given the virtual $920 million profit that the purchaser was able to secure at the time of closing. Furthermore, the express ruling of the Supreme Court of North Carolina — relying on Delaware case law[167] — that the subscriber was not a controlling shareholder, does not exempt the case from being considered a cheap issuance in a controlled company for the purpose of this analysis. In fact, although the study of the standards to be met in order to be considered a de facto controller is beyond the purpose of this Article,[168] it seems worth noting that the purchaser was a forty-two percent shareholder, with a significant influence over the board,[169] and did not share the profit with the outsider public shareholders — whose shares were the only ones that the issuance diluted. To this extent, the ruling corroborates the claim that the outsiders lack adequate instruments to avoid exploitation of value and voting rights from the most powerful shareholder of the firm.

b. Non-Cheap Issuance

The second scenario is met when the actual goal of the controller is to obtain non-direct benefits from the transaction, which are not (or not entirely) shared with the minority shareholders. The feature of the transaction, therefore, is that the issuance price does not have to be unfair or, in a more sophisticated way, is not below the market value of the firm's shares. Professors Fried and Spamann pointed out the case of a controller seeking to dilute minority shareholders in order to strengthen her voting power and cross a specific voting threshold, which, for example, is required to approve certain transactions.[170] In such a scenario, the issuance price

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note 95, at 353; Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 81–83 (describing cheap-issuance tunneling as a transaction that dilutes the minority shareholders who do not purchase their ratable portions of the new equity in that the overall equity value of the firm is not sufficiently increased to offset the loss in their fractional equity ownership).

166. *See supra* text accompanying notes 7–9.

167. Corwin v. Brit. Am. Tobacco, 821 S.E.2d 729, 737–39, 743 (N.C. 2018).

168. *See supra* text accompanying notes 153–57.

169. *See Corwin*, 821 S.E.2d at 753–54 (Hudson, J., dissenting).

170. Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra*

might include a premium over the market value, provided that the benefits that the controller obtains from the transaction are higher than the price she is paying to purchase the shares: the shares would not be *absolutely* cheap but would be *relatively* cheap from the controller's perspective[171] since the transaction enables her to capture indirect economic benefits. Reasonably, this situation occurred in *Reith v. Lichtenstein* since in 2017, the alleged controlling shareholder strengthened its stake through an issuance of convertible preferred shares whose conversion price was at a 31.5 percent premium over the closing price of the traded stocks on the day before the closing of the transaction.[172] Notably, as a result of this issuance — coupled with the equity grants to three directors affiliated with the same shareholder — the purchaser was able to cross the line of majority control of the firm, achieving a 52.3 percent stake.[173]

The same above-mentioned research addresses when the controller's benefits concern the use of the proceeds of the issuances (*e.g.*, the new equity is used to enter into an overpriced purchase from the controller).[174] The use of the proceeds of issuances is even more troublesome since it requires neither a cheap issuance price nor the voting dilution of the minority shareholders. However, for the purpose of this Article, it seems reasonable to argue that the damage to the minority shareholders is not directly perpetrated through equity issuances but rather through the use of proceeds in the subsequent — although connected — purchase from the controller.[175]

note 95, at 362–63 (emphasizing the importance of voting rights in analyzing equity issuances). Notably, the statement was not tailored to public corporations but seems applicable in such a context too.

171. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 100 (introducing the concept of price-relativity in the context of new share issuances in the case of securities that could be overpriced but still "*effectively* cheap" for the controller).

172. Reith v. Lichtenstein, No. 2018–0277-MTZ, 2019 WL 2714065, *4 (Del. Ch. June 28, 2019).

173. *Id.* at *5.

174. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 357–58.

175. Professors Fried and Spamann studied the issuance of cheap stocks from the perspective of the asymmetric information issue in the context of the right offer. *See id.* Therefore, the controller's information about the use of proceeds (which in the considered hypothesis was at her advantage) might effectively lead her to relatively appreciate the shares in a different way compared to general public shareholders. *See id.* at 357. Contrarily, the purpose here is to show how the managers of a public corporation might damage minority shareholders with an equity issuance. In the example at hand, unless the two transactions (issuance and use of proceeds in a related party purchase of goods or securities) are considered as a whole, the position of this Article is that the issuance by itself does not damage the minority shareholders.

The non-underpriced issuance becomes more hybrid should the purchaser be a quasi-controller — *i.e.*, dominating but not controlling the firm[176] — who seeks to acquire control of the firm. In such a case, the quasi-controller can extract massive benefits from the transaction[177] and therefore is willing to pay a material premium over the market shares.[178] A corporate transaction that Delaware courts scrutinized in 2014 witnessed this situation.[179] Although the control of the corporation was contestable, the combination of the securities, contractual rights, board representation, and relationships with management that the shareholder Yucaipa American Alliance Fund II, L.P. ("Yucaipa") carried made Yucaipa a quasi-controller of Morgans, a Nasdaq listed corporation.[180] Among other things, Yucaipa held the majority of the senior subordinated notes of the company — convertible in common stocks starting from three months before their due date — as well as 100 percent of the preferred stocks and warrants to purchase a non-trivial amount of public stocks; furthermore, it had invasive veto rights on several extraordinary transactions and was entitled to appoint one member of the board.[181] The transaction was structured as a rights offering issuance at a price that provided an unusual twenty-six percent premium over the then-current

176. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 94–95 (providing as an example of a quasi-controller, the thirty percent shareholder of a corporation whose second-largest shareholder has a twenty percent stake). The notion of quasi-controller may belong to the same family as that of "effective negative control," which the Delaware Court of Chancery framed as a case of shareholders exercising "disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power." Third Point LLC v. Ruprecht, No. 9469-VCP, 2014 WL 1922029, at *21 (Del. Ch. May 2, 2014).

177. *See* Xueping Wu et al., *A Rent-Protection Explanation for SEO Flotation-Method Choice*, 51 J. FIN. & QUANTITATIVE ANALYSIS 1039, 1040 (2016) (providing a recent literature review of the studies concerning the private benefits of control); *see also* Kahan & Rock, *Anti-Activist Poison Pills*, *supra* note 118, at 937–38 ("Unlike positive control — which enables the investor who wields it to elect a board to its liking or cash out minority shareholders and consequently justify special concerns about control under Delaware law — negative control merely enables the wielder to block a limited set of transactions that the board proposes.").

178. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 95 (addressing the issue in the context of right offerings and explaining how a quasi-controller in order to achieve control "may use an offer price that is clearly high (or at least appears high) to deter other investors, including any potential rival, from participating"). Reasonably, the same argument also applies to the case of the quasi-controller increasing her fractional voting power in a non-right-offering issuance.

179. *See* OTK Assocs., LLC v. Friedman, 85 A.3d 696, 704 (Del. Ch. 2014).

180. *Id.* at 724; *cf.* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 95 n.60 (mentioning the transaction as an example of an overpriced issuance aimed at enabling the quasi-controller to gain control of the issuer through a more-than-pro-rata subscription of the new shares).

181. *OTK*, 85 A.3d at 704.

market price of shares.[182] While the structure of the equity issuance as a rights issue rather than as a cash offer[183] is not critical in this Section, what matters is that management allegedly acted in conjunction with Yucaipa to maximize the latter's odds to pursue the issuer's control. Namely, based on its financial advisor's forecasts, Yucaipa was expected to reach a fraction equal to thirty-five percent of the common stocks issued after the transaction.[184] Yucaipa sought to gain control of the corporation — at the time challenged by another significant shareholder who subsequently was the claimant in the Delaware dispute — through an overpriced issuance aimed at discouraging many public shareholders from the subscription.[185] However, in the context of the fight, Hyatt offered to buy all the shares of Morgans, in exchange for a higher price (*i.e.*, \$7.50 per share against \$6.00), but the managers of the issuer ignored the proposal and avoided its disclosure.[186]

Even if the control of the corporation is formally contested before the equity issuance, this Article treats this transaction as if it were a controlling shareholder's subscription in light of the dominant position that a quasi-controller may exercise within the firm. The influence she is able to exert over management — sympathetic with her goal to acquire control — further confirms this intuition. Also, in terms of the possible damages that the shareholders non-related to the quasi-controller may suffer because of the transaction — and of the protection that a legal system needs to set forth — the issuance proves to be close to the case of the purchasing-controller, witnessing the board acting in conjunction with her. In fact, in both cases, the firm's ownership structure after the transaction provides for a controller that has diluted the other shareholders' shares through a strategic and selective equity issuance approved by the board. Although the merit of legal protections will be discussed later in this Article, in the mentioned case, *OTK v. Friedman*, the court itself analogized Yucaipa's influence to that exercised by a controller: namely, "for purposes of the motion to dismiss, Yucaipa is deemed to control Morgans."[187] The transaction was deemed to confer "a unique benefit on a party exercising de facto control."[188]

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182. *Id.* at 707.

183. *See* Wu et al., *supra* note 177, at 1039 (describing the most common floatation methods in seasoned equity offerings and their respective features).

184. *OTK*, 85 A.3d at 707.

185. *See id.*

186. *Id.* at 709.

187. *Id.* at 724.

188. *Id.* Note that depending on the definition of quasi-controller that is adopted, even *Reith v. Lichtenstein* might seem to fall in this category as well as most of the cases of minority controlling shareholders. However, the court expressly affirmed that Steel

As a final remark, both controllers and quasi-controllers may have an increased incentive in strengthening their position in the firm through a non-underpriced (or an overpriced) issuance, in the event of an activist's action. As a dedicated research study explained, there are a non-trivial quantity of cases of controlled companies that are subject to activist intervention.[189] Although companies whose control is completely uncontested are not fully insulated, the risk is even more material for de facto *controllers* — since the activist may challenge them in a proxy fight[190] — and, of course, for quasi-controllers.

As Part II pointed out,[191] the current legal framework fails to protect shareholders should the firm issue shares in exchange for a price that Delaware courts deem "objectively" fair. This Section explained the managers' incentives and how they — acting in conjunction with the controlling shareholders — may take advantage of this flaw to exploit the minority shareholders. The following Section addresses the same flaw from the perspective of managers who have the opposite goal of diluting the controller.

ii. The Non-Purchasing Controller

The last case that this Article considers is the controller who does not purchase the newly issued shares: the hypothesis in which the controller decides to refrain from the subscription of the new shares for any reason, including that she is seeking to exploit the minority shareholders or other investors issuing overpriced shares (*i.e.*, overpriced-issuance tunneling),[192] but this is beyond the purpose of this Section since there is no harm to

Holdings was a controlling shareholder before the transaction and, more importantly, this Article considers controllers and quasi-controllers in the same group. Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 WL 2714065, at *10 (Del. Ch. June 28, 2019) ("[E]ven if control is analyzed as of December 2017, when the board approved the Challenged Transactions, it is reasonably conceivable that Steel Holdings was a controlling stockholder, and that it exercised actual control over the Company for purposes of the IWCO acquisition.").

189. *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 124–25 (2016); Lund, *Nonvoting Shares*, *supra* note 59, at 741–44 (recommending a prohibition of only issuing the public non-voting stocks because, otherwise, a firm may be able to ignore any external pressure).

190. *See* Kastiel, *supra* note 189, at 95 ("Activists may also threaten to challenge an 'effective' controller, who owns less than 50% of the voting power, by seeking board representation despite the low ex ante chances of winning a proxy fight against an effective controller.").

191. *See supra* Section II.B.

192. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 356–58 (discussing extensively the advantages of controllers over minority shareholders).

outsider shareholders in their capacity as existing shareholders but only in their capacity as new investors should they purchase the new shares. Contrarily, this Section focuses on the scenario in which management seeks the dilution of the controller in the context of the shareholder-managers conflict. To this extent, in this Section, the controlling shareholder is not considered within the category of the firm's managers since, at least in the specific transaction, she is an outsider (as is proved by the fact that the board of directors can approve a dilutive issuance against her will).

Given that the controlling shareholder is presumptively not willing to lose her status within the firm and part (or all) of the private benefits that result from it,[193] and that she is supposed to exercise control over the board, such a transaction might seem extremely unlikely to occur. Indeed, several studies on the point either implicitly or explicitly[194] assume that the incumbent controller retains a non-trivial role in the decision concerning the issuance of new equity and therefore often analyzes such transaction from the perspective of the controller who is seeking to structure the issuance in her best interests.[195] The assumption is well-grounded in the Delaware legal framework where "the controller always has such power if she controls the board and a majority of the shareholder votes, but board control by itself often suffices."[196] However, the recent *CBS v. NAI*[197] case witnessed a shareholder having a majority of the voting power, but not effective control over the managers, which proved to be non-deferential at least for the purpose of the equity issuance, and entered into a firm reorganization aimed at exacerbating the controller's influence. [198]

In this and similar contexts, the best interests of the corporation might inspire management's action: Delaware case law explicitly acknowledges the power of the board of directors to dilute a shareholder should she represent a serious threat to the corporation.[199] However, although the

193. *See* Wu et al., *supra* note 177, at 1057.

194. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 355.

195. *See* Wu et al., *supra* note 177, at 1049 ("[I]f the incumbent chooses a cash offer, new equity is sold to outside shareholders, and the incumbent's controlling ownership will be diluted.").

196. Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 82 n.10 (citing Ganor, *The Power to Issue Stock*, *supra* note 25, at 709).

197. No. 2018-0342-AGB, 2018 WL 2263385 (Del. Ch. May 17, 2018).

198. *See id.* at *1; *supra* text accompanying notes 14–18.

199. *See, e.g.*, Mendel v. Carroll, 651 A.2d 297, 306 (Del. Ch. 1994) (recognizing the authority of the board to dilute a controller in order to protect the corporation consistently with its fiduciary duties); Ford v. VMware, Inc., No. 11714-VCL, 2017 WL 1684089, at *32 (Del. Ch. May 2, 2017) (citing Hollinger Inc. v. Hollinger Int'l, Inc., 858 A2d 342, 387 (Del. Ch. 2004)); *see also infra* text accompanying note 367.

explanation seems reasonable on a theoretical ground, the board might also practically seek to dilute the controller for opportunistic reasons. There are several instances of disagreement between the managers and the shareholders that can result in an incentive of the former to weaken the influence of the latter. The ultimate purpose might be either to perpetuate their position or to have more autonomy in the firm's strategic decisions.

Issuing blocks of shares to sympathetic investors is the most immediate way to accomplish the goal, with the expectation that the new friendly blockholders support management entrenchment.[200] Notably, the emergence of new blockholders is not restricted to transactions limited to one or a few specific investors: it has been pointed out that the control-diluting equity issuances generally structured as cash offers are likely to result in the same effect.[201] The same study also explained that in the event that an investor seeks to exercise influence over an issuer, the new equity issuance may facilitate her goal in that the odds of success are higher, and the costs are lower, compared to the case of an ordinary purchase on the market.[202] Accordingly, the ultimate goal of such intruding blockholders is often not to carry out monitoring activities but rather to threaten the controller to share a fraction of the control benefits.[203] Therefore, taking advantage of the shield of the threat to the long-term interests of the corporation, managers might cause an undisputed fundamental change in the ownership structure of the firm, such as a change of control, or at least a loss of control, which undermines the influence of the incumbent controller.

The purpose of Part III was neither to advocate that the managers are likely to perpetuate self-interests while issuing new shares nor to assume this attitude but to point out that as much as shareholders have an interest in not being either voting or economically diluted, the managers *might* have an opposite opportunistic incentive to enter into selective issuances. Overall, it seems reasonable to agree with the authoritative view that shareholders might want to keep direct control of such corporate decisions.[204] This is true both in the context of a manager-shareholder conflict and of a majority-minority shareholder conflict: the legal rules should protect shareholders as a class from exploitation by the managers and the minority shareholders —

200. *See generally* Kenneth A. Borokhovich et al., *Variation in the Monitoring Incentives of Outside Stockholders*, 49 J.L. & ECON. 651 (2006) (suggesting that affiliated blockholders may be deferential with regard to managers' entrenchment in exchange for sharing control benefits).

201. *See* Wu et al., *supra* note 177, at 1041 ("[C]ontrol-diluting cash offers tend to increase the probability for the emergence of new blockholders.").

202. *See id.* at 1042.

203. *See id.* at 1056.

204. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 180.

who face the most significant case — from exploitation by the majority should the majority shareholders, as often happens, exercise significant influence over the managers, who are entitled to approve the transaction. Part IV describes the powers that the current legal framework grants to the shareholders and argues that they fail to effectively limit managers' discretion in affecting the ownership structure of the firm.

IV. CURRENT SHAREHOLDERS' POWERS

Previous parts indicated that the U.S. legal framework provides the managers of a public corporation with comparatively great flexibility and discretion in issuing new shares. Shareholders do not have significant powers neither in affecting the decision nor in determining the structure of the transaction, and they mainly rely on the fiduciary duties that managers — and, under certain circumstances, controlling shareholders — owe to the corporation.[205] However, managers' powers in the issuance of new shares are subject to two quantitative limits that, if crossed, trigger a mandatory shareholder vote. This Part analyzes the cases requiring shareholder approval to issue new shares, with the goal — building on the analysis carried out in previous Sections — of critiquing the rules' effectiveness in limiting insiders' discretion. Namely, this Part is divided as follows: Section A delves into the voting power of shareholders that Delaware corporate law sets forth; and Section B analyzes the shareholder vote requirement provided by stock exchange rules.

A. Shareholders' Vote Pursuant to Delaware Corporate Code

According to the Delaware Code, the board of directors of the corporation may issue additional shares provided that the number of authorized shares in the certificate of incorporation is not exceeded.[206] Firms shall increase the number of the authorized shares only through an amendment of the charter of incorporation, which requires the approval of the shareholders.[207] This rule, however, does not prove to significantly limit the power of the managers to effectively address shareholder interests.[208]

A relatively recent extensive analysis of the allocation of powers in the equity issuances of Delaware corporations assessed the "magnitude of the

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205. *See supra* Sections II.B, III.B.

206. DEL. CODE ANN. tit. 8, § 161 (2020).

207. *See* Min, *supra* note 89, at 294 ("Under . . . the corporate law of all 50 states, including the Delaware General Corporation Law, amending a corporate charter requires both directors' and shareholders' approvals.").

208. *See* GEVURTZ, *supra* note 35, at 135 (pointing out the minimal protection that this rule brings against the shareholders' dilution).

managers' power" in the transaction by focusing on the "excess ratio," which is the ratio of the (i) number of authorized non-outstanding shares (*i.e.*, the number of shares that the board of directors is empowered to issue without a resolution of the shareholders' meeting) to (ii) the number of the outstanding shares.[209] The analysis shows an average excess ratio of 5.79 with regard to non-financial corporations that went public in 2009, indicating that on average, each of these companies at the time of the initial public offering ("IPO") had issued less than one-sixth of the shares authorized by the corporation's charter.[210] It is an obvious remark that a very high ratio significantly weakens the purpose and the value of the shareholders' vote, in that it is seldom required. The same study also suggests that the managers' purpose to keep wide discretion in the stock-issuances may either result in them refraining from issuing shares for business purposes — even when it is the most suitable solution for the firm — or, more broadly, enhancing their incentive by entering into any business transaction that has a positive effect on the excess ratio (*e.g.*, choosing share repurchases instead of dividends as the form of cash distribution).[211] Therefore, the managers' power to affect the ownership structure of the firm, combined with the agency tension between the managers and the corporation as a whole, is capable of indirectly creating distortions over their business decisions should their priority be to retain or to enhance the magnitude of this power.

From a normative perspective, one might suggest imposing a cap on the excess ratio to limit the magnitude of the directors' power. However, that proposal fails to address at least some of the above-mentioned issues. First, it is reasonable to argue that the lower the excess ratio is, the more likely the managers' business decisions are to be influenced by their effort to retain the power to dilute the shareholders' shares in the future.[212] Second, and more importantly, the shareholders' vote to increase the number of authorized shares generally fails to distinguish between the several types of equity issuances, and it is not contingent upon their different features (*e.g.*, identity of the purchaser and price). Therefore, it does not fix the flaws of the rule in

209. Ganor, *The Power to Issue Stock*, *supra* note 25, at 740.

210. *Id.* at 741 (providing a table showing a median excess-ratio for the same companies in the same year equal to 3.75 and a standard deviation of 5.13, which resulted from some companies choosing to go public with a very high ratio and others choosing a relatively small one, with the lowest at 0.34).

211. *Id.* at 705, 710–12 (explaining that since the managers do not have any power over the number of authorized shares, their business decisions might be influenced by the goal to increase the number of authorized and non-outstanding shares).

212. *See id.* at 742–43 ("[A] high ratio, which indicates a significant power in managers' hands, can be desirable to the extent that it allows the managers to issue stock without worrying about diminishing their power.").

protecting the outsiders from the above-mentioned scenario.[213]

The rule does not require firms to seek shareholder approval in the imminence of the shares issuance, meaning that as of the time of the vote, shareholders cannot be completely aware of the rationale of the transaction and of its effects on the ownership structure of the firm (including the dilution of a specific shareholder that may not be part of shareholders base as of the time of the vote).[214] This flaw is particularly critical in the non-controlled public corporation, where the shareholders' base may vary more often depending on the presence of either active or engaged shareholders. Second, in the context of controlled companies, the charter amendment does not distinguish between issuances involving the controlling shareholder and those where the purchasers are public shareholders not related to her.[215] Indeed, a controller may easily approve the charter amendment thereby succeeding the hypothesis described in Section III.B.i.[216] For a similar reason, the solution does not fix even the issue presented in the case *CBS v. NAI*, unless the amendment process was carried out exactly just before the proposed transaction.[217]

B. Shareholders' Power Pursuant to Stock Exchange Rules

Rules that U.S. stock exchanges adopt usually require the shareholders' approval when the equity issuance has a material impact on the voting rights balance of the public company.[218] Namely any issuance either resulting in a change of control of the issuer or having a voting power above twenty percent of that of the outstanding shares, triggers the shareholder vote provision.[219] This limit seems more effective than the one that the previous Section discussed since it maintains a vote on the specific transaction. In other words, when shareholders' vote, they have (or at least they are

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213. *See supra* Part III.

214. DEL. CODE ANN. tit. 8, § 161 (2020).

215. *See id.*

216. *See* Ventoruzzo, *supra* note 22, at 519 ("[M]inority shareholders in corporations with a controlling shareholder derive little protection from this rule because majority shareholders can consent to increase the number of authorized shares."); *see also* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 943 (explaining how this protection proved to be useless in the Google recapitalization of 2012, where the founders holding the majority of the voting rights were able to approve the issuance of a new class of shares although they "were clearly self-interested").

217. *See supra* text accompanying notes 14–18 for a detailed discussion of the case.

218. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 180–81 ("U.S. listing requirements require a shareholder vote when a new issue of shares is large enough to shift voting control over a listed company . . . .").

219. NYSE, LISTED COMPANY MANUAL § 312.03(c) (2019); *see also* NASDAQ RULE 5635 (setting forth a similar provision to the NYSE rule).

reasonably supposed to have) a clear view of both the terms of the transaction including the price, the subscribers' identity, and the transaction's impact on the ownership structure of the corporation. However, some concerns remain from the substantive and procedural perspectives.

On the substantive side, the New York Stock Exchange ("NYSE") rule provides for an exemption in the event of a cash offer to the public.[220] Therefore, the rule limits the flexibility of management to privately sell blocks to sympathetic investors but fails to protect outsiders should the managers have the only goal of diluting one or several specific shareholders, which management could accomplish with an offering to the dispersed public investors (rather than having to act in concert with one or more specific purchasers).[221] Finally, the rule sets forth another exemption if the firm issues shares in exchange for cash consideration at least equal to the market price of the share.[222] Therefore, this provision excludes shareholder votes for all the cases of non-cheap share issuances: although the approach to focus only on the exploitation of economic value might be reasonable, since the source of the provision is a stock exchange regulation, it arguably does not fulfill the protection of all shareholders' interests by itself. In fact, the same critiques concerning the application of the price fairness scrutiny to new share issuances[223] apply to this rule with a stronger magnitude given that the market price is possibly below the fair price in a transaction reallocating voting rights. In addition, having recently further increased the flexibility of the issuer with regard to the minimum price, the stock market rule is even more exposed to the critique that it fails to consider that the value

220. Note that these exemptions do not apply in the case of the issuance shifting the control of the issuer. *See* JOSHUA N. KORFF ET AL., NYSE IMPROVES 20% RULE REQUIRING SHAREHOLDER APPROVAL OF CERTAIN PRIVATE PLACEMENTS 2 (2019), https://www.kirkland.com/-/media/publications/alert/2019/02/nyse-improves-20-rule-requiring-shareholder-approv.pdf.

221. *See id.* at 1.

222. NYSE, *supra* note 219, §§ 312.03(c)(2)–312.04(i) (explaining that "shareholder approval will not be required for any such issuance involving: any public offering for cash; or any other financing (that is not a public offering for cash) in which the company is selling securities for cash, if such financing involves a sale of common stock, . . . at a price at least as great as the Minimum Price," where the definition of Minimum Price is "a price that is the lower of: (i) the Official Closing Price immediately preceding the signing of the binding agreement; or (ii) the average Official Closing Price for the five trading days immediately preceding the signing of the binding agreement"); *see also* Eleazar Klein & Evan A. Berger, *SEC Approves NYSE's Amended "Related Party" and "20%" Stockholder Approval Rules*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 20, 2021), https://corpgov.law.harvard.edu/2021/04/20/sec-approves-nyses-amended-related-party-and-20-stockholder-approval-rules/ (discussing a recent amendment to the rule, which removed the "5% limit for any single purchaser participating in a transaction").

223. *See supra* text accompanying notes 41–59.

of the voting right is subjective, since the stock market rule increases the likelihood that the shareholders' vote is not triggered even if the issuance price is below the diluted shareholders' subjective value of their voting rights.[224]

From a broader and procedural perspective, the rule has been recently called into question in the context of the *CBS v. NAI* case, as the highly dilutive dividend that the managers of CBS approved would have deprived NAI of the issuer's control.[225] Given that Delaware courts did not rule on the matter, it is not clear whether CBS' directors relied on any exemption to the rule or if this structure was effectively compliant.[226] A post from the law firm Cleary Gottlieb Steen & Hamilton argues that "the CBS-NAI situation should serve as a reminder that stockholders should be wary of relying too heavily on stock exchange rules as protection against potential dilutive stock issuances."[227] The main argument is the potential lack of enforcement power of stock exchange rules that are likely to not have the force of law.[228] The lack of shareholder power for enforcing the stock exchange rules appears to be abstracted from a series of cases, including a recent 2005 ruling of the U.S. District Court for the Southern District of New York.[229] The Cleary Gottlieb Steen & Hamilton post further indicated that the board of directors

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224. NYSE has recently amended the rule in order to eliminate the requirement for shareholder approval in the event that the issuance price falls between the Minimum Price and the book value of the stock. *See supra* note 222 (defining Minimum Price); KORFF ET AL., *supra* note 220, at 1 (pointing out that the new rule enhances the flexibility of the issuer).

225. *See supra* text accompanying notes 14–18.

226. *See* Victor Lewkow et al., *Lessons from the CBS-NAI Dispute: Can Stockholders Rely on Stock Exchange Rules to Prevent Dilution of Their Voting and Economic Interests?*, CLEARY GOTTLIEB (Oct. 10, 2018), https://www.clearygottlieb.com/news-and-insights/publication-listing/lessons-from-the-cbs-nai-dispute-can-stockholders-rely-on-stock-exchange-rules-to-prevent, *reprinted in* Victor Lewkow et al., *CBS-NAI Dispute, Part III: Can Stockholders Rely on Stock Exchange Rules to Prevent Dilution of Their Voting and Economic Interests?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 24, 2018), https://corpgov.law.harvard.edu/2018/10/24/cbs-nai-dispute-part-iii-can-stockholders-rely-on-stock-exchange-rules-to-prevent-dilution-of-their-voting-and-economic-interests/ (suggesting firstly that the CBS issuance might have been grounded in an NYSE statement on the twenty percent rule that affirms it "does not apply to stock dividends and splits because they are distributions rather than transactions" and exhorts stakeholders to focus on the actual intent of the issuance, and secondly arguing that the NYSE statement was unlikely to be applied to dilutive dividends as the main purpose was to focus on effective distributions). A ruling on the matter is not available since the dispute ultimately settled. *See* Settlement and Release Agreement, *In re* CBS Corp. Litig. (No. 20180343-AGB) (Sept. 9, 2018), https://www.sec.gov/Archives/edgar/data/813828/000119312518269601/d622048dex10a.htm.

227. Lewkow et al., *supra* note 226.

228. *See id.*

229. Brady v. Calyon Sec. (USA), 406 F. Supp. 2d 307, 312 (S.D.N.Y. 2005).

might be willing to take the risk of having the company delisted (the principal sanction that the stock exchange may enact) in order to achieve their goal.[230]

In conclusion, the stock exchange rules do not seem to be a reliable source of protection for shareholders seeking to avoid a dilution of their fractional stake. Not only do they fail to address some specific instances, but there are issues concerning their overall enforcement. Furthermore, any decision maker or transaction planner of the firm is likely to structure the transaction in order to take advantage of these gaps and avoid the shareholders' vote:[231] were the voting requirement set forth by Delaware corporate law, their task would be at least harder. Finally, this Article advocates a consistent body of rules set forth by corporate law rather than by stock exchange regulations and that do not discriminate based on the stock exchange where the corporation is listed.

V. A NORMATIVE APPROACH TO THE EQUITY ISSUANCES

The analysis so far can be summarized as follows: (1) the issuance of new shares might have a material impact not only on the corporation's finance but also on its governance; (2) the current ownership structure of public firms witnesses several instances of shareholders who are concerned about the dilution of their stake, and the entire fairness standard does not address this problem; (3) the managers may use this tool to exploit shareholders' value; and (4) the current shareholders' powers do not effectively protect them from the managers' exploitation. This Part seeks to propose a new legal framework that arguably better addresses shareholders' concerns of enhancing their powers in the context of new equity issuances. This normative approach arises from the comparison with the rules that, in compliance with EU laws (when applicable), the EU countries adopt.[232]

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230. *See* Lewkow et al., *supra* note 226 (pointing out that the firm is "aware of at least one situation where the board of a major company seemed to be prepared to not comply with the NYSE Policy in the context of a competitive M&A situation, after receiving advice as to the likelihood of an NYSE enforcement action and the likelihood of other trading markets developing in the event of a delisting" and specifying that the transaction had not been completed for different reasons). On the point, see generally Steven Davidoff Solomon, *Warren Buffett's Lost Vote*, N.Y. TIMES, (Jan. 21, 2010, 9:05 AM), https://dealbook.nytimes.com/2010/01/21/warren-buffetts-lost-vote/?src=tptw, for the argument that if a company is not required to be listed, it may be willing to accept this extreme solution.

231. *See* Marco Becht et al., *Does Mandatory Shareholder Voting Prevent Bad Acquisitions?*, 29 REV. FIN. STUD. 3035, 3040 (2016) (exposing relevant literature and cases).

232. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 181 ("EU jurisdictions have a stronger tradition of putting new share issues to the vote of shareholders, although

Namely, as a default rule, (i) shareholder consent is required to approve the issuance and (ii) once the transaction is approved, shareholders are entitled to subscribe pro-rata to the newly issued shares. The remainder of this Part is structured as follows: Section A focuses on the preemptive right provision and points out why it fails to address the issues flagged in previous parts; and Section B focuses on shareholders' approval — which is arguably the most suitable improvement — and seeks to understand the best possible implementation in order to address the above-mentioned problems.

A. The Preemptive Right in Public Companies

The preemptive right is the right of existing shareholders to subscribe pro-rata to the newly issued shares.[233] It is a default provision in European countries, where it can be partially, or entirely, waived should certain specified exemptions be met.

Supporters of the preemptive right claim its effectiveness in protecting outsider shareholders from dilution by the decision makers of the new equity issuances, either the controllers or the managers depending on the circumstances. While the provision is undoubtedly a useful tool from the perspective of the firm's majority shareholder, who is able to retain her fractional economic and voting power within the firm, the majoritarian view addresses the provision as a minority's tool in the context of the conflict against the majority.[234] Arguably, the controller is supposed to find protection from any dilution in the dominant (*i.e.*, controlling) influence that she can exercise over the managers.[235]

Looking at the function of the provision, some scholars claim that the main purpose is to prevent the exploitation of minority shareholders' economic value.[236] Namely, it has been indicated that, should the issuance of shares be

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the company's charter or the shareholders in general meeting may delegate that decision to the board, for periods of up to five years."). *See generally* Ventoruzzo, *supra* note 22 (providing a comparative analysis between corporate laws and specifically new share issuances in Europe and the United States).

233. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 83.

234. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 182 (pointing out how "[p]reemptive rights are a paradigmatic example of the sharing strategy" as a way to protect minority shareholders).

235. *See* GEVURTZ, *supra* note 35, at 134 (noting that a controller who is not willing to be diluted is presumed to block the issuance).

236. *See* Amal Abu Awwad, *Diritti di Opzione nelle Società Quotate e Non Quotate e Metodi di Protezione* [*Shareholders' Preemptive Rights in Listed and Closely-Held Corporations and Shareholders' Protection Methods*], 11 NUOVO DIRITTO DELLE SOCIETÀ [NEW CORP. L.] 142, 144, 157 (2013) (It.) (pointing out that for public corporations, market liquidity might be a suitable replacement of preemptive rights since

underpriced, the outsiders have the option to purchase a proportional fraction of the new equity and therefore offset the decline in their existing stake's value with the gain they capture in the purchase of underpriced new shares.[237] Transfer of value occurs only should the existing shareholders fail to completely exercise their respective preemptive rights.

However, other scholars pointed out how the preemptive right enables the existing shareholders to retain their fractional voting power.[238] Reasonably, both explanations are correct and retaining the same proportional stake is a way to avoid economic dilution.[239] Since preemptive rights fulfill both protections, wondering about the main function of the provision may seem a speculative and pointless exercise; however, it is critical to assess the provision's efficiency and effectiveness, as well as whether its goal could be better achieved otherwise. To this extent, the preemptive right indirectly leads the corporation to keep the same ownership structure, and it has been pointed out that this interest is perceived as compelling mainly in closed corporations.[240] Although the restatement of the preemptive right as a default provision in the issuance of new shares does not seem to be the best solution to address the issue of shareholder dilution, this Article disagrees with this statement and claims that outsider shareholders of public corporations do have some interests in limiting the discretion of the managers in diluting shares.[241]

The provision also encourages a dialogue between managers and shareholders in that the latter have to approve of any waiver of the preemptive right.[242] Arguably, the magnitude of the argument on the engagement between insiders and outsiders depends on the strictness of the requirements that the applicable law maintains in order to waive the

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any diluted shareholder is able to purchase additional shares on the market); *see also* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 83 (suggesting that the feature enabling shareholders to retain the same fraction in the ownership structure of the firm is an indirect protection).

237. *See* Holderness & Pontiff, *supra* note 29, at 253.

238. *See* MYNERS, *supra* note 60, at 10–11.

239. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 182 ("[P]reemptive rights permit minority shareholders to safeguard their proportionate investment stakes and discourage controlling shareholders from acquiring additional shares from the firm at low prices.").

240. *See* Abu Awwad*, supra* note 236, at 149 (arguing that mainly shareholders of family-owned companies have this concern).

241. *See supra* Part II.

242. *See* FERRAN & HO, *supra* note 32, at 106; Eilís Ferran, *Legal Capital Rules and Modern Securities Market — the Case for Reform, as Illustrated by Equity Markets*, *in* CAPITAL MARKETS AND COMPANY LAW 115, 121–22 (Klaus J. Hopt & Eddy Wymeersch eds., 2003).

shareholders' preemptive rights.

Differing from EU jurisdictions, the U.S. legal framework does not empower existing shareholders with preemptive rights, which are only an opt-in option[243] and are rarely implemented into corporate charters.[244] Namely, the preemptive right quickly and unsuccessfully appeared in the United States and its importance started to decline around the second half of the twentieth century.[245] Nowadays, the main mechanism for shareholder protection lies in the application of directors' fiduciary duties to new share issuances.[246] In the relatively few cases where the issuers decide to provide existing shareholders with preemptive rights in a specific issuance, the transaction is structured as a rights offering.[247] This historical evolution may be a reason not to argue for the implementation of preemptive rights in the United States; however, it is not the only argument.

An additional argument lies in the provision's function to protect outsider shareholders from underpriced issuances. The approach that this Article seeks to suggest concerns the economic side of the transaction and advocates the enhancement of shareholder protections from economic dilution through the improvement of the overall process of new share issuances. This seems to be the established trend in Delaware law with regard to different corporate law transactions entered into by public corporations.[248] In fact, the legal approach that Delaware courts repeatedly adopt is to assess the fairness of the price to the minority shareholders in controlled transactions through the quality of the process.[249] The argument is to extend the attitude that was

243. *See* Rock et al., *Fundamental Changes*, *supra* note 37, at 182; *cf.* Abu Awwad, *supra* note 236, at 156–57 (suggesting that the policies of the United States and European countries are converging with regard to the use of preemptive rights in public corporations).

244. *See* CLARK, *supra* note 37, § 17.1.4.

245. *See* Ventoruzzo, *supra* note 22, at 520–21.

246. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 84.

247. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 353; *see also* Massa et al., *supra* note 30, at 6, 13 (describing the procedure of a rights offer).

248. *See generally* Guhan Subramanian*, Appraisal after* Dell, *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 222 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019) (arguing that in the context of appraisal proceedings, the deal price should receive a material presumption of fairness if the courts find the deal process to have been at arm's length).

249. *See id.* at 236 ("[T]he Delaware Supreme Court converted a substantive inquiry (Was the deal price entirely fair to the minority shareholders?) into a procedural inquiry (Did the minority shareholders have adequate procedural protections?)."). Subramanian mentioned the case *Kahn v. M&F Worldwide Corp.* as a paradigmatic example of his statement. *Id.* (citing Kahn v. M&F Worldwide Corp., 88 A3d 635 (Del. 2014)).

endorsed in the context of freeze-out transactions and appraisal proceedings to the equity issuances, which to an extent are comparable cases because the broad purpose of corporate law in such instances is to protect outsider shareholders from possible abuses of managers through the transaction.

On this side, the preemptive right fails to enhance the quality of the process, as well as the fairness of the price. Contrarily, the cornerstone of the provision is that, should the issuance price be below the fair market value of the shares, the loss that existing shareholders incur is offset by the right to purchase pro-rata new shares at a price that is advantageous from the purchaser's perspective.[250] Alternatively, the existing shareholders may sell their preemptive right. In sum, the incentive to focus on the quality of the process is arguably undermined by the purported lack of interest in the existing shareholders that may recover the unfairness of the price through subscription rights. On that point, financial studies noted that, customarily, rights offers provide "a 10-15% discount from the stock's current market price."[251] The preemptive right is an ex-post remedy (with the weaknesses that authoritative scholars pointed out and this Section has exposed) to limit the negative impacts of a flawed process, rather than a tool to improve the quality of the process itself.

To this extent, a further critique of the provision is its necessary reliance on the efficient functioning of the financial markets. Namely, as above mentioned, the provision's main purpose is to protect outsiders from economic exploitation and this purpose is only achieved if there is a full exercise of the rights, should the offer be underpriced. Therefore, the provision is flawed for those shareholders whose financial or other constraints prevent them from exercising their rights.[252] The traditional solution lies in a shareholder's ability to sell the right to another investor;[253] should the rights market be not sufficiently liquid or non-tradable, the recommended approach for existing shareholders is to exercise the right and sell the share immediately after the purchase[254] or to sell the shares before

250. *See* Ventoruzzo, *supra* note 22, at 520 (explaining that the traditional approach in the United States was to grant shareholders the right to purchase pro-rata any new shares issued).

251. B. Espen Eckbo, *Equity Issues and the Disappearing Rights Offer Phenomenon*, 20 J. APPLIED CORP. FIN. 72, 72 (2008).

252. *See* GEVURTZ, *supra* note 35, at 135 (pointing out the flaws of preemptive rights in protecting a shareholder "who lacks either the funds or the willingness to take advantage of the right by purchasing more shares").

253. *But see* Massa et al., *supra* note 30, at 2 (indicating the problematic side of this alternative in that shareholders who fail to communicate their preference between subscribing and selling incur a loss).

254. Holderness & Pontiff, *supra* note 29, at 261.

the distribution of the right. In each case, the protection of the investor is shifted to financial markets: a recent financial study suggested that if the right is non-tradable, shareholders often seek to sell their shares before receiving the right (if they do not plan on exercising it).[255] The resulting pressure to sell, therefore, undermines the value of the right.

In addition, the preemptive right fails to fulfill the protection of certain shareholder interests pointed out in previous Parts[256] because it concerns both non-controlled and controlled corporations. To begin with, the preemptive right forces the outsiders to choose between being diluted and increasing their overall investment in the firm.[257] This is a critical concern, particularly for embedded shareholders who cannot increase their economic exposure in the firm, and institutional investors or hedge funds that may not want to increase their exposure in the firm by investing too many resources.[258]

In addition, the fact that the outsider shareholders subscribe to the new shares does not imply, by itself, that they are not being exploited for economic value.[259] Namely, as mentioned, the controller may have an interest in the firm issuing shares that are either absolutely overpriced — with the controller voluntarily refraining from the purchase of the new shares — or relatively overpriced, meaning that the insider seeks to extract private benefits from the firm and this makes the purchase of new shares convenient for her at a price above their fair market value.[260] The preemptive right fails to address the shareholders' concerns in all cases where the issuance is not underpriced, since it grants the outsider shareholders the right to purchase the new shares at a disadvantageous price. The facts of the above-mentioned *OTK v. Friedman* case are aligned with this argument.[261]

Recent studies indicated that the lack of adequate information undermines the effectiveness of the preemptive right in protecting the minority

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255. Wai-Ming Fong & Kevin C.K. Lam, *Rights Offerings and Expropriation by Controlling Shareholders*, 41 J. BUS. FIN. ACCT. 773, 776 (2014) (hypothesizing a relation between the agency issue and the number of non-exercised rights).

256. *See supra* Section II.C.

257. *See* FERRAN & HO, *supra* note 32, at 124 (pointing out the coercive effect of the preemptive right provision, especially in the event of an underpriced offer, which often occurs with preemptive rights).

258. *See supra* text accompanying notes 145–47.

259. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 86 (pointing out both the cases of overpriced-issuance tunneling and minorities' fear of overpriced-issuance tunneling).

260. *See supra* Section III.B.i.b.

261. *See supra* Section III.B.i.b.

shareholders from cheap-stock tunneling.[262] Namely, the information asymmetry between the insiders and the outsiders — which enhances the disclosure rules that apply in the context of public companies —[263] prevents the outsiders from assessing whether the issuance price falls below or above the fair price of the issuer's shares. On that point, a recent empirical study involving the Hong Kong stock market found that agency concerns may prevent the shareholders from exercising their rights while, if the issuance was underpriced, the controllers, who often act as underwriters, strengthen their position at a deep discount.[264]

Were the shareholders fully informed, the preemptive right would be a more useful provision to avoid the cheap-stock tunneling, but this scenario is unrealistic in practice.[265] In the context of public companies, not even tradable rights are effective in solving the issue, since the purchaser of the right faces the same lack of information as the outsider shareholders.[266] A recent proposal claims that in the context of a right offering, the insiders' decision on the subscription is material information for the outsiders and suggests that outsiders should be allowed to condition the exercise of their rights on the insiders' decision.[267] However, the case of the relatively underpriced issuance undermines this solution, since the fact that an exercise price is convenient for the insider does not, by itself, make it convenient for the outsiders.

This flaw undermines the effectiveness of the provision not only in protecting the outsiders from cheap-stock tunneling and overpriced-stock tunneling but also in avoiding the decline in their voting power through the exercise of subscription rights. The fact that a given outsider shareholder has an incentive to retain her voting power does not necessarily mean that she is willing to overpay for the newly issued shares — or to incur such risk,

262. *See* Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 86. *See generally* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95 (discussing the pros and cons of preemptive rights in defending all shareholders from cheap-stock tunneling).

263. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 363.

264. Fong & Lam, *supra* note 255, at 787.

265. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 363.

266. Fried, *Powering Preemptive Rights with Presubscription Disclosure*, *supra* note 153, at 93.

267. *See* Mira Ganor, The Case for Non-Binary, Contingent, Shareholder Action 3, 23 (Feb. 2, 2020) (unpublished manuscript) [hereinafter Ganor, The Case for Non-Binary, Contingent, Shareholder Action], https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3530596.

since she does not know the range in which the price falls[268] — to achieve the goal. Therefore, building on these studies, it seems reasonable to argue that the information asymmetry is likely to frustrate the preemptive right's avoidance of voting dilution.

This analysis is consistent with the finding of a recent study, which focused on the impact of the announcement that a public firm has approved a new share issuance over the market price of the already traded shares of that issuer. The overall impact of new equity issuances is usually negative, and structuring the transaction as a rights offering does not change the outcome by itself. In other words, granting preemptive rights to existing shareholders does not result, by itself, in a positive effect on the shares' price, contrarily to what happens should the issuance be approved by the shareholders.[269]

B. The Proposal for Reform: Shareholders' Vote

The Italian experience may serve as a proper introduction to this normative Section. Italian law, pursuant to European rules, requires shareholders to vote on issuing new shares. Although, for reputational reasons, the board reasonably tends to engage with the major shareholders and secure consent ahead of proposing the resolution, there are two recent cases of shareholders that successfully opposed an increase in the number of outstanding voting shares.

In June of 2015, the French company Vivendi S.A. acquired a stake of 14.9 percent in Telecom Italia S.p.A. and, by December of 2015, had become its major shareholder with participation equal to 20.116 percent of the voting rights.[270] As of December of 2015, Telecom Italia S.p.A. had issued 13,499,911,771 share of common stock and 6,027,791,699 shares of non-voting stock.[271] At the shareholders' meeting on December 15, 2015, the

268. Specifically, the outsider shareholder does not know whether the newly issued shares are underpriced, relatively underpriced from the perspective of the controller, or absolutely overpriced.

269. *See* Holderness, *supra* note 107, at 427 (noting that "[w]hen there is no shareholder approval, average returns are typically negative and are sometimes large," but the announcement of a shareholder-approved right offering positively affects the stock price).

270. TELECOM ITALIA S.P.A, EXPLANATORY REPORT BY VIVENDI S.A. TO TELECOM ITALIA S.P.A. SHAREHOLDERS 1 (2015), https://www.gruppotim.it/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/Explanatory-report-Vivendi-bis.pdf.

271. TELECOM ITALIA S.P.A, MEETING MINUTES OF TELECOM ITALIA S.P.A. ORDINARY SHAREHOLDERS' MEETING 1 (2015), https://www.gruppotim.it/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/minutes-ordinary-shareholders-meeting-15-dic-2015.pdf.

board of directors of Telecom proposed an extraordinary resolution to convert each non-voting stock into one common stock.[272] If the shareholders had approved the transaction, the conversion would have diluted the voting rights of the common shareholders by 31.1 percent,[273] resulting in a dilution of Vivendi's stake below fourteen percent of the voting rights. Due to Vivendi's opposition — which in the same context successfully also achieved the appointment of four directors — the board's resolution failed to reach the necessary threshold to be adopted, and the number of issued common stock was not increased.[274] Notably, the proposed transaction was not technically an issuance of new shares for consideration but a recapitalization still aimed at significantly increasing the number of voting stock. Furthermore, this conversion would have prevented the shareholders from exercising preemptive rights that they are usually granted in equity issuances in Europe.

In December of 2018, the board of directors of Banca Carige S.p.A. proposed at the shareholder meeting to adopt a resolution empowering the directors to issue new shares in exchange for an amount equal to or up to €400 million.[275] According to the proposal, the board would have eventually determined the terms (including the number of new shares) of the transaction,[276] and existing shareholders would have been granted preemptive rights.[277] The proposal failed to meet the required votes even if

272. Press Release, Telecom Italia, Telecom Italia Shareholders' Meeting Held (Dec. 15, 2015), https://www.gruppotim.it/content/dam/telecomitalia/en/archive/documents/media/Press_releases/telecom_italia/Corporate/Financial/2015/PR-AGM-15-12-15.pdf.

273. TELECOM ITALIA S.P.A., EXPLANATORY REPORT OF EXTRAORDINARY GENERAL SHAREHOLDERS' MEETING TO SHAREHOLDERS 12 (2015), https://www.telecomitalia.com/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/English-Translation-of-directors-explanatory-report-EGM-151115.pdf. Note that the transaction, if approved, had a voluntary conversion and a mandatory conversion: since the first one had a more convenient term for the holders of non-voting shares, it is fair to assume that all the holders would have picked the voluntary option.

274. TELECOM ITALIA S.P.A., SUMMARY REPORT OF THE VOTES OF SHAREHOLDERS' MEETING 1 (2015), https://www.telecomitalia.com/content/dam/telecomitalia/en/archive/documents/investors/AGM_and_Meetings/2015/summary-report-of-the-shareholders-meeting-votes-15-12-2015.pdf; *see* Gaia Balp, *Activist Shareholders at De Facto Controlled Companies*, 13 BROOK. J. CORP. FIN. & COM. L. 341, 365–66 (2019).

275. BANCA CARIGE, BOARD OF DIRECTORS' REPORT OF THE THIRD ITEM ON THE AGENDA OF THE EXTRAORDINARY SHAREHOLDERS' MEETING 1 (2018), https://www.gruppocarige.it/grpwps/wcm/connect/265f54ba-ee55-41f7-9638-9bdb9d302435/03+Relazione+CdA+aumento+di+capitale_ENG+con+commenti+per+Legali+e+AS.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-265f54ba-ee55-41f7-9638-9bdb9d302435-mvMmw4h.

276. *See id.* at 1, 3 (citing Section 2443 of the Italian Civil Code, which expressly sets forth this alternative).

277. *See id.* at 9.

it did not undermine the shareholders' right to avoid dilution of their stake; therefore, the transaction was not completed.[278] Arguably the lack of approval of the issuer's major shareholder — carrying 27.5 percent of the voting rights — played a critical role.[279]

Taking advantage of the comparative experience, this Section seeks to put up a new legal framework aimed at addressing the corporate governance issues[280] that may arise in the context of the transaction, either in controlled or non-controlled public firms.

This Article applies Professor Bebchuk's argument that managers "should not have control over 'constitutional' decisions that affect the basic corporate governance arrangements to which the company is subject" to the transaction.[281] The proposed change lies in the allocation of powers between shareholders and managers and seeks to empower the former with a property rule protection. Therefore, shareholders may not be expropriated of their voting rights without their approval, notwithstanding the transaction's fairness.[282] Namely, the new rule requires the fully informed and uncoerced shareholders' vote to complete the transaction. While the raising of additional equity capital —– as well as the distribution — is a business decision, its potentially strong impact on the ownership structure of the firm

278. BANCA CARIGE, ASSEMBLEA ORDINARIA DEGLI AZIONISTI TENUTASI [ORDINARY SHAREHOLDERS' MEETING] 2 (2018), https://www.gruppocarige.it/grpwps/wcm/connect/b035d1ca-239a-44e7-9699-7561ac1c34ad/Elenco+Votazioni.pdf?MOD=AJPERES&CACHEID=ROOTWORKSPACE-b035d1ca-239a-44e7-9699-7561ac1c34ad-mvMmvbg (showing that despite the fact that more individual shareholders voted in favor of the proposal, the shareholders who abstained from voting held a larger percentage of the voting shares).

279. Raoul de Forcade, *Carige*, *Malacalza Si Astiene: Salta L'Aumento di Capitale da 400 Milioni* [*Carige, Malacalza Abstains: 400 Million Increase in Capital Falls Through*], IL SOLE 24 ORE (Dec. 22, 2018), https://www.ilsole24ore.com/art/carige-malacalza-si-astiene-salta-l-aumento-capitale-400-milioni-AEDylR4G (noting the impact of the abstention by a major shareholder, Malacalza Investments, on the ultimate fate of the proposal).

280. *See* Min, *supra* note 21 (manuscript at 13, 14) (claiming for a "distinctive treatment" of transactions that can potentially affect the governance of the firm).

281. Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75, at 837. Note that while the Author develops this argument in a paper about public firms with dispersed ownership, the following Sections extend its application to the case of controlled firms, thereby seeking to limit the autonomy of the managers both when they act in conjunction with the controller or against her will.

282. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 601 (explaining that under property rules, "minority shareholders or courts cannot unilaterally take control rights away from the controller even for objectively fair compensation"). Notably, although Goshen and Hamdani addressed the rule from the perspective of the controlling shareholders, its features are the same both in controlled and non-controlled firms.

positions it as a fundamental corporate governance change.[283] Under the current legal framework, the assumption underlying the lack of shareholder approval for a new share issuance is that it does not fall within the corporation's fundamental changes unless it crosses the limit of the number of the firm's authorized shares by the charter of incorporation (as this specific case triggers the requirement of the shareholders' vote).[284] However, since this threshold is arbitrarily settled by the charter of incorporation and is usually very large,[285] it does not seem to be a good benchmark to capture the materiality of the change. For the same reasons, it should not be argued that the shareholders had in advance approved the transaction as of the time of the charter's amendment. A recent article points out the downsides of an allocation of power that entrusts the managers with decisions that may materially change the governance of a public firm:[286] in fact, this effect may be achieved even without having to increase the number of authorized shares. Another study extensively analyzed the allocation of power in the context of new shares issuances and found that "the power to issue stock in its current format enables managers to circumvent the will of the shareholders and promote the managers' own self-interest at the shareholders' expense."[287] Accordingly, the strategic selective distributions of the new shares (and therefore of newly created votes) to a board-friendly shareholder might substantially accomplish the same goal as the direct purchase of votes.[288]

CBS v. NAI differs from the other cases that this Article discussed in that the diluted shareholder was able to block the transaction.[289] In fact, the order endorsed the principle that the controlling shareholder is entitled to react to

283. *See* Min, *supra* note 21 (manuscript at 19) ("When a company distributes a newly created class of stock as a dividend, while the problems tend to be somewhat different, concerns over governance changes can nevertheless arise."). Notably, Min's paper applies this reasoning to all new share issuances regardless of whether they are structured as a distribution or not.

284. *See* Kim & Min, *supra* note 158, at 4 (pointing out a similar argument with regard to spin-off transactions, *i.e.*, "[a]n important assumption for such lack of shareholder approval in a spin-off is that there are no fundamental changes to shareholder rights before and after the spin-off").

285. *See supra* text accompanying notes 207–17 (discussing the other limits of the rule).

286. *See* Min, *supra* note 21 (manuscript at 24) ("As the CBS case demonstrates, directors' power to declare a stock dividend, if unchecked, confers significant power to the board and management to impact a company's governance structure.").

287. Ganor, *The Power to Issue Stock*, *supra* note 25, at 707.

288. *See id.* at 733.

289. *See supra* text accompanying notes 14–18.

the managers' action diluting her voting power.[290] However, as previous parts pointed out, the controlling shareholders may not be the only parties concerned with dilution and interested in opposing the managers of a public firm. While the case shows that the controllers — even when they lack control over the board of directors in the context of the transaction — are usually empowered with some instruments to neutralize the management's action and prevent the dilution of her participation, the other more or less significant but non-controlling shareholders lack any instruments. Arguably, the loss of a portion of voting rights is not considered an expropriation, dissimilar from what occurs with the loss of control.

This Article claims that any voting rights dilution may prove to be an issue even if it does not shift the control of the firm and seeks to extend its scope to any equity issuances regardless of the presence of a controlling shareholder.[291] The ultimate goal of the proposal is to enhance the protection of the outsiders from the dilution that the insiders — whoever they are depending on the circumstances: controlling shareholders, managers or directors — may seek. It advocates a consistent framework granting the shareholders relatively homogenous powers (*i.e.*, proportional to the fraction of voting shares they own) and tailored to the specific issuance. Mirroring the structure of previous sections,[292] the rule may deem even the controller to be an outsider, depending on the degree of influence that she exercises over the corporation's decision maker with regard to the specific issuance.

Arguably, this suggested approach also improves the issuance process, in that it favors a constructive dialogue between shareholders and managers since in the large majority of cases, the insiders have a strong incentive to seek the approval of the outsiders.[293] On that point, reputational arguments make managers more careful to avoid submitting unfair proposals (or at least unfair to the majority of those entitled to vote) to the shareholders' vote, facing the risk of having the proposal rejected. The requirement of a shareholder vote on the transaction — and an increasingly intense interaction with the management — appears to be strictly connected to the sophistication of the shareholder base.[294] Although it might be argued that the customary

290. *See* CBS Corp. v. Nat'l Amusements, Inc., No. 0342-AGB, 2018 WL 2263385, at *6 (Del. Ch. May 17, 2018). Note that a definitive ruling on the item is not available since the dispute subsequently settled. *See generally* Settlement and Release Agreement, *supra* note 226 (detailing the settlement between the two parties).

291. *See* text accompanying notes 55–58.

292. *See supra* Section III.B.ii.

293. *See* Kim & Min, *supra* note 158, at 49–50 (pointing out the advantages of ex-ante shareholder approval in the context of spin-offs).

294. *See* Holderness, *supra* note 107, at 437 (wondering whether mandatory shareholder approval and the resulting increased engagement between shareholders and

retail shareholder lacks the financial resources to cast an informed vote and therefore finds it a burdensome task,[295] the previous Parts embrace a different view.[296] On that point, an authoritative work exposed the transformation of U.S. capital markets and claimed that the transformation resulted in a shift of control over corporate affairs from courts to markets:[297] accordingly, "the increased deference of the Delaware courts to market actors reflects the Delaware courts' correct understanding that sophisticated shareholders are better positioned to adjudge the merits of board decisions and to discipline disloyalty and incompetence."[298] To this extent, not only the sophisticated shareholders may properly vote on the transaction, but also they need this right to avoid an unduly dilution and carry out such monitoring activity, which now may take place ahead of the transaction rather than through subsequent litigation. In fact, the proposal is consistent with the expectations that the institutional shareholders shared: indeed, BlackRock has recently advocated for the requirement of shareholders' approval in the context of new share issuances.[299]

Finally, the proposal is consistent with the thesis of a study that analyzed the new issuance in several countries from the stock-price perspective and found an overall positive effect of the announcement of a shareholder-approved issuance on the market price of the firm's shares.[300] Accordingly, a reasonable explanation of the outcome lies in agency tensions that usually affect the issuance since, should only the managers approve the transaction,

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managers would make the shareholder base more sophisticated).

295. Ganor, The Case for Non-Binary, Contingent, Shareholder Action, *supra* note 267 (manuscript at 2).

296. *See supra* Section II.C.

297. *See* Goshen & Hannes, *The Death of Corporate Law*, *supra* note 79, at 265.

298. *Id.* at 289.

299. *See* Barbara Novick, *Open Letter Regarding Consultation on the Treatment of Unequal Voting Structures in the MSCI Equity Indexes*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 3, 2018), https://corpgov.law.harvard.edu/2018/05/03/open-letter-regarding-consultation-on-the-treatment-of-unequal-voting-structures-in-the-msci-equity-indexes/ ("[S]hareholders should be able to vote on matters that are material to the protection of their investment including but not limited to changes to the purpose of the business, matters related to capital issuance such as dilution levels and preemptive rights, the distribution of income and the capital structure.").

300. *See* Holderness, *supra* note 107, at 425 (exposing the findings of an analysis carried out on public firms without differentiating the concentration of the ownership structure). Note that while a market-oriented critique of the proposed rule might argue that if it were a material improvement, the market would have already implemented it, these empirical outcomes might offer an adequate response. Namely, the positive market reaction to shareholder-approved issuances should be read as an implied incentive to add this feature in order to benefit from a better stock performance.

the investors perceive them as possibly perpetrating self-interests.[301]

Arguably, the framework should be declined in different ways depending on the structure of the transaction and the identity of the subscribers in order to properly address the relevant conflicts and risks of exploitation. In addition to the general features of the shareholder vote — arguably applicable to each case — the remainder of this Part seeks to focus on the different scenarios, explaining how the rule should be implemented and positioning it in the current case law and literature. Mirroring the distinction that Part III drew, Section V.B.i focuses on the case of dispersed public corporations, while Section V.B.ii focuses on the case of firms with a controlling shareholder.

i. The Rule for Non-Controlled Corporations

In a corporation where control is contested,[302] the transaction would require the approval of a plain majority of the shareholders. Professor Bebchuk's seminal work strongly advocates an overall increase in shareholders' powers in dispersed public companies and repeatedly labels certain changes in the category of the "rules-of-the-game,"[303] which "concern[s] the choice of the rules by which corporate actors play."[304] These rules mainly include amendments to the corporate charter and the state of incorporation of the firm and "generally require a vote of shareholder approval" on the managers' proposals.[305] While Professor Bebchuk argues for empowering shareholders to propose and adopt rule-of-the-game decisions, this Article suggests broadening the "rule-of-the-game" definition to encompass the issuance of new shares, regardless of whether it requires an amendment to the charter of incorporation (*i.e.,* exceeds the number of authorized shares). Although the rule generally limits the abuse of power by managers, it has a stronger impact on strategic issuances.

Namely, assuming that the managers seek to dilute a specific engaged or active shareholder, with the current allocation of powers, they may achieve the goal of preventing the shareholders from expressing their dissent.[306] Contrarily, under the proposed framework, although the to-be-diluted

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301. *Id.* at 434 (finding that if the shareholder vote is intense and close to the issuance, the positive impact of the announcement over the stock price is further strengthened and pointing out that the structure of the issuance is irrelevant).

302. *See supra* Section II.A (analyzing shareholder-manager conflict in this context).

303. *See generally* Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75 (suggesting that shareholder intervention power can be grouped into two categories: "rules-of-the-game decisions" and "specific business decisions").

304. *Id.* at 844.

305. *Id.* at 837.

306. *See supra* Section III.A.

shareholder would obviously not have the voting power to veto the issuance by herself, the shareholder class would be entitled to choose between the agenda of the shareholder and the managers when casting the vote. The vote on the transaction de facto moves forward on the agenda and, in the context of an activist campaign, the proxy contest. Therefore, in the event of the action of an activist hedge fund, the other shareholders could vote on her dilution by the managers, taking a position in favor of or against her interests. The scenario fits with the facts of *Third Point LLC v. Ruprecht*, where institutional shareholders joined the activist in the dispute.[307] Under the proposed scenario, they would have voted on the dilution of the plaintiff before it could be completed. The proposed rule increases the shareholders' powers in equity issuances and is likely to protect long-term shareholders' engagement, reducing the power of the managers to frustrate their activity.[308]

Finally, comparing the shareholder vote with preemptive rights, the proposal shares the feature of encouraging interaction between the managers and shareholders before a vote, given the former's incentives to propose a structure that is approved when it fulfills shareholders' expectations. However, the proposal does not condition protection on further economic investment in the firm[309] and seems to be a more flexible tool from the perspective of the managers. In fact, there are instances where managers may legitimately believe that broadening the ownership base of the firm fulfills the corporation's interest. In order to pursue this goal under the proposed rule, the managers would need the approval of the majority of shareholders with voting rights, while when the mandatory preemptive right applies, all the entitled shareholders will subscribe pro-rata.[310]

ii. The Rule for Controlled Corporations

Mirroring the analysis that Part III carried out, the application of the proposed rule is two-fold, depending on the participation of the controller in the transaction. As a general approach, the rule complies with the traditional mission of corporate law to protect the outsider shareholders from agency costs[311] without undermining the controllers' position. Namely, depending

307. *See supra* text accompanying notes 134–39.

308. *See supra* Section III.A.

309. *See supra* Part IV (acknowledging this downside of the preemptive right).

310. Even if we assume that under certain circumstances the preemptive right could be waived, the majority's approval of the voting rights on the preemptive right would be insufficient by itself to achieve the goal. Otherwise, if the consent of the majority of the votes was sufficient to waive the preemptive right, one of the main alleged upsides of the provision (*i.e.*, the protection of the minority shareholders) would be frustrated.

311. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 595.

on the circumstances, the controlling shareholder may be considered an outsider for the purpose of the transaction, and therefore granted a property rule protection. In fact, the criterion that positions the controlling shareholder in the group of outsiders or that of the insiders, is the percentage of the new shares that she subscribes to: she falls in the management group if she participates more than pro-rata to the new equity issuances and within the outsiders in the opposite scenario. The solution — which relies on the presumption that should the controller purchase more than her ratable shares, she has a strong influence over such decision[312] — is consistent with the general approach of corporate law in similar circumstances[313] and avoids disputes on whether the transaction falls in one category or the other by setting an objective quantitative threshold (*i.e.*, the percentage of shares that the controller subscribes).[314] Section V.B.ii.a focuses on the case of the controller subscribing more than pro-rata to the newly issued shares, while Section V.B.ii.b focuses on a different scenario where the shareholder either retains her fractional voting power or the managers dilute it.

a. The Case of the Subscribing Controller

In this scenario, the managers negotiate with the controller (or the controller-manager is issuing shares to herself) for a transaction that strengthens her voting power in the firm, since she purchases the new shares more than pro-rata. Within the group of the controlling shareholders, this Section positions the case of a quasi-controller seeking to achieve control of the firm through more than pro-rata participation in the equity issuance. As explained above,[315] in order to assess the existence of a (either de jure or de facto) controller — and therefore adopt the appropriate protections for the

312. Note the distinction between cases of, respectively, the subscribing controller and the non-subscribing controller. This is only aimed at declining different voting mechanisms with regard to the approval of a new share issuance and claiming that even a controller may be an outsider if she does not exercise any influence on the decision makers of the firm. Contrarily, this is not to suggest that the controlling shareholder should not be considered as such if the managers seek her dilution or to take a position on the debate concerning whether the control-assessment should focus on the single transaction or on the day-to-day management of the firm. *See* Lipton, *supra* note 156, at 1994 ("[D]espite the abundance of case law — decided both before and after *Corwin* — treating control over day-to-day management as a factor to be considered in the controller analysis, the *Corwin* court cast that aspect of the arrangement aside.").

313. *See* Min, *supra* note 21 (manuscript at 27–28) (advocating a new definition of pro-rata distributions entailing a breakdown between business and governance decisions).

314. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 944 (mentioning the Google case to point out the lack of a quantitative criterion to assess whether a disputed transaction is self-dealing).

315. *See supra* text accompanying notes 184–88.

diluted shareholders — the focus should be on the ownership structure of the firm after new share issuances. As indicated,[316] the controller might seek to exploit minority shareholders not only through the cheap-stock tunneling but also by issuing non-underpriced shares that reinforce her position and possibly result in midstream changes to the corporation's governance.[317] Either case claims for a protection of the rights of the minority shareholders, who do not share the benefit of the transaction with the controller and whose stakes are diluted. The traditional dichotomy in this context is between empowering the controller to reallocate the voting rights — protecting the outsiders with the entire fairness standard that the courts carry out after the completion of the transaction — or the minority shareholders to block the transaction, requiring the ex-ante approval of the majority of the minority shareholders ("MoM") to complete it.[318]

As of now, Delaware courts adopt either of the two approaches, depending on the choice of the controller-manager, and the controller-manager has the burden to prove that the transaction is entirely fair unless she has obtained the MoM.[319] From the perspective of minority shareholders, this system carries the same weaknesses and flaws of the plain entire fairness standard[320] since the controller, in the least favorable scenario that did not want to seek or was not able to achieve the MoM, may always return to judicial review: therefore, this framework is known as "voluntary MoM."[321] Among other things, it fails to consider that the value of voting rights is highly subjective.

The application of the mandatory shareholder voting rule seeks to exclude the vote of the controlling shareholders, therefore making the MoM a requirement to complete the transaction. This would have had a significant impact on several cases analyzed in Part I.[322] In *Reith v. Lichtestein*, the Delaware Court of Chancery applied the entire fairness standard to the

316. *See supra* Section III.B.i.b.

317. See Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 608 ("Controlling shareholders could theoretically enjoy more than their pro rata share of the business by using their control to change the firm's governance arrangements midstream either directly through changes in the charter and/or bylaws or indirectly through some business combination, such as a merger.").

318. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 963–66 (providing a detailed analysis of the upsides and downsides of each approach).

319. *See id.* at 950; Lipton, *supra* note 156, at 2005–06 (defining the procedure as "cleansing mechanisms" and describing the relationship between the shareholder vote and the presence of independent directors).

320. *See supra* text accompanying notes 41–59.

321. Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 978 ("Delaware doctrine does not *require* controllers to subject a self-dealing transaction to a vote by minority shareholders.").

322. *See supra* text accompanying notes 1–13.

issuance of the convertible preferred stocks and stated that the defendant had failed to prove it, notwithstanding a 31.5 percent premium over the shares' market price.[323] However, this did not prevent the controller from completing the transaction, with the only concern being subject to the entire fairness standard. Contrarily, under the proposed property rule, the minority shareholders would have been willing to block the issuance rather than being mere witnesses to the managers' negotiation of a transaction that granted the controller the absolute majority of the voting rights. In a similar way, the outsiders could have blocked the transaction in *Klein v. HIG Capital*, which was also eventually subject to an entire fairness judgment.[324] Arguably, *Corwin v. British American Tobacco* makes the argument even stronger.[325] Although the majority opinion of the court found British American not to be the controlling shareholder on the basis that it "could not and did not exercise actual control over the Reynolds [(the issuer)] board"[326] — therefore possibly undermining the application of the MoM under the proposal — strengthening the odds of a different outcome. In fact, the proposed rule strongly favors an assessment of a single transaction, considering the quantitative criterion of the percentage of the purchased shares. A forty-two percent shareholder who is the only purchaser of the new stocks and whose consideration is below the public closing price of the shares the day before the signing would be likely to be deemed a controller for the purpose of the transaction, therefore making the issuance subject to the vote of the diluted shareholders only.[327]

In addition to the already mentioned upside of the shareholder vote in general share issuances, recent studies demonstrate the benefits of minority shareholder approval in the specific context of transactions with controlling shareholders.[328] Building on this, another work has considered a similar solution, as a countermeasure to the cheap-stock tunneling.[329] An international empirical study examined the effects of the announcement of

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323. Reith v. Lichtenstein, No. 2018-0277-MTZ, 2019 WL 2714065, at *20 (Del. Ch. June 28, 2019).

324. Klein v. H.I.G. Cap., L.L.C., No. 2017-0862-AGB, 2018 WL 6719717, at *15 (Del. Ch. Dec. 19, 2018).

325. *See* Corwin v. Brit. Am. Tobacco PLC, 821 S.E.2d 729, 729, 751 (N.C. 2018).

326. *Id.* at 743.

327. *See id.* at 742.

328. *See generally* Fried et al., *The Effect of Minority Veto Rights*, *supra* note 159 (studying the effectiveness of veto rights for minority shareholders regarding "related-party transactions").

329. *See* Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 364 (acknowledging the massive benefit of majority-of-minority approval but also flagging the material costs that it carries).

an equity issuance on the trading price of the issuer and corroborates the proposal. While shareholder approval was found to have an overall positive effect on the market price of the shares, there were specific cases of negative perception by the market.[330] Accordingly, a possible explanation lies in the alleged incentive of the blockholder-manager to perpetuate self-interests through the equity issuance, without acting in the best interests of the corporation.[331] Indeed, the approval of the majority of the outsiders seems to fix the possible flaw of a plain shareholder vote in controlled firms.

Finally, the rule outperforms preemptive rights — which European legal tradition perceives as the landmark minority's antidilution tool — for several reasons. In *OTK v. Friedman*, the outsider shareholders would have had the power to block the transaction¸ rather than being offered the right to purchase pro-rata new shares at a twenty-six percent premium over their market price.[332] Not only do outsiders not need to increase their economic investment in the firm under the proposal, but also the proposal arguably addresses the information asymmetry issue.[333] While preemptive rights are effective only after the relevant constituency (either the shareholders or the managers) have approved the transaction, the vote on the transaction can block it.[334] Therefore, the rule shifts the burden (and, indirectly, the cost of the information asymmetry) onto the controller since each time that a minority shareholder feels that she lacks complete information to approve, she may simply vote against the transaction and in favor of the status quo. Since the proposal allocates the cost to the side that has complete information, it creates an incentive to disclose all the material information in order to achieve approval of the transaction.

By contrast, authoritative scholars have addressed the topic of protecting minority shareholders and pointed out how, differently from the case of the controller's dilution, the best fit for the protection of the minority shareholders is the liability rule.[335] Namely, a number of objections may be

330. Holderness, *supra* note 107, at 434.

331. *Id.*

332. 85 A.3d 696, 707 (Del. Ch. 2014); *see supra* text accompanying notes 182–88.

333. *See supra* text accompanying notes 262–67.

334. Note that the expression "can block it" means that the shareholders can vote to block the transaction as it is structured at the time it is subject to the shareholders' approval. In fact, the failure to obtain approval does not prevent the company from completing the equity issuance. The structure of the transaction can subsequently be amended in order to obtain the approval of the majority of disinterested shareholders or to limit the participation of the controller up to her ratable new shares.

335. Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 610 ("[T]he tradeoff between minority protection and controller rights supports a liability-rule protection for minority shareholders to better balance minority protection against agency costs and preservation of idiosyncratic vision.").

raised against the mandatory MoM: the remainder of this Section exposes and tries to respond to several possible critiques to the proposal.

1. Costs

To begin with, corporate legal scholarship does not undermine the costs that seeking the consent of the MoM requires.[336] Making the approval a requirement to engage in the transaction rather than a condition for being granted the shield of the business judgment rule further strengthens the reasoning. Within the category of the proposal's costs, it has been authoritatively pointed out that the veto power of minority shareholders excessively limits the controllers and might prevent the firm from raising additional capital when useful or from completing efficient transactions.[337] This unfortunate effect may result either from a strategic decision of the minority shareholders — which may adopt an aggressive approach aimed at enhancing their benefit from the transaction — or from their mistake.[338] To this extent, a recent study — reporting on the case of a corporation whose shares' market price dropped after having missed the opportunity to grow — argued that the voluntary MoM (which reasonably should be identified as a liability rule protection)[339] should prevail over the mandatory MoM since it avoids the risk of hold-outs.[340] Finally, the adoption of such property rule possibly prevents the controller from completing any firm's recapitalization that she deems necessary to pursue her "idiosyncratic vision."[341]

However, the specific framework of the proposal and the unique features of the transaction hopefully address these concerns. Namely, the proposal does not seek to grant minority shareholders a general veto power on the new

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336. See Fried & Spamann, *Cheap-Stock Tunneling Around Preemptive Rights*, *supra* note 95, at 364 (highlighting the benefit of MoM approval).

337. *See* FERRAN & HO, *supra* note 32, at 110.

338. *See* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 458.

339. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 978 (explaining how the controller's option to have the transaction approved without the minority's approval may affect the negotiation since "the controller and the minority shareholders[] negotiate 'in the shadow' of Delaware's fair-price requirement").

340. *See* Edward B. Rock, *Majority of Minority Approval in a World of Active Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 105, 123 (Luca Enriques & Tobias H. Tröger eds., 2019) [hereinafter Rock, *Majority of Minority Approval*] (building on the example of the Cablevision case).

341. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 965 (stating that the concerns raised by giving minority shareholders a veto on the reallocation of control rights "suggest that while empowering minority shareholders will protect them from the risk of agency costs, it will also increase the risk of frustrating the controller's pursuit of idiosyncratic vision").

share issuances since the controller's vote is frozen only if she subscribes more than pro-rata. The difference is material since the failure to achieve the MoM — as well as the non-willingness to seek it — does not prevent the firm from engaging in any new shares issuances but rather implies that the transaction be structured in a different way to avoid the requirement.[342] In other words, the proposed rule does not undermine the controller's control over the capital structure of the firm[343] since should she deem it critical to quickly issue additional shares for any reason, she refrains from increasing her proportional stake in the firm and is not prevented from voting.[344] From this perspective, the new share issuances materially differ from the other conflicted transactions that have witnessed the application of the MoM in that its structure can easily be amended in order to lose the feature of being a self-dealing transaction. Deepening the hold-out concern, there are two different kinds of allegedly value-enhancing transactions that the public firm could miss because of the failure to achieve the outsider's consent. The first category — which belongs to the corporate finance side of the transaction — encompasses all the cases where raising additional equity capital is beneficial for the firm for any business reason, possibly connected to the potential for growth. However, in this scenario, the controller has the option to avoid any corporate governance effects, limiting her purchase to her ratable shares. Her voting rights would prevent the firm from losing interesting growth opportunities. In *Reith v. Lichtenstein*, the issuer was raising capital to fund an acquisition.[345] Under the proposal, the controller could either subscribe her ratable part or seek that the MoM increase her stake: each path could be an effective way to complete a valuable acquisition.

The second category is more problematic since the controller is mainly interested in the corporate governance side of the transaction. Namely, if she specifically deems the reallocation of voting rights necessary to pursue her vision and the issuance of new shares as only a tool to complete this reorganization rather than as a way to raise funds,[346] she would actually be prevented from successfully accomplishing her goal absent consent from the minority shareholders. While this undoubtedly exposes the controlling shareholders and the firm to the holdout risk, this scenario arguably requires

342. Note that the fact that the controller does not purchase more than pro rata does not mean that the preemptive right should be granted. In fact, the remaining part of the offer should be structured also as a private placement to an outsider or as a public offer.

343. *Id.* at 462 (arguing that control over the capital structure of the firm should belong to the controller).

344. *See infra* Section V.B.ii.b.

345. *See supra* text accompanying notes 1–5.

346. *See* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 963–64.

the involvement of the shareholders' meeting and the consent of the minority shareholders, who have invested funds in the firm and should not be forced to accept a fundamental governance change without any consideration. In fact, this feature flags a material difference between the new share issuances and freeze-out transactions — the traditional field of the debate between the entire fairness standard and shareholders' consent. Namely, minority shareholders are diluted but are not part of the transaction, which is entered into by the firm and the new purchaser of shares (*i.e.*, the controller in the case at hand): they witness a dilution of their stake but do not receive any proceeds. This non-trivial difference calls for a stronger approach (mandatory MoM) for the dilutive equity issuances, compared to the freeze-outs (voluntary MoM) when the controller takes the company private by paying a premium of the share market price. The bottom line is that the proposal does not subtract any managerial decision from the controller's autonomy; oppositely, it distinguishes between the business decision (the above-mentioned "first category") and the extraordinary corporate governance decisions (the above-mentioned "second category"), which reallocate voting or control rights and require the shareholders' consent.

2. Lack of Flexibility

One of the intrinsic costs of the mandatory property rules — including the proposed one — is the material decrease in the issuer's flexibility. Professors Goshen and Hamdani, endorsing a contractarian approach, have recently advocated the adoption of a firm-by-firm approach that enhances the autonomy of the corporations' charters with regard to the allocation of power to redistribute control rights.[347] Accordingly, the institutional shareholders may effectively exercise a strong influence over the provisions of the corporate charter and, on the other hand, the protection of the controller's idiosyncratic vision should not be undermined.[348] However, in the context of new share issuances, the reliance on the charter of incorporation presents some of the flaws that this Article pointed out about the limit of the authorized shares.[349] Namely, as much as the latter proves to be ineffective since firms usually go public with a significant number of unissued authorized shares, controller-managers would likely be able to

347. *Id.* at 986–89; *see also* Klausner, *supra* note 113, at 1327–28 (exposing a review of the contractarian approach and explaining that according to its supporters, "contractual governance is seen as superior to legally imposed governance arrangements because firms are different along numerous dimensions and market forces create incentives to customize and to innovate").

348. Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 990–92.

349. *See supra* Section IV.A.

enjoy the same broad power in structuring the firm's pre-IPO charter of incorporation.[350] On the point, an authoritative opinion undermines the trust in IPO charters, finding that they are usually empty documents with regard to corporate governance provisions and mainly adopt default rules.[351] The Institutional Shareholder Service ("ISS") recently disclosed an update on its policy for voting on charter amendments and pointed out that pre-IPO boards usually try to include provisions aimed at increasing their insulation from post-IPO investors.[352] Reasonably, the argument that in the context of the IPO, public investors are more concerned with the share price than governance provisions in the firm-charter,[353] helps explain the empirical evidence and flaws in the allocation of powers at the IPO stage (including the high number of authorized non-issued shares). In addition, it seems reasonable to predict that during the corporation's life, any controller's amendment reallocating voting rights may occur only as an increase:[354] the case of a controller self-decreasing her power with regard to this critical governance issue appears very unlikely.[355] The complex process and the distortions underlining the charter amendments in midstream companies, as well as the power of the controller both before and after the IPO with regard to the issue, calls for a mandatory rule.[356]

Adopting the charter-oriented approach, the power of the controller would not result from her ability to deal with and reward public shareholders, but mainly from her bargaining power at the time of the IPO. It must be pointed out that an investor, which may or may not exercise a certain level of pressure at the time of the IPO, might find it difficult to predict the development of

350. *Cf.* Goshen & Hamdani, *Corporate Control, Dual Class*, *supra* note 21, at 989–90 (arguing that minority institutional investors usually have decent power to suggest a pre-IPO amendment to the charter).

351. Klausner, *supra* note 113, at 1329–39; Lin, *supra* note 55, at 483–84 (exposing an updated literature review pointing out the flaws in the contractarian theory).

352. *ISS Releases 2016 Benchmark Policy Updates*, INSTITUTIONAL S'HOLDER SERVS., https://www.issgovernance.com/iss-releases-2016-benchmark-policy-updates-2/ (last visited Mar. 3, 2021) ("While some pre-IPO boards argue that these governance structures will benefit investors over the long run, few of them provide opportunities for post-IPO shareholders to ratify these provisions post-IPO.").

353. Lin, *supra* note 55, at 485.

354. *See id.* at 486 (discussing amendments in the context of takeover defenses and entrenchment provisions).

355. *See* Klausner, *supra* note 113, at 1348 (noting that empirical evidence shows that managers seldom initiate governance changes unless shareholders exert pressure on them). Notably, should a controller-manager be empowered to reallocate voting rights, the degree of pressure would be extremely weak.

356. *See* Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75, at 867 ("Mandatory legal rules and reversible defaults are indeed desirable, taking as given the existing distortions in the charter amendment process.").

the firm and the degree of power that the founder should be entrusted with to reallocate voting rights. Therefore, an investor would be asked to enter into a blind decision and empower the founder with a blank check. Notably, the decision and the alleged pressure of the initial outsider shareholders bind not only themselves but also any other investors who might eventually purchase the firm's public shares. While this Article agrees with the intuition of an increased reliance on institutional shareholders' powers, it favors the use of such powers with regard to the specific transaction and not broadly to the charter of incorporation. Enhancing the shareholder powers with regard to voting rights — considering their increased sophistication and incentives — would help distinguish opportunistic value-destroying recapitalizations from value-enhancing ones, since only the latter are expected to receive the approval.[357] Finally, if the controller really seeks to increase her power to pursue her idiosyncratic vision — and she is not able to convince her public investors — she may always take the firm private and enjoy more autonomy. Although this transaction might require an increase in funding, the controller may resort to a private partner. Contrarily, if she is not able to convince either private or public investors of her plan, reasonably the "market check" of her vision did not work.

3. Effectiveness

A separate but connected critique has been made about the real effectiveness of the rule: arguably, in the context of a freeze-out transaction or a management buyout ("MBO"), the minority shareholders might be tempted by the idea of divesting and are unlikely to block the transaction absent a higher offer than the proposed one.[358] However, the fact that the shareholders are not part of the transaction and do not receive any monetary benefit during a new share issuance undermines this risk. Contrarily, the shareholder vote might effectively provide the unique benefit of a market check on the issuance price: in fact, once the proposed issuance price is public, a third party may offer to purchase the firm's shares at a higher price

357. *See* Lin, *supra* note 55, at 504 ("[E]mpowering shareholders would best mitigate the risks of midstream opportunistic change by controllers with leveraged control and would allow shareholders to adopt value-increasing midstream charter amendments.").

358. *See* Rock, *Majority of Minority Approval*, *supra* note 340, at 121, 123; Kastiel, *supra* note 189, at 100 (reporting that "[c]ritics of MFW often argue that giving shareholders the additional protection of a majority-of-minority vote adds little value because shareholders who suffer from information asymmetry will always vote for a good premium deal offered by the controller" but also pointing out that in a M&A deal, an informed activist shareholder — if present — would be able to use the MoM to obtain a higher premium, therefore benefitting all shareholders).

(or to enter into any other transaction).[359] Namely, although the controller may claim that she should be the purchaser in light of her "idiosyncratic vision" and her business plan, she would still have a problematic task in explaining why she should be preferred against a more economically rewarding offer for the company. *OTK Associates v. Friedman* experienced a similar situation:[360] the structure of the issuance (rights offering) required that the transaction be publicly pending for a longer period in order to let the shareholders exercise their rights and, during this period, a third party offered to purchase the share at a higher price. While the issuer ignored and did not disclose the offer, under the proposed rule, shareholders would have to vote on the alternative to accept.

4. Coerced Vote

The intrinsic flaw of any shareholder veto power — a broad family which encompasses the MoM — concerns the possible coercion of the vote by the decision maker who submits the resolution. However, the presence of a controller amplifies the risk.[361] Arguably, in the context of this transaction, this issue is hardly avoidable from an ex-ante perspective, although it might be limited. The proposed framework, requiring the full and uncoerced vote of the MoM acknowledges that the approval of the MoM might not be sufficient to guarantee the effectiveness and the value-maximization of the process and the protection of minority shareholders. In fact, the insider might condition the completion of an objectively value-enhancing transaction on the approval of a new share issuance that the outsiders would not have otherwise approved.[362] However, the proposal does not set forth a practical solution to the case of a coerced vote, nor a tool to exacerbate those circumstances. While the overall goal of the proposal is to deal with the

359. *See* Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 1, 53 (2005) (explaining the market check upside with regard to the MoM in a freeze-out transaction). Notably, the timeframe of the market check is reasonably shorter in new share issuances in order to not paralyze the business of the firm.

360. *See supra* text accompanying notes 182–188.

361. *See* Lipton, *supra* note 156, at 1982–83 (noting that the presence of a controlling shareholder alone may suffice to make the vote coerced without the need for the controller to take further threatening action).

362. *See* Sciabacucchi v. Liberty Broadband Corp., No. 11418-VCG, 2018 WL 3599997, at *6 (Del. Ch. July 26, 2018) (explaining that the value-enhancing acquisition was contingent on the approval of a dilutive new share issuance); *see also* Rock, *Majority of Minority Approval*, *supra* note 340, at 124 (pointing out the issues arising from a coerced vote in the MoM approval); Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 75, at 864 (explaining the flaw of a shareholder veto right in public corporations should managers bundle "a value-decreasing rule change favored by management with a move that is value-increasing by itself"); Goshen, *The Efficiency of Controlling Corporate Self-Dealing*, *supra* note 33, at 428.

issue from an ex-ante perspective, it appears hard to avoid court intervention in such case. The most effective solution seems to be to empower the shareholders to seek a court's injunction ahead of the shareholders' meeting (*i.e.*, between the post of the proposed resolution and the expected day of the vote). The other, weaker but likely more flexible, remedy consists of liability protection after the vote and the completion of the transaction, against the controller-manager for having failed to submit to the outsiders a proposed resolution with an uncoerced vote. The first option — which completely avoids the liability protection — is likely to be a more useful tool in both addressing the problem and preventing it, since it allows the shareholders to affect the outcome of the meeting rather than operating as an ex-post remedy. However, the first option requires a prompt outcome of the court as to whether the vote is coerced or not. Notably, although it is critical to address the risk of a coerced vote — which would frustrate the purpose of the rule — the case must be distinguished from the mere walk away, or threat to walk away, from the overall deal by the controller.[363]

b. The Case of the Non-Purchasing Controller

The feature of this scenario is that the controlling shareholder does not purchase the new shares more than pro-rata and the transaction dilutes (or does not increase) her stake.[364] Thus, she is positioned within the outsiders of the group. The proposed rule is to let the controller vote and, therefore, condition approval of the transaction on the consent of the holders of the majority of the voting shares. Although the application of the shareholder vote facially resembles the case of the non-controlled firm,[365] the underlying policy debate is significantly different.

The Delaware court witnessed this scenario in the recent *CBS v. NAI* dispute and, in its order, acknowledged the "apparent tension in [Delaware] law between a controlling stockholder's right to protect its control position and the right of the independent directors . . . to respond to a threat posed by a controller, including possible dilution of the controller."[366] Namely,

363. *See* Subramanian, *supra* note 359, at 15 (exposing a practical case when, in the context of the negotiation of a freeze-out, the controller-alleged threat was "nothing more than an invocation of Alcatel's [*i.e.*, the controller] otherwise legal walkaway alternative").

364. *See supra* Section III.B.ii (analyzing the shareholder-manager conflict in this context). Note that, as mentioned, the case of the controller who does not purchase newly-issued shares does not consider the hypothesis of the controller who voluntarily refrains from purchasing new (and overpriced) shares.

365. *See supra* Section V.B.i.

366. CBS Corp. v. Nat'l Amusements, Inc., No. 0342-AGB, 2018 WL 2263385, at *5 (Del. Ch. May 17, 2018).

corporate law may lay on the managers' side — empowering them to dilute the controller threatening the corporation[367] — or on the controller's side, protecting her rights with a property rule.[368] According to a recent scholarship commenting on the mentioned dispute, the position of the board "had some merit."[369] The proposed rule significantly undermines (if not completely nullifies) this power of the directors to fight against a controlling shareholder allegedly abusing her status and destroying the firm's (and minority shareholders') value, on the ground that, from a policy perspective, there is a strong case to enhance the controllers' rights.

Professors Goshen and Hamdani recently argued that in the context of a concentrated ownership structure, the managers should not be empowered to expropriate controllers' power and, therefore, called for a propriety-rule defending the controlling position, applicable also in the context of "a broader — and less intuitive — range of corporate actions, where corporate-law doctrine is less clear" and may result in the dilution of the controller's position.[370] Arguably, the property-based protection should not be limited to the controller of a firm with concentrated ownership — who invests a significant amount of resources to achieve and retain her influence — but extended to the firms adopting a dual-class structure. Not only does Delaware law (as last interpreted in *CBS* v. *NAI*) value control in dual-class firms, but policy considerations also call for this approach. Namely, a recent study pointed out the value of the non-voting shares — an extreme case of dual-class structures — in that they efficiently allocate the voting rights to the shareholders that value them the most and help make the management accountable to the informed and motivated shareholders.[371] Clearly,

367. *See id.* at *6 (reviewing the case law affirming this argument); *see also supra* text accompanying note 199.

368. *See id.* (quoting passages of the cases that explicitly drew the power of the controller to respectively "avoid its disenfranchisement as a majority shareholder" and "prevent the issuance [which would have destroyed his voting control] by unseating directors"); *see also* Adlerstein v. Wertheimer, No. CIV. A. 19101, 2002 WL 205684, at *9 (Del. Ch. Jan. 25, 2002) (stating that the shareholder Adlerstein was empowered to prevent its dilution through the new share issuances by "executing a written consent removing" either of the two directors approving the issuance from the board); Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985).

369. *See* Min, *supra* note 21 (manuscript at 46) (noting, on the other hand, that "it is not clear that it would apply to every controlling shareholder where dual-class stock is involved" and arguing that, given the preponderant governance purpose of the transaction, the business judgement rule should not apply).

370. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 601–02 ("Controllers can lose control not only when they sell their shares, but also when the company takes action — like issuing new shares — that dilutes the controllers' holdings.").

371. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 696–98.

undermining the position of the shareholders with voting shares — as is the case for controllers — frustrates this rationale. This Article does not intend to argue in favor of the dual-class share structures for public companies; however, should they be considered a problem, but the way to deal with it is not to empower managers to dilute the controller through strategic issuances.

A possible critique of the rule is that since large shareholders are deemed critical to avoid the dilution, they may oppose the issuance of new stocks in order to retain their influence should they be not willing to invest additional resources: this may lead to an underinvestment in the firm, preventing it from reaching its optimal capital structure.[372] The magnitude of this argument may be particularly strong in the case of firms with concentrated ownership structures. Namely, since this type of firm "bundles cashflow rights and control rights,"[373] the controller must subscribe the new shares in order to retain control of the firm, contrary to what happens in the firms adopting a dual-class structure. Notably, this rule does not necessarily result in a veto right of the controller, since a controlling minority shareholder (or de facto controller) may be deemed to have a controlling influence and still not prevail in the vote, having the transaction approved against her will and her fractional voting power and interest decreased. However, it must be acknowledged that in the majority of cases, the approval of the controller would be critical; therefore, she may successfully oppose an issuance that is in the best interests of the firm.[374] However, it must be noted how the same underinvestment issue may be even worse with the current allocation of powers. In fact, since large controllers are concerned with the dilution, they also need to feel fairly protected from it: a seminal comparative corporate law study claimed that freeze-out transactions should be endorsed, among other things, because controllers may have weaker incentives to "invest additional capital in positive net present-value projects if they are forced to

372. *See* Poulsen, *supra* note 97, at 152 ("It is hypothesized that firms in which the largest shareholder would lose more influence in an equity increase have smaller equity increases and lower investments."); *see also* Kahan & Rock, *Index Funds and Corporate Governance*, *supra* note 84, at 50 (expressly mentioning the case of the issuance of new voting shares).

373. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 592 (suggesting that this bundling feature makes the concentrated ownership structure the middle-ground alternative to respectively dual-class and dispersed ownership structures, which may solve the agency issues of the two extreme structures).

374. *But see* Goshen & Hamdani, *Majority Control and Minority Protection*, *supra* note 21, at 454–55 (explicitly addressing a similar case and arguing that, in order to preserve the controller's ability to pursue "idiosyncratic vision" and her right to make managerial decisions — absent controller's consent — a dilution should not occur even if it is in the best interests of the corporation, regardless of whether the compensation is fair).

share their returns with minorities."[375] The argument should be transposed, and is even stronger, to the opposition to new equity issuances since the controlling shareholder, rather than being only prevented from increasing her participation in the company (as it would happen were the freeze-out not allowed), would face the risk of a significant decline in her fractional stake in the firm at managers' will.

On a practical note, the outcome of *CBS v. NAI* would not be significantly different under the proposed framework since the order against the shareholder was denied.[376] However, some differences appear. First, the controller achieved her goal, but the scope of her efforts was not tailored to the issuance: the move was an amendment to the corporation's charter, strengthening the approval requirements applicable to any dilutive issuance and, as such, it was effective but not narrowed.[377] Second, while the case eventually settled,[378] the new rule clarifies the allocation of powers between shareholders and managers in favor of the former. Third, the shareholders' vote is consistent with the above-mentioned deference of Delaware courts to the assessment of the financial markets and its increasingly sophisticated players.[379] To this extent, the same reputational and market-oriented arguments that made some minority shareholders' campaigns in controlled companies effective[380] may also deter the controller from abusing her powerful voting rights, therefore limiting the risk that she vetoes appropriate issuances.

The majority of this Section dealt with the hypothesis of equity issuances diluting the controller. However, as mentioned, the same process applies to the case of the controller participating pro-rata to the transaction, which is subject to the plain shareholders' vote that the controlling shareholder's voting power massively influences. Arguably, the controller-manager should be entrusted with the business decisions[381] and this issuance —

375. Rock et al., *Fundamental Changes*, *supra* note 37, at 174.

376. *See* CBS Corp. v. Nat'l Amusements, Inc., No. 0341-AGB, 2018 WL 2263385, at *1 (Del. Ch. May 17, 2018).

377. *See id.* at *2 ("NAI had executed and delivered consents to amend CBS's bylaws to, among other things, require approval by 90% of the directors then in office at two separate meetings held at least twenty business days apart in order to declare a dividend . . . .").

378. *See supra* Part I.

379. Goshen & Hannes, *The Death of Corporate Law*, *supra* note 79, at 289.

380. *See* Lund, *Nonvoting Shares*, *supra* note 59, at 742 (reporting cases in which the public pressures of minority investors resulted in the controller adopting a governance change, including the abolition of dual-class structures).

381. For a perspective where the controlling shareholder is pursuing its idiosyncratic vision, see Zohar Goshen & Assaf Hamdani, *Corporate Control and the Regulation of Controlling Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS

reasonably lacking any target with regard to the governance of the issuer — genuinely falls in this category.[382] Also, as explained in the previous Section, this case represents the proper solution for a controller hoping that the firm raises additional capital to take advantage of a business opportunity. Here the cornerstone of the overall rule lies: all shareholders are entitled to exercise their voting right regardless of their status (either controller or minority), and there is enhanced protection for the minority shareholders when the controller favors a corporate governance change. However, should the transaction be only a business decision, the impact of the minority's votes in a controlled firm is likely to prove to be trivial.[383]

VI. CONCLUSION

The claim of this Article is to empower shareholders of public corporations with a voting right in new share issuances. The proposal lies in the massive impact that the issuance of new shares may have on the corporate governance of the public firm. The proposal enhances the shareholders' powers, seeks to limit these corporate governance impacts, and restates the notion of new share issuance mainly as a corporate finance transaction. Namely, the reduction of the managers' flexibility in affecting the ownership structure of the firm also prevents several abuses of the equity issuances when they are not necessary from a business perspective. In fact, in addition to the explained benefits of addressing the shareholder-manager and the majority-minority conflicts, the proposed framework also reduces the distortions that may occur in connection with a decision to issue new shares. In fact, on one side, it limits new share issuances only to the cases where the firm genuinely needs to raise additional capital or, alternatively, a reasonable weighted majority of the shareholders agree with the decision to affect the

23, 30–31 (Luca Enriques & Tobias H. Troger eds., 2019), which explains how asymmetric information and differences of opinion might lead to a different outcome if the controller is entrusted with the decision or only outsider investors are. Note that — with reference to *supra* notes 75–77 and accompanying text — in this scenario, the controller reasonably falls among the managers of the firm, who are reasonably entrusted with the business decisions.

382. *See* Goshen & Hamdani, *Corporate Control and Idiosyncratic Vision*, *supra* note 21, at 607 (applying a similar reasoning to distributions and noting that "[a]ny rule that would try to scrutinize pro rata dividend distributions would necessarily interfere with the controller's management rights and her ability to secure her idiosyncratic vision"); *see also* Min, *supra* note 21 (manuscript at 45) (strongly arguing for a different treatment between pro-rata and non-pra-rata transactions, although in the context of the dividends issuance).

383. Lipton, *supra* note 156, at 1988 (noting that in the case of a controller with a small stake, the benefit of MoM is trivial and following this line of reasoning, a minority controller may be defeated regardless of her position).

ownership structure. On the other side, it eliminates the incentives of the managers to use alternative tools should the equity issuance be needed, given that their purpose to keep authorized, but not issued shares, available for strategic issuances would be frustrated by a shareholder vote on any equity issuance.

UNLOCKING PROGRESSIVE CORPORATE GOVERNANCE: THE BLACK AND BROWN HDFC KEY

GREGORY E. LOUIS*

For decades, progressive corporate law scholarship has lamented corporate law's captivity to the neoliberal conception of business corporations. For progressive scholars, corporate governance doctrines based in neoliberalism have been a formula for anomie as they reduce corporations — and especially publicly traded ones — to a profit-generating device for equity investors, disregarding anything and anyone else. Progressive scholarship has also criticized neoliberal corporate law on communitarian grounds, namely, for its denial that corporations have any social responsibility or public obligations. But to date, the progressive corporate law critique and corresponding reform program has failed to transform mainstream corporate law. This failure flows from progressive scholarship's perpetuation of neoliberalism's premise that corporations exist to generate wealth. This Article argues that the key to unlocking progressive corporate governance is to base reform on New York City's housing development fund corporations ("HDFCs"). These are business corporations formed by low-income households of color in the 1970s and 1980s so that they could secure themselves with housing denied to them by markets. The HDFC is best suited as the measure for progressive reform because it has been especially harmed

* Associate Professor of Law, City University School of Law. J.D., Fordham University School of Law, 2009 (David F. and Mary Louise Condon Prize in American Legal History); B.A., Columbia University, 2006. I am eternally grateful to the late Kathleen. S. Jones and Luz Yolanda Coca for their mentorship and inspiration and to Jonathan D. Morris, Sheryl L. Orr, Mary Grace Ferone, Nancy J. Marrone, Martin S. Needelman, Shekar Krishnan, Lina Lee, David Lopez, Juan Ramos, and Barbara Schliff for the opportunities from which this Article emerged. I presented the framework for this Article at The John Mercer Langston Writing Workshop conducted virtually in July 2020. I wish to thank all workshop participants and especially Cedric Powell, Del Wright, and Daniel Harawa for their helpful comments. I add a special note of thanks to my colleague Ruthann Robson for her tireless support and guidance, reflected in extensive comments over several drafts and boundless generosity in making herself available to assist with all aspects of the writing and submission process. And I thank the entire *American University Business Law Review* editorial staff, Abigail Gampher and Lauren Bomberger especially, for their extensive suggestions and comments.

by the neoliberal corporate governance paradigm and is a proven antidote for neoliberal reduction: against the operation of an aggressive market in the global capital of real estate and finance, HDFCs have successfully preserved their Black and Brown shareholders from disinvestment and displacement. As such, the HDFC advances the progressive perspective by supplying it with an understanding of shareholding that combines the public company equity investor with the sweat equity stakeholder. For concrete reforms advancing a progressive project, this Article proposes that corporate law adopt more searching judicial review of board decisions modelled on anti-discrimination and Massachusetts corporate law and that corporate law be amended to include "sweat equity" investors in governance. With such, corporate law can reflect pluralism, stand as an ally to social movements, and advance the original social function of corporations, obscured during this neoliberal age.

I. INTRODUCTION

The plight of Black and Brown business corporations, typified by New York City's Housing Development Fund Corporations ("HDFCs"), illustrates how the law of corporate governance suffers from enthrallment to business, and to a limited understanding of "business" at that.[1] Under this dominant paradigm, corporate governance doctrines flow from the proposition that business corporations exist for equity investors to earn money from their activities: there is scarcely a controversy in the field free of this supposition.[2] As such, the law, reduced to "law-and-economics" finance trends, compels boards of directors solely to look after the wealth of shareholders.[3] It frees the board from considering any other interest aside from shareholders' wealth.

Progressive scholars recognize neoliberal corporate law as a social and normative problem.[4] The social problem is that corporations, with the public benefit of limited liability, do not have any corresponding public duties to corporate stakeholders, such as employees.[5] Corporations can exploit a tremendous public benefit to manipulate, destroy, and alienate.[6] The normative problem is that neoliberal governance doctrines are not, properly speaking, law. As Adam Winkler writes in *Corporate Law or The Law of Business?: Stakeholders and Corporate Governance at the End of History*,[7] the dominant neoliberal model — the law-and-economics "nexus of contract" approach — argues that "[t]he terms of corporate activity are . . . effectively set by markets, not by law."[8] Winkler locates some limits serving to protect non-stakeholder corporate constituents in other areas of law such as consumer, employment, and securities law.[9] But by looking beyond corporate law codes for this protection, Winkler indirectly concedes that

1. *See* Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 345–46 (2005) (describing the methodological dominance of modern finance in corporate law study).

2. *See id.*

3. *See* discussion *infra* Part II.

4. *See* discussion *infra* Section III.A.

5. *See* Kent Greenfield, *If Corporations Are People, They Should Act Like It*, ATLANTIC (Feb. 1, 2015), https://www.theatlantic.com/politics/archive/2015/02/if-corporations-are-people-they-should-act-like-it/385034/ (describing opposition to shareholder primacy theory).

6. *See infra* notes 62–64 and accompanying text.

7. Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History*, 67 L. & CONTEMP. PROBS. 109 (2004).

8. *Id*. at 109–10.

9. *Id.* at 111.

corporate law, as such, does not serve to prescribe and limit.[10] Similarly, in *Citizenship and the Corporation*,[11] Ian B. Lee uses political theory to supplement the gap of meaning in corporate law that the same "nexus of contracts" view has produced.[12] For Lee, political theory — the concept of citizenship — is needed to make sense of and legitimize power actually exercised by corporate officials that the economic reduction of the corporation omits or obscures.[13] As with Winkler's, Lee's argument squarely assumes that the neoliberal understanding of corporate law fails to account for many of its aspects.[14]

But to date, this progressive challenge has not transformed corporate law. One reason progressive challenges to corporate law have failed is that even progressive arguments have perpetuated neoliberalism by proposing reforms assuming that corporations exist to generate profit.[15] But in doing so, progressive challenges to corporate law have revealed their own normative problem of prescribing more than they are describing and defining,[16] weakening the whole project. For accepting neoliberalism's reductive premise delegitimizes progressive corporate law from the standpoint of American legal realism, or the supposition that legitimate law must be understood as the empirical reflection of ordinary human activity.[17] This is

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10. *See id*. at 132–33 (outlining how progressives have used other bodies of law to regulate "corporate conduct," like labor law, environmental law, workplace safety law, consumer protection law, and securities law).

11. Ian B. Lee, *Citizenship and the Corporation*, 34 L. & SOC. INQUIRY 129 (2009).

12. *Id.* at 131.

13. *See id*. at 156–58 (arguing the benefits of analyzing the corporation via "a political-theoretical lens" lie in uncovering the corporate officials' power, whereas viewing the corporation through the "nexus-of-contracts" approach "either denies the phenomenon of power as an empirical matter or else conceptualizes it as residual slack").

14. *See id*. at 161–62 (explaining that the theoretical conceptualization of a corporation matters from the standpoint of culture because the dominant paradigm allows managers, "when confronted with a business decision raising an ethical issue involving the rights of a third party, not to approach the issue from the standpoint of ethics but rather to adopt one of two rather different frameworks of analysis [an amoral or latitudinarian one]").

15. *See* discussion *infra* Section III.B.

16. *Cf.* Lyman Johnson, *Re-Enchanting the Corporation*, 1 WM. & MARY BUS. L. REV. 83, 98–99 (2010) [hereinafter Johnson, *Re-Enchanting the Corporation*] (arguing that corporate law's recognition of institutional pluralism within the realm of business would make corporate law more "descriptively accurate" in that it would reflect private actors who "are not altogether self-seeking in business dealings" but rather "value integrity and consciously strive to serve others").

17. *See id.*; *see also* RAYMOND WACKS, PHILOSOPHY OF LAW: A VERY SHORT INTRODUCTION 93–96 (1st ed. 2006) (describing critical legal studies as originating in the United States as a "latter-day version" of American realism, a philosophy of empiricism); AMERICAN LEGAL REALISM xiv (William W. Fisher III et al. eds., 1993).

because many *business* corporations do not exist, simply or even primarily, to make money for their investors and stakeholders.[18] Rather, like the HDFC,[19] many business corporations are formed to protect their investors from the operation of markets.[20]

This Article argues that the key to reviving progressive corporate law, as a corrective to neoliberal reduction, is using the example of HDFCs to unlock reform, in much the same way that Black constitutionalism has brought the American political order to fulfilment in Nikole Hannah-Jones' acclaimed argument.[21] There are three reasons why the progressive corporate law project can be revived by the HDFC. First, HDFCs are fully business corporations, governed by the same procedures, rules, and principles as any other,[22] except that they reject economic rationality as conventionally understood. Instead, they are based on a communitarian ethos associated with people of color that regards social solidarity as a basis for strength.[23] This perspective serves as a cipher key concretizing progressive corporate law's principle of communitarianism,[24] but in a way that also helps corporate law to overcome its tendency toward white ethnocentric presumption, or "perspectivelessness."[25] The HDFC take on rationality is what civil rights

18. *See* discussion *infra* Section IV.A; *see also* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L & BUS. REV. 163, 164–66 (2008) [hereinafter Stout, *Why We Should Stop Teaching* Dodge v. Ford]. In that article, Stout argues that *Dodge v. Ford* — or the case commonly cited and taught for the proposition that a business corporation is organized and carried on primarily for the profit of the stockholders — is bad law because it is an inaccurate description of corporate charters and bylaws, corporate statutes, and case law. As will be clearer in this Article, I agree with Stout that *Dodge v. Ford* is bad law to the extent it says all corporations are, or should be, organized for profit; indeed, I cite low-income housing cooperatives as a counterexample. But her observations in the introduction to her paper demonstrate that *Dodge v. Ford* is shorthand for a view of corporations, amplified by Milton Friedman, that has dominated corporate law thinking of the past forty years. In that sense, it is more "the law" than any other source that she cited. For a discussion of this, see *infra* Section III.B.

19. *See* discussion *infra* Section IV.A.

20. *See* discussion *infra* Section IV.A.

21. *See* Nikole Hannah-Jones, *Our Democracy's Founding Ideals Were False When They Were Written. Black Americans Have Fought to Make Them True*, N.Y. TIMES (Aug. 14, 2019), https://www.nytimes.com/interactive/2019/08/14/magazine/black-history-american-democracy.html (illuminating the necessary role Black Americans have played throughout U.S. history in reconciling the inherent contradictions and hypocrisy surrounding the drafting of the U.S. Constitution).

22. *See* discussion *infra* Section IV.A.

23. *See* discussion *infra* Section IV.A.

24. *See* discussion *infra* Section IV.A.

25. *See* Kimberlé Williams Crenshaw, *Foreword: Toward A Race-Conscious Pedagogy in Legal Education*, 11 NAT'L BLACK L.J. 1, 2, 12 (1988) (defining "perspectivelessness" as the natural consequence of "positing an analytical stance that has no specific cultural, political, or class characteristics").

scholarship has termed as a "counterstory,"[26] such a term is generally lacking in corporate law.[27] Second, HDFCs especially illustrate the harm of applying a neoliberal governance framework based on *one* type of business corporation — the public company — to *all* business corporations. As we shall see later, with corporations like HDFCs, neoliberal corporate governance is a formula for board corruption that allows subversion from within.[28] Third, in having allowed their Black and Brown owners to withstand disinvestment and displacement in the global capital of real estate and finance,[29] HDFCs prove that business corporations do in fact counter markets, and quite effectively. Thus, the HDFC supplies progressive corporate law with a concrete, American example of an effective business corporation based on communitarian rationality, a concept thus far absent from its analysis.[30]

This Article elaborates the HDFC key in five parts. In Part II, this Article summarizes and historicizes the current neoliberal corporate governance paradigm to elaborate on the problem that progressive corporate law reacts to. So that this summary can be most applicable to the HDFC, this Article uses New York law. However, this discussion will have more general applicability since New York law necessarily brings up Delaware decisional law, as is customary in New York jurisprudence.[31]

In Part III, this Article summarizes the progressive critique of neoliberalism governance and explains its failure to change the law. First,

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26. *See* George A. Martinez, *Legal Indeterminacy, Judicial Discretion and the Mexican-American Litigation Experience: 1930–1980*, 27 U.C. DAVIS L. REV. 555, 614–15 ("One way to help judges break down mindset, broaden their perspectives, and promote justice in civil rights cases, is to provide counterstories — *i.e.*, explain how decisions were not inevitable. Through this process judges can 'overcome ethnocentrism and the unthinking conviction that [their] way of seeing the world is the only one — that the way things are is inevitable, natural, just, and best' and thereby avoid moral error when deciding *any* civil rights case.").

27. *See* Mae Kuykendall, *No Imagination: The Marginal Role of Narrative in Corporate Law*, 55 BUFF. L. REV. 537, 589 (2007) (arguing that narrative is largely absent from corporate law and does not have a role since business is about efficiency). As will become clear in this Article, I disagree with Kuykendall's view on the role of narrative in changing corporate law.

28. *See* discussion *infra* Section IV.C.

29. *See* SAMUEL STEIN, CAPITAL CITY: GENTRIFICATION AND THE REAL ESTATE STATE 95–115 (2019) (describing features of New York City as a neoliberal real estate state); DAVID MADDEN & PETER MARCUSE, IN DEFENSE OF HOUSING: THE POLITICS OF CRISIS 26–34 (2016) (describing the era of "hyper-commodification" in New York City real estate).

30. *See* discussion *infra* Section IV.B.

31. *See, e.g.*, City Trading Fund v. Nye, 72 N.Y.S.3d 371, 376 (Sup. Ct. N.Y. Cnty. 2018) (observing that North Carolina, like New York, generally follows and applies Delaware corporate law).

in Section III.A, this Article summarizes the key points of the progressive critique of neoliberal corporate law. In Section III.B, this Article addresses the failure of the progressive corporate law movement to inspire reform in terms of its critique. Ultimately, it attributes the movement's failure to challenge the function of corporations to its reliance on theory, tweaks, and subtlety.

In Part IV, this Article introduces the HDFC key. First, in Section IV.A, this Article frames these entities as the paradigmatic counter-market business entity by historicizing them and explaining the particular Black and Brown economic rationality driving them. Then in Section IV.B, this Article describes how, despite the clear difference between HDFCs and public companies, standard neoliberal corporate governance nonetheless applies to HDFCs wholesale. This Article ends Part IV with a case study, presented in Section IV.C, demonstrating the baleful effects of applying standard governance doctrines to such entities.

In Part V, this Article summarizes two existing progressive proposals for reforming corporate law outside of the public company context: the nonprofit charitable corporation and the public benefit corporation. It demonstrates that their limitations prevent them from achieving progressive corporate law's goal of liberating corporate governance from corporate finance.

Finally, in Part VI, this Article proposes solutions for the current law's shortcoming. It argues that the HDFC — and the measure of Black and Brown economic rationality — should be the standard for progressive corporate reform. Reforms inspired by the HDFC would push the law to serve all business corporations, including those formed to counter markets, and not just public companies, by: (i) replacing the business judgment rule ("BJR") with more searching review of board actions affecting such counter-market entities; and (ii) amending New York's Business Corporation Law ("BCL") to modify the norm of board supremacy[32] by granting shareholders of such entities more statutory rights of participation. This Article concludes by arguing that such HDFC-inspired reform not only would enrich corporate law with more pluralism but also would grow the law from its original, public roots.[33]

32. N.Y. BUS. CORP. LAW § 701 (McKinney 2021).

33. *See* Naomi R. Lamoreaux & William J. Novak, *Corporations and American Democracy: An Introduction*, *in* CORPORATIONS AND AMERICAN DEMOCRACY 7–10 (Naomi R. Lamoreaux & William J. Novak eds., 2017) (stating that after U.S. independence, new state governments started relying on corporations as they helped fund public works projects for tax breaks); LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 159 (4th ed. 2019) (chronicling that, before 1800, few corporations were business corporations and that almost all colonial corporations were churches, charities,

II. THE NEOLIBERAL CORPORATE GOVERNANCE PARADIGM

It is well-established that in the business corporation, there is a sharp division between ownership and control.[34] Under the standard model, shareholders, those contributing capital to propel the corporation's business, enjoy profit from the business with their exposure cabined to equity, or the residual value after every other claim has been satisfied.[35] The cost of this freedom from risk is the requirement that shareholders cede control to professional directors whom they elect.[36] Shareholders' current role in corporate governance is limited to electing directors, approving matters that would fundamentally alter or end the corporation, and suing corporations to enforce their collective interests against managers' disregard.[37] Managers, in turn, enjoy the full power of control over the corporation's affairs and activities but do not necessarily share in equity; they profit primarily in their salaries.[38] And so one finds in corporate law a neat framework reverberating

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or cities or boroughs); Ronald E. Seavoy, *The Public Service Origins of the American Business Corporation*, 52 BUS. HIST. REV. 30, 31–33 (1978) (highlighting that corporate privilege was granted to almost any association that worked toward the public benefit and emphasizing that public corporations no longer have important civic responsibilities); KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 1 (2006) [hereinafter GREENFIELD, THE FAILURE OF CORPORATE LAW] ("For much of the history of the United States, 'public' corporations were deemed to have important civic responsibilities. At the beginning of the twenty-first century, however, 'public corporation' is among the most misleading terms in all of law or business.").

34. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U.L. REV. 547, 559–60 (2003) [hereinafter Bainbridge, *Director Primacy*] ("As Berle and Means famously demonstrated, most public corporations are marked by a separation of ownership and control. Corporate law effectively carves this separation into stone."); FRANKLIN A. GEVURTZ, CORPORATION LAW 179 (2d ed. 2010) (describing corporate governance as following a republican, or representative model, in contrast to partnerships' Athenian, or direct democracy model, of governance).

35. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgement Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 110–11 (2004) [hereinafter Bainbridge, *The Business Judgment Rule As Abstention Doctrine*]; J. MARK RAMSEYER, BUSINESS ORGANIZATIONS 242–43 (2012) (describing the economic justifications for this allocation).

36. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 568–69 (characterizing shareholder control rights as weak and "scarcely qualify[ing] as part of corporate governance"); RAMSEYER, *supra* note 35, at 242–43; *see also* MODEL BUS. CORP. ACT § 8.01(b) (2002) (AM. BAR ASS'N, amended 2020).

37. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 569; D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 284–86 (1998).

38. RAMSEYER, *supra* note 35, at 242–43. In the United States, federal law has developed toward aligning manager compensation with performance. *See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH § 3.3.2 (3d ed. 2017) (discussing amendments to tax and securities law tying executive compensation to performance and granting shareholders

with good sense, but lacking an origin by which it can be assessed.

The origin story is this: the distinction between ownership and control arose as a premise of limited liability, but nowadays is considered a "cornerstone" of Anglo-American corporate law.[39] As framed in Victorian debates about the enactment of England and Wales' Limited Liability Act of 1855,[40] limited liability arose to encourage people of limited means to invest their savings in business, or wealthy people to invest in businesses run by such people.[41] The historicity of this necessity is debated among scholars,[42] but limited liability's role in democratizing investment stands undisputed.[43] Limited liability served this function because, despite Nicholas Butler Murray's potentially hyperbolic and famous observation,[44] before limited liability statutes, a person investing in the dominant business entity and the partnership risked total ruin if the business incurred liabilities beyond the value of the entity's assets.[45] In such a situation, the partners were personally

an advisory vote on executive performance).

39. Philip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 574–75 (1986); *see* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93–97 (1985).

40. Limited Liability Act 1855, 18 & 19 Vict. c. 133 (Eng.).

41. *See* Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 118 (1980) (stating John Stuart Mill advanced a theory that "the rich would be more likely to invest money in business ventures" of the middle class if there were limited liability because if the business failed, they would not be targeted by the creditors); GEVURTZ, *supra* note 34, at 26–35.

42. *See, e.g.*, Lawrence E. Mitchell, *Close Corporations Reconsidered*, 63 TUL. L. REV. 1143, 1155–56 (1989) (arguing that there is little history supporting the notion that limited liability is needed to incentivize investment); John Morley, *The Common Law Corporation: The Power of the Trust in Anglo-American Business History*, 116 COLUM. L. REV. 2145, 2146 (2016) (contending that corporate form is not "the exclusive historical source of . . . legal powers," such as limited liability, as these were available in the common law business trust).

43. *See* FRIEDMAN, *supra* note 33, at 160–62 (describing the growth of corporations in the mid-1800s from partnerships with "two or three partners, often related by blood or marriage" to a more efficient "form for organizing a business, legally open to all," which increased competition in the free market).

44. "The limited liability corporation is the greatest single discovery of modern times. Even steam and electricity are less important than the limited liability company." Stephen M. Bainbridge, William D. Warren Professor of L., Univ. of L.A. Sch. of L., Reflections on Twenty Years of Law Teaching: Remarks at the Rutter Award Ceremony (Apr. 16, 2008), *in* UCLA SCHOOL OF LAW: PUBLIC LAW & LEGAL THEORY RESEARCH PAPER SERIES 1, 8 (2008) (quoting Nicholas Murray Butler, President, Colum. Univ.).

45. Of course, this risk of ruin had long been reduced with some unincorporated entities, such as joint-stock companies based on their diffused ownership, and the legal requirement that debts be first satisfied out of business assets before turning to individuals. *See* Mason v. Am. Express Co., 334 F.2d 392, 401 (2d Cir. 1964) (describing theoretical liability of the unincorporated joint-stock association's individual members under New York law as practically unimportant and virtually identical to

liable beyond their share of the partnership.[46] So before the enactment of limited corporations, investment in a company was attractive only to individuals who either wished to take an active role in management (so that they might be in control of risk reduction) or who were sufficiently knowledgeable about the character of management so as to be comfortable placing trust in others.[47] The old regime excluded pure capitalists as we now understand them: gilded folks, wholly ignorant of a business' particulars, who contribute money solely for a return on investment.[48]

Because limited liability is connected to encouraging investment by pure capitalists,[49] it makes sense that the enterprise should be directed by experts who should, as a result of this expertise, enjoy complete freedom to grow investments through risks.[50] Put in contemporary terms, modern corporate governance, and its centerpiece doctrine of the BJR,[51] is rooted in, and informed by, the exact sort of business organization whose shares have long been traded on public markets: the entity in which one takes an

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theoretical liability of the same shareholders under section 630 of New York Business Corporation Law); *see also* Morley, *supra* note 42, at 2174–75 (arguing that the common law business trust also provided protection against limited liability).

46. *See* Halpern et al., *supra* note 41, at 118; *cf.* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 50–54 (2003) (recounting the origins of limited liability corporations in the mid-19th century).

47. *See* Stephen B. Presser, Commentary, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U.L. REV. 148, 155–56 (1992) (explaining how limited liability is credited for keeping markets democratic and accessible to modest investors).

48. *See id.* (discussing New York's adoption of limited liability as a means of democratizing investment).

49. *See id.*; Halpern et al., *supra* note 41, at 118 (discussing Victorian proponents of limited liability who argued that it would encourage middle and working classes "otherwise discouraged from investing by the large variance in possible investment outcomes under an unlimited liability regime" to invest and would encourage "the rich . . . to invest money in business ventures involving members of the middle and working classes" if they were certain that the middle and working classes would become "the chief targets of creditors' attention").

50. This is Bainbridge's basic justification for the busines judgment rule. *See* Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, *supra* note 35, at 110–11, 123 (discussing how "encouraging optimal risk taking is necessary" and how judicial abstinence is needed to ensure directors are not "skew[ed] . . . away from optimal risk taking"). Indeed, even in the corporate law debate about who "owns" the corporation — shareholders, managers, directors, or stakeholders — all submit that managers should be those in control. *See* WALTER A. EFFROSS, CORPORATE GOVERNANCE: PRINCIPLES AND PRACTICES §§ 1.02, 1.05 (2010).

51. *See* Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, *supra* note 35, at 83 ("The business judgment rule pervades every aspect of state corporate law, from the review of allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation, and so on.").

ownership interest purely for the sake of making money from its activities.[52]

This last point invites a brief excursus on the BJR. In its classical form, the BJR is the legal doctrine under which a court eschews substantive review of a corporate board's decisions unless shareholders can show that a board violated its fiduciary duties of care and loyalty, or proceeded without good faith, in making those decisions.[53] And even these standards are far less rigorous than they initially appear, as scholars have observed how the duty of care, since its highpoint in the Delaware Supreme Court's decision of *Smith v. Van Gorkom*,[54] has become dead letter.[55] So ultimately, acts of boards that conform with proper procedure, including the aspects of procedure relating to conflicts of interest and minimal attentiveness, enjoy legal impunity.[56]

Eminent corporate scholar Stephen M. Bainbridge has explained the BJR in the same terms as those justifying limited liability,[57] existing precisely because it encourages the risk-taking that public company shareholders rely upon to grow their investment.[58] But the BJR applies only insofar as directors are doing what they are supposed to under the bargain with shareholders accounting for the separation of ownership and control: minding shareholders' wealth.[59] Shareholders' theoretical preference for the BJR ends at precisely the point where directors' decisions are motivated by considerations other than shareholder wealth: self-dealing or a desire to defraud shareholders.[60] In other terms, within public companies the BJR actually performs the very function that bringing shareholders into the

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52. *See* Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, *supra* note 35, at 109–11; RONALD E. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784–1855 7 (1982) (explaining the "five stages of corporation creation" and how "rapid technological innovation and [market] expansion" incentivize individuals to mobilize and take advantage of wealth opportunities).

53. *See* RAMSEYER, *supra* note 35, at 86, 135–36; Auerbach v. Bennett, 393 N.E.2d 994, 999–1000 (N.Y. 1979) (quoting Pollitz v. Wabash R.R. Co., 207 N.Y. 113, 124 (1912)).

54. 488 A.2d 858 (Del. 1985).

55. Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 404 (2007) (stating that the duty of care has been reduced to an unenforceable aspiration).

56. *See id*. 404 n.49; *see also Auerbach*, 393 N.E.2d at 1000.

57. Bainbridge, *Director Primacy*, *supra* note 34, at 601 ("The business judgment rule is the chief common law corollary to the separation of ownership and control.").

58. Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, *supra* note 35, at 111.

59. *See id.* at 103 (explaining that a contractual responsibility to shareholders limits the otherwise extensive discretionary powers of the directors to actions that will increase the returns to shareholders).

60. *Id.* at 122–23.

governance structure would: it compels directors to maximize shareholders' interests.[61]

It is this very connection between limited liability and shareholder welfare maximization that has provoked progressive calls for reform.[62] For progressive scholars, there is a great dissonance between conferring the tremendous public benefit of limited liability upon enterprises sociopathically focused on their own private interests.[63] In progressive scholars' observations, this has been a formula for corporate anomie.[64]

Historicizing and contextualizing corporate governance doctrines is the first step in evaluating them. For hardly any expertise in corporate law is required to observe that there are many business corporations that are unlike public companies; rather, these businesses' investors are not nearly so indifferent to the function of the entity as their public company counterparts are.[65] Even leaving aside business structures such as trade unions and worker cooperatives, many business corporations are ones where shareholders are invested in operations. In fact, most corporations doing business in the United States are closely held business corporations[66] — which substantially overlap with, but are analytically distinct from, the private company, or one whose shares are not traded on a public market.[67] We are most familiar with

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61. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 601–02.

62. *See id.* at 593–94 ("Many progressives believe that corporate directors currently do not take sufficient account of nonshareholder constituency interests and that legal reform is necessary.").

63. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1428 (1993) [hereinafter Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm*] (describing one of Green's arguments to which he replies as "envision[ing] the limited liability rule as a privilege conferred by society, in return for which society can demand socially responsible corporate behavior").

64. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 17, 25–26 (illustrating that many shareholders are generally unaware or disinterested in a corporation's machinations and instead are quite removed from the initial offering, having "bought the stock from someone who bought the stock from someone who bought the stock from someone who bought the stock from an investment banker who bought it from the company").

65. *But see id.* at 25 (discussing how shareholders are indifferent to companies in which they own stock because of limited liability and diversified investment portfolios).

66. *See* DANA SHILLING & CHRISTINE VINCENT, LAWYER'S DESK BOOK § 1.09 (2d ed. 2020) ("Although most of the largest businesses are publicly owned (i.e., their securities are freely traded on exchanges), most businesses are close corporations, whose shares have no public market.").

67. *See* GEVURTZ, *supra* note 34, at 231–32; PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.06 (AM. L. INST. 1994) (defining a closely held corporation as a small number of people owning its equity securities for which "no active trading market exists").

many "Mom and Pop" businesses run by owners who are often related and for whom the appeal of ownership is having an active role in the business.[68] To express this point from the angle of recent constitutional debate, much of the discussion today about whether corporations enjoy "religious freedom" is based, in part, on corporations' claims that their business is more than a commercial activity.[69] Or these corporations at least insist that commercial activity is also interested in how money is made or what is done to make it.[70]

And yet, with procrustean disregard for peculiarities and real differences, all these business entities are governed by the same law of internal governance. To engage with New York law on this question, it reflects this same, sharp distinction between ownership and control,[71] where default rules provide that shareholders have a veto only in matters such as voting for management, on fundamental changes,[72] and in a corporation's terminal events such as whether to dissolve or merge with another entity.[73] And for

68. *See* GEVURTZ, *supra* note 34, at 473 (explaining that "the extraordinarily common practice of closely held corporations" is to disperse "their income to their owners through salaries rather than dividends," as owners "attribute the earnings of the business to their work").

69. *See generally* Amy J. Sepinwall, *Corporate Piety and Impropriety*: Hobby Lobby*'s Extension of RFRA Rights to the For-Profit Corporation*, 5 HARV. BUS. L. REV. 173 (2015) (discussing RFRA defenses by corporate defendants).

70. *See* Burwell v. Hobby Lobby Stores, 573 U.S. 682, 701 (2014) (discussing business owners' claims about how operation of their business is connected with religious values). Matthew T. Bodie notes a similar reading of *Burwell v. Hobby Lobby* by other scholars. *See* Matthew T. Bodie, *The Next Iteration of Progressive Corporate Law*, 74 WASH. & LEE L. REV. 739, 762–63 (2017) ("Despite the result in *eBay* [*Domestic Holdings, Inc. v. Newmark*], stakeholder theorists have not given up hope for doctrinal victories . . . [due to] [t]he Court's willingness to depart [in *Burwell*] from shareholder primacy . . . ."); *see also* David K. Millon, *Looking Back, Looking Forward: Personal Reflections on a Scholarly Career*, 74 WASH. & LEE L. REV. 699, 736–37 (2017) [hereinafter Millon, *Looking Back, Looking Forward*] (articulating a similar interpretation of *Hobby Lobby*); KENT GREENFIELD, CORPORATIONS ARE PEOPLE TOO: (AND THEY SHOULD ACT LIKE IT) 98 (2018) (arguing that for-profit corporations can have spiritual values too, but the law must be careful to ensure that such is not a pretext for avoiding regulation).

71. *See* N.Y. BUS. CORP. LAW § 701 (McKinney 2021) ("Subject to any provision in the certificate of incorporation authorized by paragraph (b) of section 620 (Agreements as to voting; provision in certificate of incorporation as to control of directors) or by paragraph (b) of section 715 (Officers), the business of a corporation shall be managed under the direction of its board of directors, each of whom shall be at least eighteen years of age. The certificate of incorporation or the by-laws may prescribe other qualifications for directors.").

72. *See generally id*. § 706 (regarding the removal of directors for cause, without cause, under certain circumstances, and via court order).

73. *See id*. § 614(a) (vote on directors); *id.* § 803(a) (change of certificate of incorporation subject to shareholder vote or approval except for certain minor matters); *id.* § 903(a) (merger or consolidation authorized only by shareholder vote); *id.* § 1001(a)

all business corporations, corporate governance culminates with the same BJR, which crystallizes the statutory recognition that boards call the shots in corporations.[74] True, the law acknowledges special circumstances, in closely held corporations, that require the imposition of a "fairness" fiduciary duty on directors and even majority shareholders.[75] But even there, New York law regards the BJR as protecting procedurally sound decisions: "fair procedures," it seems, is the sole limitation on directors' conduct that shareholders enjoy.[76]

How is this absolutism justified? The short answer is that New York corporate law has applied public company reality to every type of business corporation.[77] This is presumably based on the historically recent belief that the BJR and norm of shareholder maximization represent what *all* shareholders would bargain for or what the democratic capitalist society requires.[78] Or perhaps the operative assumption is that all business corporations are simply aspiring public companies.[79] Whatever the underlying reason, the law assumes that if a shareholder has a problem with how a corporation is managed, then she can just sell her shares, including, in the case of a private company, by inducing the corporation or majority shareholders to buy her out.[80] If the shares are too valuable to part with —

(shareholder vote on dissolution).

74. *See* Auerbach v. Bennett, 393 N.E.2d 994, 999–1000 (N.Y. 1979) (stating that application of the BJR — which defers to directors' good-faith business decisions — is dispositive).

75. *See* GEVURTZ, *supra* note 34, at 345–51.

76. *See* Gallagher v. Lambert, 549 N.E.2d 136, 138 (N.Y. 1989) (holding that minority shareholder has no claim for breach of fiduciary duty where he was terminated before higher buy-back percentage vested as buy-back offer was "fair" to him, even if below actual value of shares).

77. *See infra* notes 222–26 and accompanying text.

78. *See* EFFROSS, *supra* note 50, at 11–12; Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship,* 82 CORNELL L. REV. 856, 903 (1997) [hereinafter Bainbridge, *Community and Statism*] (contending that progressive corporate law, departure from mainstream law, and economics views of the corporation "run counter to the spirit of a democratic capitalist society").

79. *See* SHILLING & VINCENT, *supra* note 66, § 1.09 (describing a "typical pattern" as one where a company starts up and then goes public with an initial public offering, before which stage a series of problems arises from its small and familial shareholder composition); Benjamin C. Waterhouse, *The Small Business Myth*, AEON (Nov. 8, 2017), https://aeon.co/essays/what-does-small-business-really-contribute-to-economic-growth (arguing that in the 1980s, the Republican Party manipulated the mythology of small businesses to abandon the vast majority that, remaining small, promote competition and preserve local values in favor of elevating the few whose value is in "the[] potential to *cease to be small businesses*").

80. *See* N.Y. BUS. CORP. LAW §§ 1104-a, 1118 (McKinney 2021); *In re* Cristo Bros., Inc., 478 N.E.2d 176, 177 (N.Y. 1985) (holding that the judicially induced buyout

say, the corporation owns some valuable, inalienable property or is party to exclusive contracts — then the law suggests that the shareholder vote out the directors by persuading her peers to appoint a new board.[81] Or, the law insists, the shareholder can just buy a controlling stake and then appoint directors who will do her bidding.[82] Regardless of the law's solution, the supposition remains the same: the value of stock in a corporation always can be monetized and liquidated. This means that the law never supposes an investor to be irreparably harmed, in a nonmonetary fashion, by board irresponsibility, even where participation in a corporation is her chief source of income. The remedy always remains the monetary one of dissolution and liquidation.[83] The question remains whether this exclusively monetary view of corporations' value is an accurate description of reality.

III. CRITIQUING THE NEOLIBERAL GOVERNANCE PARADIGM

A. The Progressive Corporate Law Critique and Reform Program

Criticism of neoliberal corporate governance has not been limited to its incompatibility with "Mom and Pop" businesses. Rather, the criticism has most vigorously and roundly been applied to public companies, the very context in which neoliberal corporate governance was developed. The critique of public company corporate governance law has generally been labelled progressive corporate law, but has also been referred to as "communitarianism," the "multi-fiduciary model," or the "stakeholder theory."[84]

This critique has been carried out by many participants, but its main ideas are contained in articles by six scholars[85] and two books: a 1995 collection

procedure under section 1118 of New York's Business Corporation Law applies to holders of fifty percent of shares of a closely held corporation).

81. *See* S. & S. Realty Corp. v. Kleer-Vu Indus., Inc., 384 N.Y.S.2d 796, 797 (App. Div. 1976) (upholding shareholder's petition for access to shareholder list to distribute materials to fellow shareholders urging them not to re-elect board).

82. *See* Crane Co. v. Anaconda Co., 346 N.E.2d 507, 514 (N.Y. 1976) (upholding shareholder's right to access list of shareholders in connection with offer to purchase stock).

83. *Compare In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1176 (N.Y. 1984) (upholding lower court dissolution of corporation because majority shareholders refused to issue dividends to minority shareholder), *with* Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1313 (N.Y. 1989) (upholding dismissal of action for damages, holding that minority shareholder in a close corporation is not insulated from being fired at will).

84. Bodie, *supra* note 70, at 748.

85. I focus on these six scholars because, as of June 13, 2020, a Westlaw search for "progressive corporate law" produces 527 law review articles. Each of the twenty most cited articles under the search term "progressive corporate law" analyzes or references writings by these six scholars. Ultimately, I acknowledge a point that one of the listed

of essays contained in an anthology entitled *Progressive Corporate Law*,[86] edited by Lawrence Mitchell, and Kent Greenfield's 2010 work, *The Failure of Corporate Law*.[87] The articles, whose basic points are summarized in this Section, are by Lynne Dallas,[88] Kent Greenfield,[89] Lyman Johnson,[90] David

scholars concedes: that the exercise of constituting a list is admittedly "idiosyncratic." *See* David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1391 n.47 (1993) [hereinafter Millon, *Communitarians*] (citing other participants in the communitarian critique and reform movement).

86. PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

87. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33.

88. Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REFORM 19 (1988) [hereinafter Dallas, *Two Models of Corporate Governance*]; Lynne L. Dallas, *Proposals for Reform of Corporate Boards of Directors: The Dual Board and Board Ombudsperson*, 54 WASH. & LEE L. REV. 91 (1997) [hereinafter Dallas, *Proposals for Reform of Corporate Boards of Directors*]; Lynne L. Dallas, *Law and Socioeconomics in Legal Education*, 55 RUTGERS L. REV. 855 (2003) [hereinafter Dallas, *Law and Socioeconomics in Legal Education*].

89. Prior to publishing his 2010 book, Kent Greenfield had described its main points across nearly twenty years of scholarship. *See* Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. 799 (1997); Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283 (1998); Kent Greenfield, *There's a Forest in Those Trees: Teaching About the Role of Corporations in Society*, 34 GA. L. REV. 1011 (2000); Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS. L. REV. 581 (2002); Kent Greenfield & Peter C. Kostant, *An Experimental Test of Fairness Under Agency and Profit-Maximization Constraints (With Notes on Implications for Corporate Governance)*, 71 GEO. WASH. L. REV. 983 (2003); Kent Greenfield, *Proposition: Saving the World with Corporate Law*, 57 EMORY L.J. 948 (2008); Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL'Y REV. 1 (2008); Kent Greenfield, *The Third Way*, 37 Seattle U. L. Rev. 749 (2014).

90. Lyman P.Q. Johnson, *The Social Responsibility of Corporate Law Professors*, 76 TUL. L. REV. 1483 (2002) [hereinafter Johnson, *The Social Responsibility of Corporate Law Professors*]; Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597 (2005) [hereinafter Johnson & Millon, *Recalling Why Corporate Officers Are Fiduciaries*]; Lyman P.Q. Johnson, *Faith and Faithfulness in Corporate Theory*, 56 CATH. U. L. REV. 1 (2006) [hereinafter Johnson, *Faith and Faithfulness in Corporate Theory*]; Johnson, *Re-Enchanting the Corporation*, *supra* note 16.

Millon,[91] Lawrence Mitchell,[92] and Lynn Stout.[93] The two books, also summarized below, have bookended progressive corporate law scholarship, though articles have been published since. For example, Matthew Bodie's 2017 article, as part of a symposium celebrating the scholarship of Lyman Johnson and David Millon, speaks of the *Next Iteration of Progressive Corporate Law*.[94]

Stephen Bainbridge has described the *Progressive Corporate Law* ("*PCL*") volume as a useful introduction to scholarship opposing law and economics movement in public company corporate law.[95] Published fifteen years after *PCL*, Greenfield's book stands out as the foremost progressive critique since, in his description, it is the only work expressly challenging the neoliberal, contractarian perspective on corporations informing the current state of law[96] and proposing concrete reforms advancing the common good.[97] But all progressive scholars, writing before and after Greenfield's book, put forward similar criticisms of neoliberal governance. Despite their main critic's claim that progressive corporate law scholars "are far more firmly united by what they oppose — Chicago-style law and economics —

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91. *See* Millon, *Communitarians*, *supra* note 85; David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991) [hereinafter Millon, *Redefining Corporate Law*]; David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment at Will Versus Job Security*, 146 U. PA. L. REV. 975 (1998) [hereinafter Millon, *Default Rules*]; David Millon, *New Game Plan or Business As Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001 (2000) [hereinafter Millon, *New Game Plan or Business As Usual?*]; David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L.J. 1013 (2013); David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. 911 (2013) [hereinafter Millon, *Shareholder Social Responsibility*]; Millon, *Looking Back, Looking Forward*, *supra* note 70.

92. Lawrence E. Mitchell, *The Human Corporation: Some Thoughts on Hume, Smith, and Buffett*, 19 CARDOZO L. REV. 341 (1997) [hereinafter Mitchell, *The Human Corporation*]; Lawrence E. Mitchell, *Trust and Team Production in Post-Capitalist Society*, 24 J. CORP. L. 869 (1999) [hereinafter Mitchell, *Trust and Team Production in Post-Capitalist Society*]; Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591 (2001) [hereinafter Mitchell, *The Importance of Being Trusted*].

93. Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) [hereinafter Blair & Stout, *A Team Production Theory of Corporate Law*]; Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735 (2001) [hereinafter Blair & Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*]; Stout, *Why We Should Stop Teaching* Dodge v. Ford, *supra* note 18.

94. Bodie, *supra* note 70.

95. *See* Bainbridge, *Community and Statism*, *supra* note 78, at 857.

96. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 3–5.

97. *See id*. at 5.

than by what they support"[98] — their various criticisms cohere into three main points.

First, progressive scholars contend that modern corporate law has ignored the public function of public companies.[99] Specifically, they posit that corporate law mistakes public companies for private bodies whose activities serve the common good, if at all, simply by operation of the invisible hand and trickling down.[100] Greenfield observes this by framing his book as a gap filler for neoliberal, contractarian analysis.[101] Later on, Greenfield articulates a guiding principle for law: public companies should be measured by whether the value they create is greater than the cost they impose on society on the whole.[102] Similarly, in introducing *PCL*, Lawrence Mitchell states that, in view to all the harms corporations visit upon society, "[o]ur historical treatment of the corporation as a public good in the private service can no longer be sustained . . . . It is time that the corporation be recognized as what it is: a public institution with public obligations."[103]

Second, progressive scholars contend that, as public institutions, public companies must be made to serve the interests of all those with ties to them.[104] All includes direct stakeholders such as workers, but also indirect one such as the public at large, who are injured by the externalities of corporations' activities.[105] Progressive scholars are also united in asserting that corporate law should recognize and protect the nonmonetary and humanistic benefits that public companies confer upon other stakeholders, primarily employees. In an essay within *PCL* entitled *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*,[106] David Millon describes the "challenge[] to corporate law's traditional commitment to the shareholder primary principle" as the "communitarian approach," where the focus is on the "sociological and moral phenomenon of the corporation as

98. Bainbridge, *Community and Statism*, *supra* note 78, at 857.

99. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 1–2.

100. *See id.* at 2 (discussing the harms and flaws in American corporate law as a result of the way corporations are organized).

101. *See id.* at 4–5.

102. *See id.* at 128.

103. *See* Lawrence E. Mitchell, *Preface* to PROGRESSIVE CORPORATE LAW xiii (Lawrence E. Mitchell ed., 1995) [hereinafter Mitchell, *Preface*].

104. *See* David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW 5 (Lawrence E. Mitchell ed., 1995) [hereinafter Millon, *Communitarianism in Corporate Law*].

105. *See id*. (noting that, for example, when a plant closes, communitarians consider not only the employees who will lose their jobs, but also the consumers who may lose access to the product and the community that may lose tax revenues).

106. Millon, *Communitarianism in Corporate Law*, *supra* note 104.

community, in contrast to the individualistic, self-reliant, contractarian stance that dominates current academic discourse in corporate law."[107] Millon regards this communitarian turn in public company corporate law as being inspired by "concern about the harm to nonshareholders that can occur as a result of managerial adherence to the shareholder primacy principle."[108] In a more recent article, Millon makes the same point negatively by arguing that the modern, mainstream corporate governance view of shareholder welfare maximization, based on self-interest, is simply incompatible with a public company exercising any social responsibility to anyone.[109] Returning to *PCL*, Lewis D. Solomon closes the book with an essay entitled *On the Frontier of Capitalism: Implementation of Humanomics by Modern Publicly Held Corporations — A Critical Assessment*,[110] where he favorably examines two corporations — one formed in the United States and the other in England — that have implemented a humanonics approach to business operations.[111] Solomon frames the humanonics approach as one that can create "business organizations that will promote both human growth and ecological considerations as part of a larger interest in the quality of life and the preservation of the planet."[112]

Third, all progressive scholars reject the contractarian reduction of public company corporate law, or the contention that such corporations are not societies in and of themselves governed by social mores, but rather are mere "nexus[es] of contracts."[113] These progressives reject contractarianism because it obscures the degree to which all contracts are subject to pre-contractual entitlement rules that are not themselves products of the market but rather are informed by socio-cultural considerations.[114] For example,

107. *Id*. at 1.

108. *Id.*

109. Millon, *Shareholder Social Responsibility*, *supra* note 91, at 911, 928–29 (arguing that short-termism, the current practice arising out of the shareholder welfare maximization norm, is incompatible with corporate social responsibility).

110. Lewis D. Solomon, *On the Frontier of Capitalism: The Implementation of Humanomics by Modern Publicly Held Corporations: A Critical Assessment*, 50 WASH. & LEE L. REV. 1625, 1642–43 (1993), *reprinted in* PROGRESSIVE CORPORATE LAW 281 (Lawrence E. Mitchell ed., 1995)

111. *See generally id.* (analyzing Ben & Jerry's, the American one, and The Body Shop International PLC, the English one).

112. *Id.* at 282.

113. *See, e.g.*, GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 149 (stating that under the "nexus of contracts" view of a firm, important market participants should be put in decision-making positions as this is the best way to make fair decisions).

114. *See* Mitchell, *Preface*, *supra* note 103, at xiii–xv (stating that the "dominant trend in corporate law scholarship" that treats corporations like private contractual arrangements is "doomed to fail" because it does not consider human behavior and is detached from reality).

Millon criticizes what he classifies as progressive contractarian arguments on the very basis that they elide how property rights are the product of societal policy decisions.[115] Likewise, Lynne Dallas' essay in the same volume, *Working Toward a New Paradigm*,[116] expresses deep skepticism of the shareholder primacy norm as "economically natural," remarking that it is the product of policymaking.[117] Dallas also follows Millon in arguing that contractarianism is normatively suspect because it ignores other, pre-contractual considerations such as the public function of work for employees, disregarding other stakeholders' investment of labor, an asset.[118] In another *PCL* essay, *Some Observations Writing the Legal History of the Corporation in the Age of Theory*,[119] Gregory A. Marks reinforces this critique through tracing the historiography of corporate law, showing that neoliberal theory has overtaken history to recast the origins of corporations as the natural result of market economics, instead of as the product of policy-making.[120] Finally, although Greenfield notes that his proposal ironically stands as "the genuine realization of the 'nexus of contracts' view of the firm,"[121] he rejects contractarian atomization of the corporation in that he advocates for the robust participation of other stakeholders in governance by having a seat on the board as a matter of course.[122] This reflects a social, rather than contractual, view of entities.

As part of criticizing this reduction, progressive corporate scholars also reject the contractarian, self-interest rationality undergirding neoliberal governance for a more social and relational understanding of human beings.[123] Solomon's essay on humanonics discussed above points to this,[124] though other progressive scholars are more explicit. They all agree on a more social and communitarian view of economic rationality, but their precise conceptions span a range whose poles are a harder institutional

115. *See* Millon, *Communitarianism in Corporate Law*, *supra* note 104, at 24–25.

116. Lynne L. Dallas, *Working Toward a New Paradigm*, *in* PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

117. *See id*. at 39.

118. *See id.* at 49–50.

119. Gregory A. Mark, *Some Observations on Writing the Legal History of the Corporation in the Age of Theory*, *in* PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995).

120. *See id*. at 85.

121. GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 149.

122. *See id*. at 149–50.

123. *See* Blair & Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, *supra* note 93, at 1737 (arguing that self-interested contractarian rationality cannot fully account for how corporate constituents cooperate amongst each other).

124. *See supra* notes 110–12 and accompanying text.

understanding and a softer cultural one. At the harder end is Dallas' power vision of public companies, where a corporation is thought of as a more formal institution, but one molded by historical, cultural, and political forces, rather than standing as an economically efficient firm.[125] Almost twenty years later, Dallas stood by her basic viewpoint, describing this perspective as law and socioeconomics ("LSOC").[126] As Dallas describes it, LSOC understands all economic participants, and not just corporate ones, to be consumers within the context of the legal/institutional environment, social rules, and market power, not just economically efficient structures.[127] At the center is Stout and Blair's team production model, which regards public companies as webs of personal relationships mediated by the board,[128] sort of like electrons circulating a nucleus. In an article two years after their team production one, Stout and Blair elaborated the interstitial fulcrum of the team, or the matrix in which the electrons and nucleus exist: the central concept of trust.[129] This concept both brings us back to the center and segues to the opposite pole. Looking backwards, Mitchell draws upon Blair and Stout's observation and argues that trust renders the corporation a social institution, and much less an arms-length nexus of self-interested actors.[130] Moving forward, Mitchell and Johnson both argue that the operative necessity of trust emphasizes the humanity of corporations, a quality that allows for a pluralistic view of corporations as also being governed by social values, including religion, instead of rational self-interest.[131] In a later article, Johnson and Mitchell join Blair and Stout[132] in arguing that the personal, social notion of trust also better explains certain elements of corporate law doctrine such as the fiduciary duties of loyalty and care,[133]

125. Dallas, *Two Models of Corporate Governance*, *supra* note 88, at 25–27.

126. *See* Dallas, *Law and Socioeconomics in Legal Education*, *supra* note 88, at 855–56, 858–59.

127. *Id.*

128. *See* Blair & Stout, *A Team Production Theory of Corporate law*, *supra* note 93, at 253–54 (arguing that boards exist to protect enterprise-specific investments of all members of the team).

129. *See* Blair & Stout, *Trust, Trustworthiness, and the Behavioral Foundations*, *supra* note 93, at 1737–38.

130. Mitchell, *Trust and Team Production in Post-Capitalist Society*, *supra* note 92, at 870–72.

131. *See* Mitchell, *The Human Corporation*, *supra* note 92, at 358–61; Johnson, *Faith and Faithfulness in Corporate Theory*, *supra* note 90, at 6; Johnson, *Re-Enchanting the Corporation*, *supra* note 16, at 98–99 (positing that many business actors are motivated more by "sympathy towards others" than profit maximization).

132. *See* Mitchell, *Trust and Team Production in Post-Capitalist Society*, *supra* note 92, at 871; Johnson, *Faith and Faithfulness in Corporate Theory*, *supra* note 90, at 6.

133. *See* Johnson, *The Social Responsibility of Corporate Law Professors*, *supra* note 90, at 1499–1500 (arguing that law professors have a duty to teach fiduciary duties in a

which we considered above in Part II.

Building from these three points, progressive scholars propose the same communitarian changes to corporate governance. In his book, Greenfield refers to "three proposals most often put forward by progressive corporate law scholars . . . : relaxation of the profit norm, including workers within the directors' fiduciary duties, and placing workers' representatives on the boards of directors," based on European models.[134] He describes these as so common among progressives that he need not even discuss their rationales.[135] Millon, though uncertain of the concrete details of a communitarian turn, aligns with Greenfield in proposing reforms meant to bring social benefit into corporate law by authorizing directors to consider other stakeholders' interests.[136] In a later article, Greenfield becomes a bit more concrete and proposes what he characterizes as a "modest reform": enacting a statute changing default rules whereby employee stakeholder interests would be assumed.[137] By this, they would not be left to protect themselves through private bargaining, an inadequate path given clear wealth and power disparities.[138] Continuing along this path of statutory reforms, Millon and Johnson argue that to build cultures of morality, corporate law should adopt the more rigorous agency-law fiduciary standard for corporate managers, and not the lesser standard corporate law applies to directors.[139] For Dallas, the key reform is a variant on the sort Greenfield describes: a requirement that public companies have two boards, each led by an independent ombudsperson serving outsiders.[140] Through this reform, corporations can monitor for conflicts (the task of one board), but also advance the relationships with corporations consistent with her power theory (the task for the other).[141]

It is important to observe from this summary what the progressive corporate critique affirms of public companies. It recognizes them as valid

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broad, moral, and social sense); Johnson, *Re-Enchanting the Corporation*, *supra* note 16, at 98–99; Mitchell, *The Importance of Being Trusted*, *supra* note 92, at 614–15.

134. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 124.

135. *See id.*

136. *See* Millon, *Communitarianism in Corporate Law*, *supra* note 104, at 13, 30–31 (describing the communitarian turn as reforming the entitlement structure underlying corporate law).

137. *See* Millon, *Default Rules*, *supra* note 91, at 979, 995.

138. *See id*. at 979.

139. Johnson & Millon, *Recalling Why Corporate Officers Are Fiduciaries*, *supra* note 90, at 1601.

140. Dallas, *Proposals for Reform of Corporate Boards of Directors*, *supra* note 88, at 130–32.

141. *Id*. at 132–34.

and useful in and of themselves, avoiding the notion that they should be abolished in the name of public good. Indeed, Greenfield goes the furthest on this point and identifies four specific characteristics of business corporations — "[the] easy transferability of shares, limited liability, specialized and centralized management, and a perpetual existence separate from their shareholders" — as features that render them "especially able to create financial prosperity."[142] Millon recognizes how public companies, in providing "adequate compensation, healthful and pleasant working conditions, some amount of control over work, and job security are necessary for the achievement of self-realization in the workplace."[143] Millon's problem is that the "current market conditions may render these goods unattainable for many employees."[144]

From this, we should appreciate that the progressive project has simply sought to ensure that public companies' social function is not undermined by the market; they identify the source of corporate anomie as the norm of shareholder welfare maximization, not the structure itself. Accordingly, they propose changes to corporate law that amount to advancing a "thicker" conception of the public company as a community of all constituents formed for the benefit of larger society, instead of as a loose nexus of self-interested profiteers. They argue that this thickening can happen by broadening the scope of interests that corporate directors must take into account.

B. The Failure of Progressive Corporate Law to Reform Public Company Governance

To date, this "thicker" communitarian conception of a public company has failed to displace corporate law's looser, contractual conception apotheosizing profit.[145] The question remains why it has failed. I submit that this is because progressive proposals have been too theoretical, modest, or subtle to take. For example, take the reform of weakening the maximization norm and mandating stakeholder representation on the board, principally workers. It is based on the landscape in Germany,[146] which serves to suggest that it is feasible. But relying on a German example raises the question of whether it can be implemented in the United States' different

142. GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 131.

143. *See* Millon*, Communitarianism in Corporate Law*, *supra* note 104, at 9.

144. *Id*.

145. *See* Bodie, *supra* note 70*,* at 740 (explaining that progressive corporate law is moving away from shareholder wealth maximization towards a "communitarian vision of the corporation," yet progressive theory must continue to evolve in order to be a formidable alternative).

146. *See* GREENFIED, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 42, 150.

socio-legal culture. When shifting to other proposals, the problem becomes that they appear as mere tweaks to the standard model:[147] for example, the proposals calling for the application of agency-law fiduciary standard,[148] a shift of contract rules default rules,[149]or conception of omnipotent boards of directors as relational mediators.[150]

One reason why progressives seem to tread lightly is because of what they affirm about public companies: they propose reform in the name of classical capitalism as found in Adam Smith's *The Wealth of Nations*.[151] As discussed above, the whole point of the progressive critique is for public companies to serve as the greatest vehicle for wealth creation in human history for all, not just a miniscule elite.[152] As such, the critique seems to presuppose that business corporations serve ends defined as market capitalism, instead of standing as a counter to the ruthlessness of markets. For this reason, their proposals focus on public companies, and largely leave intact the basic structure of neoliberal governance corporate law discussed above in Part II.[153]

At the root of the progressive critique's inefficacy is its description of the problem as "shareholder primacy." On closer inspection of progressives' arguments, they posit the problem as the law's requirement that managers care only about shareholders' monetary interests, to the detriment of any nonmonetary interest for anyone.[154] This is what shareholder primacy actually means, regardless of whether one technically adheres to a neoliberal governance theory giving directors, as opposed to shareholders, corporate primacy.[155] But as we saw from the discussion above in Part II, New York

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147. Bodie, *supra* note 70, at 750–51.

148. *See* Johnson & Millon, *Recalling Why Corporate Officers Are Fiduciaries*, *supra* note 90, at 1601 (discussing their proposed reform).

149. *See* Millon, *Default Rules*, *supra* note 91, at 979, 995 (discussing his proposed reform).

150. *See* Dallas, *Proposals for Reform of Corporate Boards of Directors*, *supra* note 88, at 130–32 (discussing the conceptualization of boards).

151. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS: COMPLETE AND UNABRIDGED 421–22 (Edwin Cannan ed., 1904) (1776) (discussing the "classicus locus" of the invisible hand concept).

152. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 132.

153. *See* Bodie, *supra* note 70, at 750–51; *see also* Millon, *New Game Plan or Business As Usual?*, *supra* note 91, at 1003–05 (arguing that the Stout and Blair team production model perpetuates the status quo regarding a board of directors as a mediating hierarch within a relationship conception of corporations but does not propose anything serving to insulate boards from political pressure undermining communitarianism).

154. *See, e.g.*, Millon, *Communitarianism in Corporate Law*, *supra* note 104, at 5–6.

155. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 563, 574 ("[D]irector primacy does not discard the concept of shareholder wealth maximalization as a bargained for right of the shareholders.").

corporate law and corporate law generally, do not really protect or care about *anyone's* nonmonetary interests, even if those folks are shareholders.[156] And so, the problem of neoliberal corporate law is not so much shareholder primacy, but rather the absolutization of profit, for which the idea of shareholder primacy stands as a proxy.[157]

However, because progressive scholars have expressed their criticisms in terms of shareholder primacy, they have set their critique up for rejection. This is because, wholly assuming that corporations, and especially public companies, are uniquely suited to generate wealth — a point that progressives seemingly concede in, for example, Greenfield's observation of their special attributes[158] — weakening shareholders' legal primacy threatens to undermine corporations' ability to do what they are best suited for. Eminent corporate scholar Bainbridge has formulated the entire case against progressive public company law by reinforcing this risk with two points. First, Bainbridge has suggested that the current law, especially its norm of shareholder wealth maximization, reflects what economically rational investors would bargain for anyway.[159] That is why the shareholder norm governs even when, as Bainbridge holds, directors technically enjoy primacy in corporations.[160] Second, he has contended that the wealth maximization norm reflects human nature and the quiddity of the U.S. democratic capitalist system.[161] If Europeans allow for another norm to govern, that is because

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156. *See supra* notes 78–83 and accompanying text.

157. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 218, 224–26; EFFROSS, *supra* note 50, § 1.07(C) (citing LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 4–5 (2001)) ("Unlike advocates of shareholder primacy, communitarians have attacked the maximalization of shareholder wealth as 'an imperative that is as destructive as it is simple' because it emphasizes short-term financial gains over long-term social welfare.").

158. *See* Johnson & Millon, *Recalling Why Corporate Officers Are Fiduciaries*, *supra* note 90, at 1630 (citing Greenfield's research on officers' "duty to maximize stockholder wealth").

159. *See* EFFROSS, *supra* note 50, § 1.05 (citing STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 65–66 (2008)); *see also* MICHAEL R. DIAMOND, CORPORATIONS: A CONTEMPORARY APPROACH 23–26 (5th ed. 2019) (citing ALLAN A. KENNEDY, THE END OF SHAREHOLDER VALUE: CORPORATIONS AT THE CROSSROADS (2001)) (discussing shareholder valuism, on the obsession over stock price arising out of the high tech boom, in the context of Allan Kennedy's thesis in *The End of Shareholder Value: Corporations at the Crossroads* that "the contemporary obsession on stock prices has created the idea that the sole purpose for the existence of business is to make money . . . driving managers to focus on stock prices in the short-term, with adverse consequences for long-term business health . . .").

160. *See* Bainbridge, *The Business Judgment Rule As Abstention Doctrine*, *supra* note 35, at 110–11, 123.

161. *See* Bainbridge, *Community and Statism*, *supra* note 78, at 903.

their society is different: they might be statists.[162]

The upshot of Bainbridge's argument is that shareholder wealth maximization may be a fifth feature — to add to Greenfield's four mentioned above[163] — explaining why corporations have a genius for attracting capital. Even worse for the progressive project, it too would be a cultural principle, standing as a normative account of how *all* corporations should be organized in our "free society."[164] If it is true that the feature of shareholder welfare maximization is why corporations are so effective in attracting investment, it follows that displacing the maximization norm risks ruining corporations' very social utility. On the basis of progressives' theoretical and subtle arguments so far, why should policymakers take any chances, especially where even progressives agree with the social benefit of corporate wealth-generation?[165]

The progressive argument has suffered from want of a concrete, American example of an effective communitarian business corporation. Absent this example, the progressive case cannot seize the argument. Rather, its proposals are received as ideals corporate managers are free to adopt and test out in a market and judges are free to disregard. But such an approach produces no change. This is a danger Millon recognized twenty-five years ago.[166] His observation remains. As a result, progressive proposals for public company reform have failed to cure corporate law's disregard of communitarian rationality.[167] Having failed to question whether the *purpose* of a business corporation is profit, but rather only having raised some concern about profits for whose benefit, it has reinforced the validity of neoliberal governance.

162. *Id.*

163. *See supra* note 142 and accompanying text.

164. *See* Bainbridge, *Community and Statism*, *supra* note 78, at 890–900 (arguing that the progressive corporate law project is statist and, thereby, incompatible with American culture's ideal of free, voluntary trust and community). This, of course, also is Milton Friedman's argument in his famous 1970 article: that social responsibility should arise out of the free choice of charity, not the normative compulsion of corporate social responsibility. *See* Milton Friedman, *A Friedman Doctrine — The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES (Sept. 13, 1970) [hereinafter Friedman, *A Friedman Doctrine*], https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.

165. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 131–32.

166. *See* Millon, *Communitarianism in Corporate Law*, *supra* note 104, at 13.

167. *See* Bodie, *supra* note 70, at 740 (discussing the shortcomings of progressive theory despite its successes).

IV. ADVANCING THE CRITIQUE: THE HDFC AS A BUSINESS CORPORATION COUNTERING MARKETS

A. Unlocking Function: The Key of the Black and Brown HDFC

As we saw in Section III.B, the progressive critique of public company governance leaves us to imagine that all corporations serve a monetary function. For it invites us to question to whom corporate profit should go, but it does not question whether the point of a corporation is profit. The HDFC comes in to pick up where progressive corporate law leaves off, providing a different answer. For like the public company, the HDFC is incorporated as a business corporation; New York's business corporation law, and the whole standard corporate drama involving derivative suits and shareholder inspection and proxy contests, fully apply to it.[168] And the HDFC operates its business in a competitive and cutthroat market: New York City's hypercommodified real estate market.[169] But serving as a vehicle for stability countering the real estate market,[170] it rejects the public company's understanding of corporate function and posits that at least some business corporations exist for reasons other than profit.

A closer examination of the HDFC allows this duality to become clearer. In an HDFC, tenants invest to own shares in a corporation owning and operating a residential apartment building as housing for low-income individuals.[171] Even though HDFCs, when formed as business corporations, are still subject to the "non-distribution constraint" typical of nonprofits,[172]

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168. *See* N.Y. PRIV. HOUS. FIN. LAW § 573(1) (McKinney 2021); Valyrakis v. 346 W. 48th St. Hous. Dev. Fund Corp., 76 N.Y.S.3d 523, 527 (App. Div. 2018) (determining shareholder tenant's complaints under the derivative litigation demand standard and business judgment rule); Santiesteban v. 94–102 Hamilton Place H.D.F.C., No. 11736/09, 2009 N.Y. Misc. LEXIS 6446, at *13–14 (Sup. Ct. Nov. 18, 2009) (granting HDFC shareholder right to access records under business corporation law and common law).

169. *See* sources cited *supra* note 29.

170. *See* Greg Olear, *A Look at HDFCs: Understanding Housing Development Fund Corporation Co-Ops*, N.Y. COOPERATOR, (Sept. 2017), https://cooperator.com/article/a-look-at-hdfcs/full ("'One of the things that is beautiful about HDFC co-ops is that the people who lived in the distressed, neglected, and abandoned buildings in the neighborhoods in the '70s and '80s where these HDFCs were first created are still there now,' says Rachel Christmas Derrick, director of communications and fundraising for [Urban Housing Assistance Board]. 'Though sadly, many of their neighbors in rentals are being displaced by gentrification. So that many of these people — particularly in Harlem and Brooklyn neighborhoods — are still the primarily black and Latino residents who lived there in the beginning. And they can now enjoy the positive aspects of the neighborhoods that they fought so long and hard to improve.'").

171. *See* N.Y. PRIV. HOUS. FIN. LAW §§ 571, 573.

172. *See id.* § 573(3) ("3. The certificate of incorporation of any such corporation shall, in addition to any other requirements of law, provide: . . . b. that all income and

their shareholders benefit from owning shares worth hundreds of thousands of dollars in gentrifying real estate markets.[173] HDFCs also offer standard tax-law benefits such as mortgage interest deduction.[174] And since HDFCs have to pay New York City property taxes, albeit reduced ones — one reason why HDFCs came to own buildings was that the government could generate tax revenue[175] — shareholders often benefit from an effectively run, solvent business. This is especially the case in New York City, where building owners behind on property taxes face divestment under a Third Party Transfer Program ("TPT") discussed further below.[176]

But there is a different rationality at operation. At the level of investment, we can observe another type of logic. Buying into a housing cooperative is a business decision — it is a tenant's perennial interest to obtain the most affordable, stable, and secure housing.[177] But buying into a housing

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earnings of the corporation shall be used exclusively for corporate purposes, and that no part of the net income or net earnings of the corporation shall inure to the benefit or profit of any private individual, firm, corporation or association."); James J. Fishman, *The Development of Nonprofit Corporation Law and An Agenda for Reform*, 34 EMORY L.J. 617, 663 (1985) (noting the "non-distribution constraint" in the HDFC statute).

173. *See* Emily Nonko, *New York City's Affordable HDFC Co-Op Explained*, CURBED N.Y. (Mar. 25, 2020, 8:56 AM), https://ny.curbed.com/2020/3/25/21192807/hdfc-new-york-income-based-housing ("[O]riginally, the apartments were sold to residents for a mere $250. For years the units were resold for moderate amounts, but the past decade or so has brought super-gentrification to some of the neighborhoods in which HDFCs are plentiful. Resale listings have popped up for as much as $1 million (though that high of an asking price is rare), and buyers have increasingly made all-cash offers. As a result, prices have trended up for HDFC coop housing in recent years and made many out of reach for low-income New Yorkers . . . . The modern-day HDFC buyer tends to be one with a lower income but significant assets: retirees, young buyers with financial assistance from parents, and those with trust funds or an inheritance."); Memorandum from Geoffrey Propheter, N.Y. Indep. Budget Off., on Cost Estimates for Alternative Tax Exemptions for Some HDFC Coops to George Sweeting, N.Y. Indep. Budget Off., 8–9 (Dec. 3, 2015), https://ibo.nyc.ny.us/iboreports/estimating-cost-of-full-tax-exemption-for-hdfc-coop-buildings.pdf (stating that New York City-wide median sales price for HDFC cooperative units from 2010 through 2015 had been $270,200, with median prices in strong markets such as mid-and-lower Manhattan and downtown Brooklyn and Williamsburg/Greenpoint being $360,000); Michelle Higgins, *Bargains With a "But,"* N.Y. TIMES (June 27, 2014), https://www.nytimes.com/2014/06/29/realestate/affordable-new-york-apartments-with-a-catch.html.

174. *Cf.* United Hous. Found. Inc. v. Forman, 421 U.S. 837, 846, 853–54 (1975) (highlighting the income-boosting benefits of co-ops, including the tax benefits, which raised a question as to whether shares in the co-op were securities).

175. *See* Olear, *supra* note 170 (referring to statement from Gregory Baggett, executive director of the New York Council for Housing Development Fund Companies ("NYC HDFC"), that a significant number of abandoned properties mainly "[w]ent to private real estate developers," nonprofit entities, and building residents — which served as the basis for the formation of the HDFC — thus increasing the city's tax revenues).

176. *See infra* note 251 and accompanying text.

177. *Cf. United Hous. Found.*, 421 U.S. at 841 (listing the benefits afforded to tenants

cooperative is not the same type of business decision as that made by an investor, or a money manager on her behalf, in the stock market. For the individual buying into an HDFC spends money or gives other consideration to buy a home that will remain more affordable than one she can rent on the open market.[178] By contrast, the person buying into a publicly traded company generally does not care about the specifics (if she even knows them); all she cares about is money.[179] The same point can be made by saying that with HDFC investors, their bottom-line is affordable housing. But this benefit is one that they cannot obtain unless they pool resources with trustworthy individuals sharing these social values.

Historicizing the HDFC highlights its communitarian function. As best captured in Jacqueline Leavitt and Susan Saegert's study *From Abandonment to Hope: Community-Households in Harlem*,[180] studying the formation of HDFCs in Harlem, and Malve von Hassell's *Homesteading in New York City, 1978–1993: The Divided Heart of Loisaida*,[181] studying the same in Manhattan's Lower East Side, HDFCs arose as a response to landlord "economically rational" neglect and abandonment, a gradual de-housing in New York City from the late 1960s to the early 1980s.[182] Confronted with the choice of being gentrified out, staying put in such dilapidation, or leaving, "many tenants stayed in their communities, some seizing the opportunity of landlord disinvestment to take control of their own housing . . . ."[183] Specifically, neglected tenants availed themselves of government programs to preserve their homes and rebuilt abandoned communities by assuming the status of resident owner.[184] By doing so, they thwarted the ostensible goal of widespread neglect: to use "planned

who purchase shares in the co-op).

178. *See id*. at 853–54.

179. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 122–23.

180. JACQUELINE LEAVITT & SUSAN SAEGERT, FROM ABANDONMENT TO HOPE: COMMUNITY-HOUSEHOLDS IN HARLEM (1990).

181. MALVE VON HASSELL, HOMESTEADING IN NEW YORK CITY, 1978–1993: THE DIVIDED HEART OF LOISAIDA (1999).

182. *See* LEAVITT & SAEGERT *supra* note 180, at 3–4; *see also* David Reiss, *Housing Abandonment and New York City's Response*, 22 N.Y.U. REV. L. & SOC. CHANGE 783, 787–89 (1997) (outlining how inflation, heightened housing costs, and declining public assistance payments have contributed to New York City's abandonment crisis); Andrea McArdle, *[Re]Integrating Community Space: The Legal and Social Meanings of Reclaiming Abandoned Space in New York's Lower East Side*, 2 SAVANNAH L. REV. 247, 249–54, 257–59 (2015) (describing abandonment and enterprising residents' reinvestment in deteriorating neighborhoods through their own labor, which is known as urban homesteading).

183. LEAVITT & SAEGERT, *supr*a note 180, at 5.

184. *See* VON HASSELL, *supra* note 181, at 2; McArdle, *supra* note 182, at 247–54, 257–58.

shrinkage" as a way of razing low-income communities and transforming them into luxury housing by skirting slum clearance or eminent domain.[185]

Under such government programs, New York City, default owner of properties abandoned by capital, transferred its ownership title to HDFC corporations, also to divest itself of responsibility for such properties.[186] These entities were formed by tenants who had already been working collectively to oppose their marginalization through rent-strikes and Article 7A proceedings to compel repairs; indeed, their collective actions often induced capital to abandon the properties.[187] These collaborating tenants then became shareholders of a real-estate company by paying as little as $250.[188] As part of their transformation into shareholders, the tenants also contributed labor — or "sweat equity" as it is often termed[189] — by participating in the rehabilitation of housing.[190] Overall, the "sweat-equity" urban homesteading "was a community-based response to the shortage of affordable housing for the working poor:"[191] that is, a rational response to a market failure.

In sum, tenants, overwhelmingly low-income households of color headed by women,[192] ironically *went corporate* — that is, formed corporations and became shareholders by investing a month of rent and years of labor[193] — to protect themselves from markets. And from the description, we can see that rationality spurring this investment is fundamentally communitarian: it conceives of incorporation as a collective action for self-protection against market forces.[194] Most tenants who bought shares in HDFCs invested in

185. *See* VON HASSELL, *supra* note 181, at 54.

186. *See* LEAVITT & SAEGERT, *supra* note 180, at 3; Reiss, *supra* note 182, at 787–89 (describing efforts by the New York City Council to alleviate the abandonment crisis through tax initiatives and the establishment of the Department of Housing Preservation and Development).

187. *See* LEAVITT & SAEGERT, *supra* note 180, at 84–87; *see also* Nonko, *supra* note 173.

188. *See* LEAVITT & SAEGERT, *supra* note 180, at 7.

189. *See* McArdle, *supra* note 182, at 253.

190. *See* VON HASSELL, *supra* note 181, at 80–81.

191. VON HASSELL, *supra* note 181, at 1.

192. VON HASSELL, *supra* note 181, at 65 (stating that the Lower East Side homesteaders were overwhelmingly Puerto Rican and had lower incomes than others); LEAVITT & SAEGERT, *supra* note 180, at 25–30 (describing how homesteading households were overwhelmingly Black or Hispanic and headed by women).

193. *See* VON HASSELL, *supra* note 181, at 2.

194. *See* Peter Marcuse, *Abandonment, Gentrification, and Displacement: The Linkages in New York City*, *in* GENTRIFICATION OF THE CITY 172–73 (Neil Smith & Peter Williams eds., 1986).

corporations owning worthless, abandoned buildings.[195] They did this to secure place in a community by attaining a status to which the law accords real power: that of a property owner. And in operating their corporation, they sought civic and community-minded investors whom they trusted, not just individuals who would infuse cash despite the desperate need for such funds. The following passage from Leavitt and Saegert's study captures the nub of this rationality:

> Tenants placed great emphasis on filling vacancies [in HDFCs] with people who would be active and have skills. The one vacancy that occurred after co-opting was filled with John Paynes and his wife, Martha. Paynes, who had some experience with housing organizations and city agencies, became the bookkeeper for the tenants' association. The women on the board were trying to help the wife set up a day-care center to bring in income for the building. A beautification club to do painting and cleaning was formed and involved many of the young people. Here, we see the extension of domestic activities from the individual household to the building.[196]

As we have hopefully come to appreciate during these continuing days of Reconstruction,[197] this rationality has roots in civil rights protests. It is that which seeks empowerment through collective strength, evocative of Malcolm X's description of the business aspect of Black nationalism most forcefully described in his April 1964 speech, "The Ballot or the Bullet."[198] The relevant portion must be quoted at length here:

> The economic philosophy of black nationalism is pure and simple. It only means that we should control the economy of our community. Why should white people be running all the stores in our community? Why should white people be running all the banks of our community? Why should the economy of our community be in the hands of a white man? Why? If a black man can't move his store into a white community, you tell me why a white man should move his store into a black community. The philosophy of black nationalism involves a re-education program in the black community in regards to economics. Our people have to be

195. *See generally* LEAVITT & SAEGERT, *supra* note 180 (exposing typical conditions tenants faced after the deterioration of their buildings); Marcuse, *supra* note 194 (remarking on the general state of disrepair of the buildings that were abandoned in New York City).

196. LEAVITT & SAEGERT, *supra* note 180, at 43.

197. *See* Alexander Manevitz, *The Failures of Reconstruction Have Never Been More Evident — Or Relevant — Than Today*, WASH. POST (June 11, 2020, 6:00 AM), https://www.washingtonpost.com/outlook/2020/06/11/failures-reconstruction-have-never-been-more-evident-or-relevant-than-today/.

198. Malcolm X, The Ballot or the Bullet Speech (Apr. 3, 1964), *in* MALCOLM X SPEAKS: SELECTED SPEECHES AND STATEMENTS 38–39 (George Breitman ed., 1989).

> made to see that any time you take your dollar out of your community, and spend it in a community where you don't live, the community where you live will get poorer and poorer, and the community where you spend your money will get richer and richer. Then you wonder why where you live is always a ghetto or a slum area. And where you and I are concerned, not only do we lose it when we spend it out of the community, but the white man has got all our stores in the community tied up; so that though we spend it in the community, at sundown the man who runs the store stakes it over across town somewhere. He's got us in a vise. So the economic philosophy of black nationalism means in every church, in every civic organization, in every fraternal order, it's time now for our people to become conscious of the importance of controlling the economy of our community. If we own the stores, if we operate the businesses, if we try and establish some industry in our own community, then we're developing to the position where we are creating employment for our own kind. Once you gain control of the economy of your own community, then you don't have to picket and boycott and beg some [white person] downtown for a job in his business.[199]

In a word, the HDFC's genius is to combine the public company investor and the labor stakeholder into one role: the shareholder. For it reflects a conception of business purpose and economic rationality that is the American tradition of independence and concomitant power,[200] at the heart of investment. But it contains a view of power which more recently has been observed among people of color: one centered on inalienable, nonmonetizable power, and the power of individuals in a space and within a community, rather than that which can be liquidated and traded.[201] In terms

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199. *Id.*

200. As Aziz Rana details throughout TWO FACES OF AMERICAN FREEDOM (2010), economic independence has traditionally, for white Americans, been regarded as essential to the concept of free, republican citizenship foundational to our political order. *See generally* AZIZ RANA, TWO FACES OF AMERICAN FREEDOM (2010) (detailing the connection between liberty and power in the United States). See, for example, page 12:

> As a consequence, American settlerism was organized around four basic components. First, in radicalizing those seventeenth-century republican ideas that were increasingly prevalent in England, settlers came to view economic independence as the ethnical basis of free citizenship. Centuries of Americans saw control over the instruments and conditions of work as providing insiders with a collective experience in autonomy and moral independence.

Id. at 12.

201. *See, e.g.*, Thomas Boston, *The Role of Black-Owned Businesses in Black Community Development*, *in* JOBS AND ECONOMIC DEVELOPMENT IN MINORITY COMMUNITIES 161–63 (Paul M. Ong & Anastasia Loukaitou-Sideris eds., 2006) (citing studies that eighty percent of Black entrepreneurs surveyed in 2003 stated that the reason for starting their own business was the desire to exercise more control over their destiny and that Black-owned firms create more employment for Blacks than white-owned ones); MELVIN DELGADO, LATIN SMALL BUSINESS AND THE AMERICAN DREAM 94–95 (2011)

of progressive corporate law framework discussed above,[202] this is a rationality rejecting the loose bonds of self-interest limited solely by contract for thicker, more personal bonds.

Most significant to the argument here, the communitarian business corporation of the HDFC has been very successful as a counter-market strategy. As discussed above, during the 1970s and 1980s, the formation of HDFCs allowed Black and Brown households to preserve themselves against the attempt to displace and gentrify through abandonment.[203] In today's hypercommodified market[204] in the global capital of real estate and financialization,[205] HDFCs endurance as affordable housing for families of color has allowed them to remain in gentrifying neighborhoods.[206] It is for this reason that, despite the remarkable return on investment HDFC share ownership presents, HDFC shareholders have not sold in bulk.[207] Lest we imagine this success as inevitable due to the advantage of nonexistent start-up costs, the plight of similarly situated tenant enterprises in Detroit, for example, cautions otherwise.[208] Indeed, the lesson from Detroit[209] is that New York City HDFCs succeeded where others failed because their Black and Brown economic rationality was a business model perfectly adapted to its particular market.[210]

B. The Plight of Black and Brown HDFCs Within the Neoliberal Paradigm

Put in terms of the progressive critique discussed above in Section III.A,

("[Latino] [s]mall business owners are like homeowners. They're committed to the neighborhood; they're a committed citizenry. The hope is that entrepreneurship brings more civic engagement by immigrants. That they'll have their voices heard more. That they'll be anchors, developing roots in the community, and serve as role models.").

202. *See supra* Section III.A.

203. *See* Marcuse, *supra* note 194, at 172–73.

204. *See* sources cited *supra* note 29 and accompanying text.

205. *See* sources cited *supra* note 29 and accompanying text.

206. *See* Olear, *supra* note 170 (quoting Rachel Christmas Derrick, Director of Communications and Fundraising, UHAB) ("One of the things that is beautiful about HDFC co-ops is that the people who lived in the distressed, neglected, and abandoned buildings . . . in the '70s and '80s . . . are still there now . . . . Though sadly, many of their neighbors in rentals are being displaced by gentrification.").

207. *See id*.

208. *See generally* David Goldberg, *From Landless to Landlords: Black Power, Black Capitalism, and the Co-Optation of Detroit's Tenants Rights Movement, 1964–69*, *in* THE BUSINESS OF BLACK POWER (Lauren Warren Hill and Julia Rabig eds., 2012) (describing the failure of Black United Tenants for Collective Action to convert collective action of rent-strike into a sustainable homeownership model due to the lack of resources).

209. *Id*. at 158.

210. *See id.* at 163.

the HDFC is the thickest type of business corporation. It is formed under an economic rationality reflecting oppressed people's desire to counter market force through collective strength. Put another way, it suggests that the viewpoint asserted in the Delaware Chancery Court decision in *eBay Domestic Holdings v. Newmark*[211] is flat out wrong: the "philanthropic" end of aiding communities is the very reason why some people form a for-profit, *business* corporation.[212] They do so because the status of shareholder, and the rights attendant to do, are rights that a white man is bound to respect.[213]

The U.S. Supreme Court's decision in *United Housing Foundation, Inc. v. Forman*[214] reflects the distinction between this rationality, characteristic of HDFC shareholders, and that characteristic of public company investors. Reversing the Second Circuit, the Court held shares of a tenant cooperative to be exempt from the Securities Act of 1933.[215] The Court reasoned that the Securities Act, regulating the purchase and sale of investment shares, did not apply to a person investing for a home rather than money.[216] Of course, the home is an asset that has monetary value: this is the point that the plaintiffs in the case relied on for the textualist argument that the Securities Act's definition of a "security" should capture cooperative shares.[217] It is also the point informing the Second Circuit's reasoning that the lower housing cost and tax benefits derived from owning shares in a cooperative involves money, and, therefore, qualifies such shares as "securities" under the Securities Act's definition.[218] As the Second Circuit correctly reasoned, people buy into low-income cooperatives because it is cheaper than renting.[219] But the Court in *Forman* emphasizes that a cooperative is a sort of business where the value of a home as an asset is incidental to its value as a home; with it, the social value is absolute.[220] In stark contrast, it is

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211. 16 A.3d 1 (2010).

212. *See infra* note 252. *But see eBay Domestic Holdings*, 16 A.3d at 34 ("The corporate form . . . is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment.").

213. *Cf.* Civil Rights Act of 1866, 42 U.S.C. §§ 1981, 1982 (codifying and enforcing equal rights in contract and property).

214. 421 U.S. 837 (1975).

215. *Id.* at 847.

216. *Id.* at 848.

217. *See id.* (rejecting respondents' literal interpretation that because the statute defining securities uses the language "any . . . stock" that respondents' shares in the cooperative should fall within it).

218. *Id.* at 846–47, 854–56.

219. *See id*. at 855.

220. *See id*. at 851, 853–54 (emphasizing that co-ops are affordable and provide an opportunity for home ownership).

unimaginable that any capitalist would invest in a company lacking equity, and lacking any path to equity. Indeed, public markets do not even have a place for unprofitable companies.[221]

Yet for this clear difference, public company governance doctrines are applied wholesale to HDFCs. Courts continue to treat shareholders as "passive investors" yielding total control to boards of directors. In twenty-five years, New York's highest court — the Court of Appeals — has twice affirmed that the BJR governs decisions of tenant cooperatives such as HDFCs.[222] In both cases, the Court of Appeals courts invoked the distinction between "ownership" and "control"[223] to reject a standard requiring boards to show reasonableness justifying their decisions and, by that, deny shareholders substantive review of matters affecting their homes. The Court of Appeals has done this even though such shareholders have a stronger interest in controlling internal corporate affairs than their investment counterparts: the interest in preserving their homes.[224] Even worse, the Court of Appeals in its landmark *Levandusky v. One Fifth Avenue Apt. Corp.*[225] decision rather fancifully interprets shareholders' investment as the purchase of stake in a community where living decisions are through common, centralized control.[226] As if that stake, and not the quest for stable, affordable housing in a hypercommodified real estate market, was the dominant consideration of the typical cooperative investor.

The reasoning underlying the standard BJR simply does not apply to companies like tenant cooperatives, where the board are volunteers[227] typically drawn from the pool of resident shareholders: the *Levandusky* court recognized that much.[228] As such, and in contrast to management of public

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221. *See* NYSE, COMPANY LISTING MANUAL § 802.01 (2016), https://nyse.wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-167 (stating that companies where shareholders' equity is less than $50,000,000 may be suspended from dealings or removed from the list).

222. *See* 40 W. 67th St. v. Pullman, 790 N.E.2d 1174, 1176, 1182 (N.Y. 2003); Levandusky v. One Fifth Ave. Apt. Corp., 553 N.E.2d 1317, 1324 (N.Y. 1990).

223. *See 40 W. 67th St.*, 790 N.E.2d at 1178–79; *Levandusky*, 553 N.E.2d at 1320–21.

224. The *Levandusky* court based its reasoning, in part, on the fact that shareholders have the freedom not to purchase the apartment, the common argument in all disputes about whether corporations treat shareholders any which way they desire. *See supra* Part II, notes 77–83 and accompanying text.

225. 553 N.E.2d 1317 (1990).

226. *See id.* at 1320–21.

227. *See* N.Y.C. DEP'T OF HOUS. PRES. AND DEV., FACT SHEET FOR COOPERATIVE HDFC SHAREHOLDERS 2 (2019) [hereinafter HPD FACT SHEET], https://www1.nyc.gov/assets/hpd/downloads/pdfs/services/hdfc-coop-fact-sheet.pdf (providing that under New York law, HDFC directors are volunteers).

228. *See Levandusky*, 553 N.E.2d at 1320–21.

companies,[229] the board managing a cooperative are typically no more sophisticated or expert in the business of owning and running property than any resident.[230] Thus, there is no reason to suppose shareholders rising to the rank of board members are any more sophisticated or incorruptible than their neighbors. And to the extent that they ever develop "enterprise," it is acquired by serving as board members — the patina of longevity or experience, as it were.

Despite this, decisions of tenant cooperative boards are subject to no special review different to that for public companies. Nor are board members' similarly situated neighbors afforded any meaningful power to scrutinize decisions. Still worse, the BJR serves to create conditions for board entrenchment, from which corruption hails, by giving an advantage to incumbents in power.[231] The next Section elaborates the corrupting and oppressive function of neoliberal governance on corporations like HDFCs.

C. The Harm of Universalizing Neoliberal Governance: A Case Study

The corrosive impact of the current governance paradigm, and especially the BJR, on counter-market business corporations is best illustrated by a case. A few years ago, I represented a group of shareholders residing at Lindsay Park Housing Corporation, the largest Mitchell-Lama housing cooperative in Brooklyn.[232] Like an HDFC, a Mitchell-Lama housing cooperative is a business corporation serving to counter the function of markets. It is formed and owned by low-to-middle income Black and Brown households, or the same segment of the population as HDFC investors, whose created entity also owns and operates an affordable, middle-income housing project.[233] For our purposes here, the only difference between an

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229. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 559, (explaining that formal power rests with the board of directors rather than the shareholders of a publicly traded company).

230. *See* SYLVIA SHAPIRO, THE NEW YORK CO-OP BIBLE: EVERYTHING YOU NEED TO KNOW ABOUT CO-OPS AND CONDOS: GETTING IN, STAYING IN, SURVIVING, THRIVING 172 (rev. ed. 2005) (comparing the director elections process for public companies with the process for co-ops and condos, noting that directors of public corporations are subject "to the glare of public scrutiny," whereas management for co-ops and condos is "not subject to any such competency checks").

231. *See id.* at 172–73.

232. Adele Niederman, *Lindsay Park Celebrates 50th Anniversary!*, COOPERATORS UNITED FOR MITCHELL LAMA (Sept. 16, 2015), https://cu4ml.com/lindsay-park-celebrates-50th-anniversary.

233. *See* Julie Gilgoff, Note, *Local Responses to Today's Housing Crisis: Permanently Affordable Housing Models*, 20 CUNY L. REV. 587, 598–600 (2017); Camille Rosca, Comment, *From Affordable to Profitable: The Privatization of Mitchell-Lama Housing & How the New York Court of Appeals Got It Wrong*, 45 SETON HALL L. REV. 945, 951–54 (2015); *cf.* LEAVITT & SAEGERT, *supra* note 180, at 25–30 (noting that

HDFC and Mitchell-Lama is historical, as Mitchell-Lama housing arose in the robust real estate market following World War II and out of recognition that government intervention was needed to stimulate the private sector's construction of affordable housing.[234]

Continuing with the story, the Lindsay Park shareholders organized a campaign to call a special meeting for amending Lindsay Park's bylaws to prohibit the use of proxies in board elections.[235] The point of this was to further the corporation's purpose and preserve the affordable housing through corporate governance: namely, by bringing accountability to an entrenched board led by a corrupt president who, as a former educator, had no especial expertise in housing. Indeed, reflecting this apparent incompetence, she was doing a rather poor job: for reasons that will become clear shortly, her decade-long reign as board president saw significant increases in maintenance costs, serving to nullify many long-term residents' investment in affordable housing.[236]

The shareholders' reform campaign sought to address the riddle of how a disastrous board president nonetheless managed to be so consistently and overwhelmingly re-elected.[237] The proxy system at Lindsay Park conduced a vicious cycle where the board president's reign was perpetuated by proxy votes. She in turn was widely accused of sanctioning under-the-table apartment sales, which violate restrictions governing sales in Mitchell-Lama cooperatives.[238] Information that many shareholders had obtained suggested that she did this in exchange for, at least, the incoming shareholders' pledge of their proxy to her; and with these proxies, she re-elected herself and surrounded herself with a board beholden unto servility.[239] With each such

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homesteading households were Black and Hispanic-dominated).

234. *See* Robert W. Snyder, *Lower Rents: A History Lesson*, N.Y. DAILY NEWS (Jul. 13, 2018, 5:00 AM), https://www.nydailynews.com/opinion/ny-oped-historys-lesons-for-slowing-rent-hikes-20180712-story.html (discussing the passage of the Mitchell-Lama Act). *Compare* N.Y. PRIV. HOUS. FIN. LAW § 11 (McKinney 2021) (supporting Mitchell-Lama's recognizing need for private enterprise to be incentivized to build low-income housing), *with id.* § 571 (supporting HDFCs and recognizing the need for coordination among federal, state, and local governments and private actors to increase the supply of housing for low-income persons, improving quality of life in state).

235. *See* Complaint for Declaratory and Injunctive Relief at 2, 9, Gonzalez v. Been, Index No. 653242/2014 (N.Y. Sup. Ct. Oct. 23, 2014) (NYSCEF Doc. No. 1) [hereinafter Complaint].

236. *See id.* at 2.

237. *See id.* at 12–14 (describing the process by which the board president allegedly obtained votes and proxy votes and noting that in 2013, despite only 350 shareholders voting by live ballot, the incumbent president received 1,275 votes).

238. *See* RULES OF THE CITY OF N.Y. tit. 28, § 3-02(h)(13) (2021) (stating selections for next person to rent from apartment must be drawn from waiting list).

239. *See* Complaint, *supra* note 235, at 13–14.

campaign cycle, she obtained even more proxies to secure deeper entrenchment.

When the shareholder campaign had succeeded in collecting enough shareholder signatures to support a petition, the board made the wholly predictable move that absolute power does: it invented a "signature verification" procedure that just so happened to nullify enough votes to bring the tally below the threshold for triggering a special meeting.[240] Undeterred, shareholders commenced a lawsuit challenging this obvious abuse of power and attempt to evade accountability, loading their complaint with the entire gestalt, including clear evidence of the president's flagrant corruption.[241] The trial court, presided over by a justice raised in Black, home-owning Queens, immediately got it.[242] She denied the Lindsay Park's summary judgment motion on the BJR and ordered discovery on the board's invented review procedure.[243] Yet when the cooperative appealed, an appellate court panel, constituted differently, reversed the trial court by perfunctorily applying the BJR to uphold the board gambit,[244] insulating it from meaningful scrutiny.

But the story did not end there. About a year after the BJR served to leave shareholders disenfranchised and end their attempt at salutary governance, the board president was arrested and eventually convicted for participating in a commercial bribery scheme.[245] The scheme specifically involved her, and the two heads of the management team that the board hired and paid, receiving a kickback from a corporate vendor who overcharged the company for repairs.[246] Naturally, this cost was recouped from tenants in the form of the very maintenance increases that reformers cited as part of the corruption they sought to deter with accountability.[247] The kickback scheme contributed to inflated repair costs reflected in Lindsay Park's financial records.[248]

240. *See id.* at 11–12.

241. *See id*. at 13–15.

242. Gonzalez v. Been, No. 653242/14, 2015 WL 3961752, at *1 (N.Y. Sup. Ct. June 30, 2015).

243. *Id.*

244. *See* Gonzalez v. Been, 41 N.Y.S.3d 700, 701 (App. Div. 2016) (reversing trial court).

245. Benjamin Fang, *Former Lindsay Park Co-Op President Sentenced for Corruption*, GREENPOINT STAR (Jan. 30, 2018), http://www.greenpointstar.com/view/full_story/27537861/article-Former-Lindsay-Park-co-op-president-sentenced-for-corruption.

246. *Id.*

247. *See id.*

248. *Id.*

This Lindsay Park episode is an account of how neoliberal governance doctrines cost investors in business corporations such as HDFCs the very benefit of their investment. But, sadly, the problem is evident even in more mundane contexts, without this anfractuous criminality. For example, I have also represented shareholders at two other low-income housing cooperatives in Brooklyn — these both HDFCs — where directors who did not even reside at the cooperative[249] jeopardized its very existence by failing to pay water and tax bills.[250] Based on the broader social context, it was clear that their malfeasance was really a ploy seeking to force out older residents to sell units to wealthier gentrifiers and, thereby, turn a profit. In New York City, this gambit carries a tremendous risk to everyone since the government has the authority, under the TPT, to foreclose upon properties owing taxes and utilities and transfer property title to private or nonprofit corporations.[251] But even when the board creates a problem, neoliberal governance doctrines protect them in pursuing "solutions" that harm investors. For example, the BJR has been applied to protect boards in taking out loans causing maintenance increases beyond levels affordable to elderly residents instead of taking government assistance that would solve the problem in a manner more consistent with the corporation's purpose.[252]

In sum, neoliberal governance rules defeat even the thickest conception of

249. Generally, shareholders and directors are required to reside at the cooperative. *See* HPD FACT SHEET, *supra* note 227, at 2.

250. *See* Complaint for Declaratory and Injunctive Relief and Damages at 8, Coronel v. 350–52 South 4 Street Hous. Dev. Fund Corp., Index No. 8083/2014 (N.Y. Sup. Ct. May 21, 2014) (NYSCEF Doc. No. 14).

251. For the legal authority of the Third Party Transfer Program ("TPT"), see RULES OF THE CITY OF N.Y. tit. 28, § 8-01 (2021) (enacted pursuant to N.Y.C. ADMIN. CODE tit. 11, § 11-401 (2021)). It is the corollary of government policy, discussed above in Olear, leading to the transfer of abandoned property to HDFCs. As we might expect, TPT operates to disproportionately divest Black and Brown homeowners, and as such, are disproportionately affected by such divestment. *See* Claudia Irizzary Aponte, *Brooklyn Foreclosures Must Stick, City Lawyers Argue*, THE CITY (May 2, 2019, 4:00 AM), https://thecity.nyc/2019/05/brooklyn-third-party-transfer-foreclosures-must-stick-city.html; Claudia Irizzary Aponte, *City Task Force to Take Fresh Look at Feared Foreclosure Program*, THE CITY (June 14, 2019, 2:57 PM), https://thecity.nyc/2019/06/city-task-force-to-take-fresh-look-at-foreclosure-program.html.

252. *See generally* Cannings v. E. Midtown Plaza Hous. Co., No. 401071/10, 2011 WL 5142033 (Sup. Ct. N.Y. Cnty. Oct. 18, 2011), *aff'd*, 960 N.Y.S.2d 413 (App. Div. 2013) (upholding board decision to take out loan to obtain repairs even though funding for repairs was obtainable through a public, government grant conditioning funds on extending affordability requirements). An unstated premise is that boards can avoid the condition of much government assistance — that the HDFC agrees to enter into a regulatory agreement with the government in exchange for assistance. However, since the regulatory agreement would preserve affordability by the imposition of flip taxes and government oversight, it is still more consistent with corporate purpose than the alternative of market financing. *See* N.Y. PRIV. HOUS. FIN. LAW § 576 (McKinney 2021).

a corporation that has been effective in countering markets. But unlike with public companies, the standard recourse — which assumes liquidity — is meaningless to shareholding tenants seeking to defend their corporation as a society. Selling shares costs them an affordable home, the very thing that they invested for.[253] Yet neoliberal governance leaves them helpless in a society diluted by irresponsible boards, until the market tide eventually washes them out.

V. THE CURRENT PROGRESSIVE REFORM STRUCTURES FOR PRIVATE COMPANIES AND THEIR LIMITS

The discussion of neoliberal governance's effect on HDFC rationality raises the question of what corporate governance structure is most appropriate for it. Before turning to this Article's proposals, we examine progressive scholarship's ideas on governance reform of private companies, not the public ones on which progressive corporate law focuses.

As an overview, aside from the constituency statute,[254] these progressive private company reforms have been placed under the rubric of "social enterprise."[255] This term refers to the use of organizations to achieve social goals through business methods.[256] The tendency of scholars has been to regard the progressive solution as one of structures.[257] At the strict level of

253. *See* United Hous. Found. v. Forman, 421 U.S. 837, 846–57 (1975).

254. *See* Roberta Romano, *The States As a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 215 (2006) (counting thirty-one states with other constituent statutes); *see also* Millon, *Redefining Corporate Law*, *supra* note 91, at, 266–68 (setting forth principles of how constituency statutes should be interpreted to accomplish the purposes for which they were enacted).

255. Dana Brakman Reiser, *Theorizing Forms for Social Enterprise,* 62 EMORY L.J. 681, 682 (2013) [hereinafter Reiser, *Theorizing Forms for Social Enterprise*].

256. *See id.* (describing the impact "social enterprises" can have on society compared to profit-generating and nonprofit corporations due to the combination of the business methods found in profit-generating corporations and the social goals found in nonprofits); *see also* Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1352–53 (2011) (describing progressive corporate law as "a collection of proposals aimed at remaking corporate law to encourage processes and outcomes more beneficial to the interests of [stakeholders or] nonshareholders with significant stakes in a corporation's activities" as "the most muscular and structural interaction of [corporate social responsibility]" and contending that the social enterprise movement is connected to corporate social responsibility).

257. *See* Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 255, at 683 (describing how, across the county and around the globe, jurisdictions have begun to respond to the claims that traditional for-profit and nonprofit legal forms frustrate social entrepreneurs' bold vision for achieving social change by offering a variety of specialized legal forms intended to house social enterprises).

corporate law,[258] scholars have promoted the use of two alternative structures as reform: the old, familiar form of nonprofit corporation, and the newer, more obscure form of the public benefit corporation. Both are considered and critiqued below.

A. The Traditional Alternative: The Nonprofit Corporation and Its Limits

American law's longstanding structure for protecting and advancing social and non-monetary enterprise is the nonprofit corporation.[259] Legal scholarship and decisional law have arrived at this view both affirmatively and negatively. The affirmative claim is that the non-distribution constraint governing such entities[260] makes them best suited to provide public goods that the market will not.[261] Put differently, the claim is that they are structured in a manner inspiring more confidence that they can better deliver public goods and services than for-profit entities.[262] The negative view, epitomized by the Delaware Chancery Court's discussion in *eBay Domestic Holdings, Inc. v. Newmark*,[263] assumes that anyone seeking to operate an entity for philanthropic ends should not form it as a for-profit business corporation lest they cheat investors.[264] This leaves the nonprofit, with its hallmark non-distribution constraint, as the default option.[265]

One essential point to clear up, and to explain why an article on business

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258. This Article excludes discussion of limited liability companies ("LLCs"), including the low-profit limited liability company ("L3C"), and the benefit limited liability company. Discussion of LLCs — which are commonly regarded to be more like partnerships — would go beyond the scope of this Article.

259. Fishman, *supra* note 172, at 630–31 ("As early as the seventeenth century the [nonprofit] corporation was used in the New World as an organizational form for charitable activities . . . . Almost all colonial corporations had charitable purposes. They were churches, charities, educational institutions, or municipal corporations . . . . Many of the colonial business corporations would be considered cooperatives or quasi-philanthropic today.").

260. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter Hansmann, *The Role of Nonprofit Enterprise*].

261. *Id.* at 873 (stressing the non-distribution constraint as "the essential characteristic that permits nonprofit organizations to serve effectively as a response to contract failure").

262. *See id.* at 844–45 (arguing that, according to economic theory, lack of profit incentive renders nonprofits more desirable market participants). *But see* Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2452–54 (2009) (describing Google's development of a division within its for-profit entity dedicated to philanthropy as a means of being free to invest in for-profit business pursuing philanthropic goals and avoiding restrictions on that division's ability to access Google resources, and on political activities).

263. 16 A.3d 1 (Del. Ch. 2010).

264. *See id.* at 34.

265. *See* Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 260, at 838.

corporation reform is discussing nonprofit corporations, is the economic nature of nonprofit firms. Many people who work for social services nonprofits suppose the nonprofit's quiddity to be something amounting to "socialism" or "mendicancy."[266] Nothing could be further from the truth. Nonprofits are businesses, rather big and sophisticated businesses, in fact.[267] Many, referred to as "commercial nonprofits" in scholarship, quite explicitly rely on sales revenue to sustain operations for the mission.[268] Along these lines, the law has routinely cautioned that it is a mistake to regard nonprofits as anything other than profit-generating businesses.[269] Indeed, they meet the definition of "social enterprises" precisely because, like business corporations, they use business methods to advance their social missions.[270] The only difference is that, with nonprofits, corporate profits are not supposed to go into the pockets of their owners or other individuals; instead, corporate profits should be applied to further the entity's purpose or mission.[271]

Despite all this, there are two reasons why nonprofits have never served to revolutionize corporate law and change the way that people think about business law generally. First, because nonprofits lack shareholders[272] and are subject to the non-distribution constraint,[273] they cannot offer investors

266. *See* Gail A. Lasprogata & Marya N. Cotten, *Contemplating "Enterprise": The Business and Legal Challenges of Social Entrepreneurship*, 41 AM. BUS. L.J. 67, 87–88 (2003) (noting a primary concern for many social service nonprofit organizations is the disconnect between service and supporting the enterprise as opposed to earning a profit).

267. *See, e.g.*, Henry J. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 54–55 (1981) [hereinafter Hansmann, *The Rationale for Exempting Nonprofit Organizations*] (stating that nonprofit organizations now more commonly resemble the for-profit sector and even compete with for-profit companies in various industries); Lasprogata & Cotten, *supra* note 266, at 67 (providing that the economic impact of nonprofit organizations amounts to $700 billion annually and over $1 trillion in assets); Felix Salmon, *Introducing the Slate 90: A Dive into the Multibillion-Dollar Nonprofit Sector*, SLATE (May 10, 2018, 5:50 AM), https://slate.com/business/2018/05/nonprofits-need-more-scrutiny-enter-the-slate-90.html.

268. *See* Robert A. Katz & Antony Page, *Sustainable Business,* 62 EMORY L.J. 851, 855 (2013) (quoting Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 260, at 840–41).

269. *See* Am. Baptist Churches of Metro. N.Y. v. Galloway, 710 N.Y.S.2d 12, 14–15 (App. Div. 2000).

270. *See id.* at 15 ("Just as the goal of a for-profit corporation is to make money for its investors, the goal of a not-for-profit is to make money that can be spent on furthering its social welfare objectives.").

271. *See id.*; Fishman, *supra* note 172, at 630–31.

272. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 501 (McKinney 2021) (prohibiting nonprofits from issuing equity).

273. *Id.* §§ 102(a)(5), 204.

anything but tax deductions[274] or, in some cases, tax credits as part of an affordable housing project.[275] Their main "investors" are: (1) their individual members paying dues, which also includes members of the limited nonprofit, tax-exempt entities that are permitted to distribute profits to such members;[276] (2) governments that pay nonprofit corporations to exercise public welfare functions;[277] or (3) private persons, and the pools of their wealth known as foundations, who may wish to support the business of charity.[278] As mentioned before, nonprofits can also obtain income from sales revenue and other commercial activities,[279] but that is not investment.[280] Outside of the affordable housing venture, nonprofits fail to attract folks looking to invest capital or anything else counting as consideration under the law.[281] As a result of this, they are not thought to be relevant to discussions about how business law can be reformed to advance nonmonetary

274. *See* VICTORIA B. BJORKLUND ET AL., NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS § 20.01 (2d ed. 2013) (discussing restrictions on nonprofits related to charitable contributions).

275. *See* Megan J. Ballard, *Profiting from Poverty: The Competition Between For-Profit and Nonprofit Developers for Low-Income Housing Tax Credits*, 55 HASTINGS L.J. 211, 233 (2003) (citing I.R.C. § 501(c)(3)) ("The Internal Revenue Code prohibits the payment of profits from a tax-exempt charity to shareholders, members, or individuals.").

276. *See* BJORKLUND ET AL., *supra* note 274, § 1.02 n.8 ("There are some specialized New York nonprofit corporations to which the nondistribution constraint [under I.R.C. 501I(3) and Treas. Res. 1.501(c)(3)] does not strictly apply. These include cooperative corporations and public housing finance corporations."). I note here that this exception includes the tenant cooperatives discussed in Part IV above.

277. *See* Elizabeth T. Boris & C. Eugene Steuerle, *Scope and Dimension of the Nonprofit Sector*, *in* THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK 74–75 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006) (discussing government funding of nonprofits).

278. *See* BETSY SCHMIDT, NONPROFIT LAW: THE LIFE CYCLE OF A CHARITABLE ORGANIZATION 255 (2011).

279. *See* Hansmann, *The Rationale for Exempting Nonprofit Organizations*, *supra* note 267, at 58–62.

280. New York also allows not-for-profit entities to induce capital contributions from insiders (members) and from outsiders through a device termed a "subvention." But since they basically are subordinate debt securities, financing obtained through the use of them should not be considered an investment. *See* N.Y. NOT-FOR-PROFIT CORP. §§ 502–505 (McKinney 2021); BJORKLUND ET AL., *supra* note 274, § 5.05[2]–[3]. (discussing capital contributions for members of nonprofit corporations and subventions).

281. *See, e.g.*, N.Y. BUS. CORP. LAW § 504(a) (McKinney 2021) ("Consideration for the issue of shares shall consist of money or other property, tangible or intangible; labor or services actually received by or performed for the corporation or for its benefit or in its formation or reorganization; a binding obligation to pay the purchase price or the subscription price in cash or other property; a binding obligation to perform services having an agreed value; or a combination thereof.").

considerations.[282]

As a second problem, the nonprofit corporation is not a particularly effective structure for protecting its beneficiaries from market forces. This is because its beneficiaries are at the mercy of nonprofit directors as they have no legal remedy against board decisions undermining a nonprofit's purpose and mission.[283] In jurisdictions like New York, beneficiaries can try to increase their power and leverage by becoming nonprofit "members," or assuming a governance role roughly equivalent to shareholders' in business corporations.[284] However, as we saw of shareholders in business corporations under the neoliberal order, this practically means the reign of directors, who are especially dominant in the nonprofit realm since most nonprofits lack members.[285] As with for-profit entities, nonprofit boards remain largely free and unfettered to give their own meaning to corporate purpose and function.[286] Still worse, they are even authorized to exercise power that undermines members' major control: their power to elect directors.[287] This reflects how much New York's Not-For-Profit Corporation Law is modelled after the BCL and imports its public-company concept of board supremacy.[288] The upshot of all this is that nonprofit corporations are a "third way" between the public sector and private

282. *See* Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 255, at 683 ("If [a founder] forms a for-profit, particularly a for-profit corporation, shareholder primacy will force her to single-mindedly focus on profit, with no way to protect the social mission of the entity or its founders. If she forms a nonprofit, this social vision can be protected, but business strategies, especially equity capital, are foreclosed.").

283. *See* Alco Gravure v. Knapp Found., 479 N.E.2d 752, 755 (N.Y. 1985) (analogizing New York not-for-profit corporations to trusts and applying the general rule that "one who is merely a possible beneficiary of a charitable trust, or a member of a class of possible beneficiaries, is not entitled to sue for enforcement of the trust" or nonprofit); Kemp's Bus Serv., Inc. v. Livingston-Wyo. Chapter of NYSARC, Inc., 701 N.Y.S.2d 575, 575 (App. Div. 1999) ("[The] Not-For-Profit Corporation Law was enacted to protect defendant [corporation] and its members, not plaintiff [bus service vendor]."); BJORKLUND ET AL., *supra* note 274, § 11.05[1][a] ("In New York, as in most jurisdictions, beneficiaries of an organization . . . cannot sue [to enforce directors' duties].").

284. BJORKLUND ET AL., *supra* note 274, § 9.01. Members can be individuals or entities. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 601.

285. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 601 (noting that charitable corporations are not required to have members); *see also* BJORKLUND ET AL., *supra* note 274, § 9.01.

286. *See* Van Campen v. Olean Gen. Hosp., 205 N.Y.S. 554, 554–55, 557–58 (App. Div. 1924), *aff'd*, 147 N.E. 219, 219 (N.Y. 1925) (emphasizing the court's inability to interfere with actions taken by the board in furtherance of the corporation unless clearly erroneous).

287. *See* Bailey v. Am. Soc'y for Prevention of Cruelty to Animals, 125 N.Y.S.2d 18, 24–25 (App. Div. 1953), *aff'd*, 120 N.E.2d 853, 854 (N.Y. 1954) (holding that directors' adoption of bylaws allowing their self-perpetuation did not violate members' powers).

288. *See* BJORKLUND ET AL., *supra* note 274, § 9.01.

businesses.[289] Nonprofit corporations are not the key to reconceptualizing business corporation law.

B. The Innovation: The Benefit Corporation and Its Limits

Perhaps recognizing these limitations on nonprofits, thirty-seven states have passed benefit corporation statutes creating a hybrid corporate structure with monetary and non-monetary purposes.[290] New York's benefit corporation statutory scheme — contained in Article 17 of its Business Corporation Law — seeks to address the problem of monetary reduction by codifying others' interests.[291] Specifically, the New York benefit corporation statute, which has been cited as a model for other states,[292] provides that "[e]very [such] corporation shall have a purpose of creating general public benefit" (in addition to any other lawful business purpose) and that the general public benefit shall limit, and prevail over, any other or inconsistent corporate purpose.[293] It also requires the "directors and officers of [such] a corporation [to] consider the effects of any action upon:"

> (A) the ability of the benefit corporation to accomplish its general and any specific public benefit purpose; (B) the shareholders of the benefit corporation; (C) the employees and workforce of the benefit corporation and its subsidiaries and suppliers; (D) the interests of customers as beneficiaries of the general or specific public benefit purposes of the benefit corporation; (E) community and societal considerations, including those of any community in which offices or facilities of the benefit corporation or its subsidiaries or supplies are located; (F) the local and global environment; and (G) the short-term and long-term interests of the benefit corporation . . . .[294]

At first blush, the benefit corporation seems promising. The statute creating benefit corporations mandates board recognition of the nonmonetary, social, and even counter-capitalism function of entities.[295] As such, it reflects and advances an approach to business and of economic

289. *See* THOMAS WOLF, MANAGING A NONPROFIT ORGANIZATION 6–7 (21st ed. 2012) (describing the nonprofit corporation's mediating standing).

290. *See* Ofer Eldar, *Designing Business Forms to Pursue Social Goals*, 106 VA. L. REV. 937, 964 (2020) (citing *State by State Status of Legislation*, B-LAB, BENEFIT CORP., https://benefitcorp.net/policymakers/state-by-state-status (last visited Feb. 5, 2021)).

291. N.Y BUS. CORP. LAW §§ 1701–09 (McKinney 2021).

292. *See* Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 255, at 704 (stating that specialized form legislation should follow New York's lead and "clearly state that only social enterprises that prioritize social good may adopt the specialized form[]").

293. N.Y BUS. CORP. LAW § 1706(a).

294. *Id.* § 1707(a)(1).

295. *See id.*

rationality liberated from the neoliberal paradigm: namely, team or "we" rationality. This is a perspective, associated with Black, Brown, and marginalized people around the world, that has gained traction in Europe and the United States.[296]

The ultimate problem with the benefit corporation, however, is that its liberated understanding of business is consigned to corporate "contracts" such as the articles or certificate of incorporation. As such, it leaves change to bargaining, rather than imposing it as a substantive principle. This point can be expressed with the same criticism as that made of standard progressive corporate law: the lack of a corporate governance theory, or rules that apply where contracts are insufficient.[297] In many ways, the benefit corporation worsens the neoliberal director principle by making everything dependent upon directors.[298]

Since, then, private company progressive reform depends upon the benefit corporation, it can be stymied simply by investors' refusal to invest. And it

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296. *See, e.g.*, Solomon, *supra* note 110, at 281–303 (describing the corporation Ben & Jerry Homemade, Inc. as modelling a humanonics approach, or the running of business as the "reflection of our conscious caring for the people around us"); Robert T. Esposito, *The Social Enterprise Revolution in Corporate Law: A Primer on Emerging Corporate Entities in Europe and the United States and the Case for the Benefit Corporation*, 4 WM. & MARY BUS. L. REV. 639, 671–95 (2013) (describing Europe as the birthplace of modern social enterprise, with its social cooperative and community interest company forms, and forms in the United States such as low-profit limited liability companies ("L3C"), flexible purpose corporation ("FPC"), social purpose corporation ("SPC"), and benefit corporation); Luigino Bruni, *Toward an Economic Rationality "Capable of Communion," in* TOWARD A MULTI-DIMENSIONAL ECONOMIC CULTURE: THE ECONOMY OF COMMUNION 41–67 (Luigino Bruni ed., 2002) (describing economic "We" rationality based in the work of Martin Hollis and Robert Sugden that invites a person, in deciding which action to undertake, not to think about whether the action has good consequences for individuals but rather whether their part in action has good consequences for us); LORNA GOLD, NEW FINANCIAL HORIZONS: THE EMERGENCE OF AN ECONOMY OF COMMUNION 13–31 (2010) (introducing the economy of communion, tying fiscal crisis and economic instability to the notion of economic self-interest under the *homo economicus* paradigm and proposing alternatives informed by the developing world's perspectives reflecting different economic rationality based in value and social solidarity instead of self-interest). *See generally* JOHN GALLAGHER & JEANNE BUCKEYE, STRUCTURES OF GRACE: THE BUSINESS PRACTICES OF THE ECONOMY OF COMMUNION (2014) (studying business, marketing, and competitive practices and governance of fourteen companies throughout the United States and Canada reflecting such economy of communion principles: Mundell & Associates and Sofira Violins (Indianapolis, IN), Finish Line (Hyde Park, NY), Terra Nuova (Rhinebeck, NY), First Fruits Farm (Los Angeles, CA), Dealerflow (Kokomo, IN), Ideal Safety Communication (Chicago, IL), Netutive (Reston, VA), Spiritours (Montreal, QB), Arc-en-Saisons (Granby, QB), La Parola (Denver, Co.), The Solinsky Financial Group (Tuscon, AZ), Techquest, Inc. (Houston, TX), and CHB Consulting (Freehold, NJ)).

297. *See* Bodie, *supra* note 70, at 752.

298. *See id.* at 750–51 (explaining the expanded discretionary authority of directors under the stakeholder theory and the constituency statute).

makes sense that investors would avoid the benefit corporation since it reproduces neoliberal's director primacy but frees directors of the one constraint serving to ensure that they serve investor's interests: the shareholder welfare maximization norm.[299] Since shareholders have long been solicitous of channeling board discretion toward serving investor interests,[300] it is hard to see why shareholders would sign on to a structure authorizing boards to exercise power for someone else's benefit. The complete absence of decisional law reflecting disputes under New York's public benefit statute[301] suggests that this project too has failed to shift the paradigm.

But even if the benefit corporation appealed to investors, a second problem lurks: the issue of enforcement against dissenters. The question is how effective radical contracts can be within the neoliberal paradigm. Scholarship has suggested that enforcement is the problem of benefit corporations.[302] I suspect that scholars have arrived at this conclusion by looking at the fate of other contractual terms reflecting social values in corporate law. To take an example, federal securities law implies certain governance rights for shareholders such as the right to participate by including policy proposals in proxy materials.[303] But as exemplified by

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299. *See* Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm*, *supra* note 63, at 1423.

300. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 576–77 (noting that shareholders have sought to constrain director discretion in public companies by compensating directors with stock, thus incentivizing the corporation to operate under the shareholder welfare maximization principle); KRAAKMAN ET AL., *supra* note 38, § 3.3.2 (discussing the reward-based compensation structure for managers).

301. *See* DIAMOND, *supra* note 159, at 26–28, 761.

302. *See* Dana Brakman Reiser, *Benefit Corporations — A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 592–93 (2011) ("[L]ike the other hybrid forms simultaneously under development, the benefit corporation lacks robust mechanisms to enforce dual mission, which will ultimately undermine its ability to expand funding streams and create a strong brand for social enterprise as sustainable organizations.").

303. Regulations implementing the Securities Exchange Act of 1934 explain the right as follows: "(i): If I have complied with the procedural requirements, on what other bases may a company rely to exclude my proposal? (1) Improper under state law: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization; Note to paragraph (I)(1): Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." 17 C.F.R. § 240.14a-8(h)(3)(i) (2020).

Apache Corporation v. NYC Employees Retirement System,[304] these rights are analyzed through a neoliberal lens. In the case, a Delaware independent energy corporation headquartered in Houston, Texas sought a declaratory judgment in federal court that it properly excluded the proposal of five shareholders, all New York City pension funds, from its proxy materials.[305] The proxy proposal invited all of the company's shareholders to vote on a proposal requesting that the corporation adopt a policy against discrimination on the basis of sexual orientation and gender identity.[306] The company refused to include it, invoking Rule 14a-8(i)(7) of the Securities and Exchange Commission ("SEC")'s Rules implementing the Securities Exchange Act of 1934.[307] That rule allows regulated corporations to exclude proposals related to the company's ordinary business operations.[308] In establishing what "ordinary business operations" means, the district court, in following Second Circuit precedent, interpreted the law de novo, rather than simply affirming the SEC's exclusion action and the interpretation implied within.[309] Relying on SEC guidance, the court held the "ordinary business operation" exception to permit the exclusion of mundane matters involving significant policy issues that nonetheless involve what it described as micromanagement of a business.[310] For the court, proposals about significant policy issues were nonetheless excludable as "micromanagement" when proposals prevent management from exercising its "specialized talents,"[311] that familiar justification for the BJR.[312] As a result, the court determined that, because the proposal at issue in the case included some principles that did not implicate social policy, and because those which did nonetheless constituted "micromanagement" because they directed the board to change certain business practices, the corporation could rightly exclude it.[313] This was so despite the proposal being, on its face, a request that is nonbinding by its nature[314] (and, therefore, incapable of

304. 621 F. Supp. 2d 444 (S.D. Tex. 2008).

305. *Id*. at 445–46.

306. *See id.* at 446–47 (referring to the full text of the proposal).

307. *See id.* at 446, 449 (citing 17 C.F.R. § 240.14a-8(i)(7) (2008)).

308. 17 C.F.R. § 240.14a-8(i)(7); *see also Apache Corp.*, 621 F. Supp. 3d at 449.

309. *See Apache Corp.*, 621 F. Supp. 3d at 449–50.

310. *Id*. at 451.

311. *Id*. (citing Med. Comm. for Hum. Rts. v. SEC, 432 F.2d 659, 679 (D.C. Cir. 1970), *vacated as moot* 404 U.S. 403 (1972)) ("As one court explained, 'management cannot exercise its specialized talents effectively if corporate investors assert the power to dictate the minutiae of daily business decisions.'").

312. *See id.*

313. *Id.* at 452–53.

314. *See* Sarah C. Haan, *Shareholder Proposal Settlements and the Private Ordering*

managing whatsoever) and clearly a social policy issue.[315]

Apache is thus doubly concerning. As a case about textual interpretation, it reveals corporate law's tendency to narrow law-and-economics construction of express and implied contractual rights.[316] As a case developing the meaning of management prerogatives, it suggests that the neoliberal view of director supremacy prevails over non-directors' contractual rights. Accordingly, the case cautions that even if the benefit corporation caught on in the market as an attractive business vehicle, its socially useful ends would still have to overcome judicial conceptualization of their function. This brings us to consider what might be a more effective path to securing progressive reform.

VI. AN ALTERNATIVE REFORM PROGRAM: JUDICIAL AND LEGISLATIVE CHANGE BASED ON THE HDFC

Neoliberalism governance cannot be solved merely with tweaks or structures.[317] The tweaks discussed in Section III.A above, including following Germany in adding stakeholders to corporate boards, adopting agency law's fiduciary standard, shifting default rules to serve workers, and rethinking boards as relational mediators, have not taken. As for structures, the simplest argument against them is that their longstanding existence has

of Public Elections, 126 YALE L.J. 262, 273 (2016) ("[M]ost shareholder proposals — and virtually all social and environmental proposals — are precatory, which means that they are recommendations and are not binding on management.").

315. *See Apache Corp.,* 621 F. Supp. 2d at 450–53. *See generally* Joseph A. Roy, Note, *Non-Traditional Activism: Using Shareholder Proposals to Urge LGBT Nondiscrimination Protection*, 74 BROOK. L. REV. 1513 (2009) (explaining that workplace discrimination is a clear, significant social policy issue).

316. Quite sensibly, no one ever feels *that* badly for banks and billionaires, but the infamous case of *Metropolitan Life Insurance Co. v. RJR Nabisco, Inc.* reflects this judicial tendency in corporate law to read contracts exceedingly narrowly given the sophistication of parties. *See* 716 F. Supp. 1504, 1518–19 (S.D.N.Y. 1989), *vacated*, 906 F.2d 884 (2d. Cir. 1990). But as one commentator has said, this "if it isn't prohibited then it is permitted" approach is too simplistic. *See* John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495, 1503 (1990). A narrow approach to contracts also pervades *Local 1330 United Steel Workers v. United States Steel Corp.*, a case Kent Greenfield relies upon in urging the need for public company reform giving workers a seat on corporate boards as they cannot protect their interests with contracts. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 194, n.19 (citing Local 1330, United Steel Workers v. U.S. Steel Corp., 631 F.2d 1264, 1277 (6th Cir. 1980)).

317. *See generally* Katz & Page, *supra* note 268 (arguing that because none of the new structures have any enforcement mechanisms, the most important factor for producing enforceable change in corporate law is getting the people in charge, including investors, on board).

not served to displace neoliberalism's normative dominance.[318] Two reasons account for why theorizing tweaks and structures has not worked. First, theory is generally a tough sell, but especially so in an area of the law so very concerned with practical outcomes for everyone.[319] Second, the legal problem is more substantive than procedural. The real change needed is at the cultural level. Structures are helpful in the consideration of culture as they signal social acceptability and reduce transaction costs.[320] But structure, itself, is not culture.

So, successful reform requires two things. First, it must rely on something tried and true here in the United States to allay concerns about feasibility, since public companies succeed as businesses under the current governance paradigm. Second, it must be centered on the cultural element since that is what neoliberalism governance is missing. These two reasons are why reform should be based on the HDFC. As discussed in Section IV.A, they have a proven track record of success in the crucible of New York City's market, satisfying the element of corporate law concerned about equity investors. But as also mentioned, they epitomize the communitarian culture of protecting "sweat equity" stakeholders from market depredation.[321] As noted in Section III.A, the best way to think about the HDFC is as a vehicle combining the public company investor and stakeholder ("sweat equity") into one role, the shareholder. From this combination, the HDFC bridges neoliberalism's insistence on shareholder rights with communitarianism's focus on stakeholder protection.

In elaborating what culture means for corporate law, we must proceed from the most essential part of any reform project: the role of the judiciary. Corporate governance reform requires all participants, and investors especially, to have an explicit role.[322] This must be done for no other reason than, as discussed above, relying on directors to benevolently exercise discretion just will not do.[323] Humankind are not angels; and so, we must have governance by all.[324] But investors can have a real role only if the

318. *See* Bodie, *supra* note 70, at 740.

319. *See* KRAAKMAN ET AL., *supra* note 38, § 1.5 (describing the goal of corporate law as "to serve the interests of society as a whole").

320. *See* Katz & Page, *supra* note 268, at 864, 869–70.

321. *See* McArdle, *supra* note 182, at 253–54.

322. *See* Katz & Page, *supra* note 268, at 864, 869–70. *See generally infra* note 347 (discussing the potential of benefit corporation statutes to make way for corporate managers to "do the right thing").

323. *See* Bodie, *supra* note 70, at 750–51.

324. This, of course, is the famous basis for both government and checks and balances of government articulated in Federalist No. 51. *See generally* THE FEDERALIST NO. 51 (James Madison) (discussing the necessity for a "separate and distinct exercise of the

judiciary aids them: that is the lesson of *Apache*. Corporate law reform cannot continue to disregard this factor, or regard contracts including corporate charters, as self-executing.

The misplaced confidence in contracts has led scholarship to regard the "bad law" perpetuating extreme neoliberal governance — *Dodge v. Ford*[325] and *eBay Domestic Holdings, Inc. v. Newmark* — as aberrations.[326] But another equally valid explanation is that these cases are indeed "the law" in that they have effectively discouraged corporate boards from even trying Henry Ford, Jim Buckmaster, and Craig Newmark's brazen imposition of communitarianism upon equity investors.[327] If boards really had the power to impose philanthropy, why are *Dodge* and *eBay* the only two cases of their kind? Sure, law students are assigned cases about courts authorizing boards to make minor philanthropic donations,[328] but never ones with *Dodge* and *eBay* facts and a different result. Consequently, it largely remains another bit of theory, upon which the benefit corporation idea especially depends, that the BJR goes so far as to protect directors in philanthropizing the business corporation.[329]

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different powers of government which . . . is . . . essential to the preservation of liberty . . .").

325. 170 N.W. 668 (Mich. 1919).

326. *See* Stout, *Why We Should Stop Teaching* Dodge v. Ford, *supra* note 18, at 166 (criticizing the reliance on *Dodge v. Ford* because the case is outdated and its most often cited proposition is merely dicta); Katz & Page, *supra* note 268, at 864 (claiming that new forms have been devised to avert outcomes caused by *Dodge* and *eBay* and describing them as essentially the only two cases in a century where controllers lost).

327. *See* Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 255, at 687–88 (citing anecdotal reports that secretaries of state will not accept certificates of incorporation containing blended mission clauses and data suggesting that directors have internalized the shareholder welfare maximization norm); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2073 (2001) ("Norms in American business circles, starting with business school education, emphasize the value, appropriateness, and indeed justice of maximizing shareholder wealth . . . ."); Bainbridge, *Director Primacy*, *supra* note 34, at 575–76 ("Although some scholars claim that directors do not adhere to the shareholder wealth maximization norm, the weight of the evidence suggests the contrary. First, shareholder wealth maximization is not only the law, but also is a basic feature of corporate ideology. A 1995 National Association of Corporate Directors (NACD) report stated: 'The primary objective of the corporation is to conduct business activities with a view to enhancing corporate profit and shareholder gain.' A 1996 NACD report on director professionalism set out the same objective, without any qualifying language on nonshareholder constituencies. A 1999 Conference Board survey found that directors of U.S. corporations generally define their role as running the company for the benefit of its shareholders.").

328. *See* Steinway v. Steinway & Sons, 40 N.Y.S. 718, 722 (Sup. Ct. 1896); A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 589 (N.J. 1953); *see also* DIAMOND, *supra* note 159, at 15–20, 28–31.

329. Some corporate scholars claim this. *See* Katz & Page, *supra* note 268, at 868, 872 (citing Todd Henderson, *Al Franken, Shareholder Wealth Maximization, and the*

Thus, the HDFC supplies what progressive corporate law has long required to persuade: a concrete American example of effective and lasting communitarianism to provoke salutary legal development. The closest corporate law had to this was Ben & Jerry's, mentioned above in Section III.B in Solomon's *PCL* essay,[330] but its eventual acquisition by a publicly traded company has, in the very least, complicated its communitarian witness.[331] So the HDFC, with its hybrid shareholder, is left to compel judicial adoption of a legal realist approach toward corporate governance. How that should work is discussed below.

Progressive reformers should use disputes involving HDFCs to urge courts to review board decisions by considering the sort of business corporation at issue, much like the U.S. Supreme Court did in the securities law context with *United Housing Foundation v. Forman*.[332] Where the business corporation is like an HDFC, or one where investors rely on the corporate form itself to enjoy the nonmonetary benefit of sovereign power they would otherwise lack,[333] the court should evaluate board action under something akin to anti-discrimination law's less burdensome standard.[334] For a more apposite concretization of this, the approach advocated here would universalize the Massachusetts Supreme Judicial Court's approach in *Wilkes v. Springside Nursing Home, Inc.*[335] In that case, the court proceeded from the type of business corporation at issue — a closely held one — and fashioned a governance doctrine commensurate with such purpose.[336] Specifically, the court held that because shareholders in closely held corporations invest for the very purpose of enjoying guaranteed employment

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Business Judgment Rule, PROFESSORBAINBRIDGE.COM (Jul. 27, 2020, 4:07 PM), https://www.professorbainbridge.com/professorbainbridgecom/2010/07/shareholder-wealth-maximization-and-the-business-judgment-rule.html); Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 255, at 686–87.

330. *See* Solomon, *supra* note 110, at 1642–43.

331. *See* Katz & Page, *supra* note 268, at 858–59 (citing their 2010 article about the extinguishment of Ben & Jerry's social benefits after Unilever acquired it but mentioning that its capacity to grow after the acquisition produces other social benefits, such as allowing Ben & Jerry's to use hormone-free milk).

332. *See supra* notes 214–21 and accompanying text (discussing *United Housing Foundation, Inc. v. Forman*).

333. *See supra* note 83 (discussing *In re Kemp & Beatley* and *Ingle v. Glamore Motor Sales*).

334. *Cf.* 24 C.F.R. § 100.500 (2020) (asserting disparate impact analysis and its less discriminatory effect standard in federal housing discrimination cases).

335. 353 N.E.2d 657, 659 (Mass. 1976).

336. *See id.* at 663 (citing *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 511–12 (Mass. 1975)) (stating standard as "strict obligation on the part of the majority stockholders in a close corporation to deal with the minority with the utmost good faith and loyalty").

and other nonmonetary interests, a board infringing upon such rights must pass heightened scrutiny.[337] The board must adduce a legitimate business purpose for the infringement. Once a corporation makes this showing, the burden shifts to the challenging shareholder to show that the same legitimate objective could have been achieved through means less harmful to her interest.[338]

Applied to HDFCs, this test would produce heightened scrutiny curtailing board tactics that drive out investors in a hot rental market, a tension in gentrifying areas such as Brooklyn.[339] For example, a board of an HDFC would no longer be able to increase maintenance or costs at a rate the law deems excessive or unconscionable[340] without showing that there are compelling reasons and no alternatives.

Lest we regard heightened scrutiny as some novelty in corporate law, it has long existed in the mergers and acquisitions context. Neoliberalism had long ago pushed courts to apply heightened scrutiny to such transactions where shareholder profit is at stake. This more searching examination, emerging from the Delaware Supreme Court's decisions in *Unocal Corp. v. Mesa Petroleum Co.*,[341] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[342] and *Paramount Communications Inc. v. QVC Network, Inc.*,[343] takes the shareholder welfare maximization principle seriously to give it teeth.[344]

337. *See id.* (holding the strict standard set forth in *Donahue* applied to the instant case).

338. *See id*. at 663 (emphasizing courts must consider the "practicability" of the less harmful means asserted by minority shareholders in examining the action).

339. *See* Olear, *supra* note 170.

340. *See, e.g.*, 303 W. 122nd St., HDFC v. Hussein, No. 570123/14, 2015 WL 753367, at *1 (N.Y. App. Term 2015) (remanding eviction case for new trial where trial court dismissed eviction predicated on tenant's refusal of a ninety-two percent rent increase as unconscionable).

341. 493 A.2d 946 (Del. 1985).

342. 506 A.2d 173 (Del. 1986).

343. 637 A.2d 34 (Del. 1994).

344. *See Unocal Corp.*, 493 A.2d at 958 (holding the "Court will not substitute its judgment for that of the board"); *Revlon Inc.*, 506 A.2d at 185 (holding "[t]he measures were properly enjoined" and that the "board's action [was] not entitled to the deference accorded it by the business judgment rule"); *Paramount Commc'ns Inc.*, 637 A.2d at 55 ("It is not appropriate for this Court to prescribe in the abstract any particular remedy or to provide an exclusive list of remedies under such circumstances."). I argue this despite that, as Bainbridge points out, *Unocal* can legitimately be read to suggest that directors may take the interests of other stakeholders into account in opposing a takeover (the quintessential transaction involving shareholder wealth). *See* Bainbridge, *Director Primacy*, *supra* note 34, at 583 n.176. However, the key here is that in all three decisions, the court applied heightened scrutiny as a way of emphasizing the normative centrality of shareholder welfare maximization. This jurisprudence is undoubtedly a key part of why directors take shareholder welfare maximization so seriously.

For corporations formed to afford their owners a protective shield of power, courts should apply the same heightened scrutiny to give those corporate purposes bite.[345]

The HDFC, with its hybrid investor-sweat equity shareholder, also unlocks progressive legislative reform. Inspired by the harm of neoliberal governance on HDFCs, New York should amend the BCL to provide that for corporations with shareholder compositions such as those of S corporations — or ones made up of 100 or fewer natural people[346] — any decision which substantially affects shareholders' rights is subject to shareholder ratification.[347] This change, serving to check director primacy as expressed in BCL § 701, would harmonize the law in this way: just as shareholders have a say on fundamental changes to certificates of incorporation[348] or terminal events such as mergers[349] or dissolution,[350] so too must their active ones have a say in matters that effectively kill a corporation by undermining its purpose and function. The obvious categories of matters that shareholders should have to approve are decisions affecting voting procedures, decisions to alienate or encumber corporate property, or decisions that would result in increases to cooperative constituents' costs in excess of a commercial standard such as the consumer price index.

Having stated these legislative proposals, this Article cannot overstate the importance of judicial reform. As Katharina Pistor's example of property rights and the Maya illustrates,[351] the path to reform, and out of any reductionist bog, is through a sea change to the judiciary's approach to law, a change especially important since all U.S. states regulate corporate behavior through litigation rather than administrative rulemaking.[352] What

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345. Anticipating the next point, *Unocal*, *Revlon*, and *Paramount* are also instances of judicial implying of purposes. Courts have taken the "any lawful business purpose" idea and implied into it a purpose of maximizing return, at least in the auction context. *See* Bainbridge, *Director Primacy*, *supra* note 34, at 548 (discussing the fiduciary obligations of a corporation in maximizing shareholder wealth).

346. This could alternatively read 100 or fewer shareholders each of whom is a natural person. *See* I.R.C. § 1361(b).

347. This accords with former Chief Justice of the Delaware Supreme Court Leo E. Strine, Jr.'s observation, in support of the benefit corporation described above in Section V.B, that it is incumbent upon corporate shareholders, and not directors, to enforce corporate commitments to general social welfare. *See* Leo E. Strine, Jr., *Making It Easier for Directors to "Do the Right Thing"?*, 4 HARV. BUS. L. REV. 235, 246–47 (2014).

348. N.Y. BUS. CORP. LAW § 803(a) (McKinney 2021).

349. *Id.* § 903.

350. *Id.* § 1001.

351. *See* KATHARINA PISTOR, THE CODE OF CAPITAL: HOW THE LAW CREATES WEALTH AND INEQUALITY 24–29 (2019).

352. *See* CAN DELAWARE BE DETHRONED? EVALUATING THE DOMINANCE OF CORPORATE LAW 10 (Stephen M. Bainbridge et al. eds., 2018).

corporate law reform desperately requires is *judicial* acknowledgement of that, illustrated by HDFCs, which progressive corporate scholars have long contended:[353] the existence of other types of economic rationality aside from the relentless profit machine of Milton Friedman's imagination.[354] New York's standard business corporate law has long contained a corporate constituent statute reciting the communitarian type of BJR that Millon argues for in his *PCL* essay referenced above in Section III.A.[355] Specifically, the statute grants directors, in rendering decisions for corporations, the right to take other considerations into account aside from shareholders and managers' pockets.[356] But under the current neoliberal paradigm, disputes under these statutes have not even come up.[357] This is even true of the Indiana corporate constituent statute cited by one commentator as evidence that existing corporate law already protects corporations' ability to pursue social aims.[358]

Because, throughout the United States' legal systems, judges "say what

353. *See* discussion *supra* Section III.A.

354. *See* Eric Posner, *Milton Friedman Was Wrong*, ATLANTIC (Aug. 22, 2019), https://www.theatlantic.com/ideas/archive/2019/08/milton-friedman-shareholder-wrong/596545 (criticizing Friedman's shareholder theory as a method for corporations to escape social responsibility for actions while increasing profits); *see also* Stout, *Why We Should Stop Teaching* Dodge v. Ford, *supra* note 18, at 164 (citing Friedman, *A Friedman Doctrine*, *supra* note 164) (explaining how taxation of shareholders for social purposes is contrary to the duty of an agent to act in best interest of the principal); JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER (2004) (characterizing this shareholder welfare maximization — without regard to law, ethics, or the interests of society — as a dangerous psychopathy).

355. *See* Millon, *Communitarianism in Corporate Law*, *supra* note 104, at 11.

356. *See* N.Y. BUS. CORP. LAW § 717(b) (McKinney 2021).

357. To elaborate, in *Progressive Corporate Law* ("*PCL*") and back in 1995, Millon notes, of these provisions, that "[s]ome of these statutes limit concern for nonshareholders to management actions in defending against hostile turnovers, but most apply generally to corporate decisionmaking. No one yet knows how state courts will interpret these statutes or how corporate boards will respond to their mandate. On their face, the statutes seem to herald a potentially radical departure from the traditional shareholder primacy principle, but the statutes' vagueness allows room for a range of interpretive possibility." Millon, *Communitarianism in Corporate Law*, *supra* note 104, at 11–12. To date, no court has ever interpreted these statutes to have any force. This includes Connecticut, the lone state identified by Millon as mandating the board to so consider. *See also* DIAMOND, *supra* note 159, at 761 (noting that there is little case law addressing these statutes and that none analyze what their substantive content requires).

358. *See* Katz & Page, *supra* note 268, at 868 (citing IND. CODE. ANN. § 23-1-35-1(d), (g) (West 2021)). No court has yet to elaborate how subsections (d) and (g) apply. In *Murray v. Conseco, Inc.*, the Indiana Court of Appeals discussed these subsections in connection with a board's decision to remove a shareholder-appointed director. 766 N.E.2d 38, 44 (Ind. Ct. App. 2002). Tellingly, however, this opinion was then vacated by the Indiana Supreme Court. *See* Murray v. Conseco, Inc., 795 N.E.2d 454, 462 (Ind. 2003).

the law is,"[359] no legislative standard has any reach apart from what judges grant it. Indeed, anticipation of what judges will do discourages legal challenge to the status quo. This is a long recognized problem: the impossibility of legal reform absent a judiciary receptive and deferential to social reality, as captured by litigants in Brandeis' briefs or expressed in legislative findings.[360] Just as the judiciary finally came back to the world as it is to recognize the unequal bargaining power necessitating regulation in the name of social health,[361] judges must accept that there are also business corporations, such as HDFCs, formed to counter the unfettered operation of markets. This cultural change will allow nonmonetary and counter-market businesses to be given their intended force.

Finally, the legislative and judicial reforms discussed here would also further progressive public company reform by opening up the legal mind to its central claim. As discussed in Section III.B, the progressive corporate law movement has suffered from its inability to frame *business* corporations as serving goals other than shareholder profit. The implementation of the reforms proposed here, based on the concrete case of the HDFC and the dual role of the HDFC shareholder as a hybrid stakeholder-investor, would help reorient law toward imagining the business corporation as *also* serving a communitarian function, a corporate civic-mindedness emerging in the 2019 Business Roundtable's recasting of a corporation's purpose[362] and New York

359. This famously comes from *Marbury v. Madison*: "It is emphatically the province and duty of the judicial department to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule. If two laws conflict with each other, the courts must decide on the operation of each." 5 U.S. 137, 177 (1803).

360. *See, e.g.*, FRIEDMAN, *supra* note 33, at 649; G. EDWARD WHITE, AMERICAN LEGAL HISTORY: A VERY SHORT INTRODUCTION 39–40 (2013); *cf.* Javins v. First Nat'l Realty Corp., 428 F.2d 1071, 1082 (D.C. Cir. 1970) (discarding caveat lessee and adopting implied warranty of habitability).

361. *See* G. EDWARD WHITE, THE CONSTITUTION AND THE NEW DEAL 248–49 (2000) (citing Lochner v. New York, 198 U.S. 45 (1905) (Holmes, J., dissenting)) (describing the reasoning behind Justice Oliver Wendell Holmes Jr's dissent in *Lochner* — which came to frame U.S. jurisprudence on economic regulation — that stated that economic freedom is an illusion and heavily swayed by money, power, and politics).

362. Press Release, Bus. Roundtable, Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy that Serves All Americans' (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans; *see also* Andrew Ross Sorkin, *Has Business Left Milton Friedman Behind?*, N.Y. TIMES (Sept. 11, 2020), https://www.nytimes.com/2020/09/11/business/dealbook/milton-friedman-anniversary-sorkin-essay.html.

Times' essay series revisiting[363] Milton Friedman's aforementioned op-ed[364] on its fiftieth anniversary. From this emerging reorientation, the next step will be for the law to recognize public company stakeholders as investors also entitled to protection and participation, much like their HDFC counterparts. Happily, in addition to those proposed by progressive reformers,[365] federal tax and securities law and other elements of the legal code present possibilities for enforcing communitarian reform of public companies.[366]

VII. CONCLUSION

Examining and historicizing the dominant neoliberalism governance paradigm as well as the progressive challenges to it demonstrates that corporate law reform must rely on the example Black and Brown economic rationality — embodied by the HDFC — to be successful. As a business corporation countering an aggressive market, the HDFC is a concrete, and not merely conjectural, vehicle for compelling corporate law's recognition of nonmonetary communitarian rationality. As a result, using the HDFC can produce judicial and legislative change that would free corporate governance from neoliberal reduction to sustain corporations intentionally formed to protect their stakeholders from markets.

It should not be surprising that corporate law can be enriched by Black and Brown lived experiences. As discussed in the introduction, Nikole Hannah-Jones' acclaimed essay reveals how Black experiences have moved United States constitutionalism toward universality and entelechy.[367] We should expect no different of corporate law. Especially in this moment where the shameful absence of the Black perspectives in economics has

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363. *Greed Is Good. Except When It's Bad*, N.Y. TIMES (Sept. 13, 2020), https://www.nytimes.com/2020/09/13/business/dealbook/milton-friedman-essay-anniversary.html; *see also* Sorkin, *supra* note 362.

364. Friedman, *A Friedman Doctrine*, *supra* note 164.

365. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 115–16.

366. *See* Winkler, *supra* note 7, at 109–10; KRAAKMAN, *supra* note 38, § 3.3.2 (discussing the use of federal tax and securities laws as a tool inadvertently enhancing executive pay by aligning it with company performance). Greenfield might bemuse to see Kraakman's text cited as a source for ideas on progressive law reform, given how much Kraakman and Henry Hansmann are opposed to Greenfield's principle reform of empowering workers to join boards, following the German model. *See* GREENFIELD, THE FAILURE OF CORPORATE LAW, *supra* note 33, at 15–17 (discussing Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001), as criticizing, on efficiency grounds, the German model of worker-cooperative boards); *see also* PISTOR, *supra* note 351, at 24–29.

367. *See* Hannah-Jones, *supra* note 21.

become conspicuous,[368] progressive proposals based on Black and Brown economic rationality and experience can contribute to corporate reform. Through such, and especially where recent scholarship has already identified corporate power as an instrument for social activism,[369] law students, public interest lawyers, and jurists may find business corporate law to be an ally, not a hindrance, to the struggle against second-class citizenship. If this is achieved, corporate law would regain the social democratic function that it long has had in American law,[370] obscured in this neoliberal age.

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368. *See* Ben Casselman & Jim Tankersley, *Economics, Dominated by White Men, Is Roiled by Black Lives Matter*, N.Y. TIMES (June 10, 2020), https://www.nytimes.com/2020/06/10/business/economy/white-economists-black-lives-matter.html (exploring the impact of underrepresentation of Black Americans in the field of economics and how the history of discrimination in economics is relevant today).

369. *See generally, e.g.*, Tom C.W. Lin, *Incorporating Social Activism*, 98 B.U. L. REV. 1535 (2018) (providing a comprehensive account and framework for analysis of using corporations to advance social activism); Stephen M. Bainbridge, *Corporate Purpose in a Populist Era*, 98 NEB. L. REV. 543 (2020) (observing the use of corporate power for progressive ends and predicting right-of-center workers' reactions to it).

370. *See generally* Lamoreaux & Novak, *supra* note 33 (discussing the corporation's historic role in American democracy).

THE INCHOATE MEANING OF "COVERED SECURITY" UNDER THE SECURITIES ACT OF 1933 — A LOOK AT A BANK "IN ORGANIZATION"

MICHAEL D. WATERS*

* Partner, Jones Walker LLP, Birmingham, Alabama. Adjunct Professor, University of Alabama School of Law, teaching courses since 1994 in banking law and mergers and acquisitions. J.D., University of Alabama School of Law, 1977; M.A., Oxford University (Rhodes Scholar), 1975; B.A., Duke University, 1972. His practice focuses on banks, bank holding companies, and securities regulation in the banking and financial institutions area, including capital raises and mergers and acquisitions. He is the author of *Proxy Regulation*, published by the Practising Law Institute, New York, 1992. Between 1999 and 2007, the Author was counsel for thirteen de novo bank formations in Alabama and Florida, six of which were Alabama state-chartered banks, six of which were national banks, and one of which was a federally chartered savings bank. He would like to thank his law partner, Rob Carothers, for his review of, and helpful comments on, this Article.

I. INTRODUCTION**

Following the formation of 1,000 new banks between 2000 and 2008, the downturn in the economy, which began at the end of that period, witnessed 465 bank failures from 2008 to 2012.[1] More recently, there has been considerable consolidation in the banking industry through mergers and acquisitions, and as of year-end 2018, there were fewer than 5,600 banks chartered under federal and state laws, down from 8,000 banks in 2010.[2] Perhaps as a result of that consolidation, the Federal Deposit Insurance Corporation ("FDIC") stated in 2019 that it was encouraging the formation of new banks.[3] In 2018, the FDIC approved fourteen applications for deposit

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** The onset of the COVID-19 pandemic has disrupted conventional and historic ways that business has been conducted in the United States (and around the world), and the commercial banking industry is not immune to such disruption. Thus, new bank formations and the raising of capital for a de novo bank are likely to be hamstrung by current events. Nevertheless, this Article continues to focus on an essential question in the application of the National Securities Markets Improvement Act.

1. *E.g.*, Fed. Deposit Ins. Corp., Div. of Risk Mgmt. Supervision, *De Novo Banks: Economic Trends and Supervisory Framework*, SUPERVISORY INSIGHTS, Summer 2016, at 3, 3 [hereinafter FDIC, *De Novo Banks*], https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum16/si_summer16.pdf; *Bank Failures in Brief — Summary 2001 Through 2021*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/bank/historical/bank/ (last updated Feb. 18, 2021).

2. Evan Sparks, *A Fresh Perspective*, ABA BANKING J. (Dec. 5, 2018), https://bankingjournal.aba.com/2018/12/a-fresh-perspective/; Am. Bankers Ass'n, Comment Letter on the FDIC's Deposit Insurance Application Process (Feb. 7, 2019), https://www.fdic.gov/regulations/laws/federal/2018/2018-deposit-insurance-application-process-3064-za03-c-004.pdf.

3. Jelena McWilliams, Chairman, Fed. Deposit Ins. Corp., Remarks at the CATO Summit on Financial Regulation: If You Build It, They Will Come (June 12, 2019), https://www.fdic.gov/news/speeches/spjun1219.html; *see also* Monica C. Meinert, *A New Dawn for De Novo Banks*, ABA BANKING J. (Dec. 10, 2018), https://bankingjournal.aba.com/2018/12/a-new-dawn-for-de-novo-banks/; *cf.* Am. Bankers Ass'n, *supra* note 2 (commenting on the FDIC's RFI regarding its Deposit Insurance Application Process to encourage new bank formation). Frequently, new banks are formed after a merger of two relatively large banks. On February 7, 2019, BB&T and SunTrust Banks commenced a merger that, when completed, would make it the largest bank merger in a decade and the post-merger resulting bank the sixth-largest bank in the country. Michael J. de la Merced & Emily Flitter, *The Financial Crisis Put a Chill on Big Bank Deals. That Ended Thursday.*, N.Y. TIMES (Feb. 7, 2019), https://www.nytimes.com/2019/02/07/business/dealbook/bbt-suntrust-bank-mergers.html. The merger was completed on December 6, 2019. Typically, senior executives of the merging banks, such as market presidents or city executives, have the managerial experience and community connections to organize and operate a new bank. Hilary Burns, *Will BB&T-SunTrust Start a De Novo Wave?*, AM. BANKER (Mar. 12, 2019, 2:21 PM), https://www.americanbanker.com/news/will-bb-t-suntrust-merger-start-a-de-novo-wave.
Often, such persons who leave larger banks wish to have a greater impact in a smaller (de novo) bank or closer contact with the community or are unsettled or "disenchanted" with the transaction. *Id.* Thus, in addition to the FDIC's general encouragement of new bank formations, the country's largest bank merger in a decade may well lead to a

insurance for new bank charters (*i.e.*, "de novo" banks), the largest number in a decade.[4] While some stated a belief that the number of new banks chartered in 2019 would diminish compared to 2018,[5] 2019 witnessed a robust number of de novo bank applications with twenty-one applications for new banks filed in 2019.[6] Significantly, the Chairman of the FDIC, Jelena McWilliams, declared that "a dynamic banking sector needs new startups entering the marketplace," and the FDIC "wants to see more de novo banks."[7]

A key component in the organization of a new bank is the raising of funds to capitalize the bank. The FDIC's position generally is that the bank, once in operation, must be able to maintain at least an eight percent capital to assets ratio for the first three years of operation.[8] Some states, like Alabama,

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significant increase in new bank charters. *See id.* (suggesting that the BB&T merger with SunTrust could lead to a wave in new bank formations).

4. *Decisions on Bank Applications*, FED. DEPOSIT INS. CORP. [hereinafter FDIC, *Decisions on Bank Applications*], https://www.fdic.gov/regulations/laws/bankdecisions/depins/index.html (last updated Mar. 10, 2021); *see, e.g.*, Paul Davis, *Organizers Planning New Bank in New York Area*, AM. BANKER (Dec. 2, 2019, 10:49 AM), https://www.americanbanker.com/news/organizers-planning-new-bank-in-new-york-area (stating organizers filed an application for a new bank in New Jersey); Paul Davis, *Organizers Planning Bank in Southern California*, AM. BANKER (Nov. 12, 2019, 6:03 PM), https://www.americanbanker.com/news/organizers-planning-bank-in-southern-california (reporting that a charter application was filed on November 4, 2019 for a California bank in Temecula, California). *But see* Hilary Burns, *Will De Novo Activity Pick Up in 2019? Don't Bet on It*, AM. BANKER (Dec. 21, 2018, 1:33 PM) [hereinafter Burns, *Will De Novo Activity Pick Up in 2019?*], https://www.americanbanker.com/news/will-de-novo-activity-pick-up-in-2019-think-again.

5. Burns, *Will De Novo Activity Pick Up in 2019?*, *supra* note 4.

6. FDIC, *Decisions on Bank Applications*, *supra* note 4; Maria Tor & Lauren Sullivan, *Despite High Growth, Some States Have Zero Postcrisis De Novo Banks*, S&P GLOB. (Dec. 17, 2019), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/despite-high-growth-some-states-have-zero-postcrisis-de-novo-banks-55919993; *see* Paul Davis, *Utah De Novo Gets Conditional OK from FDIC*, AM. BANKER (Dec. 30, 2019, 11:07 AM), https://www.americanbanker.com/news/proposed-utah-de-novo-receives-fdic-approval-for-deposit-insurance (stating that the final number of de novo approvals is nine). As of December 17, 2020, eight new banks had opened in 2020. FDIC, *Decisions on Bank Applications*, *supra* note 4.

7. Jelena McWilliams, *We Can Do Better on De Novos*, AM. BANKER (Dec. 7, 2018, 10:00 AM), https://www.americanbanker.com/opinion/fdic-chairman-jelena-mcwilliams-we-can-do-better-on-de-novos. The growing concerns over COVID-19 have made it harder for organizers to line up initial capital for a new bank, and the number of new banks will not match what it was in recent years, but there will likely be new banks formed in certain markets. Ken McCarthy, *De Novo Activity Has Gone Silent. What Happened?*, AM. BANKER (Mar. 5, 2020, 9:00 PM), https://www.americanbanker.com/news/de-novo-activity-has-gone-silent-what-happened?.

8. FED. DEPOSIT INS. CORP., DIV. OF RISK MGMT. SUPERVISION, APPLYING FOR DEPOSIT INSURANCE: A HANDBOOK FOR ORGANIZERS OF DE NOVO INSTITUTIONS 19 (2019) [hereinafter FDIC, HANDBOOK FOR DE NOVO INSTITUTIONS], https://www.fdic.

have in the past required a nine percent ratio, and frequently the organizers themselves prefer a capital-to-assets ratio well in excess of ten percent to provide a cushion for the business conducted by the bank.[9]

The capital required to form a new bank is raised generally in the organization phase through the sale of common stock to be issued by the bank to be formed.[10] The sale of such stock triggers issues under both state and federal securities laws as to the registration (or exemption) requirements for the sale of securities to the investors that are providing the capital for the new bank.[11] In the area of the issuance and sale of securities, a bank security

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gov/regulations/applications/depositinsurance/handbook.pdf.

9. *See* STATE OF ALA. STATE BANKING DEP'T, GENERAL INFORMATION: ALABAMA STATE-CHARTERED BANK FORMATION 1, http://www.banking.alabama.gov/pdf/bank_charter/GeneraldescriptionofconditionsforformationofanAlabama1.pdf (last visited Feb. 26, 2021) (stating the leverage ratio as nine percent for Alabama state-chartered member banks); *see, e.g.*, Hilary Burns, *De Novo Activity's Up, but Organizers Face Familiar Obstacles*, AM. BANKER (Jan. 24, 2019, 1:51 PM), https://www.americanbanker.com/news/de-novo-activitys-up-but-organizers-face-familiar-obstacles (stating that organizers of banks may face difficulty in raising capital to form a new bank).

10. *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL: CHARTERS 25–29 (2019), https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/charters.pdf (providing the requirements for raising capital as new banks); *see also* Donald M. Zupanec, Annotation, *Validity, Construction, and Effect of Statutory Provisions Concerning Capital Requisites of State Incorporation of Bank*, 79 A.L.R.3d 1190 § 2 (1977) (explaining the normal method of forming a bank).

11. The Securities Act of 1933, as amended, provides, among other things, that no person may offer to sell or sell a security unless the sale is registered with the U.S. Securities and Exchange Commission ("SEC"), or an exemption from such registration is available. 15 U.S.C. §§ 77c–77e. The SEC has stated:

> The federal registration of securities offerings requires the issuer of the securities to disclose all material information relevant to an informed investment decision. This disclosure must be presented in a registration statement filed with the Commission. No sales of securities in a registered offering may occur until the Commission declares the registration statement effective. A registration statement typically becomes effective by order of the Commission. In declaring a registration statement effective under the Securities Act, the Commission does not consider the merits of the offering, but whether all material information is disclosed.

SEC, REPORT ON THE UNIFORMITY OF STATE REGULATORY REQUIREMENTS FOR OFFERINGS OF SECURITIES THAT ARE NOT "COVERED SECURITIES" (1997) [hereinafter SEC, REPORT ON UNIFORMITY], https://www.sec.gov/news/studies/uniformy.htm. States have similar provisions. *See generally* UNIF. SEC. ACT (UNIF. L. COMM'N 2002) (amended 2005) (providing a model statute of securities regulation that states can use). The Uniform Securities Act ("Revised Uniform Securities Act") provides exemptions from registration for certain transactions, such as securities not involving a public offering (corresponds with Section 4(a)(2) of the 1933 Act), and certain types of securities, including U.S. government securities (corresponds with Section 3(a)(2) of the 1933 Act). *Id.* §§ 201, 202; *see also* 15 U.S.C. §§ 77c, 77d. For a discussion of state exemptions from registration for securities issued by a bank, see *infra* notes 33 through 38 and accompanying text.

has a special place that is frequently overlooked and seldom analyzed.

In 1996, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA").[12] Among other things, NSMIA amended Section 18 of the Securities Act of 1933 ("1933 Act").[13] Section 18(a) provides in part that no state may require the registration or qualification of securities if the security is a "covered security" or "will be a covered security upon completion of the transaction."[14] The purpose of NSMIA was to "modernize" the nation's "scheme of securities regulation [in order] to promote investment, decrease the cost of capital, and encourage competition."[15] NSMIA preempted state registration over a variety of securities, including securities listed on a national securities exchange, securities issued by a registered investment company, securities sold to "qualified purchasers," as defined by the Securities and Exchange Commission ("SEC"), and securities sold subject to exemption from registration under SEC Regulation D, Rule 506 ("SEC Rule 506").[16] Much of the focus of this preemption has been placed on the issuance of securities pursuant to SEC Rule 506,[17] the federal exemption from registration that typically relates to "private placements."[18] Although NSMIA's preemption has generated a great deal of commentary about its impact on such exempt offerings,[19] other provisions of Section 18 of the 1933 Act have received

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12. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C. (2006)).

13. Securities Act of 1933 § 18, 15 U.S.C. § 77r.

14. *Id.* (codified as amended at 15 U.S.C. § 77r(a)); *see infra* note 27 and accompanying text. For ease of reference, the citations to the 1933 Act are generally to the statutory sections, not to the U.S. Code sections.

15. *See* H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.).

16. National Securities Markets Improvement Act § 102(a), 15 U.S.C. § 77r(a)–(b); *see* Rutheford B. Campbell, Jr., *The Role of Blue Sky Laws After NSMIA and the JOBS Act*, 66 DUKE L. J. 605, 607 n.3 (2016) [hereinafter Campbell, *The Role of Blue Sky Laws*].

17. *See* National Securities Markets Improvement Act § 102(a), 15 U.S.C. § 77r(b)(4) (exempting securities offered pursuant to Rule 506 from applicable state law).

18. 17 C.F.R. § 230.506(b) (2020). SEC Rule 506(c) also allows an exemption for certain public offers only to "accredited investors," with certain verification procedures of investor qualifications and other requirements. *See id.* § 230.506(c).

19. *See generally, e.g.*, Linda M. Stevens, Comment, *The National Securities Markets Improvement Act (NSMIA) Savings Clause: A New Challenge to Regulatory Uniformity*, 38 U. BALT. L. REV. 445 (2009) (discussing how NSMIA preemption challenges regulatory uniformity); Martin Fojas, Note, *Ay Dios NSMIA! Proof of a Private Offering Exemption Should Not Be a Precondition for Preempting Blue Sky Law Under the National Securities Markets Improvement Act*, 74 BROOK. L. REV. 477 (2009) (arguing that NSMIA preemption should not require "proof of a private offering exemption"); Robert N. Rapp & Fritz E. Berckmueller, *Testing the Limits of NSMIA*

little attention. Among the other securities that enjoy the benefit of state preemption as a "covered security" are the types of securities set forth in Section 18(b)(4)(E), which include a "bank" security exempt from registration with the SEC by Section 3(a)(2) of the 1933 Act.[20] In particular, whether a security *to be issued* by a bank in organization is a covered security and, thus, is exempt from registration under federal law and a beneficiary of preemption under state law is not totally resolved.[21]

This Article focuses upon the interplay between the status of a bank security as a covered security under NSMIA and its status as a security exempt from registration under most state securities laws. This interplay is crucial because satisfaction requires compliance not only with federal law but also with the securities act in every state where the securities will be offered and sold. Thus, the discussion that follows addresses two principal topics: (1) whether, and how, a security issued by a bank to be formed (*i.e.*, a bank "in organization" or a de novo bank) may or may not be a "covered security" entitled to state preemption under NSMIA; and (2) whether a security to be issued by a bank in organization in any case is exempt as a bank security under applicable state securities laws. This second topic is compounded by the fact that, as noted in Part II, virtually all states (apart from NSMIA) provide exemptions from registration for a security issued by a bank while, at the same time, forty-six states also mirror NSMIA and exempt securities that are federal covered securities under Section 18(a) of the 1933 Act. The myriad of forms of state securities statutes that exempt (i) securities issued by banks, or (ii) securities that will be issued by banks, or (iii) securities that are "federal covered securities" under NSMIA, means that for those organizing a bank and seeking necessary capital to receive a bank charter, the roadway to the issuance of securities under federal and state law is circuitous and marked by caution.

Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure, 63 BUS. LAW. 809 (2008) (commenting on blue sky laws and "the intended scope of NSMIA preemption"); Rutheford B. Campbell Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAW. 575 (1998) [hereinafter Campbell, *The Impact of NSMIA*] (noting how NSMIA could be used to offer much-needed support to small issuers). One observation about NSMIA is that while NSMIA was supposed to "revolutionize" the securities registration process, NSMIA's effectiveness "has been limited to exempt private offerings made under Rule 506 of Regulation D." Jeffery D. Chadwick, Comment, *Proving Preemption by Proving Exemption: The Quandary of the National Securities Markets Improvement Act*, 43 U. RICH. L. REV. 765, 766 (2009).

20. Securities Act of 1933 § 18(b)(4)(E), 15 U.S.C. § 77r(b)(4)(E) (exempting from state regulation classes of securities under Section 3(a)(2), which include "any security issued or guaranteed by any bank"); *see also id.* § 3(a)(2), 15 U.S.C. § 77c(a)(2).

21. *See infra* notes 36–37 and accompanying text.

II. NSMIA AND THE BANK IN ORGANIZATION

At first glance, the ability of a de novo bank to issue a bank security without running afoul of the federal securities laws and to receive the benefit of state preemption under NSMIA seems reasonably certain. Section 3(a) of the 1933 Act contains a list of securities that are exempt from registration.[22] Among those securities are securities "issued or guaranteed by any bank."[23] The rationale for the exemption afforded to a bank security (as well as the other securities listed in Section 3(a)), as stated by the SEC, is that the exemption for such securities is based on an "alternative regulatory scheme" or federal policy.[24] Thus, because banks are heavily regulated under federal and state law, the federal exemption utilized by banks appropriately appears as an exempt security in Section 3(a) of the 1933 Act.[25]

NSMIA does not itself create new federal exemptions from registration but instead addresses the types of securities entitled to preemption from state registration requirements.[26] Section 18(a) of the 1933 Act establishes preemption as follows:

> **Scope of Exemption**. Except as otherwise provided in this section, no law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof —
>
> > (1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that —
> >
> > > (A) is a covered security; or
> > >
> > > (B) will be a covered security upon completion of the transaction.[27]

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22. Securities Act § 3(a), 15 U.S.C. § 77c(a).

23. *Id.* § 3(a)(2).

24. SEC, REPORT ON UNIFORMITY, *supra* note 11; *cf.* 1 A.A. SOMMER, JR., FEDERAL SECURITIES ACT OF 1933 § 3.03(4)(a) (Matthew Bender, rev. ed.) (stating that banks are some of the most highly regulated entities in the country). Banks are chartered and regulated by the Office of the Comptroller of the Currency ("OCC"). State banks are chartered and regulated by the state banking authority where the state bank is acquired but a state bank also has a primary federal regulator: either the Board of Governors of the Federal Reserve System, for state "member banks," or the Federal Deposit Insurance Company ("FDIC"), for state "non-member" banks. The deposits of both national and state banks are insured by the FDIC. *See* RICHARD SCOTT CARNELL ET AL., THE LAW OF FINANCIAL INSTITUTIONS 60–63 (5th ed. 2013) (highlighting the "baroque" system of financial regulatory bodies in the United States and delineating between the roles of the OCC, FDIC, Fed, and state regulators).

25. SOMMER, *supra* note 24, § 3.03(4)(b).

26. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102(a), 110 Stat. 3416, 3417 (1996) (codified as amended at 15 U.S.C. § 77r(a)).

27. Securities Act of 1933 § 18(a), 15 U.S.C. § 77r(a).

Section 18(b) furnishes a list of what constitutes a "covered security,"[28] and Section 18(b)(4)(E) specifies that with limited exceptions securities exempt from registration under Section 3(a) of the 1933 Act (*e.g.*, one of which is a bank security) is a covered security.[29]

While NSMIA mandates that states may not require the registration of a covered security under state law, Section 18(c)(2) of the 1933 Act enables states to call for a notice filing and the payment of filing fees for the covered securities offered in such states.[30] Section (18)(c)(1) also preserves the right of state securities authorities to pursue enforcement actions for fraud in the sale of a covered security.[31] Thus, even under NSMIA, a state securities regulator may nevertheless require that a notice filing be made with that regulator before a covered security may be offered or sold in the state.[32]

Just as the 1933 Act contains a complete exemption from registration for securities issued or guaranteed by a bank, state securities laws provide a similar exemption. The Revised Uniform Securities Act of 2002 sets forth in Section 201(3) an exemption for a security issued by a banking institution organized under the laws of the United States (*e.g.*, a national bank chartered by the Office of the Comptroller of the Currency ("OCC")) and a security issued by a depository institution with accounts insured by the FDIC (*e.g.*, a state-chartered bank).[33] Whether a bank follows the Revised Uniform Securities Act, however, most states also provide their own separate exemptions for bank securities that require no notice or other filing with the applicable state securities authorities because the state statutory exemption for a bank security is generally a self-executing exemption.[34] Thus, a bank security receives special treatment in two ways: (1) NSMIA preempts state

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28. *Id.* § 18(b).

29. *Id.* § 18(b)(4)(E).

30. *Id.* § 18(c)(2).

31. *Id.* § 18(c)(1). For a discussion of the ability of states to enforce antifraud rules, and a critique of Congress's failure to provide a complete preemption of state authority to require registration, see Campbell, *The Role of Blue Sky Laws*, *supra* note 16, at 613–17.

32. *See* Campbell, *The Role of Blue Sky Laws*, *supra* note 16, at 613–14.

33. UNIF. SEC. ACT § 201(3) (UNIF. L. COMM'N 2002) (amended 2005). The deposits of both national and state banks are insured by the FDIC. Most securities that are exempt from registration under Section 3 of the 1933 Act are also exempt from registration under state securities statutes. *See* 2 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 8:14 (7th ed. 2016), Westlaw (databased updated Dec. 2020). Appendix A of Hazen's treatise sets forth the applicable statutory references for exemptions for a bank security in all fifty states plus the District of Columbia. *See* 7 *id.* app.

34. *See infra* note 87; *see, e.g.*, ALA. CODE § 8-6-10(3) (2019); CAL. CORP. CODE § 25100(c) (West 2020); FLA. STAT. § 517.051(3)(a), (5) (2020); GA. CODE ANN. § 10-5-10(3)(B) (2020); MASS. GEN. LAWS ch. 110A, § 402(a)(3) (2019); VA. CODE ANN. § 13.1-514.A.3 (2020).

registration of the bank security as a "covered security"; and (2) all states apart from NSMIA provide some type of exemption from state registration requirements for securities issued by a bank under state blue sky laws, except for Nebraska.[35] The clarity of the status of a "bank" security as a covered security entitled to preemption from state law registration requirements, however, diminishes respecting a covered security that falls under Section 18(a)(1)(B) of the 1933 Act — *i.e.*, a security that "will be a covered security upon completion of the transaction."[36] Such clarity is called into question at least in part because Section 18(a)(1)(B) has not been examined in the context of a bank in organization. For example, it has been noted that while NSMIA identifies the classes of covered securities, Congress "made no provision for any determination as to the validity of a claim that a security in an offering is, in fact, a 'covered security.'"[37] Thus, whether securities to be issued by a bank in organization are entitled to covered security status under NSMIA is a question not fully answered by the language of NSMIA and, accordingly, the relationship between NSMIA and state exemptions for a bank security has yet to be examined.[38] Before focusing further upon that

35. Nebraska also does not have a separate exemption for a bank security, but bank securities receive federal covered security status under Nebraska Law. *See infra* note 116.

36. Securities Act of 1933 § 18(a)(1)(B), 15 U.S.C. § 77r(a)(1)(B).

37. Rapp & Berckmueller, *supra* note 19, at 811–12.

38. New York law ("Martin Act") differs from most other state securities acts in that it does not require the registration of securities offerings — with limited exceptions — and instead obligates issuers and others selling securities to register as securities dealers. *See* N.Y. GEN. BUS. LAW § 359-e (McKinney 2021) (detailing definitions and registration requirements regarding the sale or purchase of securities for dealers, brokers, or salesmen). The Martin Act generally does not provide for exemptions for securities offerings as other states do, such as exemptions for private placements or Regulation D offers, although it does provide an exemption for bank securities. *Id.* § 359-f.1(c), (f). The New York State Bar Association has criticized the Martin Act as being in conflict with federal law and the laws of other states because it does not specifically address the question of securities as covered securities. Comm. on Sec. Regul. of the N.Y. State Bar Ass'n, *Private Offering Exemptions and Exclusions Under the New York State Martin Act and Section 18 of the Securities Act of 1933*, N.Y. BUS. L.J., Fall 2002, at 10, 10, https://nysba.org/app/uploads/2020/07/Private-Offering-Exemptions-and-Exclusions.pdf. The Report notes the interplay between NSMIA's preemption of state registration requirements for covered securities and state law and criticizes the Martin Act as being in conflict with NSMIA. *Id.* at 13. It states that "New York State may not require the registration of issuers as dealers as a way of indirectly requiring registration of transactions in covered securities." *Id.* At the same time, effective December 2, 2020, the Office of the Attorney General of the State of New York adopted guidance for issuers selling Regulation D covered securities by permitting them to file a Form D, with a filing fee, to bring New York in line with most other states regarding exempt offerings under Regulation D. STATE OF N.Y., OFF. OF THE ATT'Y GEN., GUIDANCE ON MANDATORY FILING OF FORM D WITH ELECTRONIC FILING DEPOSITORY FOR FEDERAL COVERED REGULATION D DEALERS (13 NYCRR 10.1(A)(3) AND 10.11(B)) 1 (2020), https://ag.ny.

relationship, however, the chartering process of a de novo bank and the application of NSMIA to the chartering process should be explored.

III. THE BANK CHARTERING PROCESS

Although bank securities are exempt from registration under the 1933 Act and are generally, but not uniformly, exempt under the securities laws of all fifty states and the District of Columbia,[39] the question nevertheless arises as to whether securities offered by a bank in organization are exempt from registration under state and federal law. Typically, a bank in organization is formed under the chartering authority of either the OCC, for national banks,[40] or for state banks, the state where the bank will be headquartered.[41] The deposits of all banks (both national and state) are insured by the FDIC.[42] As part of the application process for the organization of a de novo bank the organizers must submit to the chartering authority a detailed application outlining, among other things, the business plan of the bank, pro forma financial statements showing projected operations, the amount of capital to be raised, and detailed financial and biographical information on the proposed directors and executive officers.[43] An application for deposit insurance must also be submitted to the FDIC for both national and state banks to be formed.[44] This review process by the banking regulators can

gov/sites/default/files/part10-efd-formd-guidance.pdf. The Texas Securities Act is similar to New York's Martin Act in that it requires the registration of dealers (including issuers) to sell securities. A "dealer" includes "any issuer" who offers for sale or sells its own security. TEX. REV. CIV. STAT. ANN. art. 581-4, § C (West 2019); TEX. REV. CIV. STAT. ANN. art. 581-7 § A (West 2019).

39. Some states exempt securities issued by a bank, regardless of whether the bank is a national bank, a bank organized under the law of the state in question, or under the law of any other state. *See, e.g.*, COLO. REV. STAT. § 11-51-307(1)(c) (2020); GA. CODE ANN. § 10-5-10(3); MD. CODE ANN., CORPS. & ASS'NS § 11-601(3) (LexisNexis 2021); VA. CODE ANN. § 13.1-514A.3. Other states exempt securities issued by a national bank or only a bank organized in that state but do not grant an exemption for banks organized under the laws of other states. *See infra* note 87; *see, e.g.*, ARIZ. REV. STAT. ANN. § 44-1843A.2 (2021); CAL. CORP. CODE § 25100(c); LA. STAT. ANN. § 51:708(3) (2020); OR. REV. STAT. ANN. § 59.025(3), (6) (2019).

40. 12 U.S.C. § 27(b).

41. *See supra* note 24.

42. 12 U.S.C. § 1815(a).

43. *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 23–24 (highlighting factors that the OCC considers in approving bank charter applications); FDIC, HANDBOOK FOR DE NOVO INSTITUTIONS, *supra* note 8, at 13–17; *see also* FDIC, *De Novo Banks*, *supra* note 1, at 4–5.

44. *See* FDIC, *De Novo Banks*, *supra* note 1, at 4–5. For a helpful overview of the bank chartering process, see Am. Bankers Ass'n, *supra* note 2.

take months to complete.[45] During that time, the organizers of the bank (typically the proposed directors and executive officers) contact potential investors about investing in the common stock of the bank once the bank in organization receives regulatory approval to open and obtains its charter. Normally, regulatory approval is a "conditional approval" with the major condition being the raising of the minimum capital required to open the bank.[46] During this time, when subscriptions for the common stock of the bank to be formed are being received from investors, the question arises as to whether the solicitations and receipt of such subscriptions by the bank in organization must be registered under either applicable state securities acts or the 1933 Act.

As already noted, under NSMIA, Section 18(a) of the 1933 Act specifies that no law, rule, or regulation of any state requiring registration of securities shall apply not only to a security that is a covered security,[47] but also to a security that "will be a covered security upon completion of the transaction."[48] Section 18(b)(4)(E) then states that a covered security is, among other things, a security that is exempt from registration under Section 3(a)(2) of the 1933 Act, and that Section includes a bank security.[49]

Section 18(a)(1)(B) thus implies, if not expressly provides, that the offer of a security that will become a covered security upon completion of a transaction, such as happens with a bank in organization, is not subject to state registration requirements.[50] This conclusion follows because Section 18(b)(4)(E) designates a bank security as a covered security, and Section 18(a)(1) preempts state registration requirements both for covered securities and a security that will become a covered security upon completion of the transaction.[51] Accordingly, a security to be issued by a bank, once formed, should be entitled under NSMIA to preemption from state registration, albeit a state may require a notice filing for the bank in organization.[52] The

45. *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 34.

46. *Id.* at 39–40.

47. *See* Securities Act of 1933 § 18(a)(1)(A), 15 U.S.C. § 77r(a)(1)(A).

48. *Id.* § 18(a)(1)(B).

49. *Id.* § 18(b)(4)(E); *see id.* § 3(a)(2).

50. *Id.* § 18(a)(1)(B).

51. *See id.* § 18(a)(1), (b)(4)(E).

52. A.A. Sommer, *Introduction to the National Securities Markets Improvement Act of 1996*, *in* THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996 3, 4 (Matthew Bender ed., 1996). The legislative history of NSMIA does not expressly address this issue, and there seems to be little commentary or focus on this matter. One noted commentator has simply said that NSMIA lists those securities (including bank securities) that are covered securities and that a covered security is defined as, among other things, "a security that will become a covered security under any of the foregoing definitions of covered security upon completion of the transaction." *Id.*

foregoing seems simple and logical, but the logic is inconclusive because Congress granted no explicit path for determining whether or how a covered security is present.[53]

Similarly, the SEC has not taken an official position regarding the interpretation or application of Section 18(a)(1)(B). However, in response to an inquiry regarding whether the SEC has voiced an opinion regarding how Section 18(a)(1)(B) might apply to a bank in organization, the staff has stated informally that SEC no-action letters pre-dating the passage of NSMIA would be the most likely source expressing the staff's views.[54] In other words, the staff's pre-NSMIA views outline how, and whether, a security of a bank in organization is entitled under the 1933 Act to the exemption from registration as a *bank* security under Section 3(a)(2).[55] The SEC has a number of no-action letters which speak to this issue and which reinforce the concept that a bank in organization may seek and accept subscriptions for the stock to be issued upon the formation of the bank in reliance on the exemption for a bank security under the 1933 Act.[56] Analyzing these letters provides a foundation for determining how to apply the language in NSMIA Section 18(a)(1)(B) to whether a security will be a covered security upon completion of the transaction.[57]

In *County First Bank*,[58] the organizers sought a no-action position from the SEC that they could seek subscriptions, with funds placed in escrow, in reliance on the exemption for a bank security under Section 3(a)(2) of the 1933 Act, for a bank to be formed under Maryland law.[59] According to the no-action request, the subscription funds would be placed in escrow with an independent bank, with funds invested in government-backed or money-market funds.[60] Such funds would not be released until the State of Maryland

53. *See* sources cited *supra* note 19 and accompanying text.

54. Telephone Interview with SEC Staff Member (Sept. 25, 2019) (on file with author). The SEC has a procedure pursuant to which requests for Interpretive Advice may be submitted by e-mail with a staff response within one day.

55. *See id.*

56. *See, e.g.*, County First Bank, SEC Staff No-Action Letter, 1989 WL 245807 (Mar. 31, 1989); Bank of World, SEC Staff No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,503, 1983 WL 28341 (June 6, 1983).

57. *See generally* County First Bank, *supra* note 56 (stating staff will not recommend that the Commission take any action for a proposed pre-organizational public offering by County First Bank in which the bank is relying on exemption for bank securities); Bank of World, *supra* note 56 (stating staff will not recommend enforcement action for issuance of pre-organizational subscriptions by Bank of World in which funds would only be collected upon conditional approval by the state regulator).

58. County First Bank, *supra* note 56.

59. *Id.*

60. *Id.*

Bank Commissioner ("Commissioner") issued a certificate for the bank to conduct business and the FDIC had granted approval for deposit insurance.[61] Specifically, under Maryland law, the organizers of the bank were required to file the bank's proposed articles of incorporation, certain economic information about the proposed bank, and biographies of its directors with the Commissioner.[62] If the Commissioner approved the articles of incorporation, the organizers were then required to provide a certified list of stockholders and the number of shares for which subscriptions were received.[63] The organizers raised initial funds for the proposed bank to defray organizational costs followed by a "public subscription offering" commenced after filing the documents noted above with the Commissioner.[64] The SEC staff agreed that the exemption from registration found in Section 3(a)(2) was available and granted the no-action request.[65] The staff remarked in particular that the bank and its organizers would be subject to regulations issued by the Commissioner and that "there will be no risk of loss of funds invested in the public pre-organizational common stock subscription offering."[66]

An earlier no-action letter dealt with Pennsylvania law.[67] In *Bank of World*,[68] a Pennsylvania state-chartered bank was in organization and requested a no-action letter from the SEC staff for the issuance of stock through pre-organization subscriptions.[69] The request explained that the bank in formation would not distribute an offering circular or collect any subscription funds until it had received conditional approval from the

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.* The staff had previously taken the same position in similar circumstances. *See, e.g.*, Commerce Bank Corp., SEC Staff No-Action Letter, 1988 WL 235078 (Sept. 19, 1988) (noting that investors have an "absolute right" to withdraw subscription funds from escrow if the bank in organization does not receive state and federal approval, and finding that the investor had an absolute right to withdraw subscriptions if a bank charter was not granted under Maryland law); The Springs Bank, SEC Staff No-Action Letter, 1987 WL 108290 (June 15, 1987) (stating that the proposed bank's organizers immediately began the offer and sale of subscriptions after filing its application with the Florida banking authorities, and subscription funds held in escrow would be returned to subscribers if the bank was unable to obtain a charter and commence operations under Florida law). The cover letter in the Springs Bank request stated that it is not clear at what point "a bank in the process of organization" becomes a "banking institution" under Section 3(a)(2) of the 1933 Act. *See id.*; *see also infra* Part VI.

67. Bank of World, *supra* note 56.

68. *Id.*

69. *Id.*

Pennsylvania banking regulator for the charter.[70] Thereafter, subscription funds would be placed in escrow and the funds would be returned to investors if the Pennsylvania regulator so directed.[71] As the letter from the bank in organization stated: "there [is] no risk of loss [to the investor] during the subscription period."[72] The SEC staff granted the no-action request that the exemption for bank securities under Section 3(a)(2) of the 1933 Act could be followed.[73] As with *County First Bank*, the staff noted particularly that the organization of a bank is governed by Pennsylvania law and there would be "no risk of loss of funds invested in pre-organizational subscriptions."[74]

The foregoing analysis of whether a security of a bank in organization is entitled to NSMIA preemption seems simple enough, but it is compounded by the fact that some state securities regulators do not follow the same logic employed by the SEC staff in the foregoing no-action letters and do not view securities to be issued by a bank in organization to be either "bank" securities subject to a state exemption or covered securities under NSMIA.[75] In addition, some state securities statutes contain language similar to that in Section 18(a)(1)(B) of the 1933 Act to include banks in organization under the state law exemption for bank securities, while other state statutes providing for a bank security exemption do not incorporate such language, leaving open the question of whether a bank in organization may rely on the state exemption in question for bank securities.[76] As outlined further below, some states have explicitly ruled that the exemption is not applicable to a bank in organization.[77] While a clear purpose of NSMIA is to "eliminate duplicative and unnecessary regulatory burdens"[78] in the sale of securities,

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70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* A more recent SEC no-action letter involved an analogous situation in which distressed assets of credit unions in danger of failure were to be placed in special purpose entities ("SPEs"). The SPEs would sell securities of the SPE to investors. The securities would be guaranteed by the full faith and credit of the National Credit Union Administration ("NCUA"). NCUA submitted a no-action request to the SEC stating that the investments in the SPEs were exempt from registration under Section 3(a)(2) of the 1933 Act, which, among other things, exempts securities issued or guaranteed by any person controlled or supervised by an instrumentality of the United States. The SEC staff agreed the securities could be sold to investors who had been given information describing, among other things, the assets held in the SPEs and the guaranty program. *See* Corporate Credit Union Legacy Assets Resolution Program of the National Credit Union Administration, SEC Staff No-Action Letter, 2010 WL 3737921 (Sept. 24, 2010).

75. *See supra* notes 37–38 and accompanying text.

76. *See infra* note 87.

77. *See infra* notes 109–14 and accompanying text.

78. H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.); *see also* Campbell, *The Role*

NSMIA has been criticized for failing to eliminate such burdens.[79] It has been argued that small businesses are subject to the same state rules after NSMIA as they were before it was passed.[80] This argument mirrors the issues confronted by the organizers of a bank as to whether NSMIA preempts the state regulatory burdens in the formation of a de novo bank or whether, despite NSMIA, state securities authorities may still apply state registration requirements for banks in organization.

IV. THE INTERPLAY BETWEEN NSMIA AND STATE LAW

Section 201(3)(B) of the Revised Uniform Securities Act contains a concept similar to Section 18(a)(1)(B) by exempting from state registration "a security issued by and representing *or that will represent* [emphasis added] an interest in or a direct obligation of . . ." a banking institution organized under federal law (*e.g.*, a national bank) or a depository institution with deposits insured by the FDIC (*e.g.*, a state bank).[81] The emphasized language of the Revised Uniform Securities Act plainly provides that a security to be issued by a bank in organization is exempt from registration.[82] The official comments to the Revised Uniform Securities Act do not address this issue, however, and they only refer to Section 18(b)(4)(C) (now 18(b)(4)(E)) of NSMIA.[83] Nevertheless, the Revised Uniform Securities Act appears to be asserting, consistent with NSMIA Section 18(a)(1)(B), that a security of a bank in organization will have the benefit of the exemption as a bank security inasmuch as the bank in organization is offering a security that, in the organization phase, "will represent" a bank security upon the

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of Blue Sky Laws, *supra* note 16, at 627–30 (analyzing the inefficiencies in securities regulation before the enactment of NSMIA).

79. *See* Stevens, *supra* note 19, at 446–47 (arguing that the "savings clause" of NSMIA, which allows states to investigate securities fraud, has been used by states as a "loophole" to enforce disclosure requirements and defeat the purpose of NSMIA). It has also been argued that "state securities registration requirements . . . are ineffective in protecting investors." *E.g.*, Fojas, *supra* note 19, at 484.

80. *See* Campbell, *The Impact of NSMIA*, *supra* note 19, at 581. *But see* Campbell, *The Role of Blue Sky Laws*, *supra* note 16, at 627 n.118 (noting that NSMIA does not preempt a state's ability to prosecute securities fraud, allowing states to "enjoy [the] efficiencies" afforded to federal authorities in prosecuting "bad acts"). However, that NSMIA does not preempt a state's ability to prosecute securities fraud is a positive feature. "States may actually enjoy efficiencies compared to federal authorities in prosecuting . . . bad acts." *Id.* For example, the proximity of state regulators to the actual participation of the fraud may make the detection and gathering of information less expensive.

81. UNIF. SEC. ACT § 201(3)(B), (C) (UNIF. L. COMM'N 2002) (amended 2005).

82. *Id.* § 201(3)(B).

83. *See id.* § 201(3) cmt. 3.

grant of the bank charter.[84] Louis Loss and Joel Seligman stated without equivocation that "[t]he Revised Uniform Securities Act totally exempts preorganization certificates or subscription agreements of depository institutions subject to state or federal supervision."[85] Thus, in those states that follow the Revised Uniform Securities Act, even without NSMIA preemption contained in Section 18(a)(1)(B) of the 1933 Act, a bank in organization should be free to utilize the applicable state law exemption for a bank security.[86]

Not all states have adopted the Revised Uniform Securities Act, however. The exemption under many state securities acts for a bank security declares only that a security issued by any bank organized under federal law or the laws of the state in question is exempt from registration, and it does not address a security that "will represent" a bank security.[87]

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84. *See id.* § 201(3) (including in the list of exempt securities a security "that will represent an interest in . . . a banking institution . . . .").

85. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 21 n.51 (3d ed. 1995).

86. *See* UNIF. SEC. ACT § 201(3)(B).

87. The following states have adopted the language or substantially similar language from the Revised Uniform Securities Act that exempts a security issued by, or that "will represent" a security issued by, a bank: Alaska, Connecticut, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, New Mexico, North Dakota, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin, and Wyoming. *See, e.g.*, CONN. GEN. STAT. § 36b-21(a)(3) (2019); GA. CODE ANN. § 10-5- 10(3) (2020); IND. CODE § 23-19-2-1(3)(B) (2020); MINN. STAT. § 80A.45(3)(B) (2020); N.M. STAT. ANN. § 58-13c-201.C(2) (West 2021); WIS. STAT. ANN. § 551.201(3)(b) (2021). The securities acts in the following states, while exempting a security issued by a bank, do not contain language purporting to exempt a security that will represent a bank security: Alabama, Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Montana, Nevada, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Texas, Utah, Virginia, Washington, and West Virginia. *See, e.g.*, ALA. CODE § 8-6-10(3) (2019); CAL. CORP. CODE § 25100(c) (West 2020); DEL. CODE ANN. tit. 6 § 73-207(a)(3) (2021); LA. STAT. ANN. § 51:708(3) (2020); N.C. GEN. STAT. § 78A-16(3) (2020); TENN. CODE ANN. § 48-1-103(a)(3) (2019); WASH. REV. CODE § 21.20.310(3) (2020). Nebraska's law does not explicitly exempt a bank security, but it exempts a federal covered security if no commission is paid. NEB. REV. STAT. § 8-1108.02(6) (2020); *see infra* note 116. As stated, some state exemptions apply to national bank securities — and only to securities issued by banks organized under the laws of that particular state — but not to securities of banks in other states. *See supra* note 39. The Uniform Securities Act of 1956, as amended, while providing an exemption from registration for a federal covered security, does not state in its exemption for a security issued by a bank that the exemption is also for a security that "will represent" a bank security. UNIF. SEC. ACT § 402 (UNIF. L. COMM'N 1956) (amended 1958). The official comment to that section states that the exemption applies only if the security represents an interest in the "particular issuer." This may imply that an interest in a bank to be formed is not exempt. *Id.* § 402(a)(3) cmt.

Given the language from NSMIA that state registration requirements are preempted for a security that is a covered security, or a security that will be a covered security upon completion of the transaction, together with the "prospective language" in those state securities laws that follow the Revised Uniform Securities Act and exempt bank securities or a security that "will represent" a bank security, it seems clear that a bank in organization may (without considering NSMIA's impact) offer in those states securities of the bank that will come into existence on the date the bank charter is granted.[88] The foregoing, while seemingly straightforward, does not completely answer the question of whether state blue sky registration requirements apply to securities offered by banks in organization. Many states, as already noted, do not follow the most recent version of the Revised Uniform Securities Act's exemption for a security "that will represent" a bank security, and for those states, the offer of securities of a bank in organization may (without considering NSMIA's impact) still present registration questions under state law.[89] Even for states that follow the Revised Uniform Securities Act, a state registration issue for a bank in organization could be present, as explained below.[90]

A. State Recognition of "Federal Covered Securities"

Under Section 18(a)(1)(B) of NSMIA, a security offered by a bank in organization, while not a "bank" security when offered but a bank security "upon completion of the transaction," should be entitled to federal covered security status. If so, then securities offered by a bank in organization ought to receive preemption of state registration requirements, subject to any applicable state notice filing requirements.

Most states themselves have exemptions from registration for federal covered securities.[91] Such states generally define a federal covered security as a "security that is, or upon completion of a transaction will be, a covered

88. *See* 15 U.S.C. § 77r (establishing preemption of state regulation of securities offerings); UNIF. SEC. ACT § 201 (detailing securities that are exempt from registration).

89. *See supra* note 87.

90. *See infra* Part V.

91. The following states have exemptions from registration for a "federal covered security": Alaska, Arkansas, Arizona, California, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming. *See, e.g.*, GA. CODE ANN. § 10-5-2(9); KAN. STAT. ANN. § 17-12a301(l) (2020); ME. REV. STAT. ANN. tit. 32, § 16301.1 (2021).

security under Section 18(b)" of the 1933 Act.[92] Thus, the language in such state statutes addressing a security that is or "upon completion" of a transaction is a federal covered security reinforces the concept under state law that a bank in organization may seek and accept subscriptions for the securities to be issued by the bank when formed.[93] Yet, there are only a few interpretations (official or informal) by state securities administrators as to how the federal covered securities definition should be applied to a security that will be a federal covered security upon completion of the transaction.

The states that recognize a statutory exemption for a federal covered security generally provide by statute or regulation that the state securities regulator may require a notice filing for a covered security.[94] Such notice filings are frequently made for SEC Rule 506 offers and certain other types of federal covered securities, but no notice filing is typically required for a federal covered security that is a bank security.[95] For example, Texas requires a notice filing for federal covered securities offered in Texas, but the Texas Administrative Code provides that the filing requirement does not apply to federal covered securities that are exempt from registration under the Texas Securities Act.[96] The Texas Securities Act exempts from registration securities issued by a national bank or a bank organized under state law.[97]

One state that has furnished informal, non-binding advice about a bank in

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92. *See, e.g.*, GA. CODE ANN. § 10-5-2(9); KAN. STAT. ANN. § 17-12a301(l)); *id.* § 17-12a102(7); ME. REV. STAT. ANN. tit. 32, § 16301.1.

93. *See, e.g.*, GA. CODE ANN. § 10-5-2(9); KAN. STAT. ANN. § 17-12a301(l); ME. REV. STAT. ANN. tit. 32, § 16301.1.

94. *See, e.g.*, OR. REV. STAT. ANN. § 59.049(2) (2019); KAN. STAT. ANN. § 17-12a302(c).

95. *See, e.g.*, COMM'R OF SEC. STATE OF GA., UNIFORM ACT IMPLEMENTATION ORDER 2009-03: ORDER REQUIRING ENTITIES ISSUING FEDERAL COVERED SECURITIES IN GEORGIA TO MAKE NOTICE FILING 1 (2009), https://sos.ga.gov/admin/files/Uniform_Act_Implementation_Order_2009-03.pdf; GA. CODE ANN. § 10-5-2(9); KAN. STAT. ANN. § 17-12a302(c); ME. REV. STAT. ANN. tit. 32, § 16302(5); MASS. GEN. LAWS ch. 110A, § 306(c) (2019); OR. REV. STAT. ANN. § 59.049(2), (3).

96. 7 TEX. ADMIN. CODE § 114.1(b) (2021).

97. TEX. REV. CIV. STAT. ANN. art. 581-5, § L (West 2019). The Arkansas Securities Commission, following the passage of NSMIA, adopted regulations providing that, in keeping with NSMIA, certain covered securities, such as securities issued by an investment company or pursuant to SEC Regulation D, would be subject to a notice filing and payment of a fee, but it did not address the status of other covered securities such as a bank security. STATE OF ARK. SEC. DEP'T, ORDER NO. 98-031-S: ORDER WAIVING REQUIREMENTS PURSUANT TO ARK. CODE ANN. § 23-42-509(f) (1998), http://www.securities.arkansas.gov/!userfiles/Orders/1998/98_031_S.htm. The Illinois statute provides that all issuers of any covered security (with limited exceptions not including bank securities) shall annually file a notification with the secretary of state and pay a prescribed filing fee. ILL. ADMIN. CODE tit. 14, § 130.293(a) (2021).

organization is Oregon. The Oregon Securities Act exempts securities issued by a national bank or a bank issued under Oregon law.[98] Oregon grants an exemption for federal covered securities provided that a notice filing is made with the State of Oregon but provides that no notice filing is required for certain federal covered securities, including bank securities.[99] In response to an informal written inquiry regarding the applicability of the Oregon exemption for a security to be issued by a national bank in organization, the staff of the Oregon Department of Consumer and Business Services stated that while no bank exemption would be available for securities offered by a national bank in organization, it was possible that such a security would be exempt under Section 3(a)(2) and fall under the definition of covered security under Section 18 of the 1933 Act.[100] The Department noted that Oregon is "preempted from requiring the registration of a security that is or *would be* a federal covered security."[101] The Department also stated that the analysis would turn on "whether the security 'would be' a federal covered security,"[102] and emphasized that that is a question of federal law.[103]

The foregoing response from Oregon is insightful in that it highlights that in addition to state securities law exemptions for a bank security, a federal covered security is preempted from state registration or filings apart from notice filings and the payment of a filing fee, as NSMIA provides.[104] The response also mirrors the question as to how NSMIA's Section 18(a)(1)(B) should be applied.[105] Thus, the real issue reverts to whether a federal covered

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98. OR. REV. STAT. ANN. § 59.025(3), (6). Note that the statutory bank exemption does not apply to state banks organized in states other than Oregon. Thus, the status of a security of a bank to be formed as a covered security under NSMIA is all the more important where state securities registration exemptions apply only to securities issued by a national bank or by the bank organized under the laws of the state in question, but *not* under the laws of other states. *See infra* notes 100–08 and accompanying text.

99. *See* OR. REV. STAT. ANN. § 59.049(2); OR. ADMIN. R. 441-049-1001(3) (2020).

100. E-mail from Staff, Or. Dep't of Consumer & Bus. Servs., to author (Jan. 25, 2019, 10:12 AM) (on file with author).

101. *Id.*

102. *Id.* The staff noted that a notice of filing would be required under OR. ADMIN. R. 441-049-2041(1)(a) with a filing fee. *Id.* Wisconsin has a summary statement about "federal covered securities," and it states that "federal covered securities" includes a list of securities noted in the statement as covered securities under NSMIA, one of which is a security sold pursuant to Section 3(a) of the 1933 Act. Significantly, the statement concludes that covered securities entitled to NISMIA preemption include "[s]ecurities that will be federal covered securities under any of the above upon completion of the transaction." *Federal Covered Securities*, STATE OF WISC. DEP'T OF FIN. INSTS., https://www.wdfi.org/fi/securities/regexemp/covered_securities (last visited Feb. 28, 2021).

103. E-mail from Staff, Or. Dep't of Consumer & Bus. Servs., *supra* note 100.

104. *See* 15 U.S.C. § 77r(a)(1)(A).

105. *See* E-mail from Staff, Or. Dep't of Consumer & Bus. Servs., *supra* note 100

security is present.

B. State Exemptions Only for "Bank" Securities

Apart from NSMIA, however, securities offered by a bank in organization should also be entitled to status as a bank security under state blue sky laws, even for those state laws that do not provide that the exemption applies to a security that will represent a bank security.[106] A state that has taken a different approach, however, and published reasonably detailed official guidance on this issue is Alabama. The Alabama Securities Act at Section 8-6-10(3)[107] provides an exemption for "any security" issued by a national bank or a bank organized under the laws of Alabama. The statute says nothing about a security that "will represent" a security of a bank.[108]

The Alabama Securities Commission ("Alabama Commission") in a policy statement concedes that NSMIA expanded the exemption for bank securities as a "covered security."[109] The Alabama policy also states, however, that the Alabama Commission's position is that "the status of covered security is not available for securities issued by a bank in the process of organization."[110] The Alabama policy does not address the language in Section 18(a)(1)(B) of NSMIA regarding a security that "will be" a covered security.[111] The Alabama policy further states that if any securities are to be "sold to generate funds that will be *used or placed at risk* before the formal incorporation of the bank," those securities must find an exemption from registration other than the exemption for a bank security or else be registered under the Alabama Securities Act.[112] The Alabama policy then provides a

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(indicating it is the state government's interpretation that Section 18(a)(1)(B) preempts state securities registration requirements).

106. The states where the security of the bank in organization is offered could require a notice filing. *See, e.g.*, ALA. CODE § 8-6-10(3) (2019) (noting one state where the security of the bank in organization is subject to supervision by federal laws or by state laws).

107. *Id.*

108. *See generally id.* (finding no mention of securities that represent the security of a bank). Between 2002–2004, the author was the Chairman of the Advisory Committee for the Alabama Law Institute, which submitted a revision of the Alabama Securities Act for consideration to the Alabama Legislature. The Advisory Committee did not include in its proposal the exemption for a bank security that "will represent an interest in" the security.

109. *Alabama Securities Commission Policy on Sales of Securities of De Novo Banks*, ALA. SEC. COMM'N, https://asc.alabama.gov/Policies/5-6-03%20Sales_of_Securities-DE_NOVO.aspx (last visited Feb. 28, 2021).

110. *Id.*

111. *See generally id.* (containing no mention of the Section 18 language in NSMIA).

112. *Id.* (emphasis added).

notice filing procedure for such securities that requires placing funds in escrow with a third-party depository institution, not accepting funds until the primary state or federal banking regulator has determined that the charter application is substantially complete, and the subscription funds are held in escrow until the bank charter is issued.[113] The Alabama policy also requires a notice filing with the Alabama Commission containing the offering circular and subscription agreement.[114]

Alabama is not the only state whose state securities regulator has addressed the state exemption for securities offered by a bank "in organization," but state securities administrators addressing the issue have taken varying positions. Some states have no-action or interpretive letters expressly declaring that the state statutory bank exemption in question is available for a bank in organization.[115] Other states have opined that a bank in organization does not qualify for the exemption of a bank security.[116]

113. *Id.*

114. *Id.*; *see also Policy Statement*, ALA. SEC. COMM'N, https://asc.alabama.gov/Policies/ASC_Policy_Statement.aspx (last visited Feb. 28, 2021) (stating that a "bank in formation is not yet a bank" and, therefore, "any security issued by a bank in formation is a security subject to registration").

115. *See, e.g.*, [Bank in Organization] Blue Sky L. Rep. (CCH) ¶ 31,631, 2015 WL 8571932 (Sept. 1989) (finding that Massachusetts has stated that although a bank in organization may not yet have been issued its charter, it is "subject to regulation" by the appropriate banking authorities and therefore would qualify for an exemption under the Massachusetts Uniform Securities Act).

116. Pennsylvania has a regulation stating that a "bank" does not include a bank in organization. *See* 10 PA. CODE § 102.021(a) (2021) ("The term [bank] does not include: . . . [a] bank-in-organization if the state or Federal regulator with primary authority over the bank-in-organization determines that it is not a bank under the law governing that bank-in-organization."). An earlier Pennsylvania interpretation had stated that for purposes of determining whether a security issued by a bank in organization was exempt under Pennsylvania law, the position of the Pennsylvania Department of Banking that "a bank becomes a bank as of the time the Articles of Incorporation are filed" means that a bank in organization becomes a "bank." *See* [Exemption Request — "Bank" Exemption] Blue Sky L. Rep. (CCH) ¶ 48,679T, 2015 WL 8572662 (Apr. 3, 1989). Nebraska permits a bank in organization to utilize the exemption for a federal covered security without a notice filing. The staff of the Nebraska Department of Banking and Finance has confirmed informally that the Nebraska Securities Act was amended to remove the state exemption from registration for a bank security because NSMIA provided preemption for such a security. *See* E-mail from Staff, Neb. Dep't of Banking & Fin., to author (Oct. 21, 2019, 4:47 PM) (on file with author). Prior to the passage of NSMIA, Nebraska had ruled that in order for a security to be issued by a bank in organization to qualify for an exemption from registration, the "entity" must have obtained the charter issued by the appropriate regulatory agency. *See* Interpretative Opinion No. 5 — Financial Institution Offerings and the Sections 8-1110(3), 8-1110(4) and 8-1110(5) Exemptions, Blue Sky L. Rep. (CCH) ¶ 37,456, 2015 WL 8572140 (Mar. 27, 1978, rev. July 1, 1985). "Therefore, securities issued by an entity formed for the purpose of applying for a charter to operate [as a bank] and for which no such charter has yet been issued, are *not exempt*

Some states have provided informal, non-binding advice. Arkansas and Virginia seem to recognize that a bank in organization may utilize the exemption for a bank security.[117] Maryland, Oregon, and Washington have informally advised that a bank in organization is not entitled to the bank security exemption, but Oregon has also informally stated that a security for a bank in organization should be considered a federal covered security.[118] Finally, the Rhode Island Uniform Securities Act exempts a subscription agreement for a bank in organization as a transaction exemption.[119]

At the same time, even under those state securities acts that do not contain the language from the Revised Uniform Securities Act that a security is exempt if "it will represent an interest in" a bank,[120] a bank in organization should be able to solicit and offer securities of the bank to be formed under the state statutory exemption for a bank security.[121] Conversely, it is also possible for banks in organization offering securities in states that contain the language that the security "will represent" an interest in a bank to run afoul of the registration provisions under the state securities statute.[122] Much of the analysis as to whether a security of a bank in organization is entitled *either* to a state exemption for a bank security *or* to preemption under NSMIA must focus upon whether, upon completion of the bank organization process, a security of a "bank" will be sold.

While not addressing bank securities as covered securities, some courts and commentators have stressed that a mere allegation of covered security status is insufficient to obtain NSMIA's preemption.[123] For example, in

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securities . . . ." *Id.*

117. E-mail from Staff, Ark. Sec. Dep't, to author (Jan. 23, 2019, 9:50 AM) (on file with author); Telephone Interview with Staff, Va. State Corp. Comm'n (Jan. 23, 2019) (on file with author).

118. *See* OR. REV. STAT. ANN. § 59.025(1)–(3) (2019); *see also* E-mail from Staff, Md. Div. Sec., to author (Jan. 23, 2019, 9:16 AM) (on file with author); E-mail from Staff, Wash. Dep't Fin. Insts., to author (Jan. 29, 2019, 3:02 PM) (on file with author).

119. 7 R.I. GEN. LAWS § 7-11-402(12) (2020). Securities exemptions generally fall into two categories: an exemption for the security itself or an exemption for the type of transaction in which any security might be issued. *See supra* note 11 and accompanying text.

120. UNIF. SEC. ACT § 201(3) (UNIF. L. COMM'N 2002).

121. *See supra* note 87 (listing states with an exemption for bank securities but not specifically securities that "will represent" a bank security).

122. *See supra* note 87 (listing states with an exemption for securities that "will represent" a security issued by a bank).

123. *See, e.g.*, 1 THE LAW OF SECURITIES REGULATION, *supra* note 33, § 4.8 (asserting that in order to establish preemption for a Regulation D offering, "it must be shown that the applicable federal exemption [is] in fact available to the offering [and] [i]t is not sufficient to allege that the securities were offered in purported compliance with the exemption").

Buist v. Time Domain Corp.,[124] a claim that securities offered in an SEC Rule 506 private placement were entitled to NSMIA preemption from the Alabama Securities Act was rejected because the offer and sale of the securities did not satisfy the exemption requirements of SEC Rule 506.[125] Therefore, no covered security was present.[126] Thus, while NSMIA preempts state securities registration requirements for covered securities, the offering must be for a security that qualifies as a "covered security."[127] With the foregoing warnings, there are two situations where registration and exemption requirements must be followed or else an exemption other than one for a bank security or a federal covered security must be utilized.

V. EXCEPTIONS TO "COVERED SECURITY" STATUS

First, organizers of a bank typically provide "seed money" for the organizational expenses of the bank in organization.[128] These expenses include legal, accounting, and consulting costs and often include compensation to be paid to certain organizers who have left current jobs with a previous bank employer to work full-time on the de novo project.[129] Such

124. 926 So. 2d 290 (Ala. 2005).

125. *Id.* at 294–95, 298; *see also* Brown v. Earthboard Sports USA, Inc., 481 F.3d 901, 911 (6th Cir. 2007) (observing that "spurious boilerplate language" to a subscription agreement purporting to create covered security status does not in itself create a "covered security"). *But see* Channa's Corp. v. Gilmore, 539 F. Supp. 2d 1299, 1304–05 (W.D. Wash. 2003) (holding that the failure to file a Form D for an SEC Rule 506 offering does not eliminate the security as a "covered security" entitled to state preemption under NSMIA).

126. *Buist*, 926 So. 2d at 298; *see also* Hamby v. Clearwater Consulting Concepts, LLLP, 428 F. Supp. 2d 915, 920–21 (E.D. Ark. 2006) ("[T]he only way to assert federal preemption is to first show that an exemption from federal registration actually applies."). *See generally* Chadwick, *supra* note 19 (discussing helpful case law and theories behind the argument that if there is no valid exemption under the 1933 Act, there can be no preemption of state law under NSMIA); *Securities Act Rules: Questions and Answers of General Applicability*, SEC, https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (last updated Nov. 6, 2017) (question 257.08) (stating that a security does not lose covered security status if an issuer fails to file a Form D).

127. *See Buist*, 926 So. 2d at 294.

128. *See* Fed. Deposit Ins. Corp., *Application Handbook and Procedures Manual for Deposit Insurance Application*, Fed. Banking L. Rep. (CCH) ¶ 38,045, 2017 WL 3082088 (Dec. 6, 2018) [hereinafter FDIC, *Application Handbook*] (describing stock benefits provided to organizers in return for seed money for organizational funds); Fed. Deposit Ins. Corp., *Statement of Policy Regarding Applications for Deposit Insurance*, Fed. Banking L. Rep. (CCH) ¶ 54,571, 2015 WL 6172358 (July 1998) [hereinafter, FDIC, *Statement of Policy*] (including "seed money" in funds placed at risk in the organizational fund).

129. *See* FDIC, *Statement of Policy*, *supra* note 128 (including "the market value of legal, accounting, and other professional services rendered" in organizational expenses funded by seed money).

expenses are generally funded by the organizers (those persons who will be directors and executive officers of the bank when formed) either through the contribution of cash by such persons to cover the organization costs or by such persons' personally guaranteeing a loan to the organizing entity from a commercial bank to fund the expenses.[130] In the former case, the organizers will receive securities of the bank (when formed) in exchange for their contributions to capital.[131] In the latter case, the loan will normally be paid from the proceeds of the capital in the bank when formed.[132] In either situation, however, it should be clear that the organizers have purchased a security.[133] As such, the funds provided or guaranteed by the organizers are funds that are "at risk" before the bank has been formed, and the security represented by the investment of such funds must have an exemption from registration under state and federal law other than the exemption for a "bank" security.[134] In the circumstance of raising "seed" money to organize a bank, the utilization of an exemption other than the bank securities exemption to raise the funds is workable because of the small number of "investors" involved and because those investors are the persons putting the project together.[135]

The second area where the bank securities exemption presents greater difficulty for the use of the bank exemption is where the required funds necessary to capitalize and charter the bank are obtained during the organization/regulatory application process. In that circumstance, the bank in organization seeks investors to provide the needed capital to charter the bank and offers common stock of the bank to be formed.[136] The amount

130. *See* 12 C.F.R. §5.20(g)(1), (3)(i) (2020) (noting that the board is usually comprised of most of the organizers who should have a financial commitment to the institution's success).

131. *How to Raise Capital When Starting a New Bank*, BMA (Dec. 20, 2019), https://bmabankingsystems.com/how-to-raise-capital-when-starting-a-new-bank/ (noting organizers may be required to raise fifteen percent securities-based capital).

132. *See generally* FDIC, *Application Handbook*, *supra* note 128 (describing the requirements for raising capital).

133. The contribution of capital by the organizers is obviously a security. The loan guarantee is an "investment contract" under Section 2(a)(1) of the 1933 Act. Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1). It should be noted that this analysis applies to a determination as to whether there is an exemption for a "bank" security under either federal or state law. *See* 1 THE LAW OF SECURITIES REGULATION, *supra* note 33, § 1.50 (detailing the test used by the courts to determine whether a security exists).

134. Normally, the applicable exemption is the private placement under Section 4(a)(2) of the 1933 Act or SEC Rule 506(b) of SEC Regulation D. *See* Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2); 17 C.F.R. § 230.506(b) (2020).

135. *See infra* Part VIII for a discussion of "integration" issues in this circumstance.

136. *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 27–28.

raised can often equal or exceed $20 million.[137] Whether this process involves the issuance of a bank security that allows an exemption from registration under *state* law depends on the circumstances. The Alabama policy referred to above treats the offer of a security of a bank in formation as a "sale" and assumes that funds are "at risk."[138] Therefore, a sale occurs *before* the bank receives its charter from either the OCC or the Alabama State Banking Department.[139] Typically, a "sale" includes "every contract of sale" of a security for "value" and it is that sale of the security that must be registered.[140]

If the sale of a security of a bank in organization includes a sale of something other than a bank security, the exemption for a bank security in that state is not available regardless of whether the state securities act in question exempts a bank security or a security that will represent an interest in a bank.[141] Thus, neither "covered security" status under NSMIA nor a "bank" security exemption under state law may be relied upon. But whether a bank security is present in such sales activity begs the question of whether the exemption for a bank security may be utilized, and that leads to the second situation. Determining if a bank security is the only security being offered, and thus if a bank security exemption is available, hinges upon when and how, an investor's money is put "at risk."[142] The documentation governs that determination.[143] Usually the securities of the de novo bank are sold

137. *See id.* at 40–41 (specifying the OCC has conditions for approval, including a minimum capital amount); *see, e.g.*, Hilary Burns, *North Carolina De Novo Receives FDIC Approval*, AM. BANKER (Feb. 13, 2019, 11:13 PM), https://www.americanbanker.com/news/north-carolina-de-novo-receives-fdic-approval (requiring organizers to raise $20 million); Paul Davis, *Community Banking Group Files to Open Atlanta Area Bank*, AM. BANKER (Jan. 7, 2019, 10:55 AM), https://www.americanbanker.com/news/group-files-to-open-atlanta-area-bank (noting organizers' plan to raise between $18 million and $25 million); Paul Davis, *FDIC Paves Way for Another De Novo Effort in North Carolina*, AM. BANKER (Dec. 31, 2018, 4:53 PM), https://www.americanbanker.com/news/fdic-paves-way-for-another-de-novo-effort-in-north-carolina (requiring $25.5 million).

138. ALA. SEC. COMM'N, *supra* note 109.

139. *See id.*; ALA. CODE § 8-6-10(3) (2019); 12 C.F.R. § 5.20(i)(6) (2020) ("A proposed national bank may offer and sell securities prior to the OCC preliminary approval of the proposed national bank's charter application . . . ."); *supra* notes 106–14 and accompanying text.

140. UNIF. SEC. ACT § 102(26) (UNIF. L. COMM'N 2002) (amended 2005); *see infra* Part VI.

141. *See infra* note 150; *see also* ALA. SEC. COMM'N, *supra* note 109 ("If any securities are to be sold to generate funds that will be used or placed at risk before the formal incorporation of the bank, then the sale of those securities must have an exemption other than Ala. Code § 8-6-10(3) . . . .").

142. *See, e.g.*, ALA. SEC. COMM'N, *supra* note 109.

143. *See infra* notes 147–52 and accompanying text.

utilizing an offering circular describing such items as the bank to be formed, its business plan, geographic market, biographical and compensation information of officers and directors, articles and bylaws, and regulatory environment.[144] In short, the offering circular contains material information needed by the investor to make an informed investment decision about the bank.[145] Again, what is the nature of the security as to which an investment decision is made? That decision must relate only to a bank security and nothing more. It is essential that the offering circular makes that clear and the subscription agreement signed by the investor should provide the legal framework for the conclusion that the investor's funds are only at risk for a bank security.[146]

For example, each investor signs the subscription agreement which sets forth the number of shares the investor wishes to purchase.[147] The subscription agreement may also contain certain representations and warranties by the investor regarding the investor's financial status, confirmation of receipt of the offering circular, an acknowledgment by the investor that the subscription agreement is subject to acceptance by the bank in formation, and that the subscription funds will be held in escrow by an independent third-party depository institution to be released only upon the chartering of the bank by the appropriate regulatory authorities.[148] Consequently, when prepared in the foregoing format, the documents of the bank in organization demonstrate that the investor's funds are not at risk for any security other than a bank security.[149] If the bank is not chartered, the investor receives a full refund of the investor's money.[150] It seems illogical

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144. *See* Statement of Policy on the Use of Offering Circulars, 61 Fed. Reg. 46,807, 46,808 (Sept. 5, 1996); *see also supra* Part III.

145. There are a variety of ways an investor or a securities authority may initiate a claim for fraud in the sale of a security. Under federal law, even outside a registration requirement, a person who offers or sells a security by means of untrue statements or material facts, or by omissions of material facts, is liable to the persons purchasing the security. *See* 15 U.S.C. §§ 77l, 78j; 17 C.F.R. § 240.10b-5 (2020). There are similar provisions under state securities laws. *See* Campbell, *The Role of Blue Sky Laws*, *supra* note 16, at 618–26.

146. Statement of Policy on the Use of Offering Circulars, 61 Fed. Reg. at 46,808 (explaining that offering circulars should notify investors that the securities for sale are not insured and the investments are at risk of loss).

147. *See id.* ("The subscription order form should provide specifically designated blank spaces for dating and signing.").

148. *See id.*

149. *Cf.* 15 U.S.C. § 77l (stating when one might be civilly liable for bank securities).

150. Sometimes the subscription agreement states that the subscription is not revocable by the investor. That can present problems for the bank in organization if an amendment to the offering circular contains new material information that the investor does not like. Also, if an investor wants to terminate a subscription prior to the issuance

to argue in such circumstances that a bank securities exemption is not available or that a security other than a bank security is being offered or sold. The essence of the registration obligation under both federal and state law is to provide the purchaser of the security with all material information about the investment.[151] The investment in this situation is only for a bank security.[152]

VI. THE CONTEXT OF A SALE

Some arguments have been made that for a bank in organization, whether the state bank security exemption is available depends on the status of the regulatory application.[153] Such status was considered by the SEC staff in the *Bank of World* no-action letter.[154] For example, one commentator has observed that if the bank's capital must be raised *before* the bank in organization may apply for a bank charter from its regulatory authority, the bank securities exemption is not available.[155] "On the other hand, if the regulation and supervision of the banking agency attaches from the outset of the organizational process then the securities should be exempt."[156] Yet, this approach does not fully solve the problem or address the practicalities of the bank chartering process. Once the charter application is filed with the appropriate agency, the agency commences a thorough scrutiny of the proposed bank, its business, and organizers, including obtaining fingerprint cards and conducting background checks on the organizers with various agencies.[157] This process should bring sufficient regulatory oversight over the bank in organization to allow it to utilize the state law exemptions for a

of the securities, it is better to make a refund rather than have a disgruntled shareholder at the commencement of the charter. Finally, allowing the investor to withdraw a subscription at any time reinforces the argument that no "sale" of a security other than a bank security has been made.

151. *See supra* note 11.

152. Long before NSMIA was enacted, the SEC staff dealt with this issue in a series of no-action letters. *See supra* notes 58–74 and accompanying text.

153. *See* County First Bank, *supra* note 56; Bank of World, *supra* note 56; *see, e.g.*, [Bank in Organization], *supra* note 115 (noting that a bank in organization, and its potential exemptions, is subject to the regulatory schemes of Massachusetts banking authorities).

154. *See* Bank of World, *supra* note 56.

155. JOSEPH C. LONG ET AL., BLUE SKY LAW § 6:18, Westlaw (database updated Nov. 2020).

156. *Id.*

157. *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S LICENSING MANUAL: BACKGROUND INVESTIGATIONS 1 (2019), https://www2.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/background-investigations-licensing-manual.pdf; *supra* Part III.

bank security.[158] Generally, the organization process commences with the preparation of the applications, and the capital raise sometimes unfolds *before* the applications are filed or else when the applications are merely in the review process by regulators.[159] While the SEC staff in *Bank of World* observed that an offering circular would not be distributed until the OCC had granted conditional approval, thereby furnishing comfort that a bank charter is likely to be received, this fact does not seem by itself to protect investor funds.[160] Protection against risk of loss during the subscription period is achieved by the terms of the offering, particularly the subscription agreement and the escrow of subscription funds.[161] The real issue to be addressed is when the investor funds are *at risk*.[162] While delaying the capital raise until conditional approval is received from the chartering authority, as set forth in *Bank of World*, gives some regulatory oversight to the process, such delay still does not fully recognize the circumstances at issue.[163] At what point does an investor's fund become at risk and for what entity?

Perhaps the key question to consider here can be found in both the 1933 Act and most state securities acts. That question is whether the collection of subscriptions or a "preorganization certificate" for a de novo bank must be registered. Under the 1933 Act and most state securities laws, the definition of "security" includes a "preorganization certificate" and a "subscription."[164] At the same time, even if the subscriptions to acquire a security in the bank to be formed are deemed "securities," the prohibition in the 1933 Act and state securities statutes relates to the conducting of a "sale" of or an "offer to

158. *See supra* Part III; *see also* OFF. OF THE COMPTROLLER OF THE CURRENCY, *supra* note 10, at 26.

159. *See supra* Part III; *see also* County First Bank, *supra* note 56 (seeking an SEC no-action letter where organizers "intend" to submit an application to Maryland officials); *see also* Bank of World, *supra* note 56 (seeking a no-action letter while application is under review by Pennsylvania officials).

160. *See* Bank of World, *supra* note 56.

161. *See id.* (recommending no-action where the organizing bank's application was under review by a state agency and an escrow account was established); County First Bank, *supra* note 56 (recommending no-action where organizing bank "will be" under review by state authorities and an escrow account was established).

162. *See* Bank of World, *supra* note 56 (outlining steps the bank will take once the conditional approval is granted).

163. *See id.* (stating that upon granting the conditional approval, the Bank will be required to raise capital).

164. *See* Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1); *see also* UNIF. SEC. ACT § 102(28) (UNIF. L. COMM'N 2002) (amended 2005) (defining security to include a "preorganization certificate or subscription"). The Rhode Island Securities Act exempts from registration an offer to sell a preorganization certificate or subscription agreement with a depository institution. *See* 7 R.I. GEN. LAWS § 7-11-402(12) (2020); *see also supra* note 119 and accompanying text.

sell" such security without registration or an exemption from registration.[165] Thus, the registration requirements under federal and state law generally apply to the sale *or* the offer to sell a security.[166] Both the 1933 Act and most states define "sell" or "sale" to include a contract to sell or to dispose of a security "for value."[167] An offer also includes an attempt to offer or solicitation of an offer to buy a security "for value."[168] Assuming a subscription agreement to acquire a security of the bank when formed is considered to be a "security," that security is hardly offered or sold for "value."[169] The only value being transmitted (and held in escrow) is for a bank security. The "subscription" itself is an offer to buy, but it is only an offer to buy a bank security, not a preorganization certificate. This argument is also reinforced under both the 1933 Act and most state securities acts, in which the definition sections of such acts are qualified by the language "unless the context otherwise requires."[170] It seems obvious that the context of an offering of securities in a bank to be formed, where no investor's money is at risk until the bank is chartered, leads to a clear conclusion that no sale or offer of anything in this context applies to anything other than a bank security.[171]

VII. REGISTRATION OBLIGATIONS WITH THE BANK REGULATORS

Although bank securities are exempt under Section 3(a)(2) of the 1933 Act from registration with the SEC, a bank issuing its securities must nevertheless consider whether it must register the sale of its securities with its primary federal bank regulator or utilize an exemption from registration. This question arises because the primary federal regulator for a bank may itself impose registration requirements for the issue of securities by banks under the federal banking regulator's jurisdiction. Thus, a national bank issuing securities must file a registration statement with the OCC or utilize

165. *See* 15 U.S.C. § 77e; UNIF. SEC. ACT §§ 201–202.

166. *See* 15 U.S.C. § 77e; UNIF. SEC. ACT § 301.

167. *See* 15 U.S.C. § 77b(a)(3); UNIF. SEC. ACT § 102(26).

168. *See* 15 U.S.C. § 77b(a)(3); UNIF. SEC. ACT § 102(26).

169. *See* 15 U.S.C. § 77b(a)(3); UNIF. SEC. ACT § 102(26).

170. *See* 15 U.S.C. § 77b; *see, e.g.*, NEV. REV. STAT. § 463.1598 (2020); N.M. STAT. ANN. § 58-13C-102 (West 2021); VT. STAT. ANN. tit. 9, § 5102 (2021).

171. For a helpful discussion of the concept of "unless the context otherwise requires," see Gary M. Brown, *Reach of Securities Act Regulation*, *in* SODERQUIST ON THE SECURITIES LAWS § 5:2:3 (5th ed. 2006 & Supp. 2011). It should be emphasized that while offers to sell a security are subject to registration requirements under Section 5 of the 1933 Act, if the security being offered is exempt from registration under Section 3 of the 1933 Act, the registration requirements of Section 5 do not apply. *See* 15 U.S.C. §§ 77c, 77e. Thus, the issue resolves as to whether a bank security is being offered or some other security is being offered for value.

an exemption from registration.[172] The OCC has promulgated regulations that essentially state that the OCC adopts the rules and regulations of the SEC that relate to registration statements, exemptions, and other matters — such as the integration of offerings — and that in such regulations, references to the term "SEC" or "Commission" shall be deemed to refer to the OCC.[173]

For state banks, the situation is less structured. With state banks that are not members of the Federal Reserve System, a state bank issuing securities is required to conform to a policy statement issued by the FDIC that encourages banks to follow the rules and regulations of the SEC mandating proper disclosure and the use of exemptions.[174] However, the policy statement does not require the bank to make any filing with the FDIC.[175]

State banks that are members of the Federal Reserve System are not subject to any specific Federal Reserve regulation or policy regarding the issuance of their securities.[176] One other clarification should be noted. The analysis of whether a security of a bank in organization is a covered security under NSMIA, or is otherwise exempt from registration under state blue sky laws, only applies to a security of a "bank" — not to a security of a bank holding company. Frequently, when organizers form a bank and file applications for the bank charter, they only file applications for the bank to be formed without a holding company structure.[177] It is that situation of a "stand alone" bank in organization upon which this Article focuses. However, sometimes as part of the organization process, the organizers not only organize the bank, but they also form at the same time a separate company (a "bank holding company") to own 100 percent of the voting stock of the bank to be organized so that the bank will be a wholly-owned subsidiary of the parent bank holding company. A bank holding company is defined under the Bank Holding Company Act of 1956, as amended, as,

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172. *See* 12 C.F.R. § 16.3 (2020).

173. *See id.* § 16.2(n).

174. *See* Statement of Policy on the Use of Offering Circulars, 61 Fed. Reg. 46,807, 46,808 (Sept. 15, 1996) (laying out the requirements for insured state nonmember banks that publicly distribute bank securities).

175. *See id.* The FDIC Policy Statement does not impose the burden of filing "and allows for certain flexibility, the FDIC believes [relieving this burden] will be beneficial to small banks." *Id.*

176. *See* Bank of World, *supra* note 56 (requesting that the "state-chartered Federal Reserve member bank in formation" have the ability to sell subscriptions without complying with registration requirements).

177. *Bank Holding Companies*, FED. RSRV.: P'SHIP FOR PROGRESS, https://www.fedpartnership.gov/bank-life-cycle/manage-transition/bank-holding-companies (last visited Feb. 28, 2021) ("Relatively few [bank holding companies], however, are formed by banks while the bank itself is in the organizational phase.").

among other things, a company that "controls" a bank.[178] A bank holding company is not a "bank," however, and its securities are not exempt securities under Section 3(a)(2) of the 1933 Act or generally under state blue sky laws that provide exemptions for "bank" securities.[179] In this situation, the organizers raise funds by the sale of stock of the company that will be the parent company to the bank to be formed. A separate exemption for the sale of the bank holding company securities must be found[180] or the offer of the bank holding company securities must be registered under federal and state law.[181]

VIII. THE CONCEPT OF "INTEGRATION" IN CAPITAL FORMATION

Another issue to be considered is whether the sale of securities for organizational costs should be considered part of the actual sale of bank securities when the bank charter is granted. As explained above,[182] the securities issued to raise the seed money are not bank securities and generally would be issued pursuant to an exemption from registration as a private placement under Section 4(a)(2) of the 1933 Act or SEC Rule 506(b).[183] Such exemptions should be readily available because the organizers of a bank typically qualify as "accredited investors" under the net worth test of Regulation D, the income test of Regulation D, or their status as directors of the bank in organization.[184] At the same time, if the securities for the seed money are issued pursuant to an exemption from registration such as SEC

178. 12 U.S.C. § 1841(a)(1). The bank holding company structure has certain advantages over a stand-alone bank in that, among other things: (i) bank holding companies can engage in certain bank-related activities that banks may not; (ii) bank holding companies can incur debt and downstream the proceeds to the subsidiary bank as primary capital for the bank — not as debt for the bank; and (iii) bank holding companies can repurchase shares of its stock (within regulatory requirements) thereby creating a "market" for its stock, if no public market exists, while banks may generally not repurchase their shares.

179. One exception is Louisiana, which exempts securities issued by a bank holding company organized under the laws of Louisiana. *See* LA. STAT. ANN. § 51:708(3) (2020) (exempting a security issued by a national bank, or bank organized under Louisiana law, *or* "any bank holding company organized under the laws of Louisiana that controls one or more banks whose principal place of business is in Louisiana . . . .").

180. Such as SEC Rule 506 or SEC Rule 147A for intrastate offers. 17 C.F.R. § 230.506 (2020); *id.* § 230.147A.

181. *See* 15 U.S.C. § 77c(a)(11); *see also supra* author biographical note. Of the thirteen de novo banks for which the author was counsel, six were organized with no bank holding company.

182. *See* Bank of World, *supra* note 56.

183. *See* Securities Act of 1933 § 4(a)(2), 15 U.S.C. § 77d(a)(2); 17 C.F.R. § 230.506(b).

184. *See* 17 C.F.R. § 230.501(a).

Rule 506(b) which, among other things, limits the number of non-accredited investors to thirty-five and prohibits a public offering or general solicitation, integration of the seed money offering with the offering of the exemption for bank securities (*i.e.*, a combination of the two offerings) could result in the loss of one or both exemptions under either state or federal law.[185] On November 2, 2020, the SEC adopted amendments to a number of its rules (the "2020 Release"), including its integration standards, "to simplify, harmonize, and improve certain aspects of the exempt offering framework to promote capital formation while preserving or enhancing important investor protection."[186] As the 2020 Release states, the "current exempt offering framework is complex," and the integration of offerings is one of those complex areas.[187] The new integration rule became effective on March 15, 2021.[188] Before examining the application of the 2020 Release's new integration framework, however, a look at the integration concept that has been in place for more than a half-century may be helpful.

A. Sixty Years of History and Uncertainty

The SEC issued a release in 1962 discussing the "integration" of exempt offers and establishing factors to determine whether two exempt offerings would be integrated (the "1962 Release").[189] Essentially, the SEC's position in the 1962 Release was that if two exempt offerings of securities are integrated, then the integrated offers as a whole must satisfy all requirements for an exemption, or else the integrated offer must be registered.[190] This issue most frequently arose when an issuer undertook two separate offerings of securities, each of which was intended to be exempt from registration, but when combined did not satisfy an exemption.[191]

If the funds raised for seed money for a bank in organization were combined with the actual sale of the bank securities when the bank was

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185. *See id.* § 230.506(b).

186. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10,884, Exchange Act Release No. 90,300, Investment Company Act Release No. 34,082, 86 Fed. Reg. 3496, 3496 (Jan. 14, 2021).

187. *Id.* at 3499.

188. *Id.* at 3496.

189. *See* Non-Public Offering Exemption, Securities Act Release No. 4552, 1962 WL 69540 (Nov. 6, 1962); 17 C.F.R. § 230.502(a).

190. *See* Non-Public Offering Exemption, 1962 WL 69540.

191. For example, two offers under SEC Rule 506(b) are made, each with thirty-five non-accredited investors. If the offers are integrated into one, then the offer would have seventy non-accredited investors and violate SEC Rule 506(b)(2)(i), which limits the number of non-accredited investors to a maximum of thirty-five. *See* 17 C.F.R. § 230.506(b)(2)(i).

chartered, a judgment had to be made that the offer of the securities representing seed money had a valid exemption and would not be integrated with the offering of the bank securities.[192] If the sales were made more than six months apart, generally there would be no integration issue because the separation of the offerings by six months created a "safe harbor" from integration.[193] As was often the case, however, if the sale of securities representing the seed money was made within six months of the sale of the bank securities following the chartering of the bank, an integration analysis needed to be made.[194] Until adoption of the 2020 Release, SEC Rule 502(a) provided five factors to determine whether two exempt offerings should be integrated:

> (a) Whether the sales are part of a single plan of financing;
> (b) Whether the sales involve issuance of the same class of securities;
> (c) Whether the sales have been made at or about the same time;
> (d) Whether the same type of consideration is being received; and
> (e) Whether the sales are made for the same general purpose.[195]

Arguably, factors (a), (c), and (d) would suggest the offerings should be integrated. Factor (b) suggests no integration since the seed money is clearly not a bank security, even though it represents equity. Factor (e) (and even factor (a)) can be argued either way. The seed money can be said to represent capital for the bank when chartered. At the same time, if the bank is not chartered, the seed money only represents the costs of organization, and the actual capital necessary to charter the bank comes from the issuance of the bank securities. The organization costs are almost always funded by the organizers, which typically are a close-knit, small group of people who are accredited investors.[196] The SEC staff has stated that if the investors in a private offering, such as SEC Rule 506(b), are solicited by a concurrent registration statement, the two offerings would be integrated.[197] The foregoing integration factors, however, were used to determine whether two or more *exempt* offerings should be integrated as a single offering.[198]

Prior to the 2020 Release, there was another avenue to follow in the

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192. *See id.* § 230.502(a).

193. *See id.*

194. *See id.*

195. *Id.*

196. *See supra* notes 133–35 and accompanying text.

197. *See Securities Act Rules: Questions and Answers of General Applicability*, *supra* note 126 (discussing in question 256.34 the impact a general solicitation has on a private offering under SEC Rule 506(b)).

198. *See Securities Act Sections: Questions and Answers of General Applicability*, SEC, https://www.sec.gov/corpfin/securities-act-sections (last updated Nov. 13, 2020) (question 139.25).

approach to the integration issue. The most practical and commonly used alternative was to treat the raising of seed money from the organizers as an exempt offering under SEC Rule 506(b) (or some other appropriate exemption).[199] Following the raising of seed money from the organizers, the organizers could then turn attention to the solicitation of subscriptions for the securities in the bank to be formed.[200] The SEC stated in a 2007 release (the "2007 Release"), which continues to have validity today, that "a completed private placement that was exempt from registration under Securities Act Section 4(2) [will not] be integrated with a public offering of securities that is registered" under the 1933 Act if certain conditions are satisfied.[201] In the 2007 Release, the SEC made it clear that if investors in the exempt private placement were not solicited by the registration statement, then the two offerings would not be integrated.[202] For example, if the private placement investors become interested in the private placement through a means other than the registration statement, such as through a substantive, pre-existing relationship with the company or contact "by the company or its agents outside of the public offering effort," then no integration should occur.[203]

In the situation of a bank in organization, the organizing directors, who are themselves organizing the bank and providing the seed money, fit within the category of investors who have a pre-existing relationship with the "company" and are solicited otherwise than through a public offering.[204] Because a security issued by a bank is a security exempt from registration under Section 3(a)(2) of the 1933 Act, such a security may be offered in a

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199. *See* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7541, 63 Fed. Reg. 29,168, 29,169 (May 28, 1998) (describing the "seed capital" exemption); *cf.* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, Investment Company Act Release No. 27,922, 72 Fed. Reg. 45,116, 45,117, 45,134 (Aug. 10, 2007) (discussing whether the "seed capital" exemption should be changed to avoid abuse).

200. *Cf.* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10,884, Exchange Act Release No. 90,300, Investment Company Act Release No. 34,082, 86 Fed. Reg. 3496, 3497 n.9 (Jan. 14, 2021) (discussing the JOBS Act, which pushed "to eliminate the prohibition against general solicitation or general advertising for offers and sales of securities to accredited investors").

201. Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. at 45,129.

202. *See id.* ("[N]otwithstanding the availability of the information in the registration statement, companies may continue to conduct concurrent private placements without those offerings necessarily being integrated with the ongoing public offering.").

203. *Id.*

204. *See id.* (discussing the applicability of the Section 4(2) exemption to investors with a pre-existing relationship).

public fashion.[205] Accordingly, the offer of bank securities to be issued upon the chartering of the bank, generally offered as a "public offering," while not subject to a registration statement filed with the SEC but rather are subject to the rules of the appropriate federal bank regulatory agencies,[206] should not be a factor to cause integration of the two offers as long as the funds raised as seed money are limited to the organizers.

Moreover, SEC Rule 152 (prior to its amendment in the 2020 Release, as explained below) provided that a completed private placement exempt under the 1933 Act would not be integrated with a subsequent public offering.[207] Prior to its replacement by the 2020 Release, SEC Rule 152 read in full as follows:

> The phrase *transactions by an issuer* not involving any public offering in section 4(a)(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.[208]

Note that the rule applied not only to a subsequent registration statement but also to a "public offering."[209]

Over the years, the SEC staff has expressly addressed the integration issue in the context of a bank in organization.[210] As previously noted in *County*

205. *See* Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2); *see also id.* § 3(b)(2).

206. *See supra* notes 172–75 accompanying text. This discussion assumes that the offer of a security in a bank to be formed is conducted as a public offer. For state banks, both the FDIC and Federal Reserve permit banks to offer securities in a widespread (*i.e.*, public) manner without any exemption or filing requirements. As a practical matter, the offer of seed money by using SEC Rule 506(b), which prohibits a public offer, would be destroyed if integrated with the public offering of the securities of the bank upon organization due to the public nature of the offering of the bank securities. The OCC follows the SEC exemption and registration requirements, and a national bank in formation would normally file a registration statement with the OCC, thus constituting a public offer and leading to a similar integration analysis. *See supra* notes 172–73 and accompanying text. But even if the funds to capitalize the de novo national bank are sought by an exemption from registration, the integration of the two offers should be able to be avoided, either by the use of two distinct exemptions from registration or by the use of one exemption for the entire capital raised, such as SEC Rule 506(b), with no more than thirty-five non-accredited investors. It is also assumed that the foregoing integration analysis would generally be followed for state law purposes.

207. *See* 17 C.F.R. § 230.152 (2020).

208. *Id.* (citation omitted).

209. *Id.* The SEC staff previously stated that SEC Rule 152 did not require that the subsequent public offering be made pursuant to a registration statement. Vintage Group., Inc., SEC Staff No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,700, 1988 WL 234292 (May 11, 1988).

210. *See generally* County First Bank, *supra* note 56 (serving as an example of the SEC applying SEC Rule 152 to conclude whether two offerings should be integrated).

First Bank, the organizers of the Maryland bank conducted a private offering under SEC Rule 506 to raise funds to satisfy the organizational costs of the bank to be formed.[211] The organizers planned to commence a "public offering" within six months after the close of the private offering.[212] The staff in *County First Bank* addressed whether the two offerings should be integrated.[213] If integrated, the public offering of the security of the bank to be formed would be integrated with the private offering in which the organizers provided "seed money" for the organization process, and there would be no exemption for the private offering.[214]

The no-action request on behalf of the bank in organization argued that under SEC Rule 152, the two offerings would not be integrated.[215] The private offering was conducted as a transaction not involving a public offering and met the requirements of SEC Rule 506.[216] Within six months, the public offering for the bank securities commenced and was structured as a "bona fide offering of securities to the public, as required by SEC Rule 152, notwithstanding the fact that the securities offered may be exempt from registration by virtue of Section 3(a)(2)."[217] The staff agreed stating that "we are relying on our view that under SEC Rule 152, a public offering that follows an offering otherwise exempt under Rule 506 of Regulation D does not vitiate the [limited] registration exemption of Rule 506."[218]

More significantly, the SEC has noted that "companies may *continue* to conduct concurrent private placements without those offerings necessarily being integrated with the ongoing public offering."[219] The SEC stated that

211. *See id.* ("Each investment unit consisted of 250 shares of common stock of the Bank and a warrant to purchase up to 140 additional shares . . . .").

212. *Id.*

213. *See id.* (analyzing the integration of the offerings based on Rule 152 and addressing SEC Rules 501, 502, 503, and 506 under Regulation D).

214. *See id.* (noting that if an offering does not qualify for the safe harbor of SEC Rule 502(a), then it may be integrated after the "five factors" are applied).

215. *See id.* (applying SEC Rule 152, offering two historical examples of similar SEC Rule 152 conclusions, and finally concluding that the offerings will not be integrated).

216. *See id.*

217. *Id.*

218. *Id.*

219. *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, Investment Company Act Release No. 27,922, 72 Fed. Reg. 45,116, 45,129 (Aug. 10, 2007). The SEC has taken similar positions on integration regarding other types of exemptions from registration. For example, the SEC has stated that "an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in" a Rule 147 or 147A offering (which apply to offers in only one state) were not solicited by such offerings. Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 10,238, Exchange Act Release No. 79,161, 81 Fed. Reg. 83,494, 83,507 (Nov. 21, 2016);

"filing a registration statement does not, *per se*, eliminate a company's ability to conduct a concurrent private offering," and whether the public offering would affect the exemption for the private placement would depend on "whether the investors in the private placement were solicited by the registration statement or through some other means that would otherwise not foreclose the availability of the Section 4(2) exemption."[220] The SEC stated in its release that:

> For example, if a company files a registration statement and then seeks to offer and sell securities without registration to an investor that became interested in the purportedly private offering by means of the registration statement, then the Section 4[(a)](2) exemption would not be available for that offering. On the other hand, if the prospective private placement investor became interested in the concurrent private placement through some means other than the registration statement that did not involve a general solicitation and otherwise was consistent with Section 4[(a)](2), such as through a substantive, pre-existing relationship with the company or direct contact by the company or its agents outside of the public offering effort, then the prior filing of the registration statement generally would not impact the potential availability of the Section 4[(a)](2) exemption for that private placement and the private placement could be conducted while the registration statement for the public offering was on file with the Commission.[221]

It is axiomatic that in the formation of a bank, the organizers who provide seed money are not solicited by the subsequent offering of the securities of the bank to be formed.[222] The SEC staff in the Division of Corporation Finance addressed similar issues in its informal interpretations. In Question 256.34 of the Compliance and Disclosure Interpretations, the staff opined

see also Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Securities Act Release No. 9741, Exchange Act Release No. 74,578, Investment Company Act Release No. 2501, 80 Fed. Reg. 21,806, 21,819 (Apr. 20, 2015) (stating that "an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers . . . were not solicited by means" of a Regulation A offering, which allows public solicitation).

220. Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. at 45,129.

221. *Id.* The SEC's view is significant for a bank in organization because the organizers may have to provide seed money for the organization process, even during the application process and the capital raised in the "public offer. *See supra* Part III.

222. *See supra* Part III. It should be noted that while the release quoted above normally speaks of integrating an exempt offer with securities issued pursuant to a registration statement filed with the SEC (permitting a public offer), the exemption for a bank security under the 1933 Act permits a public offer of such security without a registration statement, which should mean that the integration analysis between an exempt offer of a security and a concurrent public offer of such security (registered or not) should apply.

that offers and sales of securities made in reliance on SEC Rule 506(b), which does not allow public advertising or general solicitation, as long as all requirements of SEC Rule 506(b) were satisfied, would not be integrated with subsequent offers and sales of securities under SEC Rule 506(c), which allows general solicitation.[223]

B. The 2020 Release and Integration Made "Clear"

In the 2020 Release, the SEC adopted a new Rule 152 ("New Rule 152") to address the complicated integration process and the varying views of integration expressed by the SEC and its staff over many years.[224] As the SEC pointed out, the integration framework for both registered and exempt offerings "consists of a mixture of rules and Commission guidance for determining whether multiple securities transactions should be considered part of the same offering."[225] The SEC admitted in the 2020 Release that Rule 502(a) of Regulation D, relying on the 1962 Release, provided a safe harbor for exempt offerings that were six months apart, but for offerings occurring within six months of each other there was, as outlined in Section VIII.A, no "bright-line test" upon which to judge integration.[226] Thus, the 2020 Release repealed the integration concepts first set forth in the 1962 Release. The SEC did not, however, eliminate the guidance set forth in the 2007 Release. Rather, such guidance was codified and expanded by New Rule 152.[227] Accordingly, the 2007 Release provides background on, and factors to consider in, an analysis of the integration process, especially respecting various elements that may be employed to analyze the possible integration of exempt and public offers.[228]

As set forth in the 2020 Release, New Rule 152 is designed to "modernize and simplify the Securities Act integration framework for registered and

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223. *Securities Act Rules: Questions and Answers of General Applicability*, *supra* note 126 (question 256.34); *see also Securities Act Sections: Questions and Answers of General Applicability*, *supra* note 198 (stating in question 139.25 that if investors in a private offering have a "substantive, pre-existing relationship" with the company, then a "registration statement would not have served as a general solicitation for the private offering").

224. *See supra* note 187 and accompanying text.

225. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10,884, Exchange Act Release No. 90,300, Investment Company Act Release No. 34,082, 86 Fed. Reg. 3496, 3499 (Jan. 14, 2021).

226. *Id.*

227. *Id.* at 3505.

228. Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, Investment Company Act Release No. 27,922, 72 Fed. Reg. 45,116, 45,129–30 (Aug. 10, 2007).

exempt offerings . . . ."[229] New Rule 152 provides "four safe harbors applicable to all securities offerings" and also sets forth a general set of integration principles if a safe harbor does not apply.[230]

i. General Principles

New Rule 152(a) prescribes a non-exclusive method for an issuer to determine whether two offers should be integrated if the safe harbors, to be discussed below, are not applicable.[231] It specifies that if the issuer can establish, "based on the particular facts and circumstances," that each offering either complies with the registration requirements of the 1933 Act or that "an exemption from registration is available for the particular offering," no integration will occur.[232] To make that determination for an exempt offering that prohibits general solicitation:

> The issuer must have a reasonable belief, based on the facts and circumstances, with respect to each purchaser in the exempt offering . . . , that the issuer . . . either (i) [d]id not solicit such purchaser through the use of general solicitation; or (ii) [e]stablished a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation.[233]

These factors are similar to the analysis that an issuer would have employed prior to the adoption of the 2020 Release.[234] They provide, however, more clarity in an exempt offering prohibiting general solicitation, and without an uncompromising time-frame, if the issuer has a reasonable belief that the issuer did not solicit the purchaser through general solicitation or else had a substantive relationship with the purchaser prior to commencement of the exempt offering.[235] With respect to the offering of securities of a bank to be formed, this reasonable belief test should be workable in a manner similar to the factors set forth above.[236]

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229. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3499.

230. *Id.* at 3500.

231. *See id.* 3500–01.

232. *Id.* at 3500.

233. *Id.* New Rule 152(a)(2) also offers guidance on two concurrent offers permitting general solicitation, something which could be possible, but not likely, in a de novo bank formation. *See id.*

234. *See supra* notes 201–03 and accompanying text.

235. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3500.

236. *See supra* note 203 and accompanying text.

ii. Safe Harbors

Equally significant, however, with respect to the offering of a security of a bank to be formed, one or more of the safe harbors established by New Rule 152 should be available. Rule 152(b)(1) provides that "no integration analysis under paragraph (a) of [New Rule 152] is required, if any" offering (such as the raising of seed money through an SEC Rule 506(b) exempt offering) is made more than thirty calendar days "before commencement of any other offering."[237] Such "other offering" could include the commencement of the public offer of the security of the bank to be formed.[238] It should be feasible for the organizers of the de novo bank to have the necessary seed money raised and in place through an exempt offering at least thirty days before the "public offer" is undertaken for the capital required under banking regulation requirements.

New Rules 152(b)(3) and (4) may also apply. Under Rule 152(b)(3)(i), an offering pursuant to a filed registration statement will not be integrated with a prior completed offering for which general solicitation is not permitted.[239] Securities offered publicly by a national bank in organization must be made subject to a registration statement filed with the OCC.[240] New Rule 152(b)(3)(i) would clearly be available in that situation and would likely be available for "public" offers of bank securities to be issued by a state-chartered bank, even though no registration statement is required.[241] If such rule is not available for a state-chartered bank, however, Rule 152(b)(4) specifies that an offer and sale "made in reliance on an exemption for which general solicitation is permitted will not be integrated if made *subsequent* to any *terminated or completed* offering."[242] This safe harbor should apply to a public offer of a security of a bank to be formed (whether a national bank or a state-chartered bank) as long as it is made subsequent to the completion of the raising of the seed money for the organizational expenses in an exempt offering.[243]

It is significant that with the safe harbors of Rules 152(b)(3)(i) and (4), no waiting period is required following the "completion" of the prior offering.[244]

237. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3595.

238. *Id.*; *see also supra* notes 207–09 and accompanying text.

239. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3595.

240. *See supra* notes 172–73 and accompanying text.

241. *See supra* notes 174–75 and accompanying text.

242. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3595 (emphasis added).

243. *See generally* Part III (describing the chartering process).

244. Facilitating Capital Formation and Expanding Investment Opportunities by

As for when an offering is "completed," New Rule 152(d) stipulates that an offering is completed, among other things, when the issuer ceases efforts to make further offers to sell the issuer's securities under such offering.[245] The rule specifically says that, respecting a Regulation D offering, the offering ceases when the issuer has "a binding commitment" to sell all securities to be sold under the offering or the issuer has ceased to make offers, whichever is later.[246] Thus, as long as the organizers of a de novo bank complete the raising of the seed money for organizational expenses *before* commencement of the public offering to sell the securities of the bank to be formed, no integration should be made.[247]

New Rule 152, therefore, provides clarity on how exempt and public offers are to be integrated, and it should present helpful guidance regarding the offer of securities of a bank to be formed. As the SEC itself has concluded, under the integration principle of New Rule 152(a), "issuers may conduct concurrent . . . offerings . . . involving an offering prohibiting general solicitation and another offering permitting general solicitation, without integration concerns, so long as the provisions of Rule 152(a)(1) and all other conditions of the applicable exemptions are satisfied."[248] As for the application of the four safe-harbors of New Rule 152(b), the SEC has said that "[f]or offers and sales meeting the conditions of these safe harbors, the issuer would not need to conduct any further integration analysis."[249] As is typical regarding any SEC exemption, however, the SEC has emphasized that no provision of the New Rule 152 will "have the effect of avoiding integration for any transaction or series of transactions that, although in technical compliance with the rule, is part of a plan or scheme to evade the registration requirements of the [1933] Act."[250]

Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3595 (noting that "no integration analysis" is required where these safe harbor exceptions apply).

245. *Id.*

246. *Id.* at 3596.

247. Under new Rule 152(c), an offering is "commenced" at the time of the first offer by the issuer or its agents. *Id.* at 3595.

248. *Id.* at 3505.

249. *Id.* at 3506.

250. *Id.* at 3504. It should be noted that the 2020 Release also adopted other rules and amendments to existing regulations that may apply to the offering of securities of a de novo bank. Two rules have a part to play in the integration context. The first rule, Rule 148, exempts from the general solicitation concept limited communications made in certain seminars sponsored by institutions, such as colleges or universities or governmental entities, in which more than one issuer participates. *Id.* at 3594–95. At such meetings, a specific offering of securities by the issuer is not made and the sponsor does not, among other things, make investment recommendations or provide advice to attendees, charge entrance fees for attendees, or receive any compensation from issuers for making introduction of attendees. *Id.* at 3594. In the 2020 Release, the SEC also

The ability of organizers of a bank in organization to raise necessary seed money followed by a public offering of securities of the bank to be formed need not present difficult integration issues for state or national de novo banks. As already noted,[251] neither the Federal Reserve nor the FDIC have filing or registration requirements for public offers of bank securities or for exemptions.[252] Thus, under New Rule 152, a legitimate exemption for the raising of the seed money should not pose an integration issue for state banks in organization.

For national banks in organization, the situation is slightly more complex because the OCC adopts the SEC's securities registration and exemption rules.[253] Nevertheless, New Rule 152 provides clear guidance for determining whether any integration issues exist between the raising of seed money by bank organizers and the raising of the necessary capital to form the bank when the OCC grants the bank charter.[254]

IX. CONCLUSION

The process of chartering a new bank is complicated and time-consuming. The OCC (for national bank charters), the state chartering authorities (for state banks), and the FDIC (which insures the deposits of both national and state banks) all heavily scrutinize a de novo bank's business plan and

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adopted Rule 241 to permit an issuer to make limited solicitations of interest from potential investors. *Id.* at 3596. Rule 241(a) permits an issuer before determining which exemption from registration will be relied upon to communicate orally or in writing whether there is an interest. *Id.* Money or other consideration may not be accepted nor may any binding commitment be in place until the issuer decides which exemption will be employed. *Id.* The issuer must state for the potential investor that the issuer is considering an offer but has not decided upon a specific exemption, no money is solicited, and a person's indication of interest involves no obligation to invest. *Id.* Rule 241(c) permits the issuer to provide a means by which the person may indicate interest and provide a name, address, telephone number, or e-mail address. *Id.* Rule 241 would most likely be useful to organizers of a de novo bank in the raising of seed money in the early stages of formation. The rule would give comfort to organizers seeking to select a group of directors and executive officers for the new bank that the seed money is likely to be available. Rule 148, however, is not likely to be of particular benefit to a group of de novo organizers who might make a presentation inasmuch as organizers of de novo banks wish to organize a bank where a new bank is deemed by the bank regulators to be needed and would not want to be participating in a pool of potential de novo bank "issuers" seeking interest for a bank to be formed in the same geographic area. On the other hand, if other types of issuers not competing with banks were present to make a presentation, a de novo bank presentation could be feasible.

251. *See supra* Part VII.

252. *See supra* Part VII.

253. *See supra* note 173 and accompanying text.

254. Because the OCC expressly follows the SEC's rules, New Rule 152 should be readily applied to the de novo national bank. *See supra* note 172 and accompanying text.

projections for future growth, the experience, legal backgrounds, and capabilities of the persons who will serve as directors and officers of the new bank, and the capital to support the new anticipated growth. Sufficient capital is a lynchpin for the foundation of a new bank.

Section 3(a) of the 1933 Act exempts bank securities from the registration requirements of the 1933 Act, and SEC no-action letters have provided practical guidance for the use of Section 3(a) for the offer of securities of banks in formation. NSMIA has also established a path under federal law for a bank in organization to solicit subscriptions in all fifty states for the securities issued by the bank when chartered. This is particularly true in those states where securities laws also provide an exemption for a federal covered security. While states can require notice filings of banks in organization, few do require such filings for that situation. For those states whose securities acts exempt securities of a bank or a security that "will become" a bank security, the capital raising process for a bank in organization should be entitled under NSMIA to proceed without concern over whether the state securities administrator may take issue with the exemption used in the offering.

In those states where the state statute only speaks to an exemption for a "bank," and no separate exemption is expressly granted for a federal covered security, NSMIA clearly affords protection from a state authority that would argue that a bank in organization is not entitled to rely on that state's exemption for a bank security. There is a key point here under NSMIA: if a security offered by a bank in organization is a covered security under NSMIA, it is entitled to preemption of *any* state registration laws, subject to the right of a state to require a notice filing. Apart from NSMIA, in those states that only exempt from registration securities of banks that are already in existence, as interpreted by some state securities authorities, there is still a reasonable basis for relying on the state exemption in any case. To emphasize, however, even in those states whose securities exemptions for a bank security only speak to a bank security, and not also prospectively to a bank security upon completion of the transaction, the security is entitled to NSMIA's federal preemption. As one comment has observed, "[t]he simple fact is that federal preemption is a viable alternative to the patchwork quilt of multi-state regulation."[255] That is not a conclusion that some state securities administrators may want to hear, but such conclusion seems evident under Section 18(a)(1)(B) of the 1933 Act.

All of the foregoing assumes, of course, that it is a bank security, and not a bank holding company security, that is being offered and that in the

255. Chadwick, *supra* note 19, at 771.

organization process the framework is established by the organizers to ensure that the context does not create doubts as to whether something other than a bank security is being "offered" or "sold" for value. An escrow arrangement with an independent bank or third-party to hold subscription funds to be released only upon formation of the bank (or otherwise upon a termination of the offering prior to the chartering of the bank), disclosure to the potential investors that the only security offered is that of a bank (albeit one to be formed), and subscription agreements from investors acknowledging the foregoing all should make it clear that an investor's funds are only at risk for a security of the bank. After all, the securities laws, both federal and state, are designed to protect investor funds, and what needs protection in this instance is the funds that are invested in the bank.

THE FECA'S FOREIGN NATIONALS PROHIBITION IN UNITED STATES V. SINGH: CRIMINALIZING CAMPAIGN CONTRIBUTIONS WITHOUT THE REQUISITE MENS REA AND THE RAMIFICATIONS FOR FOREIGN CORPORATIONS WITH DOMESTIC SUBSIDIARIES

ABIGAIL GAMPHER*

* Editor-in-Chief, *American University Business Law Review*, Volume 10; J.D. Candidate, American University Washington College of Law, 2021; B.A., International Relations, Hendrix College. The author would like to express her immense gratitude to *American University Business Law Review*'s Volume 9 and Volume 10 staff for their diligent assistance throughout the writing and editing processes.

I. INTRODUCTION

During the 2019 fiscal year, the U.S. Department of State issued over eight million temporary work visas.[1] The Federal Election Campaign Act's ("FECA") foreign nationals prohibition prevents each of these individuals from contributing campaign funds to U.S. candidates at the local, state, and federal levels because they lack lawful permanent residence in the United States.[2] The FECA authorizes the Federal Election Commission ("FEC") and the Department of Justice ("DOJ") to bring civil or criminal enforcement actions, respectively, against individuals who contribute campaign funds in violation of the foreign nationals prohibition.[3] Enforcement actions may be brought against both the party accepting a donation from an individual of foreign national status and the individual contributing funds to a campaign as a foreign national.[4]

A successful criminal enforcement action under the FECA requires the government prove the defendant "knowingly and willfully" violated the law.[5] However, courts reviewing FECA violations demonstrate a lack of

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1. U.S. DEP'T OF STATE, BUREAU OF CONSULAR AFFAIRS, FY2019 NONIMMIGRANT VISA DETAIL TABLE 42 (2019), https://travel.state.gov/content/dam/visas/Statistics/Non-Immigrant-Statistics/NIVDetailTables/FY19NIVDetailTable.pdf.

2. *See* 52 U.S.C. § 30121 (prohibiting campaign contributions from temporary residents, foreign principals, and individuals lacking lawful permanent residence); Myles Martin, *Foreign Nationals,* FED. ELECTION COMM'N (June 23, 2017), https://www.fec.gov/updates/foreign-nationals/ (outlining the prohibited campaign activities and contributions for foreign nationals).

3. *See* 52 U.S.C. § 30109(a)(4)(C), (a)(5), (a)(6), (d)(1) (creating separate civil and criminal penalties for various election offenses, including for violations of the foreign nationals prohibition).

4. *See id.* § 30121(a).

5. *See id.* § 30109(d)(1); Andy Grewal, *The DOJ Quietly Made Campaign Finance Violations Easier to Prosecute*, YALE J. REGUL. (May 3, 2018) [hereinafter Grewal, *The DOJ Quietly Made Campaign Finance Violations Easier to Prosecute*], https://www.yalejreg.com/nc/the-doj-quietly-made-campaign-finance-violations-easier-to-prosecute-2/ (explaining that the FECA's "knowingly and willfully" violation standard creates a high bar for prosecution).

unanimity when addressing the requisite mens rea sufficient to satisfy the knowing and willful violation standard of the statute.[6] As the U.S. Supreme Court indicated when it affirmed the district court's decision in *Bluman v. FEC*,[7] the foreign nationals prohibition creates unique obstacles for the government to prove the intent necessary to obtain a criminal conviction.[8]

In May of 2019, the Ninth Circuit heard *United States v. Singh*[9] and affirmed the convictions of a foreign national donor and a recipient of funds for violating the foreign nationals prohibition.[10] However, the Ninth Circuit failed to consider factors indicative of the donor's foreign national status or the recipient's knowledge thereof,[11] clouding any remnants of clarity for the foreign nationals prohibition's mens rea standard. In failing to find actual knowledge, the Ninth Circuit set a dangerous precedent for the FECA's intent standard for criminal liability because the factors relied on by the Ninth Circuit are not indicative of foreign national status and will have inadvertent and disadvantageous impacts on the electoral participation of individuals, entities, and corporations.[12]

The Ninth Circuit's reliance on foreign involvement in *Singh* obscured the distinction between the foreign nationals prohibition and how domestic subsidiaries of foreign corporations function under the prohibition because the court's analysis failed to address the status of the donor as an individual or entity.[13] The FEC should revisit the proposed regulation outlining

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6. *See, e.g.*, United States v. Whittemore, 776 F.3d 1074, 1080–81 (9th Cir. 2015) (requiring that the defendant only have a general awareness that his conduct was illegal); United States v. Curran, 20 F.3d 560, 568 (3d Cir. 1994) (requiring the government to prove that the defendant had specific intent to commit the crime); United States v. Danielczyk, 788 F. Supp. 2d 472, 486 (E.D. Va. 2011) ("'[K]nowingly' is a 'general intent' *mens rea* standard . . . ."), *rev'd on other grounds* 683 F.3d 611 (4th Cir. 2012), *cert. denied*, 568 U.S. 1193 (2013).

7. 800 F. Supp. 2d 281 (D.D.C. 2011), *aff'd*, 565 U.S. 1104 (2012).

8. *See id.* at 292 (cautioning reviewing courts against the adoption of the ordinary mens rea standard for the foreign nationals prohibition because both the recipient and the donor may have ignorance of the law and a language barrier).

9. 924 F.3d 1030 (9th Cir. 2019).

10. *See id.* at 1047 (considering involvement with a foreign corporation and foreign election in favor of constructive knowledge of the donor's foreign national status).

11. *See id.* (relying solely on factors which would indicate constructive knowledge).

12. *Compare id.* (weighing factors indicative of foreign business transactions and foreign electoral involvement in favor of the recipient's actual knowledge), *with* 52 U.S.C. § 30109(d)(1) (criminalizing a recipient's acceptance of contributions from a foreign national only if the donor "knowingly and willfully" violates the statute), *and* 11 C.F.R. § 110.20 (2020) (stating that a recipient may meet the knowing and willful violation standard through actual knowledge or constructive knowledge).

13. *See* Monica Sanders, *Relations Between International Companies and Their Subsidiaries*, HOUS. CHRON., https://smallbusiness.chron.com/relations-between-international-companies-subsidiaries-24591.html (last visited Mar. 11, 2021) (defining multinational corporations and their subsidiaries and explaining how and why they are

constructive knowledge as sufficient to satisfy the FECA's mens rea requirement and restrict judicial analysis to provide crucial clarity to the requisite mens rea of recipients, donors, individuals, entities, and corporations.[14]

Broadly, this Comment addresses the intent standard under the FECA's foreign nationals prohibition through the court's analysis in *Singh*.[15] Part II provides the necessary background on the FECA, the intent standards the government must prove to successfully prosecute a criminal violation of the FECA, the foreign nationals prohibition, Circuit Court decisions analyzing the mens rea for FECA violations, and *Singh*. Part III analyzes the intent standard outlined in *Singh*, where the Ninth Circuit held a campaign contribution recipient criminally liable under the foreign nationals prohibition despite his presumption that the donor was a lawful citizen.[16] Part IV recommends that the FEC revise or eliminate the constructive knowledge prong of the foreign nationals prohibition and require actual knowledge of the donor's foreign national status to satisfy the FECA's intent standard.

II. SAFEGUARDING THE ELECTORAL PROCESS: FINDING ENFORCEMENT POWER AND VIOLATORS

In 1867, the U.S. Congress began its initial attempts to restrict campaign financing and combat candidate reliance on funds from wealthy donors.[17] However, the turn of the twentieth century marked a proliferation of legislative concern with consolidated fiscal involvement in politics.[18] Despite legislative efforts to expand the legal framework surrounding campaign finance, many early efforts lacked efficacious enforcement mechanisms.[19] It was not until Congress granted the FEC exclusive

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formed).

14. *See* FED. ELECTION COMM'N, PROPOSED STATEMENT OF POLICY: APPLICATION OF THE FOREIGN NATIONAL PROHIBITION TO DOMESTIC CORPORATIONS OWNED OR CONTROLLED BY FOREIGN NATIONALS AND SAFE HARBOR FOR KNOWLEDGE STANDARD 13 (2016) [hereinafter FEC, PROPOSED STATEMENT OF POLICY] (stating that the FEC need not promulgate additional rulemaking to close the gaps between the foreign nationals prohibition and domestic subsidiaries of foreign corporations because there is no evidence that the current statutory framework is defective).

15. *See Singh*, 924 F.3d at 1044–48.

16. *See id.* at 1044–45, 1047.

17. *See* 106 CONG. REC. S12,928 (daily ed. Oct. 20, 1999) (statement of Sen. Patrick Moynihan) (recognizing that the Naval Appropriations Bill of 1867 began initial attempts to restrict campaign funds).

18. *See* Matt A. Vega, *The First Amendment Lost in Translation: Preventing Foreign Influence in U.S. Elections After* Citizens United v. FEC, 44 LOY. L.A. L. REV. 951, 967–68, 971 (2011) (citing Tillman Act of 1907, Pub. L. No. 59-36, 34 Stat. 864).

19. *See* Kenneth A. Gross, *The Enforcement of Campaign Finance Rules: A System*

enforcement power under the FECA that the beginnings of the campaign finance legal framework became marginally compulsory.[20]

Congress amended the FECA in the 1970s to further restrict money in politics and specifically target foreign involvement in U.S. elections.[21] The FECA provisions defined foreign national status and subsequently prohibited foreign nationals from contributing to campaigns altogether.[22] In 2002, Congress passed the Bipartisan Campaign Reform Act ("BCRA"), attempting to combat foreign involvement in elections by providing enforcement mechanisms to hold both the foreign actors and domestic recipients criminally liable.[23] Harmonization of the FECA and BCRA frameworks occurred when the FEC revised its regulatory framework to mirror the BCRA and facilitate efficient regulatory enforcement actions under the new legal framework.[24]

A. Intent Under the FECA

For a court to hold a defendant criminally liable under the enforcement prong of the FECA, the defendant must "knowingly and willfully commit[]

in Search of Reform, 9 YALE L. & POL'Y REV. 279, 281 (1991) (stating the FEC lacked effective enforcement mechanisms and disclosure requirements before the FECA).

20. *See* FED. ELECTION COMM'N, FEC REPORT TO THE COMMITTEES ON APPROPRIATIONS ON ENFORCING THE FOREIGN NATIONAL PROHIBITION 3–4 (2018) [hereinafter FEC, REPORT TO THE COMMITTEES ON APPROPRIATIONS] (explaining that the FEC may bring enforcement actions *sua sponte*, as Matters Under Review, or through Alternative Dispute Resolution); Vega, *supra* note 18, at 971–72 (noting that Congress failed to give the FEC essential mechanisms to combat the growing role of money in politics).

21. *See* FECA Amendments of 1974, Pub. L. No. 93-443, § 101, 88 Stat. 1263, 1267 (1974); FECA Amendments of 1976, Pub. L. No. 94-283, §§ 323, 324, 90 Stat. 475, 493 (1976); *see, e.g.*, 52 U.S.C. § 30116 (providing limitations on campaign contributions and expenditures); *id.* § 30121 (prohibiting contributions both to and from foreign nationals); *id.* § 30122 (prohibiting campaign contributions in the name of another).

22. *See* FECA Amendments of 1974 § 101 (defining a noncitizen as an individual unlawfully residing in the United States, or a corporation with a foreign principal); FECA Amendments of 1976 §§ 323, 324 (repealing the statute that placed the foreign nationals prohibition under the criminal code); *see also* Vega, *supra* note 18, at 971–73 (noting that Congress amended the FECA in 1974 to no longer permit direct donations from foreign nationals or corporations to candidates).

23. *Compare* Bipartisan Campaign Reform Act of 2002, Pub. L. No. 107-155, § 303, 116 Stat. 81, 96 (holding both recipients of funds from foreign nationals and foreign nationals criminally liable), *with* 52 U.S.C. § 30121 (holding donors and recipients criminally liable regardless of their status).

24. *See* FED. ELECTION COMM'N, REPORT TO THE COMMITTEES ON APPROPRIATIONS, *supra* note 20, at 1–2. *Compare* 36 U.S.C. § 510 (prohibiting individuals of foreign national status from contributing to the presidential inaugural committee), *with* 52 U.S.C. § 30121(a) (prohibiting individuals of foreign national status from contributing to elections).

a violation."[25] Reviewing courts consider the knowing and willful prongs in tandem, not with individualized attention to each prong.[26] Thus, when the government seeks criminal liability against both the recipient and the donor, the government must offer evidence that both the individual of foreign national status and the recipient of the contribution intended to violate the law when accepting and/or making the contribution.[27]

The FEC set forth a narrowly tailored three-pronged test to determine if a recipient knows of the donor's foreign national status.[28] While not exhaustive, the FEC considers whether a recipient has knowledge of a donor's foreign national status based on the following factors: a foreign passport, foreign bank transfers, and a foreign address.[29] No factor is dispositive, and a campaign contribution recipient may ascertain knowledge of the donor's foreign national status based on one or none of the factors.[30]

The government seldomly prosecutes campaign violations under the foreign nationals prohibition, and those prosecutions rarely reach the sentencing phase.[31] As one of the few cases brought under the foreign nationals prohibition, the Ninth Circuit's decision in *Singh* to uphold the district court's finding was instrumental in determining how foreign corporations could exert influence in elections.[32] The Eighth and Ninth Circuits found individuals criminally liable under the FECA and relied on one of two interpretations to determine intent under the FECA: (1) whether a defendant generally recognized that his conduct was unlawful; or (2) whether a defendant knew his conduct violated a specific law.[33]

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25. 52 U.S.C. § 30109; *see also* L. PAIGE WHITAKER, CONG. RSCH. SERV., R45320, CAMPAIGN FINANCE LAW: AN ANALYSIS OF KEY ISSUES, RECENT DEVELOPMENTS, AND CONSTITUTIONAL CONSIDERATIONS FOR LEGISLATION 32–33 (2018).

26. *See* U.S. DEP'T OF JUSTICE, FEDERAL PROSECUTION OF ELECTION OFFENSES 152–55 (Richard C. Pilger et al. eds., 8th ed. 2017).

27. *See* 52 U.S.C. § 30109(d)(2).

28. *See* 11 C.F.R. § 110.20(a)(4) (2020) (providing that a violator of the foreign nationals prohibition knows of the foreign national donor's status through one of the following: (1) actual knowledge; (2) constructive knowledge indicating a substantial probability of foreign national donor status; and (3) constructive knowledge that would lead a reasonable recipient to inquire into donor status); *see also* WHITAKER, *supra* note 25, at 32–33.

29. *See* 11 C.F.R. § 110.20(a)(5).

30. *See id.*

31. *See* Sean J. Wright, *Reexamining Criminal Prosecutions Under the Foreign Nationals Ban*, 32 NOTRE DAME J.L. ETHICS & PUB. POL'Y 563, 577–78 (2018) (stating that the sentencing guideline for FECA violations, U.S. SENT'G GUIDELINES MANUAL § 2C1.8 (U.S. SENT'G COMM'N 2018), "has only been applied fifty-nine times in the last decade [and] [n]one have involved a foreign national").

32. *See id.* at 582–83.

33. *See, e.g.*, Bryan v. United States, 524 U.S. 184, 191–94 (1998) (explaining that cases involving technical legal language require knowledge of the specific legal

i. The Bryan Standard

In *Bryan v. United States*,[34] the U.S. Supreme Court pioneered the analysis for knowing and willful intent standards under the U.S. Criminal Code.[35] In *Bryan*, the U.S. Supreme Court upheld the conviction of the defendant for engaging in the sale of firearms without a federal license.[36] The defendant argued that although he dealt firearms, he failed to meet the willfulness standard for intent because he was unaware of the specific federal licensing requirements at the time he dealt the firearms.[37] The U.S. Supreme Court rejected the defendant's argument that his actions failed to meet the willfulness standard of intent because the following facts supported the jury's finding that the defendant willfully violated the statute: he used an intermediary to acquire firearms he would not otherwise be able to obtain, filed off the serial numbers, and sold the firearms on a street known for drug trafficking.[38] The U.S. Supreme Court held that a statute with a "willfulness" requirement does not require specific intent unless the statute itself is highly specialized and implicates seemingly innocent conduct.[39]

Further, the U.S. Supreme Court explained that proof of knowledge that an act would surmount to a criminal offense, rather than knowledge of the specific statutory provision, was sufficient to satisfy the knowing and willful standard.[40] Thus, the Court rejected the defendant's request to overturn precedent and apply the ignorance of law defense, which states that the defendant may be immune from liability when he was unaware that his actions violated any law.[41] Since the foundational decision regarding knowing and willful crimes in *Bryan*, reviewing courts have largely applied

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provision); United States v. Benton, 890 F.3d 697, 715 (8th Cir. 2018); United States v. Whittemore, 776 F.3d 1074, 1080 (9th Cir. 2015); United States v. Danielczyk, 788 F. Supp. 2d 472, 486 (E.D. Va. 2011), *rev'd on other grounds* 683 F.3d 611 (4th Cir. 2012).

34. 524 U.S. 184 (1998).

35. *See* Robert D. Probasco, *Prosecuting Conduit Campaign Contributions — Hard Time for Soft Money*, 42 S. TEX. L. REV. 841, 864 (2001) (elaborating that *Bryan* set forth a new standard that would require prosecutors merely to show the defendant knew his actions were culpable).

36. *Bryan*, 524 U.S. at 189, 193.

37. *Id.* at 189–90.

38. *See id.* at 193 (requiring the defendant only to have "acted with knowledge that his conduct was unlawful" to meet the "willfulness" requirement of criminal conduct).

39. *Id.* at 194, 196–98.

40. *See id.* at 193 (citing Staples v. United States, 511 U.S. 600, 602 (1994)) (explaining that facts brought before the defendant would bring them into the realm of the statutory definition).

41. *See id.* at 194–96 (citing Ratzlaf v. United States, 510 U.S. 135, 138, 149 (1994); Cheek v. United States, 498 U.S. 192, 201 (1991)) (explaining that the exception would not extend to facts where the plaintiff already knew the conduct was unlawful).

this standard for criminal FECA violations.[42]

ii. Circuit Courts Interpreting Bryan's Knowing and Willful Conduct Standard Under the FECA

In grappling with the knowing and willful standard, three key decisions found that the *Bryan* standard applied to the FECA. In *United States v. Danielczyk*,[43] the U.S. District Court for the Eastern District of Virginia determined that the FECA was not an overly technical statute that required a heightened mens rea standard.[44] In reaching that conclusion, the court considered the DOJ's prosecution of the defendants for illegally soliciting and disbursing campaign contributions during Hillary Clinton's 2006 and 2008 senatorial and presidential campaigns.[45] The defendants promised to reimburse the donors for the campaign contributions and attempted to conceal the reimbursements by relabeling the contributions as "consulting fees" and back-dated letters to create a paper trail for the fees and services.[46] In assessing the nature of the FECA, the court relied on the Internal Revenue Code's reasonable cause defense under section 6664(c),[47] clarifying that a statute requires a heightened mens rea when a defendant could consult the law and remain unclear as to the requirements placed upon him.[48] The court distinguished provisions in the FECA governing disclosure of campaign funds from specialized provisions in the Internal Revenue Code because the defendants demonstrated their knowledge of the conduct's unlawfulness by backdating letters and concealing the funds.[49] The case was appealed by the government to the Fourth Circuit for reconsideration, but the court did not address the mens rea standard under the statute.[50]

In *United States v. Whittemore*,[51] the Ninth Circuit held that the government needed to prove that the defendant knew his actions constituted

42. *See* United States v. Whittemore, 776 F.3d 1074, 1080–81 (9th Cir. 2015). *But see* United States v. Curran, 20 F.3d 560, 567–69 (3d Cir. 1994) (suggesting that the government must prove that the defendant "specifically intended to violate federal law").

43. 788 F. Supp. 2d 472 (E.D. Va. 2011).

44. *Id.* at 487–93.

45. *Id.* at 476.

46. *Id.*

47. I.R.C. § 6664(c).

48. *See Danielczyk*, 788 F. Supp. 2d at 490 (citing United States v. Critzer, 498 F.2d 1160, 1162 (4th Cir. 1974)).

49. *See id.* at 489–92 (stating that criminal tax liability requires that the defendant voluntarily and intentionally violated the tax code).

50. *See generally* United States v. Danielczyk, 683 F.3d 611 (4th Cir. 2012) (considering only the constitutionality of a restriction on corporate electoral spending).

51. 776 F.3d 1074 (9th Cir. 2015).

a crime, but not that the defendant knew of the specific crime he committed.[52] The defendant distributed his own funds to employees and relatives and instructed them to contribute those funds to a candidate in the employees' names.[53] The defendant's actions circumvented federal reporting requirements under the guise of several donors.[54] However, the defendant argued that at the time he transferred the funds to his family and friends, he believed the monetary transfers became unconditional gifts to those parties.[55] Despite the defendant's statutory interpretation, the court determined that he knew that he was the source of the funds.[56] Therefore, the identity of the ultimate donor was irrelevant to whether the defendant's conduct was a knowing and willful violation of the FECA.[57] The Ninth Circuit ultimately determined that the knowing and willful standard was not dependent upon how each individual interpreted the statute, but the general culpability of the conduct was sufficient to satisfy the knowing and willful standard.[58]

In *United States v. Benton*,[59] the Eighth Circuit determined that a defendant did not need to meet the heightened standard of specific intent for a successful criminal conviction under the FECA.[60] The government offered evidence that the defendants, Benton and Tate, campaign officials for Ron Paul during his 2012 presidential campaign, sent an Iowa state senator money for public endorsement and engaged in a coordinated effort to conceal the transfer.[61] Benton argued that the presence of multiple standards for willfulness required that the Eight Circuit apply the standard most favorable to him.[62] The defendant's argument did not persuade the court, which ultimately found that Benton failed to prove that the FECA fits within the *Bryan* standard.[63] *Benton*, as a case demonstrative of the fragmented application of the *Bryan* standard to criminal convictions for campaign finance violations,[64] begins the discussion of *Bryan*'s inapplicability to the

52. *Id.* at 1080.
53. *Id.* at 1076–77.
54. *Id.* at 1076.
55. *Id.* at 1079.
56. *Id.*
57. *See id.*
58. *Id.* at 1080.
59. 890 F.3d 697 (8th Cir. 2018).
60. *Id.* at 714–15.
61. *Id.* at 704, 710.
62. *Id.* at 715.
63. *Id.*
64. *See* Andy Grewal, *If Trump Jr. Didn't Know Campaign Finance Law, He Didn't Break It*, YALE J. REGUL. (July 16, 2017) [hereinafter Grewal, *If Trump Jr. Didn't Know Campaign Finance Law*], https://www.yalejreg.com/nc/if-trump-jr-didnt-know-campaign-finance-law-he-didnt-break-it/.

FECA.

iii. The Cheek and Ratzlaf Standard

Despite the prevalence of courts applying the *Bryan* standard when determining knowing and willful violation of the FECA, many courts do not apply the standard to highly specialized areas of the law.[65] Pioneered in *Cheek v. United States*[66] and affirmed in *Ratzlaf v. United States*,[67] courts have held that violations of highly technical statutes require a willful violation because the public is generally unaware of such statutory requirements.[68]

In *Cheek v. United States*, the U.S. Supreme Court held a defendant airplane pilot criminally liable for failing to file his income tax return for five years.[69] The defendant testified at trial that he believed the tax regime was unconstitutional and that the wages he received were not income to him.[70] The Court considered that during the five years the defendant was not filing his income tax returns, he attended four civil cases challenging the U.S. tax regime and two trials of individuals charged with violating tax laws.[71] Although the Court found that the defendant's view on the constitutionality of the law was irrelevant, the Court determined that the misunderstanding of the law may negate willfulness, even if the misunderstanding is not objectively reasonable.[72]

In *Ratzlaf v. United States*, the U.S. District Court for the District of Nevada found a defendant criminally liable for structuring his financial transactions to strategically avoid reporting requirements.[73] In that case, the

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65. *Cf.* Sharon L. Davies, *The Jurisprudence of Willfulness: An Evolving Theory of Excusable Ignorance*, 48 DUKE L. J. 341, 361–63 (1998) (stating that while U.S. Supreme Court jurisprudence suggests that complex or technical statutes "may impose a knowledge of the law requirement" to willfulness, courts have continued to "impose their own subjective judgments" in deciding when this heightened standard should be applied).

66. 498 U.S. 192 (1991).

67. 510 U.S. 135 (1994).

68. *See Cheek*, 498 U.S. at 205 (finding that a defendant charged with failing to file his income tax return and willfully evading taxes requires the government to prove that he knew of the specific law); *Ratzlaf*, 510 U.S. at 146–48 (finding that the court could not convict the defendant regardless of his knowledge of the illegality of the offense). *But see* United States v. Starnes, 583 F.3d 196, 211–13 (3d Cir. 2009) (stating that even though the defendant did not know the exact statutory provision, was aware reports he made were false, and that misrepresentation was unlawful, this was not enough to satisfy the heightened intent standard).

69. *Cheek*, 498 U.S. at 194.

70. *Id.* at 195–96, 207.

71. *Id.* at 195.

72. *Id.* at 206–07.

73. *See Ratzlaf*, 510 U.S. at 137–38 (summarizing the trial judge's jury instructions

defendant incurred a debt in excess of $160,000 at a local casino and had a week to pay the debt.[74] The defendant returned to the casino with $100,000, but upon arrival was informed by the casino manager that under 31 U.S.C. § 5313 and 31 C.F.R. § 103.22(a), both local casinos and financial institutions must file reports with the Secretary of Treasury for cash transactions over $10,000.[75] To avoid triggering the reporting requirement, the defendant went to different banks and purchased cashier checks.[76] Upon appeal to the U.S. Supreme Court, the Court determined that violations of the anti-structuring statute, which prohibited structuring transactions in this way to avoid reporting requirements, were not so inherently "evil" that a court could hold the defendant criminally liable without specific knowledge that structuring financial transactions were illegal.[77]

In *United States v. Curran*,[78] the Third Circuit extended the *Cheek* and *Ratzlaf* standard to the FECA.[79] The defendant employer instructed his employees to write personal checks to potential political officeholders, reimbursed the employees for their contributions, and gave employees lists of their colleagues to solicit personal checks from on behalf of candidates.[80] The defendant argued that he utilized the aforementioned donation scheme to avoid other candidates seeking campaign contributions from him, not to necessarily violate the law.[81] The court determined, however, that to hold the defendant culpable, the government must prove three things: (1) that the "defendant knew of [his] reporting obligations"; (2) "that he attempted to frustrate those obligations"; and (3) "that he knew [the] conduct was unlawful."[82] The court was not willing to extend a general intent standard to the whole of the FECA because general intent failed to capture whether the defendant knew his conduct violated the FECA.[83] The Third Circuit ultimately vacated the U.S. District Court for the Eastern District Court of Pennsylvania's judgment because the lower court erroneously instructed the jury to consider criminal liability under a general intent standard when it

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that they did not have to prove the defendant knew this structuring was unlawful, only that the defendant had knowledge of and attempted to avoid the banks' reporting obligations).

74. *Id.* at 137.

75. *Id.* at 136–37.

76. *Id.* at 137.

77. *See id.* at 146–47 (stating that if Congress had intended absolute liability under the statute, the structure of the statute would not require both knowledge and willfulness).

78. 20 F.3d 560 (3d Cir. 1994).

79. *See id.* at 567.

80. *Id.* at 562–63.

81. *Id.* at 563.

82. *Id.* at 569.

83. *Id.* at 569–70.

found the defendant liable for concealing the campaign contributions from the FEC.[84]

B. A Cautioning Court: Bluman v. FEC

In *Bluman v. FEC*, the U.S. Supreme Court affirmed the D.C. District Court's consideration of the foreign nationals prohibition and cautioned against criminal penalties for FECA violations.[85] The plaintiffs were lawful temporary residents of the United States on temporary work visas that brought this action against the FEC, alleging that the statutory bar violated their First Amendment rights as temporary residents.[86] Ultimately, the court granted the FEC's motion to dismiss, stating that the government may exclude noncitizens from the democratic process because the government may restrict the rights of those involved in its political community.[87] The U.S. Supreme Court cautioned Congress that criminal penalties for willful campaign violations require the government to assess the defendant's knowledge of the relevant law.[88]

C. United States v. Singh: The Ninth Circuit Grappling with the Knowing and Willful Standard

In May of 2019, the Ninth Circuit affirmed the lower court's decision in *United States v. Singh* and held a defendant recipient criminally responsible for receiving a campaign contribution from an individual of foreign national status.[89] Defendant donor, Jose Susumo Azano Matsura ("Azano"), sought to contribute campaign funds to a California mayoral candidate seeking to develop the waterfront area near Azano's residence.[90] Azano met the definition of a foreign national under 52 U.S.C. § 30121 because he was not a lawful permanent resident of the United States.[91] Consequently, Azano could not legally contribute campaign funds to a candidate under the FECA,[92] and no individual could receive campaign funds from Azano

84. *Id.*

85. Bluman v. FEC, 800 F. Supp. 2d 281, 285–86, 292 (D.D.C. 2011), *aff'd* 565 U.S. 1104 (2012).

86. *Id.* at 285 (explaining that one plaintiff was a medical resident and dual citizen of Canada and Israel, and the other was an associate at a law firm).

87. *Id.* at 292.

88. *See id.* (stating that there are likely individuals of foreign national status that are unaware of the foreign nationals prohibition).

89. United States v. Singh, 924 F.3d 1030, 1040, 1047 (9th Cir. 2019) (affirming the conviction of a defendant campaign donation recipient under the FECA and foreign nationals test).

90. *Id.* at 1040.

91. *See* 11 C.F.R. § 110.20(a)(3)(ii) (2020); *Singh*, 924 F.3d at 1047.

92. *Compare* 11 C.F.R. § 110.20(a)(3)(ii) (stating that an individual of foreign

without facing the potential for criminal liability under 52 U.S.C. § 30121.[93]

Azano contributed funds through Singh, the CEO of ElectionMall, as an intermediary recipient, seeking to influence the candidate to advance development at a waterfront area.[94] The lower court convicted Singh under 52 U.S.C. § 30121 for accepting a campaign contribution from a foreign national.[95] Singh's primary defense was that he lacked knowledge of Azano's foreign national status at the time of the transaction.[96] Despite Azano's foreign national status, he had various ties to the United States including: a residence in California, his wife and children's lawful citizenship, and lawful entrance into the country on a temporary B1/B2 visa.[97]

In determining that Singh knew of the defendant donor's foreign national status, the court considered: the initiation of contact between the defendants during a foreign election, involvement with a foreign corporation, and attempts to conceal campaign involvement.[98] The Ninth Circuit ultimately affirmed the lower court's conviction of both defendants but reversed a count for falsification of campaign records based on insufficient evidence.[99]

D. The Impact of the Foreign Nationals Prohibition on Corporations

After the U.S. Supreme Court handed down its controversial opinion in *Citizens United v. FEC*,[100] a rising public fear of foreign corporate influence emerged in the gaps of the foreign nationals prohibition.[101] In *Citizens*

national status includes individuals lacking citizenship or lawful permanent residence), *with Singh*, 924 F.3d at 1040, 1047 (applying the foreign nationals prohibition to Azano because he possessed a B1/B2 visa).

93. *See* 52 U.S.C. § 30121(a)(2); *id.* § 30109(a)(11); *Singh*, 924 F.3d at 1040.

94. *See Singh*, 924 F.3d at 1040–41 (explaining that ElectionMall is an organization providing services to candidates).

95. United States v. Singh, No. 14-cr-00388, 2017 WL 4540747, at *1 (S.D. Cal. Sept. 6, 2017).

96. Appellant's Opening Brief at 31–32, United States v. Singh, 924 F.3d 1030 (9th Cir. 2018), (No. 3-14-cr-0388-MMA) (stating that trial court heard testimony from Singh's family indicating that they assumed Azano was a legal permanent resident of the United States).

97. *Singh*, 924 F.3d at 1040.

98. *See id.* at 1047 (explaining that each of these factors was indicative of knowledge and went to the required mental state of Singh when he accepted the donations as an intermediary recipient).

99. *Id.* at 1061.

100. 558 U.S. 310 (2010).

101. *See id.* at 372 (overruling precedent and finding that corporations have a right to political speech under the First Amendment); *see, e.g.*, Micheal Sozan, *Ending Foreign-Influenced Corporate Spending in U.S. Elections*, CTR. FOR AM. PROGRESS (Nov. 21, 2019, 12:01 AM), https://www.americanprogress.org/issues/democracy/reports/2019/

United, the U.S. Supreme Court reviewed a nonprofit corporation's request for injunctive relief to prevent the application of BCRA to its film about presidential candidate Hillary Clinton.[102] The U.S. Supreme Court determined that corporate political donations were political speech and restrictions placed on those contributions must survive strict scrutiny, the same standard as individuals, and that the BCRA could not limit corporate funding of the film.[103] The majority opinion determined that it need not assess whether legal limitations on corporate speech applied to foreign corporations because the plaintiffs brought the case under the provision preventing corporations from participating in electioneering with funds from their general treasury, not the foreign nationals prohibition.[104] The Court's consideration of 2 U.S.C. § 441(e), the former codification of the foreign nationals prohibition, would unnecessarily limit the holding of the case.[105]

Justice Stevens's key concern in his dissenting opinion was that the majority's decision afforded equal protection to foreign corporations and individual U.S. citizens.[106] This brief consideration of the foreign nationals prohibition by Justice Stevens illuminated the public's growing concern with foreign involvement in the electoral process.[107]

III. THE COURT'S ANALYSIS IN UNITED STATES V. SINGH FAILS TO REFLECT THE REQUISITE MENS REA FOR FECA VIOLATIONS

Although FEC and DOJ enforcement actions of the FECA's foreign nationals prohibition are relatively recent in U.S. jurisprudence, reviewing courts must ensure that the government meets its burden of proof because the provision has the potential to hold both recipients and donors criminally liable.[108] Each reviewing court must adequately assess the government's

11/21/477466/ending-foreign-influenced-corporate-spending-u-s-elections/ (explaining that because the legislature enacted the FECA prior to the U.S. Supreme Court handing down *Citizens United*, it left loopholes for foreign corporations with domestic subsidiaries to impact the electoral process).

102. *Citizens United*, 558 U.S. at 321–22.

103. *Id.* at 371–72.

104. *See id.* at 362 (stating that the plaintiff brought the case under the provision which mandated disclosure of certain information instead of the foreign nationals prohibition). *But see* Richard L. Hasen, Citizens United *and the Illusion of Coherence*, 109 MICH. L. REV. 581, 610 (2011) (stating that upholding the ban on foreign national campaign contributions after *Citizens United* would ignore precedent because the ban cannot require distinguishing foreign and domestic contributions based on normative concerns rather than legal).

105. *See Citizens United*, 558 U.S. at 362.

106. *See id.* at 424 (Stevens, J., dissenting).

107. *See* Vega, *supra* note 18, at 956–57.

108. *Cf.* Gross, *supra* note 19, at 292 (arguing that administrative and civil enforcement mechanisms are important to implicate lesser offenses and result in frequent

allegation that the defendant acted with the requisite mens rea for the crime as to each party individually; therefore, the court may not consider the recipient and donor's mens rea collectively.[109]

The Ninth Circuit failed to consider the entire breadth of the recipient's mens rea requirement in *United States v. Singh* in two ways: (1) it neglected to find that the foreign nationals prohibition falls within the *Cheek* and *Ratzlaf* standard; and (2) it failed to address whether Singh had actual versus constructive knowledge of the donor's foreign national status.[110] The Ninth Circuit's omissions will have important implications for foreign corporations with domestic subsidiaries because corporations often engage in foreign involvement regardless of principality.[111] The Ninth Circuit's inattention to the mens rea standard runs the risk of expanding the breadth of criminal liability under the FECA.[112]

A. The Ninth Circuit Failed to Determine that the Foreign Nationals Prohibition Falls Within the Cheek and Ratzlaf Standard

The Ninth Circuit failed to recognize that the foreign nationals prohibition statute, when applied to a recipient of funds, becomes highly technical because enforcement of criminal liability against a violating recipient requires actual knowledge of the donor's foreign national status.[113] The foreign nationals prohibition falls within the highly technical statute exception set forth in *Cheek* and *Ratzlaf* because Singh's defense extended

enforcement action); Jeffery K. Powell, *Prohibitions on Campaign Contributions from Foreign Sources: Questioning Their Justification in a Global Interdependent Economy*, 17 U. PA. J. INT'L ECON. L. 957, 963 (1996) (stating that campaign finance laws fluctuate in clarity and mens rea requirements); Scott E. Thomas & Jeffrey H. Bowman, *Obstacles to Effective Enforcement of the Federal Election Campaign Act*, 52 ADMIN. L. REV. 575, 579–87 (2000) (arguing that enforcement of the FECA remains stunted by budgetary constraints and dual civil and criminal penalties).

109. *See* Gross, *supra* note 19, at 293–94 (explaining that intent for FECA violations is difficult to prove and results in the DOJ bringing very few effective criminal enforcement actions).

110. *See* United States v. Singh, 924 F.3d 1030, 1045–46 (9th Cir. 2019).

111. *See, e.g.*, Dov H. Levin, *Partisan Electoral Interventions by the Great Powers: Introducing the PEIG Dataset*, 36 CONFLICT MGMT. & PEACE SCI. 88, 92, 96–97 (2016) (outlining the variety of political motives the United States may have for intervening in foreign elections, particularly wartime initiatives).

112. *Cf.* Nick Thompson, *International Campaign Finance: How do Countries Compare?*, CNN (Mar. 5, 2012, 4:54 PM), https://www.cnn.com/2012/01/24/world/global-campaign-finance/index.html (demonstrating through explorative examples that international campaign finance is common and presents unique challenges to global governance).

113. *See* Bluman v. FEC, 800 F. Supp. 2d 281, 292 (D.D.C. 2011) (arguing that the foreign national test may be different from other FECA violations because even the individual of foreign national status may not know of the prohibition).

beyond ignorance of the law.[114] Similar to the defendant in *Cheek*, general awareness of the relevant provision was not sufficient to hold the defendant criminally liable because he operated under the good faith belief that his conduct was not within the confines of the statute.[115] In *Curran*, the court determined that an individual must know of his specific reporting requirements and attempt to frustrate those obligations.[116] The government alleged that Singh had knowledge of his obligation not to accept the donation from the donor and sufficiently attempted to frustrate that obligation.[117] However, even if Singh had a general awareness of the FECA or the foreign nationals prohibition, he was unaware of the donor's citizenship status or that he would fall within the statute and its corresponding criminal penalties.[118] As stated in *Ratzlaf*, the defendant's conduct was not sufficiently blameworthy to eliminate the willfulness analysis entirely.[119]

The Ninth Circuit was required to apply the *Cheek* and *Ratzlaf* standard to determine whether Singh met the heightened mens rea standard under the foreign nationals prohibition because Singh's conduct was similarly facially noncriminal if the defendant lacked knowledge that the donor was of foreign national status.[120] Statutes operating under the *Cheek* and *Ratzlaf* standard require a heightened mens rea because they run the risk of implicating conduct that would otherwise be legal.[121] Singh's conduct, as to the charge

114. *See* Cheek v. United States, 498 U.S. 192, 204–05 (1991) (explaining that even if the defendant disagreed with the formation of the law and the underlying constitutionality, his only legal defense was that he "believed in good faith that" he was exempt from filing personal income taxes); Ratzlaf v. United States, 510 U.S. 135, 138 (1994) (explaining that even though the defendant knew there was a law requiring reporting of transactions over $10,000, he was not necessarily on notice that structuring transactions to avoid the reporting requirements would subject him to criminal penalties).

115. *See Cheek*, 498 U.S. at 194–95, 206 (explaining that the defendant was involved in at least four civil trials related to taxes).

116. *See* United States v. Curran, 20 F.3d 560, 567–68 (3d Cir. 1994) (expressing concern with holding laypersons criminally liable for campaign finance violations, a highly specialized area of the law).

117. *See* United States v. Singh, 924 F.3d 1030, 1040 (9th Cir. 2019) (stating that the acceptance of a donation from an individual of foreign national status provides legal grounds for prosecution under 52 U.S.C. § 30121).

118. *See id.* at 1044 (stating that a criminal violation of the FECA requires that the defendant "knowingly and willfully" violate the statute).

119. *See Ratzlaf*, 510 U.S. at 146–47 (stating that a crime may not be subject to a heightened intent standard when the crime is of an "evil" nature "irrespective of the defendant's knowledge").

120. *See Singh*, 924 F.3d at 1045; 52 U.S.C. § 30121; *see also Curran*, 20 F.3d at 567–68 (stating that without the defendant's knowledge that the structuring of financial transactions was unlawful, he would not sufficiently frustrate those obligations to meet the mens rea standard).

121. *See* Bryan v. United States, 524 U.S. 184, 194–96 (1998) (distinguishing *Bryan* from *Cheek* and *Ratzlaf* based on the language of the criminal statute, the general

under 52 U.S.C. § 30121, fell entirely within the *Cheek* and *Ratzlaf* standard. While accepting a campaign contribution from an individual is a noncriminal act, without U.S. citizenship, that acceptance of a campaign contribution transforms into a crime under 52 U.S.C. § 30121.[122] Thus, the statute endangers recipients that are not fully aware of the donor's foreign national status or do not sufficiently inquire in order to ascertain such a level of knowledge.[123]

Singh's conduct did not fall within the *Bryan* standard because the conduct in his case was not accompanied by additional overt acts of illegal activity.[124] In *Bryan*, the defendant's conduct consisted of several consecutive steps including: obtaining illegal firearms, filing off the serial numbers, and selling firearms in a high crime area.[125] Singh committed no additional crimes indicating that he knew the acceptance of a campaign contribution was illegal, outside of stating that the contribution should maintain a status of secrecy.[126] A generalized intent standard applies to generalized illegal schemes, as set forth in *Bryan*.[127] Without additional facts, Singh's conduct fails to demonstrate an equivalent scheme.[128]

The Ninth Circuit improperly determined in *Singh* that the foreign nationals prohibition involved the same knowledge inquiry for the donor and the recipient.[129] In reaching this conclusion, the court considered a distinguishable case, *Whittemore*.[130] In *Whittemore*, the defendant violated the FECA's provision prohibiting donors from making donations in the name of another, requiring only the contributor to have actual knowledge that he

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knowledge of the law, and the implication generally).

122. *See id.*; 52 U.S.C. § 30121; *see also Singh*, 924 F.3d at 1044 (elaborating that an essential element of the foreign nationals prohibition is that the defendant knew of the donor's foreign national status).

123. *See* Grewal, *If Trump Jr. Didn't Know Campaign Finance Law*, *supra* note 64; *accord* Zachary J. Piaker, *Can "Love" Be A Crime? The Scope of the Foreign National Spending Ban in Campaign Finance Law*, 118 COLUM. L. REV. 1857, 1881 (2018) (explaining that campaign finance regulations require a unique intent standard in order to satisfy the motive of combatting corruption).

124. *See Singh*, 924 F.3d at 1046; *Bryan*, 524 U.S. at 194–96.

125. *See Bryan*, 524 U.S. at 189.

126. *See Singh*, 924 F.3d at 1047.

127. *See Bryan*, 524 U.S. at 194–96.

128. *Compare id.* at 189, 194–96 (stating that the illegal act consists of several sequential steps committed by a single defendant), *with Singh*, 924 F.3d at 1047 (explaining that there are two defendants in this case that required knowledge of each other's actions in order for the conduct to surmount to a crime).

129. *See Singh*, 924 F.3d at 1047 (analyzing part of the "knowing and willful" standard for the defendant donor and another for the defendant recipient such that they are synonymous throughout the case).

130. *See id.* at 1044–46.

sourced the campaign contributions himself.[131] In *Singh*, the defendant recipient needed actual knowledge of another's ability to make a campaign contribution.[132] The facts in *Singh* are distinguishable because *Whittemore* solely required the court to inquire into the defendant's knowledge of the law, not whether the other parties were eligible to make campaign contributions.[133] The court's reliance on this case was improper because *Singh* implicates both the recipient and the donor equally under the foreign nationals prohibition.[134] The court's analysis must consist of two distinct and complete assessments of knowingly and willfully violating the foreign nationals prohibition.[135]

The *Singh* court failed to consider *Danielcyzk*, where the donor had actual knowledge that he made a donation in violation of the law when exceeding the limitation on corporate campaign expenditures.[136] In that case, the court held the actors criminally liable for reimbursing donors for their individual contributions.[137] Even though the transaction consisted of multiple parties and the donors, the court did not hold the intermediary recipients criminally liable for their role in exceeding the corporate campaign expenditures.[138] Instead, the court considered the recipient's involvement in favor of the defendant concealing the crime.[139] The defendant in *Singh* is not similarly situated to the defendants in *Benton*, who offered funds to another in exchange for a campaign contribution.[140] For the conduct to transform into a crime, the recipient needed no additional information about the contributors.[141] The role of the defendant in *Singh* as the recipient required

131. *See* United States v. Whittemore, 776 F.3d 1074, 1078–79 (9th Cir. 2015) (explaining that the defendant took steps to conceal the donations under the names of his family and friends by using their names to make the donations and give the appearance that they are from a different donor).

132. *See Singh*, 924 F.3d at 1044–46.

133. *See Whittemore*, 776 F.3d at 1078–79 (elaborating that the only consideration made concerning the intermediaries was whether they thought that the transfer was a gift to them from the defendant at the time of acceptance).

134. *See id.* at 1080 (analyzing solely the defendant donor and not any other party's knowledge of the law); 52 U.S.C. § 30121; *id.* § 30109.

135. *See Whittemore*, 776 F.3d at 1080–81.

136. *See* United States v. Danielczyk, 788 F. Supp. 2d 472, 486 (E.D. Va. 2011) (explaining that the language of the statute was clear and that the defendant took steps to conceal the transferred funds in excess of the limitation amount).

137. *See id.* at 476–78; United States v. Danielczyk, 683 F.3d 611, 614 (4th Cir. 2012) (disguising the donations as "consulting fees" and back-dating letters with modified amounts to conceal the reimbursement of the fees).

138. *See Danielczyk*, 788 F. Supp. 2d at 481 (assessing solely what the employees conceived their instructions were in relation to the funds given by their employer).

139. *See id.*

140. United States v. Benton, 890 F.3d 697, 704 (8th Cir. 2018).

141. *See id.* at 714–15 (stating that offering a sum for endorsement of a candidate

a heightened mens rea standard to satisfy knowledge of the pertinent facts because the court held both recipient and donor criminally liable for a single transaction.[142]

B. The Ninth Circuit Failed to Determine that the Recipient Knew of the Donor's Foreign National Status

The Ninth Circuit failed to reach the conclusion that Singh knew or should have reasonably known of the donor's foreign national status.[143] Instead, the court relied on three key factors demonstrative of foreign involvement rather than foreign national status.[144]

The Ninth Circuit's reliance on Singh's involvement with the donor's foreign businesses failed to prove he knew of the donor's foreign national status because business relationships are not indicative of a donor's citizenship status when globalization has facilitated extensive international business involvement.[145] As enumerated in 11 C.F.R. § 110.20, factors that indicate foreign national status are as follows: a foreign passport, foreign bank transfers, or a foreign address.[146] Foreign business relationships are notably different from these enumerated factors because business relationships are not indicative of foreign principality.[147] The involvement of foreign business is not exclusive or unique to individuals of foreign national status.[148] Reliance on factors universally present across recipient

violates the relevant provision of the FECA regardless of the individuals' status or intention behind the exchange of funds).

142. *See* United States v. Singh, 924 F.3d 1030, 1044–47 (9th Cir. 2019).

143. *Id.* at 1045.

144. *See id.* at 1047 (considering factors not of foreign status of the donor, but of involvement in foreign business); *cf.* Grewal, *If Trump Jr. Didn't Know Campaign Finance Law*, *supra* note 64 (arguing that the foreign nationals prohibition requires a heightened standard for mens rea for an agent of Trump whose ignorance of the law may be a defense to a violation of the foreign nationals prohibition).

145. *See* Emilio Carrillo Gamboa, *Globalization of Industry Through Production Sharing*, *in* GLOBALIZATION OF TECHNOLOGY: INTERNATIONAL PERSPECTIVES 86, 86–87 (Janet H. Muroyama & Guyford Stever eds., 1988) (stating that globalization in the market has emerged to such an extent that business relationships can no longer be indicative of principality).

146. 11 C.F.R. § 110.20(a) (2020).

147. *See* Rick Newman, *Why U.S. Companies Aren't So American Anymore,* U.S. NEWS (June 30, 2011, 3:58 PM), https://money.usnews.com/money/blogs/flowchart/2011/06/30/why-us-companies-arent-so-american-anymore (stating that corporations may go overseas to avoid taxes, procure cheaper labor, or expand their empire, but this does not change the principal of the corporation).

148. *Cf.* Robert E. Litan, *The "Globalization" Challenge: The U.S. Role in Shaping World Trade and Investment*, BROOKINGS INST. (Mar. 1, 2000), https://www.brookings.edu/articles/the-globalization-challenge-the-u-s-role-in-shaping-world-trade-and-investment/ (advocating for a heightened U.S. role and responsibility in shaping the future of global organizations and economies through its involvement with and influence

status diminishes the efficacy of the foreign nationals prohibition because it fails to illustrate the intent of the recipient.[149]

The Ninth Circuit's reliance on Singh interacting with the donor during a foreign election fails to prove Singh knew of the donor's foreign national status because foreign electoral involvement is not indicative of the donor's immigration status or residence.[150] This factor would not put Singh on notice of the donor's foreign national status.[151] Involvement in a foreign election may surmount to notice of foreign status when the donor runs for public office in a foreign country,[152] but the facts the government presented to the court failed to allege that Singh's involvement in foreign elections escalated to candidacy.[153]

The Ninth Circuit properly relied on Singh's concealment because the enforcement mechanism under the FECA explicitly states that concealment may weigh in favor of an offender's knowledge of unlawful conduct.[154] This consideration would weigh against Singh because he sent emails to the donor indicating his desire not to leave a paper trail.[155] Singh's concealment was

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of the International Monetary Fund and World Trade Organization).

149. *Cf.* Douglas A. Hass, *Employers and Immigration Law: Be Careful Who You Hire — and Who You Don't*, 101 ILL. BAR J. 360, 361, 372 (2013) (demonstrating the dangers of constructive knowledge tests for knowledge of illegal working status).

150. *See* Scott Shane, *Russia Isn't the Only One Meddling In Elections. We Do It, Too.*, N.Y. TIMES (Feb. 17, 2018), https://www.nytimes.com/2018/02/17/sunday-review/russia-isnt-the-only-one-meddling-in-elections-we-do-it-too.html (outlining the U.S. historical precedent for intervening in a foreign election when it achieves political and economic incentives); Bruce D. Brown, *Alien Donors: The Participation of Non-Citizens in the U.S. Campaign Finance System*, 15 YALE L. & POL'Y REV. 503, 509 (1997) (stating that the passage of the foreign nationals prohibition attempted to target a perceived problem that could not be eliminated by an outright ban of foreign funds and came with new enforcement issues); *see, e.g.*, Melissa Gomez, *Trump Said It's OK to Take Campaign Dirt from Foreign Powers. Is It Legal?*, L.A. TIMES (June 15, 2019, 10:10 AM), https://www.latimes.com/politics/la-na-pol-2020-trump-foreign-election-interference-20190615-story.html.

151. *See* Shane Dixon Kavanaugh, *US Interfered in Elections of at Least 85 Countries Worldwide Since 1945*, GLOB. RSCH. (Dec. 31, 2019), https://www.globalresearch.ca/us-interfered-in-elections-of-at-least-85-countries-worldwide-since-1945/5601481 (stating that between 1946 and 2000, the United States interfered in approximately eighty-one elections).

152. *Cf. Advice About Possible Loss of U.S. Nationality and Seeking Public Office in a Foreign State*, U.S. DEP'T OF STATE, BUREAU OF CONSULAR AFFAIRS (Mar. 12, 2019), https://travel.state.gov/content/travel/en/legal/travel-legal-considerations/Advice-about-Possible-Loss-of-US-Nationality-Dual-Nationality/Loss-US-Nationality-Foreign-State.html ("A U.S. national's employment . . . with the government of a foreign country . . . is a potentially expatriating act . . . .").

153. *See generally* United States v. Singh, 924 F.3d 1030, 1047–50 (9th Cir. 2019) (limiting the defendant's foreign electoral involvement services performed in Mexico City to the 2011 presidential election).

154. *See* 52 U.S.C. § 30109(a) (detailing the procedures for enforcement).

155. *See Singh*, 924 F.3d at 1052; *see also* Gross, *supra* note 19, at 294 (stating that

similar to the defendant's in *United States v. Danielcyzk*, where the defendant back-dated letters to mask the donations as "consulting fees."[156] The defendant in *Danielcyzk*, however, had actual knowledge that he transferred the funds to another person.[157] Singh accepted an otherwise lawful transfer.[158] Without sufficient mens rea, the court may not properly hold Singh criminally liable under the FECA.[159]

Collectively, the factors considered by the court failed to indicate Singh's knowledge of the donors' foreign national status at the time Singh accepted the campaign contribution.[160] Under the test outlined in *Curran*, Singh must have: (1) known of his duty not to accept a donation from the donor; (2) attempted to frustrate that duty; and (3) known accepting the donation was unlawful.[161] Singh cannot meet any factors of the *Curran* test because he was unaware of his duty not to accept the campaign contribution without actual knowledge of the donor's foreign national status.[162]

C. The Ninth Circuit Filling the Gaps in the Foreign Nationals Prohibition Left After Citizens United v. FEC

The divergence of these factors from those listed under 11 C.F.R. § 110.20 creates a heavy burden on campaign contribution recipients from here forth, particularly for foreign corporations with domestic subsidiaries.[163] As the U.S. District Court for the District of Columbia cautioned in *Bluman*, holding parties criminally liable under a knowing and willful standard for accepting campaign contributions proves challenging because it requires a duality of knowledge: knowledge of the law and knowledge of another's immigration

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concealing an FECA violation generally weighs against a defendant when he egregiously violates the statute).

156. *See* United States v. Danielczyk, 788 F. Supp. 2d 472, 496 (E.D. Va. 2011).

157. *See id.* at 480.

158. *See Singh*, 924 F.3d at 1043.

159. *See* Grewal, *The DOJ Quietly Made Campaign Finance Violations Easier to Prosecute*, *supra* note 5 (arguing that the knowing and willful standard attempts to combat the high mens rea requirement for FECA criminal prosecutions and has permitted the DOJ to increase flexibility in FECA prosecutions).

160. *See* 11 C.F.R. § 110.20 (2020) (explaining that factors indicative of citizenship include documentation, public awareness of foreign status, and usage of foreign banks, but distinguishing foreign corporations with domestic subsidiaries as involving foreign corporate involvement); *Singh*, 924 F.3d at 1045; Martin, *supra* note 2 (listing knowledge of a donor's foreign passport in favor of a recipient knowing a donor's foreign national status).

161. *See* United States v. Curran, 20 F.3d 560, 569 (3d Cir. 1994).

162. *See Singh*, 924 F.3d at 1050.

163. *See* FED. ELECTION COMM'N, PROPOSED STATEMENT OF POLICY, *supra* note 14, at 14–15 (stating that recipient of campaign contributions from foreign corporations with domestic subsidiaries will assumedly conduct a reasonable inquiry for the foreign nationals test).

status.[164] The U.S. Supreme Court briefly mentioned the foreign nationals prohibition in *Citizens United v. FEC*, but notably absent from both the Stevens and the majority opinions are clarifications of the foreign national test and the constructive knowledge prong for corporations.[165] The Ninth Circuit considered factors that were largely met by domestic subsidiaries of foreign corporations, regardless of the U.S. Supreme Court's reluctance to restrict this type of political speech.[166]

Domestic subsidiaries of foreign corporations often engage in foreign elections as a mechanism to influence favorable policies.[167] Domestic subsidiaries are often involved in business with foreign corporate entities because their corporate structure and globalization incentivize international and broadscale transactions.[168] These factors impede legislative intent to distinguish the role of corporate speech under the foreign nationals prohibition because U.S. citizens and corporations are routinely involved in foreign business transactions and foreign elections.[169] The court's failure to adequately address the corporate role within the foreign nationals prohibition blurs the lines between recipients, donors, and their respective corporate equivalents.[170]

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164. *See* Bluman v. FEC, 800 F. Supp. 2d 281, 292 (D.D.C. 2011) (stating that imposing criminal penalties for FECA violation requires the court to assess knowledge of the law, creating a difficult standard for the courts to exact on recipients and donors of campaign contributions).

165. *See generally* Citizens United v. FEC, 558 U.S. 310, 362 (2010) (stating that the Court need not reach the foreign nationals prohibition because the lower court's decision may be overruled on other grounds).

166. *See* CYNTHIA BROWN & L. PAIGE WHITAKER, CONG. RSCH. SERV., R44447, CAMPAIGN CONTRIBUTIONS AND THE ETHICS OF ELECTED OFFICIALS: REGULATION UNDER FEDERAL LAW 4–5 (2016) (stating that FEC guidance on the foreign nationals prohibition does not apply to foreign corporations with domestic subsidiaries).

167. *See, e.g.*, Thompson, *supra* note 112 (providing a comparative study of corporate involvement across democratic nations and stating that corporate involvement is not uncommon outside of the United States).

168. *See* Sanders, *supra* note 13. *But see Defining the Future of Campaign Finance in an Age of Supreme Court Activism: Hearing Before the H. Comm. on H. Admin.*, 111th Cong. 70 (2010) (arguing that the FECA already presents large gaps in the foreign nationals prohibition for corporate interference).

169. *See* FED. ELECTION COMM'N, PROPOSED STATEMENT OF POLICY, *supra* note 14, at 7 (quoting Contribution Limitations and Prohibitions, 67 Fed. Reg. 69,943–44 (Nov. 19, 2002) (to be codified at 11 C.F.R. pt. 102, 110)) ("The Commission based its decision 'upon the lack of evidence of Congressional intent to broaden the prohibition on foreign national involvement in U.S. elections . . . .'"); *cf.* Jieun Lee, Foreign Direct Investment in Political Influence 5 (Oct. 28, 2018) (unpublished manuscript), https://www.internationalpoliticaleconomysociety.org/sites/default/files/paper-uploads/2018-10-28-21_42_07-leejieun@umich.edu.pdf (stating that the FEC has characterized foreign PACs as "instruments of the US employees of foreign-owned companies").

170. *See* Ben Freeman, *America's Laws Have Always Left Our Politics Vulnerable to Foreign Influence*, WASH. POST (Oct. 18, 2019, 10:23 AM), https://www.washington

IV. Resolving and Consolidating the Foreign Nationals Test

The nature of the foreign nationals prohibition is such that it encompasses a wide array of foreign actors and entities.[171] The foreign nationals prohibition's definitional structure applies to entities, corporations, and individuals, but its sanctions fail to distinguish between recipients and donors.[172] Recipients of campaign contributions from a foreign national are subject to the sanctions for accepting a campaign contribution, but the recipients are not prohibited from making contributions themselves, a distinction the structure of the statute fails to reconcile.[173]

A. A Clearer Definition of Foreign National

The governing statutes surrounding the foreign nationals prohibition requires further definitional clarity with caveats for corporations, recipients, and donors.[174] Although 11 C.F.R. § 110.20 seeks to provide some clarity to the required mens rea for a recipient to knowingly accept funds from a foreign national, efforts to develop analyzing case law are largely stunted by the high bar for criminal violations of the FECA.[175] Rather than permitting the reviewing courts to analyze factors that do not support a heightened or ordinary mens rea standard for the crime, the legislature should revise the

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post.com/outlook/americas-laws-have-always-left-its-politics-vulnerable-to-foreign-influence/2019/10/18/3fb7db62-f0f3-11e9-89eb-ec56cd414732_story.html (claiming that it is difficult to discern whether foreign PAC spending stems from domestic or foreign revenue).

171. *See* Martin, *supra* note 2 (including temporary residents, foreign corporations with domestic subsidiaries, and recipients of foreign campaign contributions).

172. *See* 52 U.S.C. § 30121(b) (defining a foreign national as either a corporation with a foreign principal or an individual who is not a lawful permanent resident of the United States).

173. *Cf.* Sozan, *supra* note 101 (critiquing the structure of the foreign nationals prohibition due to its inability to recognize that foreign and domestic interests diverge); *Eliminating the FEC: The Best Hope for Campaign Finance Regulation?*, 131 HARV. L. REV. 1421, 1437 (2018) (quoting Nathan J. Muller, *Reflections on the Election Commission: An Interview with Neil O. Staebler*, AM. ENTER. INST. (Apr. 5, 1979), https://www.aei.org/articles/reflections-on-the-election-commission-an-interview-with-neil-o-staebler/) (characterizing the FEC as a flawed and "captive province" of Congress, overly influenced by incumbent politics).

174. *See* Robert Kelner et al., *Compliance with Ban on Contributions from Foreign Nationals*, COVINGTON & BURLING LLP (May 5, 2016), https://www.cov.com/-/media/files/corporate/publications/2016/05/compliance_with_ban_on_contributions_from_foreign_nationals.pdf (stating that although foreign national status appears facially straightforward, the definition contains applicative ambiguities).

175. *See* Robert Lenhard, *The FEC Revisits the Ban on Foreign Nationals' Financing of American Elections*, COVINGTON & BURLING LLP (June 20, 2017), https://www.insidepoliticallaw.com/2017/06/20/fec-revisits-ban-foreign-nationals-financing-american-elections/ (stating that enforcement of the foreign-nationals prohibition is largely dependent on the Commissioners' interpretation).

prohibition in 52 U.S.C. § 30121 and provide explicit provisions for: (1) donors of foreign national status; (2) recipients of foreign national status; and (3) domestic subsidiaries of foreign corporations.[176]

Explicit provisions would increase the clarity of the foreign nationals prohibition and outline the burden placed on a third party accepting a campaign contribution. Enumeration of these provisions would eliminate the court's reliance on 52 U.S.C. § 30121's correction provision, which requires a recipient to return a donation if they acquire knowledge of the donor's foreign national status because the violating recipient is unlikely to engage in a subsequent status inquiry after obtaining a donation.[177]

B. Including Language on Actual Versus Constructive Knowledge

The legislature should amend 11 C.F.R. § 110.20 to provide a more holistic view of the mens rea requirement for campaign contribution recipients.[178] It is particularly difficult to determine whether a recipient knew of a donor's foreign national status upon receipt of a donation.[179] Thus, courts must have a fully developed analytical framework, not merely the non-dispositive enumerated list provided in 11 C.F.R. § 110.20.

The foreign nationals test provides explicit indicators of citizenship, but prong three of 11 C.F.R. § 110.20 only requires a defendant to have constructive knowledge sufficient to spark an inquiry into a donor's citizenship status.[180] Cohesivity between these two tests would assist courts in implementing the foreign nationals prohibition against recipients in subsequent cases because it would acknowledge the current immigration structure.

V. CONCLUSION

The foreign nationals prohibition serves an essential function, namely to insulate the U.S. electoral process from corrupt foreign intervention.[181]

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176. *See* Corey R. Sparks, Note, *Foreigners United: Foreign Influence in American Elections After* Citizens United v. Federal Election Commission, 62 CLEV. STATE L. REV. 245, 253 (2014) (stating that *Citizens United* failed to remedy the convergence of the foreign nationals prohibition with foreign corporations with domestic subsidiaries).

177. *See* 52 U.S.C. § 30121.

178. *See* 11 C.F.R. § 110.20 (2020); Rick Hasen, *Will Trump Jr's Ignorance of Campaign Finance Law Let Him Off the Hook? What About Manafort?*, ELECTION L. BLOG (July 16, 2017, 10:47 AM) [hereinafter Hasen, *Will Trump Jr's Ignorance of Campaign Finance Law Let Him Off the Hook?*], https://electionlawblog.org/?p=93877 (explaining that as written, FECA mens rea requirements have extensive gaps for those ignorant of the law to avoid criminal liability).

179. *See* WILLIAM THOMAS, ADVERSE REPORT, H.R. Rep. No. 106-297, at 40–41 (1999) (permitting a constructive knowledge standard to avoid willful blindness).

180. 11 C.F.R. § 110.20(a)(5); Thomas & Bowman, *supra* note 108, at 596.

181. *See* R. SAM GARRETT, CONG. RSCH. SERV., IF10697, FOREIGN MONEY AND U.S.

Enforcement of the foreign nationals prohibition has varied,[182] but enforcement actions are hindered by the generalized standard of intent for corporations, donors, and recipients alike, irrespective of their interactions with and proximity to the donor.[183] Each of these groups and entities will necessarily have different intents and abilities to obtain knowledge of the donor's citizenship status.

The Ninth Circuit's reliance on foreign involvement in *United States v. Singh* obscured the distinction between the foreign nationals prohibition and the domestic subsidiaries exception because the court's analysis failed to address the status of the individual and corporate donors.[184] Thus, the FEC should revisit the regulation, outline how constructive knowledge may satisfy the mens rea standard, and restrict judicial analysis to provide clarity as to the requisite mens rea of recipients, donors, and corporations.[185]

These steps will provide additional safeguards to effectively ensure that individuals lacking sufficient knowledge of a donor's foreign national status either become aware of sufficient facts to reject the donation altogether, or are exempt from criminal liability.[186] In sum, the FEC must insulate the electoral process from corrupt foreign powers, and Congress and the FEC must revisit the foreign nationals prohibition and the standard for knowing and willful violation thereof.

CAMPAIGN FINANCE POLICY 2 (2019) (stating that in response to Russian involvement in the 2016 elections, enforcement of the foreign nationals prohibition will likely increase in the near future).

182. Wright, *supra* note 31, at 578.

183. *See* Kelner et al., *supra* note 174.

184. *See* Sanders, *supra* note 13.

185. *See* Hasen, *Will Trump Jr's Ignorance of Campaign Finance Law Let Him Off the Hook?*, *supra* note 178.

186. *See generally* United States v. Singh, 924 F.3d 1030 (9th Cir. 2019) (holding both the donor and recipient liable for violating the foreign nationals prohibition).

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UNIFORM MORTGAGE-BACKED SECURITIES: AN ANALYSIS OF THE REGULATORY HURDLES CAUSED BY THE FEDERAL HOUSING FINANCE AGENCY'S STANDARDIZATION OF THE TBA MARKET

ELIZABETH ASHLEE KUAN*

* Senior Articles Editor, *American University Business Law Review*, Volume 11; J.D. Candidate, American University Washington College of Law, 2022. I am incredibly grateful to my advisor, Professor Heather Hughes, my editor, Lindsey Barrington, and the entire *American University Business Law Review* staff who helped make this piece possible. I would like to thank my parents, brother, Lolo Nonoy, Lola Bebot, Pópo, and Chris for their support. This piece is dedicated to my late Yéye, Sin Leong Kuan.

I. INTRODUCTION

After the financial crisis of 2008, Congress enacted legislation establishing a new agency, the Federal Housing Finance Agency ("FHFA"), to act as conservator of the Federal National Mortgage Association ("Fannie Mae") and the Federal National Home Mortgage Corporation ("Freddie Mac").[1] Fannie Mae and Freddie Mac are both government-sponsored enterprises ("Enterprises") that function as servicers for loans that are secured by mortgage bonds.[2] Though the government regulates the Enterprises, they used to be "privately owned, publicly traded companies."[3] Under the goals of conservatorship, the FHFA announced its plans in 2012 to create a single securitization platform for Fannie Mae and Freddie Mac to trade to-be-announced ("TBA") eligible securities.[4] In 2019, the FHFA issued a final rule establishing a single mortgage-backed security ("MBS") for Fannie Mae and Freddie Mac to issue in the TBA market, which would be known as the Uniform Mortgage-Backed Security ("UMBS").[5] This

1. Housing and Economic Recovery Act (HERA) of 2008 § 1101, 12 U.S.C. § 4511 (establishing the FHFA and granting it authority over Fannie Mae and Freddie Mac); *see id.* § 4617 (enumerating the reasons to appoint the FHFA as the conservator or receiver of Fannie Mae and Freddie Mac ("Enterprises"), such as substantial dissipation and assets insufficient for obligations).

2. *About Fannie Mae and Freddie Mac*, FED. HOUS. FIN. AGENCY, https://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/About-Fannie-Mae---Freddie-Mac.aspx (last visited Mar. 27, 2021); *see* Allan Lopez & Christopher Maloney, *Why the Big Change in Agency MBS Is a Big Deal*, BLOOMBERG (June 6, 2019), https://www.bloomberg.com/professional/blog/big-change-agency-mbs-big-deal/.

3. Janice Kay McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-Up Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 141 (2009).

4. *See* FED. HOUS. FIN. AGENCY, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 13 (2012) [hereinafter FHFA, A STRATEGIC PLAN], https://www.fhfa.gov/AboutUs/Reports/Report Documents/20120221_StrategicPlanConservatorships_508.pdf (explaining that the securitization platform is necessary because Fannie Mae and Freddie Mac's infrastructures were incapable of becoming market utilities without significant investment and technological resources).

5. Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7793 (Mar. 5, 2019) (to

Comment will discuss what led to the creation of the UMBS and compare the effect of UMBS prepayment speeds on the loan originator pool with the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") on small and medium-sized enterprises ("SMEs") and community banks. This Comment will argue: (1) the UMBS fungibility is dependent upon whether the Enterprises' regulatory and disclosure processes effectively align the prepayment speeds; and (2) the current Enterprise governance model will likely restrict loan originator participation by consolidating specified loan pools into one, large multi-lender pool.[6]

II. WHAT LED THE FHFA TO CREATE THE UNIFORM MORTGAGE-BACKED SECURITY?

A. Fannie Mae and Freddie Mac: Foundation and Purpose

During the twentieth century, Congress created Fannie Mae, the Governmental National Mortgage Association ("Ginnie Mae"), and Freddie Mac to stabilize the mortgage market. Though the primary and secondary mortgage markets are separate and distinct platforms, they are connected through lenders.[7] Lenders use the primary mortgage market to supply funds to borrowers seeking to take out mortgages.[8] However, lenders use the secondary mortgage market to sell those mortgages to investors and continue providing loans to borrowers in the primary mortgage market.[9]

Congress created Fannie Mae in 1938 to help provide stability in the secondary mortgage market and promote access to mortgage credit.[10] To

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be codified at 12 C.F.R. pt. 1248).

6. *See* FED. HOUS. FIN. AGENCY, AN UPDATE ON THE STRUCTURE OF THE SINGLE SECURITY 5 (2015) [hereinafter FHFA, UPDATE ON THE STRUCTURE], https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf (using "fungible" and "interchangeable" to denote the same meaning); *see also Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 1, 2, 5 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf (discussing the regulatory burdens on community banks).

7. *See* THOMAS P. LEMKE ET AL., MORTGAGE-BACKED SECURITIES § 5.1 (database updated Oct. 2020) (noting that lenders obtain funds by selling mortgages in the secondary market).

8. *Id*. § 1:2.

9. *Id*. (adding that the sale of loans in the secondary mortgage market offers the borrower "the benefits of lower costs").

10. Federal National Mortgage Association Charter Act § 302, 12 U.S.C. § 1717.

move Fannie Mae's debt, which was traditionally held in Fannie Mae's portfolio, Congress converted Fannie Mae into a quasi-governmental private company in 1968.[11] Fannie Mae purchases mortgages from lenders, including banks and credit unions, and then sells its interest in the bundles of mortgages to investors in the market as MBS, distinguishing Fannie Mae from Ginne Mae.[12]

Created by Congress in the same year, Ginnie Mae was intended to expand the mortgage loan investment market by providing lenders with liquidity secured by the government.[13] Prior to the MBS, banks were the primary source of mortgage investment because of mortgage rate and sourcing disparities amongst differing localities.[14] In 1970, Ginnie Mae created the first MBS,[15] a security comprised of multiple residential mortgage loans used as collateral for the security.[16]

In 1970, Congress created Freddie Mac to help maintain market stability and "increase[] the liquidity of mortgage investments."[17] Unlike Fannie Mae, Freddie Mac packages mortgages into trusts and sells its interests in the trusts as "participation certificates" or "PCs."[18] "Agency MBS" is a term referring to an MBS guaranteed by Fannie Mae, Ginnie Mae, or Freddie Mac.[19] An MBS issued by the Enterprises is distinguishable from a private-label MBS because the government secures an Enterprise MBS.[20]

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11. 12 U.S.C. § 1716(b); *see* LEMKE ET AL., *supra* note 7, § 1:7 (explaining that having a quasi-governmental private company status means that Fannie Mae could now purchase mortgages that were not insured by the FHFA).

12. *See About Us*, GINNIE MAE, https://www.ginniemae.gov/about_us/who_we_are/Pages/our_history.aspx (last modified Dec. 2, 2020, 9:47 AM) (stressing that Ginnie Mae securitizes only certain government-backed mortgages, and "Fannie Mae's role was to buy FHA insured loans from lenders").

13. *See id.*

14. *Id*.

15. *Id*.

16. *See id.*

17. Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91–351, § 301, 84 Stat. 450, 450 (1970) (codified as amended at 12 U.S.C. §§ 1451–1459).

18. Rev. Proc. 18-54, 2018-45 I.R.B. 769; *see* Mark Leeds & Steven Garden, *IRS Ruling on MBS Restructuring Should Encourage Investors*, LAW360 (Sept. 13, 2018, 9:29 PM), https://www.law360.com/articles/1082765/print?section=assetmanagement.

19. James Vickery & Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, FED. RSRV. BANK N.Y. ECON. POL'Y REV., May 2013, at 1, 1, https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf.

20. *See id*. at 2 (explaining that the government-backed guarantee protects "[i]nvestors from credit losses in case of defaults on the underlying mortgages").

B. Fannie Mae and Freddie Mac in the TBA Security Market

A TBA security represents a forward agreement that allows the execution of trades before the required delivery of the securities.[21] The TBA market enables investors to manage their risk because the forward agreement allows for the parties to agree on the price before the underlying mortgages are delivered or even created.[22] In the TBA market, the exact mortgage pool characteristics or number of mortgage pools are unknown at the time of the trade because a security issued or guaranteed by a government-sponsored entity is exempt from certain federal securities registration requirements.[23]

The basic structure of a TBA trade is divided into three parts: the purchase and sale of the securities, the disclosure of the underlying loan identities of the securities, and the delivery of the purchased securities.[24] Because participants are unaware as to the identity of the actual mortgages underlying the security, there are six basic parameters agreed upon before delivery of the MBS on the day of the trade: "the issuers, maturity, coupon, paramount, settlement, and price."[25] The settlement date for agency MBS depends on the associated class of the MBS.[26] Trading behavior in the MBS market is primarily driven by the "average life" for each underlying loan; that is, how long it will take the borrower to repay the principal balance.[27] However, two days before the trade is settled, the seller is required to disclose to the purchaser the identity of the underlying mortgages, what is known as the "forty-eight-hour" rule.[28]

Under the "forty-eight-hour" rule, the seller chooses the MBS it will deliver to the buyer on the day of the trade and will often choose the lesser-valued securities, referred to as "cheapest-to-deliver."[29] Because the

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21. LEMKE ET AL., *supra* note 7, § 5:3.

22. Vickery & Wright, *supra* note 19, at 2 (emphasizing that trading in the TBA market allows investors to trade "agency MBS, out to a horizon of several months").

23. 12 U.S.C. § 1723c; *id.* § 1455(g); *see* Michael E. Murphy, *Fannie Mae and Freddie Mac: Legal Implications of a Successor Cooperative*, 10 DEPAUL BUS. & COM. L.J. 171, 178 (2012) (distinguishing TBA security disclosure requirements from that of registered MBS, which includes disclosure regarding the underlying pools of mortgages).

24. Vickery & Wright, *supra* note 19, at 5.

25. Murphy, *supra* note 23, at 178.

26. *See* LEMKE ET AL., *supra* note 7, § 5:4 (listing the associated product classes such as Class A, which includes thirty-year Fannie Mae and Freddie Mac MBS).

27. *Id*. § 5:2.

28. *See* Vickery & Wright, *supra* note 19, at 6 (detailing that this disclosure occurs approximately forty-eight hours — also known as the "forty-eight-hour-day" — before the trade).

29. Vickery & Wright, *supra* note 19, at 6.

identities of the underlying mortgages do not have to be disclosed before the trade occurs, there is an incentive for the seller to choose the lowest-value securities that satisfy the six basic parameters the buyer and seller agreed upon prior.[30] However, the buyer is not necessarily disadvantaged because the buyer, who is aware of the incentive, will lower the price they are willing to pay at the time of the trade.[31]

Once the trade has been made, a mortgage borrower typically has a set schedule to make monthly payments that include the principal and interest, but the borrower also has the option to make extra payments or pay off the mortgage completely, options known as prepayments.[32] An MBS investor can calculate their future return on investment based on these prepayments.[33] Investors rely on benchmark standards to measure prepayment speeds, such as the Conditional Prepayment Rate ("CPR") and Public Securities Association Rate ("PSA"), to calculate their future return on investment.[34] The key to calculating the rate of prepayment depends on the prevailing mortgage interest rate compared with the interest rates of the underlying mortgages.[35] Investments in MBS can expose investors to risk because the prepayment schedule is not predefined, rather providing flexibility to the mortgagor.[36] The mortgagee's ability to make prepayments or pay off the mortgage entirely at any time makes investing in MBS riskier than other investments.[37]

Securities issued by the Enterprises enable the operation of the TBA market because Enterprise-issued securities are not subject to the same

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30. *See id.*; Murphy, *supra* note 23, at 178.

31. Vickery & Wright, *supra* note 19, at 6 (defining this process as a market phenomenon called "adverse selection").

32. FED. HOUS. FIN. AGENCY, A FINANCIAL CONCEPTS TUTORIAL app. at 22, 25, Westlaw FHFA-BEM 18.6 (2013) [hereinafter FHFA, FINANCIAL CONCEPTS TUTORIAL] (explaining that prepayment speeds are just one of the many interest rate environments that investors monitor through cash flows).

33. *Id*. app. at 23–24.

34. LEMKE ET AL., *supra* note 7, § 5:14 (defining CPR as a "rate [that] assumes . . . some fraction of the remaining principal in a mortgage pool is prepaid each month," and PSA as a rate comprised of "a monthly series of CPRs and assumes that prepayment rates are low for newly originated mortgages and then accelerate over the life of the mortgages").

35. FED. HOUS. FIN. AGENCY, A FINANCIAL CONCEPTS TUTORIAL, *supra* note 32, app. at 26 ("The most important factor in determining the likelihood of prepayments is the difference between the interest rates on pooled mortgages and the prevailing mortgage interest rate.").

36. *See id*. app. at 25.

37. *Id*.

registration requirements as publicly-traded MBS. The TBA market operates in a unique way because Fannie Mae and Freddie Mac are exempt from certain requirements of the Securities Act of 1933.[38] This exemption distinguishes Fannie Mae and Freddie Mac MBS from those sold publicly[39] and allows traders to execute forward trades without the existence of the securities to be delivered on the settlement day.[40] The exemption from U.S. Securities and Exchange Commission ("SEC") registration requirements does not necessitate the existence of the securities because the seller may withhold disclosure of the actual identities of underlying mortgages.[41] The exemption from SEC registration requirements is a key component of the TBA market, but it is a primary reason why investment in the residential mortgage market is so risky and the change to UMBS prepayment speeds is significant.[42]

In the early 2000s, the United States experienced a substantial increase in home financing because the loosening of borrowing restrictions made it easier for people to take out mortgages.[43] During that time, the Federal Reserve also drastically reduced federal interest rates.[44] Because the federal rates were so low, financial institutions could offer their current and potential customers options to purchase inexpensive mortgages while still earning a profit.[45]

Prior to the Enterprises' dominance of the secondary mortgage market, Fannie Mae and Freddie Mac had "conservative underwriting standards" for lenders to trade government guaranteed loans.[46] Due to pressure from Congress to achieve affordable housing goals and pressure from shareholders to invest in the subprime mortgage market to boost profitability,

38. 12 U.S.C. §§ 1455(g), 1723c; *see* Vickery & Wright, *supra* note 19, at 9.

39. Vickery & Wright, *supra* note 19, at 9; *see also* 12 U.S.C. §§ 1455(g), 1723c (explaining that Fannie Mae and Freddie Mac, along with the other federal home loan banks, are not considered agencies).

40. Vickery & Wright, *supra* note 19, at 9.

41. *Id.*

42. *Id*. at 9, 10.

43. *See* Alexander S. Bonander, Note, *Fannie Mae, Freddie Mac, and Due-Diligence Failures: Should Comparative Responsibility Be Imposed on a Government-Sponsored Entity's Claims Brought Under Sections 11(a) and 12(a)(2) of the Securities Act of 1933?*, 98 IOWA L. REV. 835, 839 (2013) (quoting *In re* Fannie Mae 2008 Sec. Litig., 742 F. Supp. 2d 382, 391 (S.D.N.Y. 2010)).

44. *Id.*

45. *Id.*

46. *See id*. at 843 (demonstrating the Enterprises' conservative underwriting standards consisted of a "loan-to-value ratio of 80% and a single-family residential mortgage maximum-principal-indebtedness amount of $417,000").

the Enterprises abandoned their stringent underwriting standards and began guaranteeing subprime mortgages and investing in sub-prime MBS.[47]

C. Dodd-Frank Wall Street Reform and Consumer Protection Act: A Byproduct of the 2008 Financial Crisis

At the time of the crisis, Fannie Mae and Freddie Mac were sitting on millions of dollars' worth of "junk" MBS and PCs.[48] Between 2004 and 2006, the Enterprises "purchased over $434 billion in subprime mortgages."[49] The Treasury lent the Enterprises nearly $150 billion.[50] In February of 2008, Congress passed the Emergency Economic Stabilization Act, which allowed the Federal Reserve to purchase $700 billion in mortgages for the market to maintain liquidity.[51] Later that year, Congress also passed the Housing and Economic Recovery Act ("HERA"), which created the Federal Housing Finance Agency ("FHFA").[52] The FHFA's purpose was to act as conservator of Fannie Mae and Freddie Mac in governing the acceptance and issuance of agency securities.[53] Although the conservator role does not equate to micromanaging the Enterprises' operations, it does require the FHFA's approval over changes in regulations and other laws.[54]

The other major legislation resulting from the financial crisis of 2008 was the Dodd-Frank Act.[55] The Dodd-Frank Act was one of the most

47. *Id.* at 850–51.

48. *See id.* at 853; Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 60 (2009) (quoting Michael S. Barr & Gene Sperling, *Poor Homeowners, Good Loans*, N.Y. TIMES (Oct. 17, 2008), https://www.nytimes.com/2008/10/18/opinion/18barr.html) (specifying that Fannie Mae and Freddie Mac had either guaranteed or purchased $270 billion in loans from 2005 to 2008); *see also* Milan Markovic, *Subprime Scriveners*, 103 KY. L.J. 1, 8 (2015) (explaining that towards the end of 2008, the "credit rating agencies downgraded most MBS investments to junk status").

49. Bonander, *supra* note 43, at 844.

50. *Id.* (acknowledging that the amount of money the Enterprises received from the government was "the largest bailout of the [2008] financial crisis").

51. Emergency Economic Stabilization Act of 2008 §§ 2–301, 12 U.S.C. §§ 5201–5261; *see* Moran, *supra* note 48, at 11.

52. Housing and Economic Recovery Act (HERA) of 2008 § 1145(a), 12 U.S.C. § 4617; *see About FHFA*, FED. HOUS. FIN. AGENCY, https://www.fhfa.gov/AboutUs#:~:text=The%20Federal%20Housing%20Finance%20Agency,%E2%80%8B%20and%20the%20Federal%20Home (last updated Oct. 5, 2020).

53. *See Conservatorship*, FED. HOUS. FIN. AGENCY, https://www.fhfa.gov/Conservatorship (last visited Mar. 27, 2021).

54. *Id.*

55. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-

comprehensive securities regulation reforms since the Securities Exchange Act of 1934.[56] The primary purpose of the Dodd-Frank Act was to use transparency as the primary mechanism to stabilize the markets and to prohibit large financial institutions from engaging in proprietary trading practices that contributed to the financial collapse of 2008.[57] By promoting accountability and transparency, the legislation would protect taxpayers from bearing the financial burden of "Wall Street's mistakes."[58]

The Dodd-Frank Act created two new regulatory agencies: the Financial Stability Oversight Council ("FSOC") and the Consumer Financial Protection Bureau ("CFPB").[59] Due to the role of the residential mortgage market that led to the 2008 financial crisis, the Dodd-Frank Act granted the CFPB the authority to regulate all non-bank residential mortgage loan originators, brokers, and servicers.[60] The Dodd-Frank Act also granted the CFPB the authority to create rules to require disclosure of loan terms.[61] Thus, by implementing credit risk retention minimums for securitizers, the Dodd-Frank Act aims to eliminate high-risk trading of qualified residential mortgages ("QRM").[62] The Dodd-Frank Act also created the FSOC, which is tasked with identifying potential risks to the U.S. economy.[63] In response to the 2008 financial collapse, due in large part to risky trading of MBS backed by high-risk residential mortgages, the Dodd-Frank Act included strict and specific provisions to prevent lenders from allowing retail

203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. §§ 5301–5641).

56. Cody Vitello, *The Wall Street Reform Act of 2010 and What It Means for Joe & Jane Consumer*, 23 LOY. CONSUMER L. REV. 99, 99 (2010).

57. Brynne Krause, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: How Increased Regulation Has Given Large Banks an Artificial Competitive Edge*, 83 UMKC L. REV. 1045, 1049 (2015) (quoting Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010)).

58. *Id*. (quoting President Barack Obama pledging that "[t]he American people [would] never again be asked to foot the bill for Wall Street's mistakes").

59. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 111, 1002, 12 U.S.C. §§ 5321, 5481.

60. *See* 12 U.S.C. § 5107(f)(2) ("[T]he Bureau shall take into account the need to provide originators adequate incentives to originate affordable and sustainable mortgage loans . . . .").

61. *Id.* § 5531(a); *see* Jason Scott Johnston, *Do Product Bans Help Consumers? Questioning the Economic Foundations of Dodd-Frank Mortgage Regulation*, 23 GEO. MASON L. REV. 617, 638 (2016).

62. *See* 15 U.S.C. § 78o-11; Emre Carr, Commentary, *An Economic Analysis of the SEC's ABS Risk-Retention Rule Re-Proposal*, 20 NO. 1 WESTLAW J. DERIVATIVES 1, 1–2 (2013).

63. 12 U.S.C. § 5321; *see also* Vitello, *supra* note 56, at 102–03 (listing specific responsibilities of the FSOC).

consumers to take out mortgage loans that they could not repay.[64]

However, beginning in 2013, the Dodd-Frank Act was modified in response to criticisms from financial industry participants arguing that complex disclosure and compliance requirements limited participation to large financial institutions with capital.[65] Named after Paul Volcker, former chairman of the Federal Reserve, the Volcker Rule was integrated into the Dodd-Frank Act to apply to all banking entities regardless of size.[66] The Volcker Rule places broad prohibitions on banks from engaging in proprietary trading and other risky sponsoring of alternative asset classes.[67] In response to criticism of the Volcker Rule's restrictive impact on SMEs, the Volcker Rule was subsequently amended in 2018 to allow increased participation.[68] The Volcker Rule modifications provided small banks engaging in limited trading activity an exemption from certain compliance disclosure requirements.[69]

D. Regulatory Outcomes of the FHFA Rulemaking Session: Alignment of Prepayment Speeds

Since September 6, 2008, Fannie Mae and Freddie Mac have functioned under the conservatorship of the FHFA.[70] HERA grants the FHFA the

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64. *See* Johnston, *supra* note 61, at 619 (identifying the Dodd-Frank Act as the regulatory response to predatory lending practices and convoluted mortgages resulting in thousands taking on mortgages far outside of their financial reach).

65. *See* OCC Issues Annual Report to Congress, Fed. Banking L. Rep. (CCH) ¶ 156-564, 2020 WL 1323401 (Jan. 9, 2020) (stating that financial industry participants voiced concerns over the Dodd-Frank Act's effects around 2013).

66. 12 U.S.C. § 1851(a)(1); *see* Krause, *supra* note 57, at 1067–68.

67. 12 U.S.C. § 1851(a)(1); *see* Shay Raoofi, Note, *The Volcker Rule: A Regulatory Vice Under the Guise of Consumer Protection*, 26 LOY. CONSUMER L. REV. 301, 303–04 (2014) (specifying that the Volcker Rule prohibits financial institutions from "(1) engaging in proprietary trading; (2) acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and (3) sponsoring a hedge fund or a private equity fund").

68. *See* Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33,432, 33,546–47 (July 17, 2018) (proposing to allow for more diverse participation by allowing a banking entity to take on an ownership interest in a covered fund in addition to that permitted under the 2013 Volcker Rule provisions).

69. *See* Sydney Sachs, *Proposed Volcker Rule Revisions and Expected Impact*, 38 REV. BANKING & FIN. L. 98, 105 (2018) (stating that the new disclosure requirements create three distinct categories: banks with assets over $10 billion, banks with assets between $1 billion and $10 billion, and banks with fewer than $1 billion in assets, for which the banks with the most assets are subject to the strictest compliance requirements).

70. *See* Housing and Economic Recovery Act (HERA) of 2008 § 1145(a), 12 U.S.C.

authority to oversee Fannie Mae and Freddie Mac so that the entities do not fall into a position that causes destabilization in the market.[71] The statutory rulemaking authority allows the FHFA to initiate the common security platform and to request Fannie Mae and Freddie Mac to create a single security.[72]

In February 2012, the FHFA published a report announcing its goal to create a new securitization platform for Fannie Mae and Freddie Mac to issue securities in the secondary mortgage market.[73] In response to feedback on the new securitization platform in 2013, the FHFA stated it would review alignment policies pertaining to borrower refinancing, as borrower refinancing affects the prepayment risk investors must weigh.[74] In October 2013, Fannie Mae and Freddie Mac established Common Securitization Solutions, LLC to build and operate the Common Securitization Platform ("CSP").[75] In May 2014, the FHFA announced the development of a single security to boost market liquidity by attempting to decrease the trading gap between the Enterprises' securities, leading toward a more balanced market.[76] The goal of the single security would not only be to build a new infrastructure for Fannie Mae and Freddie Mac, but also a system more conducive for future market participation.[77]

In August 2014, the FHFA issued a publication detailing the structure for

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§ 4617(b)(2)(A).

71. *See* 12 U.S.C. § 4617(b)(2)(A), (D).

72. *See id.* § 4617(b)(2)(D) (allowing the FHFA to make decisions that enable the entities to operate soundly); *id.* § 4513(a)(1)(B) (listing the FHFA's regulatory responsibilities as conservator); FED. HOUS. FIN. AGENCY, UPDATE ON THE STRUCTURE, *supra* note 6, at 5.

73. FHFA, A STRATEGIC PLAN, *supra* note 4, at 13.

74. FED. HOUS. FIN. AGENCY, A PROGRESS REPORT ON THE COMMON SECURITIZATION INFRASTRUCTURE 8 (2013), https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/WhitePaperProgressReport43013.pdf.

75. Press Release, Fed. Hous. Fin. Agency, FHFA Announces Significant Steps in Organization of Joint Venture to Establish Common Securitization Platform (Oct. 7, 2013), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Significant-Steps-in-Organization-of-Joint-Venture-to-Establish-Common-Securitization-Platform.aspx.

76. *See* FED. HOUS. FIN. AGENCY, THE 2014 STRATEGIC PLAN FOR THE CONSERVATORSHIPS OF FANNIE MAE AND FREDDIE MAC 17 (2014) [hereinafter FHFA, 2014 STRATEGIC PLAN], https://www.fhfa.gov/aboutus/reports/reportdocuments/2014strategicplan05132014final.pdf (acknowledging that Freddie Mac securities traded less favorably to those of Fannie Mae).

77. LAURIE GOODMAN & LEWIS RANIERI, URB. INST., HOUS. FIN. POL'Y CTR., CHARTING THE COURSE TO A SINGLE SECURITY 1 (2014), https://www.urban.org/sites/default/files/publication/22916/413218-Charting-the-Course-to-a-Single-Security.PDF.

the new single security.[78] In an update on the Single Security Initiative in 2015, the FHFA stated that the majority of the feedback from the proposed single security structure in 2014 reflected concern over divergence of prepayment speeds.[79] Though financial institutions and government agencies suggested that the FHFA make further adjustments to align the Enterprises' securities regulations affecting prepayment rates, the FHFA expressed its belief that complete alignment of the Enterprises' regulations would be unnecessary because innovation in the issuance of loans from both Enterprises enhances the entire secondary mortgage market.[80] Feedback from commentators also showed concern over the Enterprises' differing remittance policies.[81] The remittance policies pertain to two key components: the remittance cycle and the remittance type.[82] At that time, the FHFA did not find it necessary to align Fannie Mae and Freddie Mac's remittance cycles because the agency projected little impact on prepayment speeds.[83]

On September 17, 2018, the FHFA requested public comment on a Notice of Proposed Rulemaking in the Federal Register regarding the FHFA requiring the Enterprises to adopt and maintain new regulations that would "promote aligned investor cash flows."[84] The proposed rule shifted the conservatorship responsibilities from the FHFA to the Enterprises by requiring the Enterprises: (1) create regulations with regard to alignment of prepayment speeds; and (2) adopt regulations that were aligned with one another.[85] In March 2019, the FHFA issued a final rule establishing the

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78. FED. HOUS. FIN. AGENCY, REQUEST FOR INPUT: PROPOSED SINGLE SECURITY STRUCTURE 3 (2014), https://www.fhfa.gov/policyprogramsresearch/policy/documents/rfi-single-security-final-8-11-2014.pdf.

79. FHFA, UPDATE ON THE STRUCTURE, *supra* note 6, at 15.

80. *Id*.

81. *Id*. at 16, 17 (explaining that feedback in response to the request for public input reflected concerns that new programs and policies are similarly implemented to prevent divergence in prepayment speeds).

82. *Id.* at 17 (defining remittance cycle as "the collection period for payments from borrowers and the date on which servicers must remit funds to the Enterprises," and the remittance type as "whether the payments servicers make should reflect funds actually received from borrowers or what borrowers were scheduled to pay").

83. *Id.*

84. Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,889 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248).

85. *Id.* at 46,893 (requiring the Enterprises to maintain alignment for current TBA-eligible MBS and future UMBS); *id.* at 46,895 (detailing the final rule requirements for alignment between the Enterprises).

UMBS, which Fannie Mae and Freddie Mac would issue on June 3, 2019.[86]

Historically, agency MBS issued by Fannie Mae traded at a far higher volume than agency PCs issued by Freddie Mac because MBS are known to be more liquid, which translates into safer and more stable investments.[87] Because Freddie Mac PCs were known to lack liquidity, its bonds traditionally traded at a discount in comparison to Fannie Mae MBS.[88] Moreover, Fannie Mae provided better service and issues bonds with better performance characteristics.[89] This allowed Fannie Mae to continually maintain "a larger market share with originators" in comparison to Freddie Mac.[90]

UMBS is the new common security issued by Fannie Mae and Freddie Mac, available on the TBA securities market, "backed by one-to-four unit (single family) properties."[91] The new securities should improve both Enterprises' liquidity and maintain the UMBS fungibility, meaning maintaining an equal exchange in value.[92] In November 2019, the FHFA submitted a Request for Input ("RFI") regarding the Enterprise UMBS pooling practices.[93] Comments from entities like Securities Industry and Financial Markets Association ("SIFMA") and the American Bankers Association ("ABA") reflected increasing concern over the expanded governance role of the Enterprises and the new regulations governing the UMBS under the single securitization platform.[94]

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86. *Id.* at 46,891; Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7793 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248).

87. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7795–96.

88. *See* GOODMAN & RANIERI, *supra* note 77, at 3 ("[A] greater proportion of Freddie Mac loans are locked up in collateralized mortgage obligations (CMOs).").

89. Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7795–96.

90. *Id.*

91. *Id.* at 7793 (explaining the properties are used as collateral for the security).

92. *Id.*

93. FED. HOUS. FIN. AGENCY, ENTERPRISE UMBS POOLING PRACTICES REQUEST FOR INPUT 1 (2019) [hereinafter FHFA, ENTERPRISE UMBS POOLING PRACTICES], https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Pooling_RFI.pdf.

94. *See* Am. Bankers Ass'n et al., Comment Letter on Request for Input on Enterprise Pooling Practices (Jan. 21, 2020), https://www.aba.com/advocacy/policy-analysis/letter-to-fhfa-on-the-uniform-mortgage-backed-securities (concluding that FHFA needs to specifically address misalignment issues between the Enterprises' securities); Secs. Indus. & Fin. Mkts. Ass'n, Comment Letter on Request for Input on Enterprise Pooling Practices (Jan. 21, 2020), https://www.sifma.org/wp-content/uploads/2020/01/FHFA-RFI-RESPONSE-FINAL-SIFMA-2020-01-21.pdf ("TBA liquidity has not been optimal . . . .").

III. ENTERPRISE ENFORCEMENT: LEGAL IMPLICATIONS AND GOVERNANCE OF THE UMBS LOAN POOL IN A POST-CONSERVATORSHIP MARKET

A. Examining the Dodd-Frank Act Disclosure Requirements for Qualified Residential Mortgages

The "risk retention rule" enacted by Dodd-Frank, makes it less likely that securitizers will take undue risks by requiring that they retain "five percent of the credit risk of any securitized asset."[95] In other words, securitizers will have "skin in the game."[96] The Dodd-Frank Act requires that the securitizer retain, at minimum, "five percent of the credit risk of any securitized asset," but the regulators retain the power to decide "how to calculate the five percent minimum credit risk."[97] Through this legislation, Congress gave six regulating agencies the power to create exemptions and define "underwriting standards that indicate low-credit risk in any asset class."[98] A major component of the Dodd-Frank Act is the exemption that applies to QRMs.[99] For QRMs, securitizers are not required to "retain any risk associated with the creditworthiness of [QRMs] backing their asset pools."[100] In 2011, the six regulating agencies conducted a notice and comment rulemaking to implement a final rule that complied with the Dodd-Frank Act credit risk retention requirements.[101]

The original rule, published in 2011, provided sponsors with multiple means of calculating the five percent credit risk minimum.[102] Initially, the

95. Carr, *supra* note 62, at 1; Credit Risk Retention, 79 Fed. Reg. 77,602, 77,603 (Dec. 24, 2014) (to be codified at 17 C.F.R. pt. 246).

96. Carr, *supra* note 62, at 1.

97. *Id.*

98. *Id.* at 1, 1 n.1 (denoting the six regulating agencies as the Office of the Comptroller of the Currency ("OCC"), Federal Reserve, Federal Deposit Insurance Corporation ("FDIC"), SEC, FHFA, and Department of Housing and Urban Development ("HUD")).

99. 15 U.S.C. 1639(c); *see Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 6 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf (noting that the new QRM rule conflicts with underwriting tailored to consumers).

100. Carr, *supra* note 62, at 2.

101. Credit Risk Retention, 76 Fed. Reg. 24,090, 24,090 (Apr. 29, 2011) (to be codified at 17 C.F.R. pt. 246).

102. *See* Credit Risk Retention, 79 Fed. Reg. 77,602, 77,605 (Dec. 24, 2014) (to be codified at 17 C.F.R. pt. 246) (indicating retention could include "a 5 percent 'vertical' interest in each class of ABS interests . . . or a 5 percent 'horizontal' first-loss

transactions the Enterprises sponsored would be deemed to satisfy the risk retention requirements because of their conservatorship with the FHFA.[103] However, the proposed rule was adjusted in response to major concerns over ways to satisfy the credit risk retention requirements.[104] In 2013, the agencies broadened the definition of QRM to provide more flexibility in determining how sponsors could retain the minimum credit risk retention.[105] The exemption specifically covers QRMs that are "asset-backed securities that are collateralized exclusively by residential mortgages . . . ."[106]

In 2014, the six regulating agencies stated that Fannie Mae and Freddie Mac satisfied the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, which was added by Section 941 of the Dodd-Frank Act, because of the Enterprises' government backed guarantee.[107] The final rule emphasized that as long as the Enterprises continued to operate with the FHFA as conservator, the risk retention requirements under the final rule would be satisfied with respect to the Enterprise-issued MBS.[108]

In contrast, the rulemaking process governing the UMBS reflects a marked change in the FHFA's role as conservator of the Enterprises.[109] Comments from the ABA indicate that the Enterprises' striking control over programs and policies could continue even after the conservatorship with the FHFA ends because the agency remains ambiguous as to what limitations can or will be put on the Enterprises.[110] Under the FHFA's direction, the Enterprises have gained more control over whom may participate in the TBA

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interest . . . .").

103. *See id.*

104. *See id.* (elaborating on how the rules were adjusted in the revised proposal for "eligible vertical interest" and "eligible horizontal residual interest" to satisfy credit risk retention requirements).

105. *See id.* (explaining how satisfying the final credit risk retention requirements included an option to retain "any combination of an 'eligible vertical interest' with a pro rata interest in all ABS interests issued and a first-loss 'eligible horizontal residual interest' . . . .").

106. *Id.* at 77,602.

107. *Id.* at 77,602, 77,649; *see* 15 U.S.C. § 78o-11(E)(3)(B).

108. *See* Credit Risk Retention, 79 Fed. Reg. at 77,649 (explaining that the Enterprises provide a full guarantee on the timely principal and interest payments on the MBS that they issue because of capital support provided by the Treasury).

109. *See* Am. Bankers Ass'n et al., *supra* note 94 (noting the FHFA's approval of moving the conventional markets to a multi-lender pool would yield the opposite of progress).

110. *Id.*

market and what types of loans will be pooled to create Enterprise UMBS.[111] Despite being in a conservatorship with the FHFA, the Enterprises gaining this type of control is a source of concern because the Enterprises remain loan issuance competitors.[112]

Misalignment is concerning because the Enterprises are competitors, and misalignment, meaning "[t]o diverge by, or a divergence of, 2 percentage points or more, in the three-month CPR for a cohort or 5 percentage points or more, in the three-month CPR for a fastest paying quartile of a cohort . . ." could lead investors to favor one Enterprise over the other, which is exactly what the FHFA aimed to eliminate with the implementation of the UMBS.[113] Should misalignment of cash flows occur, the Enterprises are required to report the misalignment to the FHFA.[114] The report must provide a detailed explanation of the issue including the cause of misalignment and a plan to rectify it.[115] Once the FHFA has reviewed the report, it may elect to temporarily change definitions of misalignment to adjust to market conditions.[116] Despite the FHFA's conservator role to oversee the Enterprises' alignment policies, the Enterprises are still focused on issuing the most desirable loans to investors.[117] This competitive relationship between the Enterprises causes concern amongst market participants that the Enterprises retain too much responsibility for ensuring that each entity is in alignment with the other.[118]

111. *Id.*

112. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (emphasizing concern that there needs to be effective measures implemented to prevent one Enterprise from exerting efforts to control performance).

113. Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7800 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248).

114. *Id.*

115. *Id.*

116. *Id.* at 7800–01.

117. *See id.* at 7796.

118. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (reiterating market participants' concerns that the Enterprises' current responsibilities with regard to alignment may suffer because the Enterprises will remain "fierce competitors").

B. Potential Consequences for Loan Originators

The Volcker Rule enacted compliance requirements on investment banks that regulated trading activity in order to mitigate risk.[119] Banks in particular were concerned that the overbroad scope and intricate ramifications of the Volcker Rule would make compliance for boutique banks extremely difficult.[120] The Volcker Rule also imposed high-cost compliance requirements that favored large financial institutions.[121] Reporting requirements imposed by the Dodd-Frank Act are beneficial to investors of large banks and simultaneously burdensome on SMEs and community banks.[122] Moreover, banks with fewer than $10 billion in assets are already subject to certain public disclosure requirements, such as liability quality and capitalization.[123] Repeating this disclosure information in compliance with the SEC's mandated disclosures creates even more burdens on small banks.[124]

SMEs and community banking industries have a capital disadvantage to large financial institutions because the industry focus is on core banking services as opposed to revenue streams generated from proprietary trading.[125] This is particularly significant for the small banks that are already absorbing additional compliance costs.[126] Because the banks have to absorb more fixed costs, there is an increased likelihood that they will offset their costs and push them onto consumers through methods such as higher transaction fees.[127] Fewer institutional costs could lead to more inefficient

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119. *See* 12 U.S.C. § 1851(a)(1) (prohibiting banks from engaging in proprietary trading or owning or investing in a hedge fund or private equity fund); Krause, *supra* note 57, at 1068.

120. Halah Touryalai, *Volcker Rule Is Out, How Much Will It Hurt?*, FORBES (Oct. 12, 2011, 5:25 PM), https://www.forbes.com/sites/halahtouryalai/2011/10/12/volcker-rule-is-out-how-much-will-it-hurt/#1b71cf023bd8.

121. Krause, *supra* note 57, at 1069.

122. *See Community Banks in Comment Letter Urge Relief From Disclosure Guide Requirements*, 11 ACCT. & COMPLIANCE ALERT — COMPLETE EDITION, May 22, 2017 (stating that certain SEC statistical disclosure requirements are more useful for large banks with "diversified operations and . . . complex balance sheets").

123. *See id.*

124. *See id.*

125. *See* Raoofi, *supra* note 67, at 307; *see also* Katherine Reynolds Lewis, *Volcker Rule: Why It Matters to Consumers*, BANKRATE (Nov. 11, 2011), https://www.bankrate.com/finance/banking/volcker-rule-1.aspx (explaining that the Volcker Rule forces banks to focus on making profits from core banking services as opposed to the kinds of activities that large investment banks primarily use as methods for earning profits).

126. *See* Raoofi, *supra* note 67, at 314.

127. *Id.* at 313.

markets because higher stock trading could lead to the market losing liquidity, which produces inefficiency.[128]

In January 2020, five federal agencies invited public comment on proposed modifications to the Volcker Rule in connection with "covered funds."[129] Pursuant to the Dodd-Frank Act, banking entities cannot acquire "ownership interest in or sponsor a covered fund."[130] The proposed modifications to covered funds were finalized in June, to become effective in October 2020.[131]

The costs of conforming to the Dodd-Frank Act regulations have caused small bank acquisitions and effectuated consolidation among banking institutions.[132] Large financial institutions absorbed smaller banks to relax their own regulatory burdens and the largest financial institutions continue to expand.[133] Though the costs of conforming to Dodd-Frank Act regulations impact all banks, SMEs and community banks have a more difficult time absorbing the costs of regulations.[134] Unlike large financial institutions, small banks are not always equipped with the capacity to quickly comply with the new, intricate regulations, and the cost of hiring compliance

128. *Id.*

129. Press Release, SEC, Agencies Propose Changes to Modify "Covered Funds" Restrictions of Volcker Rule (Jan. 30, 2020), https://www.sec.gov/news/press-release/2020-24 (listing the five federal agencies as the Federal Reserve, Commodity Futures Trading Commission ("CFTC"), FDIC, OCC, and SEC); *see* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46,422, 46,422–23 (July 31, 2020); *see also* Richard L. Fried, *Volcker Rule's Impact on Securitization*, 15 DERIVATIVES: FIN. PRODUCTS REP., Mar. 2014, at 1 (defining covered funds as those resulting from engaging in activity and "transactions with, certain hedge funds and private equity funds").

130. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–21 (2010) (codified at 12 U.S.C. § 1851); *see* Fried, *supra* note 129, at 1.

131. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. at 46,422; *see also* Press Release, SEC, Financial Regulators Modify Volcker Rule (June 25, 2020), https://www.sec.gov/news/press-release/2020-143.

132. *See* Krause, *supra* note 57, at 1050, 1065 (stressing that though there is not one specific cause of the decrease in small banks, critics have pointed to the extensive, incomprehensive, and complex nature of the Dodd-Frank Act itself).

133. *See id.* at 1050.

134. *See* Hester Peirce et al., *How Are Small Banks Faring Under Dodd-Frank?*, 12 (Mercatus Ctr. Geo. Mason, Working Paper, No. 14-05, 2014), https://www.mercatus.org/system/files/Peirce_SmallBankSurvey_v1.pdf (comparing the compliance staff at JPMorgan, containing more than 5,000 staff members, to a small bank compliance staff, which may have five members).

personnel can easily cause a small bank to lose profitability.[135] Mandatory costs of compliance for small banks limit profitability.[136] The effect of the Dodd-Frank Act on small banks results in more burdensome compliance costs because small banks are forced to shift regulatory costs to customers.[137]

Like the Dodd-Frank Act's blanket attempt to standardize the banking industry with increased compliance costs, the RFI's proposal affecting Enterprise UMBS similarly attempts to make pools increasingly homogenized and predictable to improve liquidity and prevent misalignment through competition within lender pools.[138] The proposal seeks to bundle more loans into larger multi-lender pools instead of the previous model allowing market-driven smaller loan pools.[139] Rather than preventing misalignments in prepayment speeds, this regulatory environment will reduce incentives for loan originators to participate in the multi-lender pool.[140]

A "'race to the bottom' in asset quality" could occur if the Enterprises begin issuing securities consisting of loans with undesirable prepayment characteristics.[141] Because the price of the UMBS will be the same for both Enterprises, investors will not be able to adequately monitor prepayment speed differentials of the Enterprises.[142] Instead of boosting market liquidity, implementation of the Enterprise UMBS could lead to an increased amount of large, multi-lender pools consisting of loans with reduced quality.[143]

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135. *See Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 3 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf (emphasizing that "hiring just two additional compliance personnel could reverse" a small bank's profitability).

136. *See* Peirce et al., *supra* note 134, at 13.

137. *Id.*

138. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (stating that the RFI's proposal regarding multi-lender pools for Enterprise UMBS will not adequately address persistent, fundamental misalignment issues).

139. *See* FHFA, ENTERPRISE UMBS POOLING PRACTICES, *supra* note 93, at 2.

140. *See* Am. Bankers Ass'n, *supra* note 94 (emphasizing that the RFI's multi-lender pool proposal will only mask problems impacting liquidity and simultaneously reduce incentives for originators).

141. Lopez & Maloney, *supra* note 2.

142. *See id.* (stating that this could result in "higher interest rates for borrowers" because it would "likely lead to lower prices for UMBS").

143. *See* Am. Bankers Ass'n, *supra* note 94 (emphasizing that the RFI proposal has the potential to create a "race to the bottom" in the quality of loan pools); *see also* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 ("[T]he RFI would simply push more loans

The Dodd-Frank Act's "one-size-fits-all" approach makes it very difficult for small banks to operate with constant compliance costs.[144] In turn, the competition pool decreases, leaving the larger financial institutions to make up larger portions of the financial system.[145] However, despite being relatively low-risk, community banks must comply with the same regulatory and examination requirements as larger banks.[146] While large banks generally utilize electronic models to determine loan risk, community banks utilize actual knowledge from customers to assess loan risk.[147] Thus, community banks, an essential component of the U.S. economy and economic growth, [148] are hit the hardest.[149] Based on data provided by the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC"), community banks seem to be on the decline, and large banks are steadily increasing in size.[150] In 2015, the FDIC reported an increase in operating banks with over $1 billion in assets.[151]

Similarly, the FHFA's proposal to further standardize the Enterprises' pooling practices could create a similar "one-size-fits-all" effect on loan originators because loan originators "strive for best price execution."[152] In

into bigger securities without doing anything to improve their fundamentals and could be seen as form [sic] of the race to the bottom that some feared would come with UMBS.").

144. *See* Daniel Wilson, *Small Banks Slam 'One Size Fits All' Dodd-Frank Regs*, LAW360, (Sept. 16, 2014, 5:47 PM), https://www.law360.com/articles/577496/small-banks-slam-one-size-fits-all-dodd-frank-regs (stating that the one-size-fits-all approach is unfair to banks because it reduces product availability).

145. *See* Krause, *supra* note 57, at 1066–67.

146. Wilson, *supra* note 144.

147. *See* Bryce W. Newell, *The Centralization of the Banking Industry: Dodd-Frank's Impact on Community Banks and the Need for Both Regulatory Relief and an Overhaul of the Current Framework*, 15 DEPAUL BUS. & COM. L.J. 1, 8 (2016) (noting that the types of interactions community banks have with their customers contribute to a better understanding of relationship banking).

148. *See id*.

149. *See* Wilson, *supra* note 144.

150. *Standard Industry Reports — Statistics on Depository Institutions (SDI): Standard Report #1*, FDIC, https://www5.fdic.gov/sdi/main.asp?formname=standard (last visited Mar. 11, 2021); *see* Newell, *supra* note 147, at 3–4, 10–11.

151. *See* Newell, *supra* note 147, at 9–10 (citing FDIC, *supra* note 150) (stating that although this increase in banks operating with over $1 billion in assets represents only "10.8% of all commercial banks," this percentage controls the majority of banking assets in the United States, amounting to 92.6%).

152. Am. Bankers Ass'n, *supra* note 94 (stating that best price execution would "be best served by issuing single-issuer pools or other specified pools depending upon investor appetite"); Secs. Indus. & Fin. Mkts. Ass'n., *supra* note 94 ("Originators today strive for best execution, which may involve creating single-issuer pools to receive

order to promote alignment, the FHFA proposed that the Enterprises standardize their policies with regard to TBA eligible MBS.[153] Despite one argument that standardization equates to simplified risk management and analytical process because market participants need only to assess risk relative to the six basic parameters associated with the TBA eligible security, the FHFA argued that standardization will reduce costs and complexities.[154] The simplified process increases market participation and competition because it appeals to a broader pool of investors, including mutual funds and foreign central banks.[155] The FHFA expressed its belief that instituting regulations promoting increased standardization would not only eliminate barriers to entry for future market participants but also reduce additional burdens such as the cost of producing data.[156]

However, standardization could significantly harm loan originators, including community and large banks, participating in the TBA market.[157] Because loan originator activity varies with conditions of the market, the proposed multi-lender pool practice in relation to Enterprise UMBS could reduce originators' profitability and result in increased costs for borrowers.[158] Standardization leads to increased generic multi-lender pools, which increases the difficulty in identifying bad actors.[159] Moreover, the RFI proposal would drastically alter the types of loans that loan originators create.[160] In subsidizing loan originators, the proposed multi-lender pooling practice for Enterprise UMBS will reduce "originator incentives to produce

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payups that are available from the market.").

153. Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,893 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248).

154. *See id.*

155. *See* Vickery & Wright, *supra* note 19, at 7 (explaining that TBA trading encourages a variety of investors because the forward enables them to project value based on the six characteristics used to identify the security versus evaluating every single security).

156. Uniform Mortgage-Backed Security, 83 Fed. Reg. at 46,893.

157. *See* Am. Bankers Ass'n, *supra* note 94 (listing credit unions and independent mortgage bankers as other types of loan originators).

158. *See id.* (noting that the proposed practice will reduce loan originators' profitability because it requires that the majority of originations be "delivered into large, multi-lender pools").

159. *See id.* (recommending the Enterprises adopt transparent standards to identify bad actors in large loan pools).

160. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (explaining that "[t]he proposal [will] force [loan] originators who make more desirable loans to subsidize originators who make less desirable loans . . . .").

desirable loans."[161] If loan originators choose to produce less desirable loans, the subsidization will help mask those bad actors, making it even more difficult to distinguish the quality of Enterprise UMBS.[162]

C. UMBS Uniform Prepayment Speeds: Legal Complications for Fannie Mae and Freddie Mac

One of the biggest changes resulting from implementation of the common UMBS is that both Fannie Mae and Freddie Mac will have fifty-five day delays on payments to investors.[163] This is significant for Freddie Mac because its remittance cycle was forty-five days.[164] This change comes in response to comments from other agencies and stakeholders in the residential mortgage lending market that advocated for alignment in Fannie Mae and Freddie Mac's policies with regard to prepayments.[165] Although the FHFA expressed satisfaction with the expected prepayment speeds resulting from the change to UMBS, the change in the law will prove inefficient if investors do not view Fannie Mae and Freddie Mac UMBS as interchangeable.[166]

With the new ability granted to Fannie Mae and Freddie Mac in the rulemaking process, the Enterprises have the power to regulate the issuance and participation in the TBA market for Enterprise UMBS.[167] The Enterprises already have the power to decide what an allowable specified pool is, its issuance price, and which lenders are eligible to participate in trading Enterprise UMBS.[168] Although the governing law requires that the UMBS align prepayment speeds, the Enterprises are still in competition with each other to issue the most desirable loans packed into the UMBS.[169] If the Enterprises act unilaterally in issuing these loans on the CSP, then the Enterprises, versus the market, could drive prepayment speeds based on the loans they accept from loan originators and how the investors will favor the

161. *Id.* (noting that this effect could be particularly harmful on bank issuers).

162. *See* Am. Bankers Ass'n, *supra* note 94.

163. Lopez & Maloney, *supra* note 2.

164. *See* Leeds & Garden, *supra* note 18.

165. *See* FHFA, 2014 STRATEGIC PLAN, *supra* note 76, at 7.

166. *See* Lopez & Maloney, *supra* note 2.

167. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (emphasizing that the Enterprises assert control over the mortgage markets in a variety of ways).

168. *See id.*

169. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7796 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248) (acknowledging concerns from commenters like SIFMA and PIMCO that indicated the Enterprises could take actions to undermine one another because they are competitors).

Fannie Mae traded UMBS versus the Freddie Mac traded UMBS.[170] Even though Fannie Mae traded UMBS and Freddie Mac traded UMBS are supposedly identical, the Enterprises will be able to control this because they govern together and ensure they follow their own guidelines.[171]

Though the purpose behind the uniform prepayment speeds is to boost overall liquidity in the loan pool, there is concern that eliminating the difference in prepayment speeds also eliminates the associated price differentials traders use to value their investment.[172] One of the main components mortgage traders use to value investments is the rate at which underlying loans within an MBS will be paid off.[173] Historically, the CPR between Fannie Mae and Freddie Mac has been substantially different.[174] If the gap between Fannie Mae CPR and Freddie Mac CPR widens, meaning the prepayment speeds continue to be dissimilar, traders may not treat the Fannie Mae and Freddie Mac UMBS as interchangeable.[175] Because mortgages in the TBA market are not identified until after the trade, the investors cannot factor prepayment speed differentials into the price.[176] With the UMBS, Fannie Mae and Freddie Mac will issue identical securities.[177] This could serve as a potential source of anxiety for investors because there is one less significant factor for them to use in valuing an investment.[178]

There are also concerns about the implementation of the UMBS as it relates to stipulated trading "because investors do not [currently] view Fannie and Freddie MBS as interchangeable" investments.[179] Stipulated trades are TBA trades where the buyer requires the seller to include additional stipulated characteristics.[180] Though the FHFA stated the change in prepayment speeds should account for the issues with interchangeability

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170. *See id.* (stating that if one of the Enterprises decides to take adverse actions against the other that impacts the quality of their UMBS, the quality of the entire Enterprise UMBS market will suffer because both Fannie Mae UMBS and Freddie Mac UMBS can be delivered into the same contracts).

171. *See id.* at 7800 (stating that the Enterprises are responsible for reporting misalignment to the FHFA in the event it occurs).

172. *See id.* at 7795 (elaborating on FHFA's response to price differences between quartiles).

173. *See id*. at 7799.

174. *See* Lopez & Maloney, *supra* note 2.

175. *Id*.

176. *Id.*

177. *See id.*

178. *See id*. (explaining the basic premise behind how investors valuate price).

179. Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7793 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248).

180. LEMKE ET AL., *supra* note 7, § 5:3.

and the potential for investors to move to stipulated trading, aligned prepayment speeds will prove insufficient to promote Enterprise UMBS liquidity unless the FHFA adjusts the standardization of large, multi-lender pools.[181]

D. Repeating the Mistakes of the Dodd-Frank Act on Small Banks with Uniform Prepayment Speeds Imposed by the UMBS

The final rule governing the UMBS prepayment speeds will restrict smaller banks from participating as loan originators in a similar manner that the Dodd-Frank Act, specifically the Volcker Rule, permitted for more market competition prior to the adjustments made in 2018.[182] Implementing uniform prepayment speeds effectively eliminates an option for investors when determining which Enterprise UMBS to invest in.[183] Eliminating this option will lead to a homogenized loan originator pool if smaller originators with less capital cannot afford the costs of complying with the UMBS regulations.[184] Though the Enterprise UMBS prepayment cycle mirrors that of Fannie Mae UMBS, the UMBS disclosure requirements mirror Freddie Mac PCs, another compliance change that will disadvantage SMEs and community banks.[185] Like the Dodd-Frank Act's effect on community banks in reducing competition, aligned prepayment speeds are burdensome on small banks struggling to maintain capital.[186] Similar to the burdensome regulatory impact on SMEs and community banks after implementation of

181. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7793 (reiterating concern that implementing policies to align prepayment speeds is insufficient so maintain Fannie Mae and Freddie Mac UMBS fungibility); *see also* Am. Bankers Ass'n, *supra* note 94 (indicating that investors could look to other markets for returns on their investment, which would reduce TBA market liquidity).

182. *See Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 4–5 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf.

183. Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7794.

184. *See id.* at 7796 (quoting the National Association of Federally-Insured Credit Unions ("NAFCU") that the UMBS equalized pricing will increase market competition).

185. *See* Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,890 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248).

186. *See* Merric R. Kaufman, Note, *Too Small to Succeed?: An Analysis of the Minimal Undue Regulatory Burdens Facing Community Banks in the Post Dodd-Frank Regulatory Environment, and How to Further Minimize Their Burden*, 37 REV. BANKING & FIN. L. 445, 463 (2017) (emphasizing that the effect of Dodd-Frank Act compliance costs on community banks has led to numerous failed banks, mergers of banks, and increased consolidation).

the Dodd-Frank Act, the UMBS aligned prepayment speeds could produce the same effect in creating a loan pool mainly consisting of large financial players.[187] If smaller loan originators cannot afford to invest in Enterprise UMBS, then there could be potential for the entire secondary residential mortgage market to lose liquidity.[188]

IV. PROTECTING/GUARDING THE PURPOSE OF THE UMBS: THE ROLE OF THE FHFA

This Comment recommends that the FHFA create stricter rules to ensure that the Enterprises develop regulations governing the acceptance and issuance of loans that align with one another.[189] Moreover, the FHFA should ensure that the Enterprises report when there is a divergence in prepayment speeds so the FHFA may adjust definitions of "fastest paying" and "cheapest to deliver" quartiles of cohorts to compensate for the misalignment.[190] This Comment also recommends that the FHFA, in its conservator role of the Enterprises, promote loan diversification for the loans that were issued in specified pools under the former governance model.[191] Because the Enterprises are already exempt from certain registration requirements with the SEC, it is even more important that the FHFA take steps to preserve the quality of the loans being put into large multi-lender pools.[192]

Although this Comment does not recommend complete alignment of all of the Enterprises' policies that would affect prepayment speeds, as this would also cause a change in Fannie Mae and Freddie Mac selling guides, the FHFA should institute stricter regulations for the possibility of divergence in prepayment speeds.[193] This Comment also recommends that

187. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796 ("[T]he reduced barriers to entry will encourage private financial institutions to again enter the market as they were prior to the financial recession.").

188. *See id.* (noting that competition leads to more effective markets).

189. *See id.* at 7800 (stating that each Enterprise must institute policies that align with the other Enterprise programs).

190. *See id.* (explaining that the FHFA retains the authority to adjust definitions of the final rule governing the UMBS).

191. *See* Am. Bankers Ass'n, *supra* note 94 (stating that the RFI proposal will not only reduce profitability and product availability for loan originators but also will result in more standardized loans).

192. *See* Vickery & Wright, *supra* note 19, at 9–10 (acknowledging that although the Enterprises publicly disclose summaries about each loan pool, the buyer still lacks this information at the time of a trade because it is unknown which securities will be delivered, which is enabled by the Enterprises' SEC registration exemption).

193. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7800 (defining material misalignment as the divergence of three or more "percentage points in the three-month

the FHFA establish stricter rules with respect to competition.[194] Like SIFMA's reasoning, this Comment argues that stricter rules affecting competition should be instituted to prevent a decrease in the value of Enterprise UMBS.[195] Because competition between the Enterprises in accepting desirable loans remains a significant source of concern with the issuance of the UMBS, the FHFA should provide a clear process relating to remedial actions in response to misalignment.[196]

Similar to the Volcker Rule's effect on small banks, the introduction of the large multi-lender pool could reduce the participation of small financial institutions as loan originators.[197] If such a reduction occurs, the loan originator pool for agency UMBS will become homogenized and dominated by large financial institutions that are forced to subsidize potential hidden bad actors.[198] A market structure consisting of fewer specified pools will be unattractive for investors, which could lead to a decline in sponsorship of Enterprise products and significantly reduce liquidity.[199]

As the FHFA acknowledged in the final rule regarding UMBS, there must be sufficient incentives to invest in Enterprise UMBS, especially for smaller financial institutions.[200] The FHFA should directly address concerns regarding the issuance of single-issuer pools as it affects loan originators because the proposal could lead to a deterioration in loan quality because the loan originator pool will become even more subsidized.[201] Because loan originators' activity varies with respect to conditions of the market, the FHFA could require that the Enterprises provide more transparency relating

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CPR for a cohort or at least 8 percentage points in the three-month CPR for a fastest paying quartile of a cohort").

194. *See* Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,893 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248) (acknowledging that the potential improvements in liquidity of Enterprise UMBS are dependent on market participants accepting UMBS fungibility, regardless of the FHFA's role as conservator).

195. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796 (reasoning that one Enterprise may take efforts to harm investors, which would harm the value of both Enterprises' UMBS because they are "deliverable into the same contracts").

196. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (acknowledging that reports may be published and discussions held between the Enterprises and the FHFA, "but the market does not know what happens after that").

197. *See* Krause, *supra* note 57, at 1069.

198. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (predicting that specified pools will become more expensive because the RFI proposes the creation of larger multi-issuer pools).

199. *See id.* (detailing that the proposed market structure could lead to a decrease in sponsorship from investors, including hedge funds and money managers).

200. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796.

201. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94.

to alignment policies.[202] To mitigate competition between the Enterprises when it comes to acceptance of loans, the FHFA could also require the Enterprises to report regularly on their loan requirements and how they are working together in ensuring that the loan requirements are met before they accept them to package as a UMBS.[203] This form of regulation by the FHFA would require that the Enterprises provide sufficient evidence that they are not competing for loans against each other and actively enforcing their loan requirements in order to avoid a potential price differentiation caused by two different factors: (1) easier entry into the market by potential bad actors due to the larger multi-lender pool; and (2) both Enterprises enforcing the maintenance of standardized loan requirements and acceptance regulations that encourage diverse loan originator participation.[204] The FHFA, in its capacity as conservator of Fannie Mae and Freddie Mac, should provide specific disclosure requirement exemptions for small financial institutions if prepayment speeds prove to decrease competition in squeezing small banks out of the market.[205]

V. CONCLUSION

Like the Dodd-Frank Act's original effect on SMEs and community banks, uniform prepayment speeds in relation to UMBS could cause the residential mortgage market to lose liquidity because such an environment will prove too burdensome for smaller banks to participate as loan originators. Moreover, the FHFA should institute stricter reporting requirements to mitigate Enterprise competition in accepting loans. In order to ensure that the legal framework governing the UMBS is protected in practice, the Enterprises must adhere to standardized loan requirements and work together to enforce compliance and bar entry of potential bad actors.

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202. *See id.*

203. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796 (reiterating concerns from commenters, such as SIFMA and PIMCO, that the Enterprises could choose to align policies and programs that may adversely affect consumers, lenders, and investors).

204. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (recommending that FHFA provide more clarity as to the Enterprises' handling of alignment and performance, which would be indicative of the increased transparency that the FHFA claimed it would provide to market participants upon implementation of Enterprise UMBS).

205. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7797.

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